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Market fragmentation in Banking Union and lessons for the Capital Markets Union

Arguably, the Banking Union has a strong record for raising the standards in supervision and thereby making a contribution to financial stability. Despite the harmonisation achieved in supervision however, market integration has not progressed much. Can this be changed? And what lessons does that hold for the other big financial markets integration project, namely Capital Markets Union (CMU)? This briefing provides an overview of 5 papers by the ECON Committee's academic expert panel for the Banking Union that have been published in September and October 2024.

After **10 years of existence of the Banking Union**, there is a clear **increase in the stability and resilience** of the banking sector, but market integration, one of the objectives of this Union, has not been achieved to the same extent. Over the last decade, a **strong supervisory mechanism** has been set up to harmonise and raise the standards of supervision. On the other hand, **market integration** has not been the main focus of the current Banking Union system. While in principle, the harmonisation of supervision and regulation might have supported it, it **has not thrived**.

Therefore, the ECON Committee has asked the Members of its Banking Union Expert Panel for their opinions and analysis on the status and **potential of banking market integration**, the contributions of the Banking Union (BU) and the **lessons for the Capital Markets Union (CMU)**. Their analysis elaborates on the successes and failures of the Banking Union, and on the different segments of the banking market, cross border exchanges and lending, private and public channels as well as the effects of national policies. Finally, the authors put forth their policy recommendation to further integration within the BU. Since also market integration within the CMU should be further strengthened, the experts also deliver their advice as to whether the Banking Union experience entails lessons to ensure its success.

Thorsten BECK, Brunella BRUNO and Elena CARLETTI highlight the varying levels of integration across market segments and jurisdictions, underlining unequal integration and stagnating integration indicators. While recognising the strong successes of the supervisory pillar of the Banking Union, the authors point out national interests and policies as reasons for fragmentation and obstacles to further integration. At the same time, they think that the successes of the Banking Union in common supervision and rule-setting can provide a path forward for CMU.

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Rym AYADI, Marco BODELLINI, Barbara CASU and Giovanni FERRI argue that the Banking Union has been successful making banks safer and more resilient, while shortcomings on account of banking integration are highlighted and the incompleteness of the Banking Union is recognised. Among other things, the authors recommend a centralisation of Emergency Liquidity Assisstance for the Banking Union and a strengthened ESMA as an institutional anchor for furthering CMU.

Ata Can BERTAY and Harry HUIZINGA analyse a specific area of legislation, namely insolvency laws and procedures, and how this segment has been a main obstacle to further integration in the banking sector. The authors look at the disparities in strength of loan enforcement mechanism, how it reflects onto the consumers and the increasing need for harmonisation in this crucial sector to prevent market fragmentation

Guilia GOTTI, Conor MCCAFFREY and Nicolas VERON analyse so far unexploited data, namely on the one hand, time-series data on sovereign exposires, which demonstrates a persistent home bias and thus bank-sovereign risk nexus, and on the other hand, cross-sectional point in time data on cross-border assets, which exhibits disappointing progress in cross-border integration.Regarding capital markets union, the authors are hopeful that supervisory integration can have more direct catalytical impact than in banking since in capital markets, there is no equivalent to the incomplete banking crisis intervention framework and public safety net.

Ignazio ANGELONI, Rainer HASELMANN, Florian HEIDER, Loriana PELIZZON, Jonas SCHLEGEL and Tobias H. TRÖGER analyse particularly the effects of overbanking on integration within the Banking Union. The authors study its influence on both the Banking Union and the Capital Markets Union project, taking into account nationalistic tendencies and a playing field that may be tilted in favour of smaller, regional or local banks. This hinders the emergence of competitive cross-boarder banks, which is also unfortunate since those banks could meaningfully support the development of an integrated capital market.

