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POTENTIAL REGULATORY OBSTACLES TO CROSS-BORDER MERGERS AND ACQUISITIONS IN THE EU BANKING SECTOR

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ABSTRACT

Over the past decade, cross-border merger and acquisition (M&A) activity in the EU banking sector has remained far below its pre-crisis levels, despite the regulatory reforms implemented after the financial crisis. While the EU equipped itself with the Single Rulebook, convergent supervisory practices, a common crisis management framework and the creation of the Banking Union, ring-fencing and limits to the circulation of funds across borders are still present and the EU still does not reap the full benefits of the Single Market.

The purpose of this paper is to map and analyse the elements of the current EU prudential framework that create obstacles to banking groups operating across borders. The results highlight the existence of a number of potential issues at both regulatory and supervisory levels.

First, policy reviews, cases and survey-based evidence suggest that the current regulatory framework relies on a territorial approach (cross-border waivers for capital and minimum requirements for own funds and eligible liabilities (MREL), inefficient intra-group financial support arrangements, a multiplicity of macroprudential tools and the existence of options and national discretions within the Single Rulebook), favours pre-positioning resources with the subsidiaries and entails market fragmentation. Ultimately, this may endanger the comparability of institutions across countries and reduce the incentive to conduct cross-border consolidation.

Second, despite the progress made in achieving convergence of supervisory practices across the EU, a number of approaches are not yet fully consistent, in particular with respect to the link between prudential requirements and restrictions on distributions, and to a more transparent approach when setting risk-by-risk requirements. The absence of common and fully transparent EU practices for prudential assessment of M&A transactions, including the determination of capital requirements, further adds to the complexity.

Finally, it is also suggested that the completion of the Banking Union, by further strengthening the institutional cooperation among Member States and national authorities, has a fundamental role to play in freeing up the potential of enhanced financial integration. There should also be no further delay in the progress made towards the Banking Union's achievement of single jurisdiction status.

Keywords

M&A; prudential regulation; prudential waivers; Banking Union; MREL; qualifying holdings.

Contents

1 Introduction

Despite the post-crisis prudential repair and the establishment of the Banking Union, cross-border merger and acquisition (M&A) activity in the EU banking sector remains far below its pre-crisis levels. Available data on cross-border penetration of banking markets confirms low levels of integration in the EU banking sector, which still carries the marks of the widespread retrenchment observed during the crisis. National fragmentation testifies that the achievements of the Single Rulebook and of the new financial architecture still fall short of fully reaping the potential and the benefits of financial integration, particularly in terms of risk-sharing and resilience.

The objective of this paper is to investigate the reasons for the persistent low levels of cross-border M&A deals as an instrument for cross-border consolidation. To this end, a mapping exercise was undertaken of those EU regulatory provisions that, through a geographical or other cross-jurisdictional angle, can penalise or otherwise add complexity to banking groups operating across borders. This regulatory mapping exercise covered capital and liquidity waivers, the large exposure regime, macroprudential policy and tools, the recovery regime (intra-group financial support arrangements or IGFSAs) and resolution, with regard to internal minimum requirement for own funds and eligible liabilities (MREL) pre-positioning. This paper also explores the persistence of fragmented national supervisory practices and the extent to which they may contribute to holding back cross-border consolidation. In this vein, the paper also covers the EU regime applicable to the prudential assessment of the M&A transaction from the perspective of its comprehensiveness, transparency and interaction with the applicable national regime.

