

# Breaking the Banking Union deadlock

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The discussion on 'breaking the Banking Union deadlock' highlighted a broad consensus on the need to deepen financial integration to strengthen the stability and competitiveness of the European economy. While significant progress has been achieved over the past decade, participants emphasised that fragmentation remains a key obstacle, limiting risk-sharing, constraining cross-border banking activity and weakening the overall efficiency of the system.

Against this backdrop, the debate focused on identifying the main sources of fragmentation and outlining the conditions required to complete the Banking Union. A central theme was the need to rebuild trust among stakeholders through a balanced policy package, combining enhanced risk-sharing mechanisms, including a European Deposit Insurance Scheme (EDIS), with stronger guarantees on risk reduction and the effective free movement of capital and liquidity within cross-border banking groups.

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## 1. Financial integration as a systemic imperative for the Banking Union

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### 1.1 Breaking the Banking Union deadlock: financial integration as a systemic imperative

#### 1.1.1 From fragmentation to systemic risk: the cost of inefficiencies and more frequent financial crises

An official emphasised that a high degree of financial integration is crucial to maintain the economic and financial stability of the eurozone. It is no exaggeration to describe fragmentation as a systemic risk. Financial institutions and markets that focus solely on the domestic economy create perverse links between economic and fiscal developments and financial stability in each jurisdiction. Given the lack of monetary tools at the national level, this could undermine the stability of the European economic and monetary union. Integration would increase efficiencies within the system and directly benefit European citizens. Additionally, the stability gained through integration could reduce the frequency and real economy costs of financial crises.

#### 1.1.2 Financial integration as a driver of risk-sharing, competitiveness and scale in the Single Market

An official noted that a more integrated European financial system would act as an effective cross-border risk-sharing mechanism and would be a crucial component of a competitive European financial industry. To achieve the necessary scale, the expansion of European financial entities within the economic area must be facilitated. These entities must be able to take full advantage of the European single market, which is impossible in a fragmented financial industry.

The collective failure of European authorities to deliver ambitious reforms and further financial integration stems from an excessive focus on short-term policy interests. Prioritising the completion of the Banking Union is essential to facilitate the removal of existing regulatory barriers (e.g. ring-fencing) for financial integration. While simplifying existing rules is welcome, it cannot substitute for the more far-reaching and politically challenging institutional reforms that are needed.

### 1.2 Banking Union and competitiveness: advancing integration over simplification

An official suggested that the Commission's report on banking competitiveness will provide useful insights. Competitiveness is primarily achieved through integration rather than simplification. The competitiveness aims will not be achieved without a deep liquid market for capital and the banking sector. Home-host labelling is not always helpful and can reinforce a misleading mindset. For example, Italy is both home and host.

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## 2. Persistent fragmentation: regulatory, structural and operational barriers

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### 2.1 Banking fragmentation in Europe: a barrier to competitiveness and strategic autonomy

An industry representative noted that risks around competitiveness and financial sovereignty arise from fragmentation. European banking frameworks must enable banks to finance strategic priorities while remaining globally competitive. European banks will need to grow within the single market to generate the necessary economies of scale. Currently providing around 75% of financing to the European economy, European banks will be essential to financing future strategic needs.

#### Ringfencing and regulatory fragmentation

An industry representative observed that, despite the development of single supervision, capital and liquidity ringfencing requirements mandate that capital requirements and the resolution framework are applied at individual and sub-consolidated levels. Although cross-border liquidity waivers exist, they are rarely used in practice. The internal minimum requirement for own funds and eligible liabilities (MREL) results in resources being trapped in subsidiaries, despite the presence of group-wide resolution strategies.

Macroprudential buffers vary significantly across member states, creating financial borders within what should be a single jurisdiction. Banks in the US or China do not need to navigate these variations. Estimates by the European Central Bank (ECB) and the Association

for Financial Markets in Europe (AFME) suggest that €225 billion of capital and €250 billion of liquidity is currently trapped in subsidiaries. This significant amount could be released through cross-border waivers. Opting for transposition at an individual level with regard to the output floor could further intensify this challenge.