1. Can the Banking Union foster market integration and what lessons does that hold for the Capital Markets Union?

By Thorsten BECK, Brunella BRUNO and Elena CARLETTI

This paper by Beck, Bruno and Carletti studies the Banking Union (BU)'s effort to **further integrate the banking sector at the EA level**, its challenges and applicability to the Capital Markets Union project. Following the EU's experience of the global financial crisis and its repercussions on the euro area, the decision to establish a Banking Union (BU) was taken in an attempt to **sever the link between bank and sovereign fragility**.

Since the inception of the BU, **aggregate price and quantity based measures of integration have only partially increased** and in 2023 reached equivalent levels as at the start of EMU in 1999. More precisely, Beck et al highlight the **inequality of integration** across market sectors: cross border lending is on the rise but mainly between banks (mainly relying on German and French banks) while **cross border retail lending** only accounts for **7%** of total retail lending. The lack of true retail banking sector integration, a crucial piece for risk diversification, has shown the limits of the current integration process. On the other hand, **interest rate dispersion has decreased** for households, a further indicator of integration. Meanwhile, **the market size of the investment industry has grown to 8 times that of the EA GDP** yet the growth of cross-border positions is mainly **driven by specific jurisdictions** (Luxembourg, the Netherlands and Ireland) and non EA residents' holdings.

The authors also argue that there a two types of obstacles challenging the BU's integration. Firstly, the limitations of the European Union (EU) regulatory framework and the incompleteness of the BU with the **lack of a genuine European safety net (European Deposit Insurance Scheme).** Secondly, national politics, which **impede decisive steps toward harmonization** in several key policy areas (such as tax regimes and national legislation on competition, credit, consumer protection). Beck et al. contend that **home bias** still exists in sovereign debt holding and that **bank failures are still managed at the national level** with little true financial integration. Furthermore, member-states still implement **ring-fencing measures**, encouraging subsidiaries rather than bank branches, while **cross border banks are not permitted to move capital and liquidity freely** within their groups, rendering resource allocation less efficient.

Although it remains incomplete, **lacking a deposit insurance pillar** and with a limited resolution pillar, the BU, based on the Capital Requirements Regulations and the Capital Requirements Directive has set a strong supervisory pillar. This text reminds us that the **success of the single rulebook and supervision mechanism** has enhanced the trust market players and institutions have in the EA. Developing a **single rulebook, stress tests and quality reviews** have also led to a **more stable banking system across the EA**. The increased soundness of EA banks since the SSM inception is reflected in a **significant reduction in the dispersion of bank risk**, as suggested by the **evolution of credit default swap rates** over the last two decades. Furthermore, the notable reduction of high non-performing loans which have been transferred out of the banking system has also been a success.

To further the integration of the BU and the CMU, the authors offer policy recommendation:

1. Increased involvement of market participants (banks in the first place) and cooperation with national and supranational supervisors

2. Utilising opportunities in the recent Cross-Border Merger Directive to increase risk-sharing initiatives from the private sector and ease the pressure on public risk-sharing mechanisms
3. Changing EU regulations to favour the establishment of pan-European banks under new and specific regulations
4. Establishing the European Deposit Insurance Scheme

Beck et al develop lessons that can be applied from the BU to the Capital Markets Union (CMU). While recognising the difference in scope between the two, the authors argue that the **success** in supervision and rule-setting can provide a path forward for the CMU. They find that a stronger supranational supervisor and better coordination among European financial authorities are essential. Harmonisation of relevant legislations must be promoted, as differences in insolvency laws, accounting practices, and tax regimes continue to impede capital movements and investment diversification. The importance of the great financial crisis in promoting the BU is also recognised by the authors as they argue that the CMU needs to be promoted as a missed opportunity rather than current cost. Beck et al. recommend the **green and digital transition as catalysts** to the necessary political support to develop the CMU and develop its backbone centred on a **common safe bond** to fund these transitions.

Full paper available on the EP homepage: **Can the Banking Union foster market integration, and what lessons does that hold for the Capital Markets Union?**

2. Can the Banking Union foster market integration and what lessons does that hold for the Capital Markets Union?

By Rym AYADI, Marco BODELLINI, Barbara CASU and Giovanni FERRI

Similarly to Beck et al, this paper explores the effect of the Banking Union (BU) on Euro Area market integration and identifies lessons for the development of the Capital Markets Union (CMU). Ayadi et al analyse the progress and successes of the BU together with its shortcomings and attempt to identify areas of improvement for policies that could further enhance banking integration within the EA.