This paper is neutral as regards the business and operating models of cross-border banking groups, which is a business choice. It therefore does not express a preference for any business or operating model: the EU single bank, the group of banks. In this context, the term ‘EU single bank’ is used to mean a bank with its head office in a Member State and branches in the other Member States where it conducts cross-border banking activities. It relies on a single balance sheet and, from a resolution perspective, is subject to a single point of entry strategy. The term ‘group of banks’ refers to a group headquartered in one Member State and expanding its business to other Member States via the acquisition or establishment of subsidiaries, which are marked by a significant degree of operational and financial independence from the head office. In the light of the operational and funding autonomy between the centre and the periphery, such types of groups are usually organised as a multiple point of entry from a resolution perspective. Finally, the term ‘banking group’ refers to a group with its head office in a Member State and subsidiaries (or, to a lesser extent, branches) in other Member States where it operates. Unlike the ‘group of banks’ operating model, the ‘banking group’ is characterised by a high level of business and operational and financial integration across the group, regardless of its legal structure. In resolution-planning terms, this reflects a single point of entry preferred resolution strategy, associated with the application of the bail-in tool at the highest degree of consolidation, which is the chosen resolution tool in the vast majority of resolution plans. This notwithstanding, the mapping exercise is mostly focused on those cross-border banking groups that – regardless of their

legal structure – are characterised by a high level of business and operational and financial integration, since their cost, efficiency and prudential soundness are most likely to be affected by territorially marked regulation. Other banking operating models are not considered in the paper, either because the group's territorial fragmentation with independent subsidiaries is a business choice or because the group rests on a single entity/single balance sheet structure based on the cross-border presence branches.

To gain a better understanding of the impact of the mapped prudential requirements on cross-border banking activities, group structures, efficiency and costs, the analysis has been complemented by a questionnaire aimed at gathering the industry's view (referred to herein simply as the questionnaire). While the paper draws autonomous policy conclusions relying on multiple sources, including data and cases, the exchange with the industry has been particularly significant in achieving a comprehensive outlook that takes into account the regulatory and the industry perspectives. The results of the questionnaire are referred to throughout the paper and laid out in detail in the annex.

This paper does not deal with cross-border banking via the freedom of provision of services (i.e. without a physical presence in other Member States). In the light of the growing relevance of technology in the structuring of bank business models, including the shift towards platformisation, this is indeed a significant aspect of financial integration, which is dealt with by other publications[1]. The scaling up of such new business models may, in particular, be hampered by non-prudential obstacles such as national consumer, employment, corporate, insolvency and tax law, as also evidenced by the responses to the questionnaire. This paper recognises the relevance of discrepancies in national legislations as a fragmentation factor, but does not directly deal with these issues, which do not completely fall within the authors' area of work.

Based on the analysis carried out in the paper, within the regulatory framework, potential regulatory obstacles can be grouped into two broad categories relating to (1) ring-fencing and pre-positioning of resources at the local level instead of centralised management of capital, liquidity and eligible liabilities and (2) fragmented regulatory framework affecting the comparability of institutions and carrying on business across Member States. These potential obstacles may therefore have an impact on market operators' ability to reap the benefits of the internal market. In addition, they may affect the Single Market's achievement of risk-sharing and financial resilience, which foremost rely on banks' ability to deploy loss-absorbing types of resources across countries (i.e. cross-border bank capital ownership).

[1] See EBA (2019).

2 Cross-border M&As in the banking sector

2.1 Drivers of consolidation in the banking sector: literature review

Berger et al. (1999) and Amel et al. (2004) provide comprehensive reviews of the literature on the causes of consolidation in the financial sector. Most of the drivers of consolidation identified in the banking sector achieve the maximisation of shareholder value. Consolidation in the banking sector can increase a firm's value through enhanced market power, economies of scale, economies of scope, enhanced efficiency of management and tax optimisation. To the extent that it results in forms of support of the 'too big to fail' type, even public policy may indirectly act as a driver of consolidation that increases shareholder value.

When banks operate in concentrated local markets, market power may allow them to charge higher interest rates and/or fees on retail products and lending to small local borrowers. Berger et al. (1999) describe the econometric evidence on the market power implications of bank consolidation as mixed. In the related literature, controlling for efficiency arises as a main methodological complexity: where efficiency is not appropriately controlled for, the changes in prices/profits are mistakenly interpreted as changes in market power.