## **2.2 Scale, competitiveness and the need for a supportive prudential framework**

An industry representative suggested that the high level of fragmentation has prevented European banks from achieving economies of scale, with non-EU banks increasingly dominating key strategic segments in Europe. US banks, for example, benefit from a unified home jurisdiction and upcoming prudential relief as part of the implementation of the Basel Accord. Self-imposed barriers in European financial services therefore increase the risk of strategic dependence. The DG FISMA consultation on banking competitiveness provides an important opportunity to assess whether the prudential framework supports Europe's strategic objectives. Competitiveness and stability should be pursued together and not viewed as opposing demands.

## **2.3 Liquidity Constraints and Regulatory Barriers: Rethinking Integration to Support Growth and Stability**

An industry representative emphasised the need to build financial stability and support growth in the real economy, while also addressing current fragmentation. Quantitative tightening is materially affecting liquidity conditions, reducing liquidity in the system and impacting banks' balance sheets. This is resulting in increased net funding gaps and liquidity being trapped in pools of excess funding across cross-border banking groups. Current legislation would permit liquidity waivers, for example making up to €30 billion of excess liquidity available within the speaker's cross-border group. With full branchification, this figure would double.

The current regulatory framework hinders cross-border mergers and acquisitions in Europe. Only contributions equivalent to 12 months of the deposit guarantee scheme (DGS) can be transferred. Additionally, a significant amount of MREL is lost due to the 18-month maturity period of the eligible liabilities that a bank can absorb when acquiring another bank.

The Chair noted that, despite the creation of the single supervisory mechanism (SSM) and single resolution mechanism (SRM), trust is still lacking.

## **2.4 Banking Fragmentation in Europe: Balancing Integration with Economic Diversity and Trust**

While earlier contributions emphasised fragmentation as a potential source of systemic risk, a former official offered a more nuanced perspective, noting that fragmentation may represent a lost opportunity but does not necessarily constitute a systemic threat, instead reflecting the structural characteristics of the European economy. He commented that although there is trust in European institutions there are concerns regarding trust in banks, which are often perceived as 'European in life and national in death'. The fragmentation of the European

banking system represents a lost opportunity, but not a systemic risk. Instead, it is an inherent characteristic of the European Union's economic system.

### **2.4.1 Structural diversity and local banking models**

A former official noted that the US is often used as an example of what Europe should aim to achieve, particularly with regard to its well-developed capital market. However, the core of the European economy consists of small and medium-sized enterprises that borrow money from local banks with which they already have an established relationship. Unlike in the US, where political union occurred before the creation of a single market and monetary union, the granularity of the European Union's banking system and the resulting characteristics of the Banking Union are due to its history. Significant differences remain between the economic structures and banking sectors of different European Union countries.

There is sometimes a perception that smaller countries oppose decisions that would strengthen the banking sector or enable mergers between banks in order to prevent larger banks from entering their markets. However, the opposite is true of Lithuania. With a return on equity in the Lithuanian banking system of over 20% in 2023, Lithuania is keen to encourage banks to enter its market and increase competition in its economy.

### **2.4.2 Trust, competition and the home-host balance**

A former official remarked that the risk-averse policies of some banks can make financing difficult to obtain. This can be mitigated through the establishment of national promotional institutions or European public mechanisms, such as the Recovery and Resilience Facility (RRF) and the European Investment Banks. This is another difference between the European and US economies. Home-host issues are inevitable and will persist in the granular European economy. When reducing barriers to cross-border banking activities, it is important to remember the unequal power balance between home and host countries. As the weaker player in the relationship, host countries should be compensated where appropriate.

Issues are still outstanding in the discussions around resolution. There is a view that not only those banks that are too big to fail should be resolved. Although the closure of smaller banks would not create systemic problems at the European level, they are vital for local economies and require resolution at the point of failure.