Established in the wake of the 2008 financial crisis, the BU's goals were to strengthen the banking system based on **three pillars**. Firstly**, the Single Supervisory Mechanism**, secondly the **Single Resolution Board** and finally **the European Deposit Insurance Scheme (EDIS)**. Ayadi et al argue that the EU achieved **success in the supervisory area**, creating the SSM and improving the resilience and stability of European banks, yet **failed to implement EDIS**, resulting in mixed results in overall integration in the banking sector. Indeed, despite great supervisory success aimed at reducing the link between sovereign and bank crises, **cross-border activity levels remained low** and there remain **significant differences** in interest rates for loans and deposits **across member states**.

The paper explains this result by the **diversity in tax regimes across member states, national regulatory obstacles and varying insolvency laws**. Ayadi et al argue that the **fragmentatio**n of the European market's legislations and regimes, driven by national interests, **is an obstacle to banking integration** and further efficiency in the system. For example, the **current framework** for **Emergency Liquidity Assistance (ELA) is inconsistent with the BU**, being managed by national central banks and in opposition to the BU's goals of a single centralised supervisory system. The authors highlight the disparities created in access to liquidity support, particularly in weaker fiscal environments. As a result, Ayadi et al. **recommend a centralisation of the ELA mechanism** at the ECB to better align with the objectives of the BU. Furthermore, the fragmentation observed along national borders, especially in the M&A market, indicates the **lack of impact the SSM has had** on the fundamental structures of the banking sector. Instead, the increase in domestic activity and domestic M&A is becoming **an obstacle to further banking integration**.

The authors find that the experience of the BU highlights the **importance of a centralised supervisory mechanism** and the need for harmonisation of regulation across member states. The authors argue that the **CMU can learn from this experience** and, most importantly, establish a centralised authority. As a result, Ayadi et al. suggest **extending the ESMA's authority** to ensure **consistent application** of legislation across member states by:

1. Creating a Pan-European Capital Markets Regulator,
2. Enhancing ESMA's Capacity for Data and Digitalization,
3. Granting ESMA Direct Supervisory Powers Over Key Capital Market Activities and actors,
4. Strengthening ESMA's Role in Sustainable Finance,
5. Reinforcing ESMA's Role in Cross-Border Investor Protection,

The authors imagine ESMA as a stronger agency, capable of **giving institutional support to the CMU**, allowing it to expand and function as conceived by the EU and giving it an institutional anchor it currently lacks.

This also supports the inclusion and reliance on **sustainability and green finance** as measures **to increase integration and support** for the BU and the CMU. Underlining the growth in this sector and the successes it has seen, this paper argues that it would be complementary to the efforts made under the BU and CMU projects and provide solid anchorage (despite the phasing out of ESG data) for the CMU project. This, combined with the highly recommended **implementation of EDIS**, **harmonisation of insolvency laws** and **promotion of cross-border M&A** could provide stability and consistency across the EA.

In conclusion, Ayadi et al. argue that the Banking Union has **overall helped further banking integration in the EA** by successfully implementing the SSM and a single pan-European rulebook. The authors **highly appreciate the establishment of the SSM and the SRB**, acknowledging their successes while also remarking on the incompleteness of the BU. As a result, although cross-border activity remains low, **banks have become increasingly resilient and efficient**. The limited degree of market integration remains highlighted by the varying interest loan rates across the EA, while M&A activity has slowed down considerably. Addressing **the lack of EDIS and centralising practices for ELA** should therefore **be a priority** to enhance the stability and integration of the EA banking market under **the supervision of ESMA** and its expanded jurisdiction.