Economies of scale occur when average costs decrease or profits increase with a firm's size (e.g. due to fixed costs being spread over a larger base or due to the diversification of risk). Whereas initial studies (e.g. Ruthenberg and Elias, 1996) found that economies of scale did not materialise for larger firms (e.g. due to the complexities of managing large entities), more recent studies conclude that, when accounting for technological progress or managerial risk-taking, economies of scale also materialise in firms of very large size. Economies of scope arise when a firm's costs decrease or its profits increase as additional activities are undertaken, due to synergies or the diversification of risk. Econometric evidence on economies of scope in the banking sector is mixed: among others, Dijkstra (2013) finds economies of scope in the Euro area using 2002-2011 banking data. Evidence of potential risk-reduction benefits from cross-border diversification were found, for instance, by Jokivuolle and Viren (2019), who show that the minimum capital needed to withstand maximum losses arising from a diversified Euro area portfolio can be only 40% of the capital needed to withstand country-specific maximum losses in the same region.

Consolidation may also be undertaken as a way to transfer assets and value from poorly managed to well-managed entities. Depending on how efficiency is measured (e.g. through growth, return on equity, return on assets or capital ratios), econometric evidence on the transfer of efficiency from more efficient bidders to less efficient target entities in M&A transactions is mixed, with only some studies concluding that M&As do transfer the quality of management. M&A transactions may also increase a firm's value by allowing the acquirer to achieve tax advantages, because, for instance, future taxable

profits of the acquirer are counterbalanced by losses of the target firm or because tax obligations of the acquirer are counterbalanced with tax credits of the target firm.

Prior to the introduction of the resolution regime, a link was also found between the incentive for institutions to grow larger and access to the public safety net (implicit guarantees, implicit bail-out commitments, etc.) put in place by governments and authorities in favour of 'too big to fail' entities. Such forms of support/subsidy increase a firm's value through various channels, including by lowering the firm's funding costs.

Faced with mixed empirical evidence on the role of consolidation drivers that increase shareholder value, researchers investigated the role of those consolidation drivers that are unrelated to that objective, in that they respond to the interests of stakeholders other than the shareholder. One stream of research has focused on the role of bank corporate governance and managers' incentives in driving M&A dynamics: abnormal returns in bidder banks were found to increase with (1) the sensitivity of the CEO's pay to the firm's performance and (2) with the proportion of outsiders in the board of directors, suggesting that when managers' compensation is not sufficiently linked to the firm's performance or when there is not sufficient outsider pressure on management, M&A transactions may be undertaken for reasons other than the maximisation of the firm's value (see, for example, Cornett et al., 2003).

Another stream of research has looked at the impact of public policies and regulations on consolidation dynamics, highlighting the existence of several channels. Antitrust policies constrain bank consolidation to ensure that financial services are provided in a competitive environment for the ultimate welfare of the consumer. Public policies of financial protectionism may result in reduced consolidation of the cross-border type: evidence of protectionist policies is, for instance, found in relation to the provision of public support to domestic banks during the great financial crisis (see Rose and Wieladek, 2014). Structural restrictions such as those on inter-state branching can sensibly restrict the possibility of banks and other financial institutions to operate across borders: clear evidence of this is the material increase in inter-state mergers that occurred in the USA at the end of the 1990s, when the inter-state branching ban dating back to the 19th century was abolished. Within the spectrum of prudential regulation, researchers have shown that defining the scope of prudential rules in terms of size thresholds, for instance by introducing regulatory thresholds in terms of total assets, may provide banks that operate slightly below the chosen thresholds with incentives not to grow larger to avoid the fixed costs of the rule under consideration. By contrast, the same research finds that banks that operate above newly introduced regulatory thresholds, and that therefore incur the fixed costs of the rule, may be incentivised to further consolidate and grow, thus reducing average costs.