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## **3. Building trust and completing the Banking Union: towards a comprehensive policy package**

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### **3.1 Building trust in the Banking Union: from institutional integration to removing remaining barriers**

A regulator suggested that the creation of the SSM's supervisory board as the single supervisor and the

SRM's has rendered the notion of home-host tension obsolete. Cooperation is now very deep at all levels, starting from the work of joint supervisory teams (JSTs) and internal resolution teams (IRTs) all the way to the top of each organisation involved. In this institutional setup, the lingering lack of trust feels like a legacy issue rather than a current reality.

### **3.1.1 Single point of entry and integrated supervision**

A regulator explained that the single point of entry strategy is the preferred resolution strategy in the vast majority of cases involving significant institutions and often also for less significant institutions. Under this strategy, in the event of failure, the banking institution would be resolved as a single group. This allows for the harmonised resolution of the entire group, including subsidiaries. Under the single point of entry strategy, prepositioning of internal MREL is not always necessary, as MREL resources can be managed flexibly at group level.

Thanks to the SPE, there are less reasons for putting up internal barriers to the circulation of liquidity and capital within the Banking Union. Liquidity waivers are determined by supervisors. In a crisis, given the fact that the framework has been tested and the high degree of cooperation of everyone involved, the preconditions are there for these waivers to become more frequent.

The situation is a bit different when a bank is active also outside the Banking Union. Nevertheless, we worked very hard in developing close ties with all our peer authorities. In fact, Resolution Colleges enable interaction, engagement and trust-building with non-Banking Union Member States. A similar approach is used for third countries, such as Japan, the US and the UK, where different authorities can share experience and practice through Crisis Management Groups.

### **3.1.2 Remaining obstacles to trust**

A regulator noted that there is still some reluctance, even within the Banking Union, to remove internal barriers due to the lack of a European Deposit Insurance mechanism. This crucial third pillar would provide the confidence that, if a resolution decision is not taken, a national liquidation decision would not overwhelm the local Deposit Guarantee Scheme.

Similarly, a liquidity backstop for the Single Resolution Fund (SRF), granting ex-ante sufficient firepower even for the largest liquidity crises, would also be instrumental in providing the necessary confidence to reduce internal barriers.

## **3.2 Completing the Banking Union: legal integration, risk-sharing and trust**

Progress on EDIS and intragroup financial support was widely seen as closely linked to greater flexibility in the use of capital and liquidity within banking groups, forming a central trade-off underpinning trust among stakeholders.

### **3.2.1 Intragroup financial support and legal barriers**

An official emphasised the importance of market integration for strategic autonomy. The SSM and the SRM are effective governance arrangements, but there

is still a lack of trust between home and host. Some gaps remain in European legislation, such as the absence of an EDIS. As noted by another speaker, arrangements around DGSs can hinder mergers. An EDIS would overcome this.

The legal entities that make up cross-border banking groups are governed by national solvency rules that could prevent the smooth transfer of funds in times of crisis. The European framework must therefore enable intragroup financial support to proceed smoothly in all situations. While harmonising all insolvency rules across Europe would be an almost impossible task, it should be considered within the more limited context of cross-border banking groups.

### **3.2.2 EDIS and risk-sharing: benefits, asymmetries and the need for complementary measures**

An official summarised that, although much progress has been made, the main aim of the Banking Union, namely to denationalise banks' risk, has not yet been achieved. Under the current approach, there remain excessive constraints for the deployment of European funds to resolve the crises of significant banks within the Banking Union. Domestic funds, including national deposit insurance schemes, are therefore required to address bank failures within the monetary union. The crisis management and deposit insurance (CMDI) package does not directly address this issue and is therefore not expected to materially advance risk mutualisation, nor to significantly contribute to the completion of the Banking Union.

Denationalisation of risk will involve transferring some risk from domestic to European sources. The benefits arising from this, such as the increased efficiency of an integrated deposit insurance scheme compared to national protection schemes, will not be evenly distributed across countries, particularly when risk is concentrated in certain jurisdictions. Therefore, other complementary measures must accompany the creation of an EDIS. The most important of these is the SSM, which has already been introduced and is performing well in its role of overseeing bank risk collectively.