Full paper available on the EP homepage: **Can the Banking Union foster market integration, and what lessons does that hold for the Capital Markets Union?**

3. Banking Market Integration in Europe and Insolvency Law

By Ata Can BERTAY and Harry HUIZINGA

This paper by Bertay and Huizinga explores the **disparities in insolvency laws** across EU Member States and the direct impact of this disparity on market integration under the Banking Union (BU). Indeed, the **BU has succeeded in the field of single supervision** and a strong pillar relying on a single rulebook under the Single Supervision Mechanism. However, harmonised bank regulation and supervision are necessary, but not sufficient for market integration. **National differences such as tax regimes or insolvency laws, hinder** the complete integration of banking markets. This difference in regimes across the Euro Area (EA) **creates inefficiencies in loan enforcement**, affecting interest margins and overall performance, particularly due to varying loan enforcement mechanisms across countries.

Using data on European banks from the 2020-2023 period, Bertay and Huizinga analyse the link between **countries with less efficient loan enforcement mechanisms** (measured through the recovery rates and enforcement times) and **higher bank interest margins**. As a result, consumers from countries with low loan recovery rates experience **increased borrowing costs and higher bank intermediation costs**, leading to **overall inequalities** in consumer experience **throughout the EA**. The link between high interest rate margins and weak insolvency regimes is shown through the net interest margin (NIM), which reflects the difference between interest income and interest expenses. In the analysis of the paper, this link is significant, including when controlling for other possible drivers of net interest margins. The authors highlight the fact that **countries with weaker recovery regimes have higher NIM, suggesting less efficient banking practices** and an overreliance on borrowers to offset potential costs. This could also lead to repercussions on **deposits** as **interest rates may be lowered to recoup the costs of lack of loan recovery**. This lack of efficiency in bank intermediation, as argued by Bertay and Huizinga, hinders and, if policy originated, **goes against the idea of the BU** as promoted by the EU.

In anticipation of the new parliamentary term, the European Council and the European Central Bank have reiterated earlier this year the importance of a greater harmonization of corporate insolvency law. Policy measures targeting procedural efficiency and value recovery would, as argued by Bertay and Huizinga, be an attempt to stop passing on the inefficiencies costs to the depositors and borrowers. Indeed, according to the authors, progress towards harmonization of insolvency law towards a common efficient standard in the years to come could help to attenuate the barrier that loan enforcement variability in the EU presently constitutes to full banking market integration

Overall, this paper underlines the need for **further harmonisation of policies at the national level**. Full banking integration, while supported by a single rulebook, requires increasing policy and legislative harmonisation. Addressing the difference in insolvency regimes across the EA, as argued in this paper, is a step in this direction and should be supported by the European Parliament during this **new legislative cycle**. The value of the paper lies in providing evidence to policy makers that differences in insolvency laws are a significant driver of the current lack of market integration and welfare losses for bank customers.

Full paper available on the EP homepage: **Banking Market Integration in Europe and Insolvency Law**

4. Banking Union and the Long Wait for Cross-Border Integration

By Guilia GOTTI, Conor MCCAFFREY and Nicolas VERON

This study by Gotti, McCaffrey and Veron uses so far unexploited data to examine the **progress of cross-border banking market integration** in the EU through pooling the **prudential framework** at Banking Union level. The authors argue that the BU attempt to sever the vicious cycle between banks and sovereign fragility has fallen short due to its failure in promoting cross-border integration. The pooling of the prudential framework according to the authors should comprise both prudential supervision and crisis intervention, which they consider a better description than the traditional reference to three pillars (supervision, resolution and deposit insurance). In this context, prudential supervision in turn is broken down into micro- and macroprudential supervision. Against this background, the authors recall that **the microprudential framework is the only piece of the Banking Union that has been completed by now**.

The empirical analysis in the present paper focuses on two areas of observation: on the one hand, an analysis of sovereign exposure home bias and capital coverage for (most) significant banks, using time series starting where possible as early as 2010. On the other hand, a country-by-country analysis per end 2023 of the asset held by significant institutions.