Public policies on crisis management and resolution may also affect consolidation dynamics. In the EU, the public response to the great financial crisis has, to some extent, been characterised by protectionism-oriented cross-border retrenchment and an overall effect of cross-border deconsolidation. In some cases, financial support by governments to national ailing institutions was made conditional on the sale of subsidiaries and business lines located in non-domestic markets. Governments and authorities in several EU countries worked towards failing entities being acquired by healthy institutions within the same country, thus spurring domestic consolidation. The tendency

to put in place inward-looking consolidation strategies remained unaltered with the introduction of the EU resolution framework whereby, based on the experience made so far, ailing institutions (in the case of Banco Popular), selected assets and liabilities of those institutions (in the cases of two Venetian banks) or bridge banks created as a result of resolution (in the cases of four Italian banks) were purchased by acquirers located in the same Member State.

By contrast, the US Federal Deposit Insurance Corporation (FDIC) responded to the crisis by implementing the purchase and assumption strategy, whereby a considerable proportion of out-of-state bidders purchased ailing institutions across the country, leading to increased cross-border consolidation (see Gros and Belke, 2015).

The literature does not investigate in depth how the drivers of consolidation may differ between cross-border and domestic transactions. However, as evidenced in the review by Amel et al. (2004), it is clear that institutional, regulatory and cultural factors play a role in explaining variations in the efficiency of national banking systems. In this respect, Abraham and Van Dijcke (2002) find that banks focusing on domestic M&As perform better than both those focusing on cross-border M&As and those that do not engage in any consolidation. Diaz Diaz et al. (2002), who focused on acquisitions, found that, in terms of efficiency, the acquirer performs better in domestic M&As than in intra-EU cross-border M&As, and better in intra-EU cross-border M&As than in M&As towards non-EU jurisdictions. Realising cross-border M&As that create shareholder value may in fact be hard due to, inter alia, cultural and language barriers, the heterogeneity of institutional frameworks, and differing regulatory and supervisory approaches between jurisdictions.

2.2 Financial integration and financial stability

The economic implications of cross-border bank consolidation are numerous. As mentioned in the previous section, by increasing in size and engaging in additional activities, banks may benefit from economies of scale and scope, diversify risk and become more efficient. The penetration of efficient foreign entities into otherwise concentrated domestic markets may improve consumer welfare in those markets, to the extent that it allows consumers to access new financial services and enjoy existing services at more competitive price conditions.

A larger size and a cross-border outreach may support banks' upscaling of technological innovation. Technology can partly explain the slowdown in cross-border consolidation in the post-crisis period, as technological progress allows institutions to reach cross-border customers without physically expanding abroad. However, cross-border acquisition of FinTechs firms is one way in which incumbent institutions can import technology in their domestic market. According to a report produced by the EBA (2018a), as of July 2018, the direct acquisition of FinTechs (without differentiation between domestic and cross-border acquisitions) is one channel through which incumbent institutions can appropriate new technologies, albeit not the predominant channel. Instead of acquiring fintechs, banks favour entering into dedicated partnerships or, alternatively, investing in them via venture capital funds.

In some cases, the acquisition of banks in foreign jurisdictions has allowed large groups to export their technological superiority abroad while benefiting from economies of scale in the jurisdiction of the acquired entity[2]. In this way, cross-border M&As also contribute to the expansion of technology in banking, further driving the overall efficiency of the sector.

It is, however, mostly because of its benefits in terms of financial integration and private risk-sharing that cross-border consolidation has become increasingly prominent in the ongoing debate on the Single Market and the deepening of the Economic and Monetary Union (EMU). A financially integrated system, which the design of the Single Market – and a fortiori the Banking Union – aims to achieve, is characterised by private risk-sharing. Private risk-sharing operates via cross-border capital markets and cross-border banking. As individuals and corporates invest on the capital markets on a cross-border basis, they become better equipped to withstand idiosyncratic (i.e. national) income shocks (Draghi, 2018a). By the same token, as banks expand their cross-border presence and activity, they become better equipped to withstand shocks hitting any one jurisdiction among those in which they operate. In addition, in the aftermath of idiosyncratic shocks, a well-functioning market for cross-border M&A can be the basis of a smooth and relatively fast profitability adjustment process (see Gros and Belke, 2015, on the US case). In this vein, enhanced integration of financial flows and financial ownership structures promotes resilience of the banking sector and overall financial stability.