### **3.2.3 Risk reduction and removing barriers: conditions for political agreement and deeper integration**

An official stated that reducing risk will be critical to building the mutual trust and political support needed to facilitate the transfer of risk and complete the Banking Union. Areas of particular focus include sovereign risk, which existing prudential controls do not address sufficiently. Introducing controls for the concentration of exposures in the domestic sovereign e would be beneficial from political and economic perspectives and should therefore be part of the negotiating package leading to the completion of the Banking Union. Moreover, the industry will need to support, or at the very least not oppose, any new measures. It might not be possible to complete the Banking Union without introducing at least some constraints, and possibly a full ban, on ringfencing practices, particularly with regard to host authority stipulations that affect the domestic subsidiaries of pan-European banks. That would generate operational

gains, such as the ability to centralise resources and therefore manage them more effectively. Banks would have more incentives to become pan-European, therefore further integrating the industry. As was noted previously, this will enhance the competitiveness and improve the stability of the banking sector. Finally, the diversification benefits related to creating an integrated deposit insurance scheme could result in the ability to mandate a smaller target size for deposit insurance as a proportion of the cover. This would provide some relief with regards to the contribution by the industry

#### **3.2.4 The missing pillars of integration**

An official advised that the focus should now be on intragroup financial support, liquidity resolution, and the creation of an EDIS. These are the final three elements needed for the success of the Banking Union. There is a great deal of political momentum. The market integration and supervision (MIS) package considers the issue from the perspective of financial markets. The idea of a pan-European market operator (PEMO) has been discussed.

National authorities still foresee situations in which subsidiaries might not receive timely group support or local financial stability concerns could override the strategies of cross-border banking groups. Without an enforceable and uniformly applied legal basis for intragroup financial support, doubts remain as to whether capital and liquidity would effectively flow within a banking group under stress. Supervisory convergence alone cannot replace the need for a legal environment that enables such mobility.

#### **3.3 From fragmentation to integration: priorities for a more cohesive European banking framework**

An industry representative advised that the approach should be to build a strong, deep banking market and then address the safeguards. Action is needed in five key areas. First, free movement of capital and liquidity within cross-banking groups should be enabled. Secondly, internal ringfencing should be reduced. Thirdly, national discretion should be reduced through convergence of macroprudential frameworks. Fourthly, the regulatory environment should be simplified and additional fragmentation limited. Finally, enhancing clarity and predictability around cross-border consolidation will clearly signal that achieving scale is a key strategic priority for the union.

#### **3.4 Advancing EDIS: Reducing Inefficiencies and Enabling Cross-Border Banking**

An industry representative indicated that their firm fully supports an EDIS and is open-minded about what form it should take. Funds have been allocated at the national level and the focus should now shift to the European level. Experience shows that adding buffers or output floors at the level of individual banks results in overcompliance with the global Basel framework and creates inefficiencies within a group. There are many other examples. The creation of an EDIS could help to address and reduce these inefficiencies.

The expected review of the intragroup large-exposure rule hopefully will also result in a system that hinders less the free flow of funds. As suggested by a previous speaker regarding sovereign exposure, some form of concentration limits could be useful. The development of intragroup large-exposure agreements in host member states will likely depend on the context. There are legal requirements around liquidity waivers. Now is the time for all stakeholders to engage and make commitments. Through dialogue, the industry will be able to provide reassurance, aware that many of the current inefficiencies will be eliminated over time.

The Chair commented that current geopolitical events have highlighted the need for integration and increased the momentum behind the Banking Union. The initial focus should be on increasing trust. Secondly, the issues around the third pillar must be addressed.

Overall, the discussion made clear that completing the Banking Union is first and foremost a political choice requiring a credible and balanced package. Progress on EDIS must be accompanied by stronger risk reduction and the establishment of robust, legally binding intragroup support mechanisms, alongside the removal of barriers to the free movement of capital and liquidity within cross-border banking groups. Without a comprehensive and balanced agreement across these elements, trust will remain insufficient to move forward. Ultimately, breaking the deadlock will depend on the willingness of Member States to align national interests with the collective benefits of a more integrated, resilient and competitive European banking system.