Firstly, the BU's goal of limiting sovereign exposure has not been able to overcome **significant home bias** within significant European banks. Indeed, the authors demonstrate that those banks across the Euro Area (EA) still hold a **disproportionate amount of sovereign debt from their home countries**. Of the 7 banks designated by the Financial Stability Board as significant on a global scale, 4 have "home bias ratios" (the banking group's domestic sovereign exposures to the group's aggregate exposures to euro-area sovereigns) above 50%, including BPCE at almost 90%. The authors conclude that this entrenched bias continues **to tie the solvency of the banks to the financial health** of their home countries, perpetuating the bank-sovereign nexus developed during the 2008 financial crisis. Secondly, the authors show that cross-border activity is still underdeveloped. Despite the establishment of the BU and the Single Supervisory Mechanism (SSM), cross-border activities remain low. The bulk of **assets in member states are held by domestic entities**, and even **large banking groups are biased towards their home market**.

Gotti et al. maintain that an important reason for this fragmentation is the **lack of a European-level safety net**, the missing European Deposit Insurance Scheme (EDIS), which hinders trust in cross-border activities. Banks also remain subject to national-level prudential requirements. EU legislation, which is the basis for the BU (CRR, CRD, BRRD…), maintains too large a role for individual-entity requirements (in supervision) and national authorities (in crisis management and resolution) for the main barriers to cross-border integration to be lifted, letting banks become affected by **ring-fencing measures**. The involvement of national authorities in the crisis management mechanism of the BU is another reason, as brought forward by the authors, why the mechanism has not been fully effective. Gotti et al. contend that the involvement of these domestic institutions can lead to **inconsistent response times and uncoordinated crisis support and interventions**. Banks become limited in their cross-border activities due to their perceived vulnerability under uneven levels of protection across the EA.

As recognised by the authors, the efforts and failures of the BU also have repercussions on the CMU. While acknowledging that the CMU faces different challenges and does not rely on public financial safety nets as much as the BU does, it still needs a **stronger centralised authority to support it**. As demonstrated in this article, a stronger European authority would allow CMU to overcome the fragmentation along national borders and ensure increasing harmonisation of national policy. The authors underline **the crucial role**

ESMA could play in this process, as supervisory integration can have a more direct impact on market integration under capital markets than the banking sector.

In conclusion, to answer to the current weaknesses of the BU and further integration both in this project and in the CMU, the authors also make policy recommendations throughout this study:

1. **Implementing EDIS** to ensure that levels of protection are equivalent for all depositors across the EU, enhancing the trust in cross-border activities,
2. Introduce **sovereign debt concentration charges** to address the home bias issues,
3. **Harmonisation of national frameworks** especially in crisis management to avoid ring-fencing measures and reduce risks of fragmentation.

Moreover, the authors call for a more in-depth analysis of national barriers to integration; greater transparency by banks on the location of their assets within the banking union; identification and possible removal of the obstacles to the conversion of subsidiaries into branches; and further integration of the macroprudential toolkit.

Overall, this paper provides new and up-to-date evidence on home bias and the lack of market integration in the Banking Union. On this basis, the authors recognise the effort made by the BU but still recommends harmonising policy fields, limiting national authority interventions and reinforcing centralised influence to support further market integration. The authors also recall that the Banking Union is only complete in one respect, namely microprudential regulation and supervision. Finally, the authors point out that the pooling of regulation and supervision that has been achieved in the Banking Union would bring more immediate benefit in the Capital Markets Union since in that context, the absence of a common safety is less of an issue.

Full paper available on the EP homepage: **Banking Union and the long wait for cross-border integration**

5. Can Banking Union foster market integration, and what lessons does that hold for capital markets union?

By Ignazio ANGELONI, Rainer HASELMANN, Florian HEIDER, Loriana PELIZZON, Jonas SCHLEGEL and Tobias H. TRÖGER

This paper by Angeloni, Heider, Pelizzon, Schlegel and Tröger explores the Banking Union's (BU)'s role in fostering market integration within the Euro Area (EA) and the applicable lessons for the Capital Markets Union (CMU) project. The authors argue that while the BU has **succeeded in establishing a common supervision and strengthening EA banks' resilience**, this has come **at the cost of cross-border activities and integration**. Having successfully surpassed the successive issues of the pandemic and the 2023 bank turmoil, EA banks have become increasingly resilient and stable. However, the EA market remains fragmented and the **BU's integration goals remain hindered** by unresolved issues such as the lack of a European Deposit Insurance Scheme (EDIS) or legislative harmonisation.