However, the 2007-2009 great financial crisis proved that, in the absence of an appropriate EU-wide regulatory and institutional framework, the uncontrolled integration of financial flows can also represent a serious threat to financial stability. In the run up to that crisis, several cross-border M&A banking deals took place, contributing to the establishment and growth of very large internationally active players. This, in turn, has led to increasing levels of cross-border interconnectedness and cross-border contagion, as well as the emergence of 'too big to fail' types of externalities. As the crisis hit, the reaction of both market participants and public authorities was characterised by sudden reversal events, cross-border retrenchment and purely domestically oriented public policies. Home supervisors realised that, in times of stress, the integrated funding model of cross-border groups could turn into a vulnerability and that, through parent funding lines, local risks could indeed become risks to the headquarters. In turn, host supervisors took geographical 'ring-fencing' measures to safeguard local foreign-owned assets from 'imported' distress, including increased capital and liquidity requirements, tightened limits to intra-group exposures, and restrictions on intra-group asset transfers and on upstreaming of profits.

In the absence of appropriate common legal, regulatory and institutional frameworks, a lack of trust can drive the response of an integrated system to financial shocks, amplifying, rather than absorbing, the impact of those of shocks, deepening the havoc and opening the way to protracted fragmentation.

The crisis events showed that no integration of financial flows can truly deliver financial stability as long as 'banks are transnational in life but national in death' (see Huertas, 2009).

[2] In this vein, the Spanish bank Santander purchased Abbey National in the UK and the Dutch bank ING purchased Direktbank in Germany.

Against that backdrop, the regulatory reforms endorsed by the G20 in the aftermath of the 2007-2009 financial crisis launched an overhaul of the EU banking prudential framework, and of the EU financial market regulation at large. The revisions aimed at repairing the EU banking sector while enshrining mutual trust within a new system of common rules, common supervisory approaches and common institutions. The EU equipped itself with (1) the Single Rulebook, (2) convergent supervisory practices and (3) a crisis management framework centred around the Bank Recovery and Resolution Directive (BRRD). Supervision and resolution colleges were created to lay the groundwork for supervisory cooperation and trust across borders, with the EBA tasked to mediate and settle potential disputes among authorities.

With the creation of the Banking Union, Euro area Member States pushed institutional integration even further. The introduction of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) subjected all significant institutions operating in the Euro area to a single supervisor and a single resolution authority. The introduction of the European Deposit Insurance Scheme (EDIS) and a common backstop (to the EDIS and the single resolution fund) will accomplish institutional risk-sharing within the Banking Union's members, further mitigating the highly damaging bank-sovereign loop[3].

The EU regulatory and institutional architecture has greatly changed since the break-up of the crisis; its implementation has significantly advanced and is on its way to completion. Given the intrinsic relationship between cross-border consolidation and crisis management, such progress and the route to completion and implementation of the overall framework are important elements of consideration for the purposes of this paper. The regulatory and institutional frameworks in the EU are now in a much better place to control and support the growth of large cross-border banking groups. The progress in resolution preparedness – the build-up of loss absorption and recapitalisation of capacity, liquidity and funding in resolution, institutions' separability – and the challenges to resolution execution, in particular in a cross-border setting, continue to represent elements to be factored-in in the general discourse about cross-border banking consolidation.

