Press release

AFME report identifies Banking Union challenges holding back EU bank consolidation

An estimated half a trillion Euros of bank capital and liquidity trapped due to regulatory ringfencing, limiting EU competitiveness

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The Association for Financial Markets in Europe (AFME) has today published a new report evaluating the state of the European Banking Union (BU). The report identifies critical implementation gaps in the BU framework, beyond the well-known existing barrier arising from the absence of a fully completed European Deposit Insurance Scheme (EDIS). These barriers largely stem from the significant discretion granted to Member States withing the Banking Union's single rule book.

The report finds that cross-border banking services remain minimal, with only marginal increases in cross-border bank lending and deposit taking. Cross-border M&A of banks has consistently declined over the last two decades, limiting consolidation and efficiency gains. Supervisory frameworks remain inconsistent, with some countries exhibiting large local participation of less systemically important institutions, which are not under ECB direct supervision.

AFME estimates indicate that EU **banking groups find it difficult to realise economies of scale beyond €450bn in assets**, likely due to regulatory fragmentation and ongoing barriers to reap the benefits of greater scale within the Banking Union. This undermines the competitiveness of EU banks against global peers, reducing their ability to support Europe's economy.

Caroline Liesegang, Managing Director of Capital and Risk Management at AFME, said: "*Europe's banks face a maze of national rules, fragmented deposit guarantee schemes, and inconsistent supervisory practices. This complexity, for example, turns potential cross-border bank mergers into costly, drawn-out negotiations, discouraging the very consolidation that could make the sector more competitive. Without a truly completed Banking Union, economies of scale will remain harder to achieve in Europe than in more integrated markets, limiting the capacity of the banking system to support growth. Understanding and overcoming the challenges we've identified could lead to a more effective and efficient EU banking sector, while at the same time simplifying a complex and fragmented framework of supervision and regulation.*"

The report identifies critical implementation gaps in the BU framework which currently hinder competitiveness:

- **Due to the lack of cross-border waivers, over €225bn of capital and €250bn of liquidity are trapped in subsidiaries of large banks.**
- This regulatory ring-fencing discourages banks from engaging in cross-border operations as it prevents transfer of resources between parent and subsidiary in times of stress. It also visibly limits the scale and competitiveness of banks operating in the EU.
- The absence of waivers is often attributed to a trust deficit between national supervisors, with the concern that in stress periods Home supervisors may prioritise the parent bank and Host supervisors focus on the local subsidiary. However, for the BU to function effectively, national supervisors must develop and maintain trust and support the use of the single supervision system which they

themselves are part of. Supervisors should recognise the structural progress made over the last decade, including a revised resolution framework.

- **<u>Inconsistent intragroup large exposure limits:</u>** National competent authorities use their discretion to apply varying limits on intra-group cross-border exposures, leading to unharmonised and inconsistent criteria for capital allocation, further preventing optimal use of capital.

- **<u>Opaque and unpredictable Single Resolution Fund (SRF) contributions</u>:** The calculation methodology for contributions to the SRF is complex and lacks transparency, making it difficult for banks to predict future commitments.

- **<u>Excessive MREL requirements compared to US and UK banks</u>:** The weighted average target level in 2024 for BU entities was 28% of Risk Weighted Assets (RWAs), compared with 22% for US entities and 27% in the UK. The stringent Minimum Requirement for Own Funds and Eligible Liabilities (MREL) in the EU places the BU at a competitive disadvantage compared to other major banking jurisdictions, significantly increasing funding costs for BU banks. Moreover, some EU banks are simultaneously subject to both MREL and TLAC (Total Loss-Absorbing Capacity) requirements, effectively duplicating the set of capital obligations, reinforcing the need for a comprehensive review of the current framework.

- **<u>Complexity and length of M&A supervisory authorisation procedures</u>:** Lengthy authorisation processes involving the national competent authorities of both the acquirer and target bank prolong the timeline of banking acquisitions in the EU, increasing the execution risk and representing a further obstacle to banking sector consolidation. Banking is the economic sector in the EU where it takes longest to complete a M&A with 285 days between announcement and completion dates, compared to 203 days in other financial services activities, or 132 days in the technology sector. Globally, EU banking M&As take longer than those in the US (219 days), China (187 days) and Switzerland (85 days). Furthermore, the time it takes to complete a banking M&A has increased by more than 100 days since 2014 (prior to the start of the BU).

- **<u>Deposit Guarantee Schemes</u>:** The European Deposit Insurance Scheme (EDIS) remains absent and there are national differences in Deposit Guarantee Schemes (DGS). Although EDIS still remains to be implemented, the report notes the longstanding lack of political consensus on EDIS should not be a roadblock to advance on other impactful BU initiatives where political agreement is more feasible.

- **<u>Unharmonised macroprudential buffers and EU regulatory over-conservativeness</u>:**
- Despite a decade of integration efforts, implementation of macroprudential buffers varies across countries, leading to different buffers for banks with identical risk profiles as some national authorities set requirements far above the ECB minimum. The report finds the EU might also be designating too many banks as Other Systemically Important Institutions (O-SIIs), far more than other regions with 175 O-SIIs - 3 times more than the UK, China and the US combined - or about 70% of the O-SIIs worldwide, hurting Europe's competitiveness.
- Countercyclical buffers are inconsistently applied with diverging and unpredictable methodologies, with Member States using up to 27 different input metrics to assess their national buffers. The Systemic Risk buffer introduces a cumbersome requirement outside the Basel standard while further amplifying divergences at the sectoral level due to the heterogenous use made by Member States. Furthermore, the Capital Conservation buffer fails to function as intended during periods of stress due to its lack of releasability.

The report also compiles a set of Key Performance Indicators to measure where fragmentation challenges are more problematic at the EU and Member State (MS) level. Among the findings at Member State level, the report shows that:

- **Cross-border banking remains limited:** Ireland (50%) and Luxembourg (60%) lead in cross-border loans likely due to their global attractiveness, attractiveness for Fund registration, and their tax framework. On the other hand, Croatia and Portugal have limited cross-border activity. Cross-border banking M&A is generally absent across the large majority of MS.

- **Risks:** Cyprus continues to exhibit high levels of NPLs (20%), which continues as a legacy issue due to the cypriot banking sector link to the Greek crisis.
- **Less Significant Institutions:** Germany, Luxembourg and Malta are among the countries with the largest portion of banking assets from less significant institutions (LSI) and therefore not under direct ECB supervision.

The report lists 6 policy recommendations to help progress the Banking Union including, implementing cross-border waivers, simplifying the macroprudential framework, harmonising Member State discretion in intra-group exposure limits, undertaking a comprehensive review of the SRF target level and contributions methodology, revising MREL requirements to ensure European banks remain globally competitive and encouraging EU authorities to lead coordinated engagement with foreign counterparts to demonstrate the eligibility of foreign law instruments.

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Notes:

1. AFME (Association for Financial Markets in Europe) promotes fair, orderly, and efficient European wholesale capital markets and provides leadership in advancing the interests of all market participants. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. AFME participates in a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) through the GFMA (Global Financial Markets Association). For more information please visit the AFME website: www.afme.eu
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