The fragmentation of the EA banking market is particularly important in the retail market. The authors highlight the **divergence between the interbank market** which has made significant progress in cross border integration and **the retail market** where client deposit and loans remain largely national if not local. Indeed, Angeloni et al. demonstrate that **cross-border activities have not progressed** as expected under the BU and argue that one of the main issues has been **overbanking in the EA**. Relative to its GDP, the EA banking sector is disproportionally larger than in the US, resulting in an overbanked market. This results in lower profitability for banks, pushing them to riskier practices while consumers do not benefit from lower pricing throughout the EA. In turn, this influences cross-border activities as it **creates a scarcity of opportunities and subdues interests in cross-border M&A**. The authors argue that resolving this problem would further integration, yet national interests and the link between politics and banking in several member-states have hindered constructive regulatory initiatives. Without a **willingness to entrust national interests to the European level** and reduce the obstacles to cross-border activities, the BU's integration is unlikely to progress further. However, Angeloni et al. point out that **smaller banks still hold significant influence** in the EA, particularly in Germany where these institutions dominate the market. The **two tiered supervision** system introduced in 2014 with the Single Supervisory Mechanism has also left these banks under national supervision, separated from the ECB's supervision of larger ones and allowing them to grow their lending market influence. **Regional banks however are reluctant to expand** across borders and therefore cannot support market integration across the EA.

Furthermore, the authors find that **overbanking also significantly affects the CMU** as it impacts the demand for capital market instruments by redirecting firms toward bank credit rather than the bond market or equity markets. On the supply side, banks' market position stands in the way of savings flowing into capital markets to a larger extent. In this paper, the authors argue both the CMU and the BU must therefore support each other to succeed. The CMU can reduce overbanking by providing alternative funding sources, thereby alleviating pressure on banks and promoting cross-border integration while the BU should ensure a stable banking environment conducive to competitive banks with capital markets abilities that can offer services and access to firms and investors, crucial for the CMU's success. Their mutual reinforcement is essential for achieving a truly integrated European financial system. In addition, the authors conclude that the experience of the Banking Union, and particularly the establishment of the SSM, demonstrates the **critical need for a common supervisory authority within the CMU**. They also believe that a common denominator of BU and CMU is that **national agendas prevent the full realization of a cohesive and**

efficient financial system across Europe, undermining efforts to create a level playing field and limiting the potential benefits of deeper economic and financial integration.

Overall, to further integration within the Banking Union, Angeloni et al. developed policy recommendations centred on harmonisations and revisions of legislation throughout the EA to encourage cross-border activities:

1. Defining 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
2. Repealing or **waiving the legal provisions that inhibit free movement** of capital, liquidity and other prudential resources within the banking groups belonging to this category
3. Establishing that these groups and/or the entities thereof, if declared failing-or-likely-to-fail by the supervisor, are resolved by the European resolution authority under the **European Crisis Management and Deposit Insurance (CMDI) framework**, not liquidated nationally
4. Prescribing that **the deposit insurance** function for these groups is performed by **a dedicated scheme,** industry-funded by the groups themselves, whereas the existing deposit insurance schemes retain their functions for banks having a predominantly national business focus

These measures, according to the authors, would help increase integration within the BU from which lessons can be learnt for the CMU project. Angeloni et al., while recognising that the CMU addresses a different aspect of the financial market, contend that there remain similarities from which the CMU can develop. This includes a common supervisory authority, since the success of the CMU hinges more on finally establishing a common framework than on selecting among the proposed options as well as challenging overbanking which does not just hinder cross-border bank integration, but also prevents the CMU from developing naturally.

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