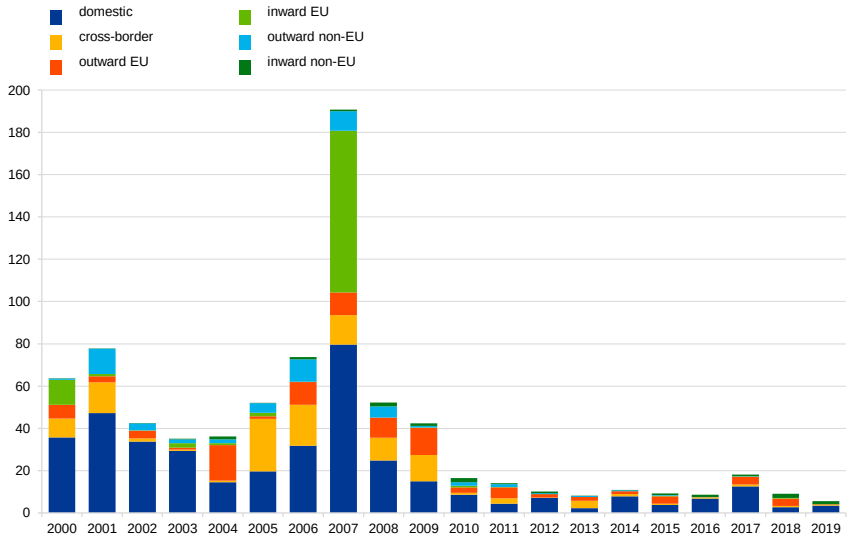
2.3 Data on cross-border banking consolidation in the EU

Consistent time series data on bank consolidation in the EU are not easily accessible. Data gathered by the European Central Bank (ECB, 2018) show that (Figure 1):

[3] With the Economic and Financial Affairs Council of June 2018, the Commission's proposed timeline and implementation for EDIS came to a halt. A high-level working group on EDIS was set up, which in June 2019 published its conclusions, highlighting diverging views among members and illustrating areas in which further progress is needed before a roadmap for the political negotiations on EDIS can be launched. These areas are (1) technical work on the features of EDIS, (2) improvements in supervision and resolution, including liquidity in resolution and bank insolvency, (3) treatment of sovereign exposures and (4) removing obstacles to banking integration, including options and national discretions. Regarding the common backstop, in June 2019, Member States of the Eurogroup reached an agreement on a revised European Stability Mechanism (ESM) treaty draft, including the new ESM task of providing a common backstop for bank resolution.

- M&A activity has been declining since the peak levels of 2007, particularly in terms of value but also in terms of number of transactions;
- in 2016, the value of transactions reached its lowest level since 2000;
- compared with pre-2008, the post-crisis period is characterised by a predominant proportion of 'domestic' transactions.

Figure 1: Bank M&A in the euro area: value of transactions

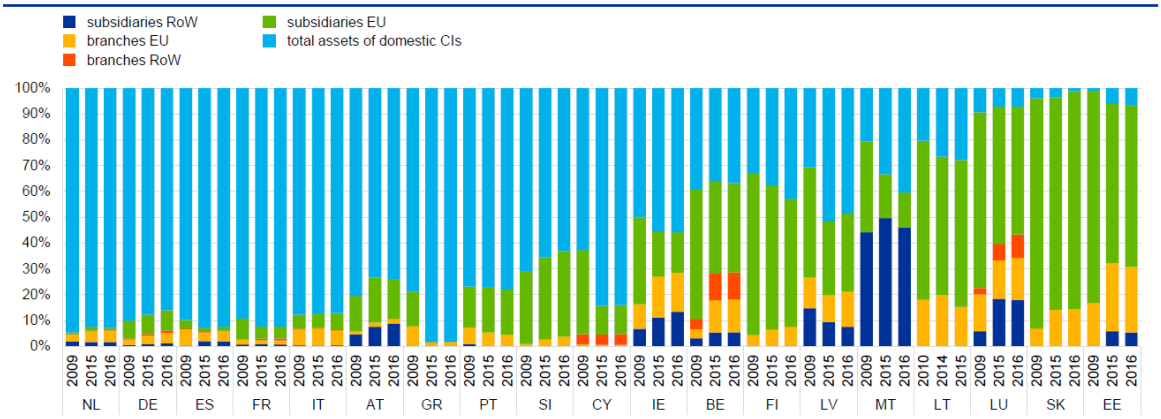


Notes: M&As refer to transactions in which the acquired stake is more than 20% of the target bank. The data do not cover participation by governments or special legal entities in the restructuring or resolution of credit institutions. Transactions whose amounts are not reported are excluded. 'Domestic' refers to transactions that take place within the national borders of euro area countries. 'Cross-border' refers to transactions involving a domestic target and a non-domestic acquirer. 'Inward' refers to M&As carried out by non-EU or non-euro area EU banks in the euro area. 'Outward' indicates M&As carried out by euro area banks outside the euro area.

Source: ECB calculations based on Dealogic

Particularly in some small EU Member States acting as host jurisdictions of foreign banking groups, the presence of foreign institutions (i.e. the assets of foreign subsidiaries and branches) decreased following the financial crisis, which highlights the retrenchment in cross-border activity that accompanied the crisis, as well as the focus of national policymakers on domestically oriented consolidation as a crisis management strategy, in the absence of an EU-wide crisis management framework. As of 2017, the structure of the banking system was predominantly under domestic control in the largest Euro area economies, whereas it was predominantly under foreign control in some smaller euro area economies (Figure 2).

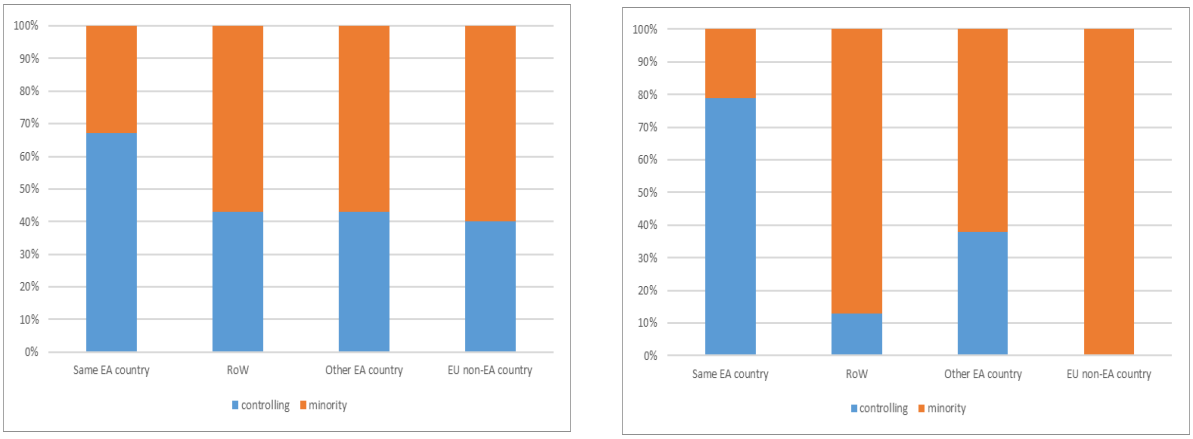
Figure 2: Evolution of the composition of banking sector assets in the euro area by type of credit institution: 2009, 2015 and 2016



Source: ECB (2017a)

Research on the evolution of M&As in the banking sector in the EU carried out at Bruegel may suggest that the creation of the Banking Union has not been effective in boosting foreign control of domestic entities within the Banking Union area. Using 2012 as a landmark year, data show that, following the creation of the Banking Union, domestic M&As have increasingly become a 'controlling stake' type, whereas cross-border M&As have increasingly become a 'minority stake' type (Figure 3).

Figure 3: M&A by type of stake: pre-2012 (left panel) and post-2012 (right panel)



Source: Raposo and Wolff (2017)

3 Potential obstacles in prudential regulation and supervision

The principles underlying the Single Market are that business should be regulated and supervised in the same manner regardless of where, geographically, it is carried out. Equally importantly, where cross-border crisis management and resolution can be fully coordinated and their costs shared within the jurisdictions involved, local authorities should not feel compelled to maintain local control of capital and liquidity resources. Pan-European banking groups should be subject to comparable and transparent regulatory and supervisory outcomes across Member States and regulation should not prevent them from operating centralised (i.e. group-wide) capital and liquidity management strategies.

Given the progress made in the implementation of the post-crisis reforms, and in the light of the outstanding challenges, the question is: is the EU delivering on its commitment to establish a single jurisdiction for banking? A recent reminder of the fact that work still needs to be done comes from the SSM Chairperson (Enria, 2019a): 'The European banking market remains segmented along national lines; it is not a domestic market from the banks' point of view, and it is not a single jurisdiction from the regulators' point of view'.

Evidence from the questionnaire seems to confirm that, while significant progress has been achieved, there are still specific regulatory, supervisory and institutional elements of the post-crisis repair that may hamper the functioning of the Single Market as a single banking jurisdiction, and thus may potentially hold back consolidation in cross-border banking within the EU.

On the regulatory front, the current Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) framework contains a number of **options and national discretions** (ONDs), which are either enacted through national legislation or exercised by national supervisors. Despite the work done by the ECB towards a more consistent application of ONDs across the jurisdictions of the SSM[4], a number of these options or discretions remain in the CRR and CRD, which, as argued by the ECB (2017d), may create an uneven playing field, increase regulatory complexity and compliance costs, and leave room for regulatory arbitrage[5].

Respondents to the questionnaire identified cross-border **waivers** to the application of capital and liquidity requirements on an individual basis as key instruments that could facilitate the efficient

[4] For significant institutions under direct ECB supervision, the harmonisation of ONDs was concluded in March 2016, when the guide and regulation on options and discretions were published (see ECB, 2016a, and ECB. 2016b). For the less significant institutions, see the final guideline and recommendation (ECB, 2017b and ECB, 2017c).

[5] See also Enria (2015), who also argues that the flexibility required to adapt common rules to different types of institutions can be better addressed through the principle of proportionality within the Single Rulebook, rather than leaving the option for national legislators to substitute common European rules with national ones.

allocation of liquidity and funding across a pan-EU banking group. In this regard, the reluctance of host authorities/Member States to abandon policies of ring-fencing and pre-positioning of resources at the local level emerged in the context of the negotiations on the Commission's proposal to introduce conditional cross-border waivers in the wider review of the CRR. Ultimately this led to those provisions being scrapped from the adopted text of CRR2.

The implementation of the **regime on large exposures** on an intra-group basis was identified by the respondents to our questionnaire as an additional element of disruption to group-wide management of capital and liquidity resources, including the capability of the group to support distressed group entities.

Similarly, the **requirements on internal MREL** and the lack of application of **IGFSAs** contribute to substantial pre-positioning of capital and funding that may hamper the circulation of funds even when a banking group will enter into financial distress. Responses to the questionnaire support this view. The majority of respondents identified pre-positioning requirements of internal total loss-absorbing capacity (TLAC) and of internal MREL, and the absence of intra-EU cross-border waivers for the latter, as very relevant factors affecting cross-border banking consolidation. In respect of the IGFSAs, respondents highlighted the legal and regulatory complexity of setting up such arrangements and the related reduced flexibility in managing capital/liquidity between the parent and subsidiary.

The **macroprudential framework** is an additional aspect of the regulatory framework that respondents to our questionnaire identified as potentially adding complexity and elements that unlevelled the playing field in the undertaking of cross-border banking business, given the multiplicity of tools made available and the complex cross-border governance of the related decisions. The same framework, in addition, considers intra-EU cross-border exposures as adding to the systemic complexity of banking business; in doing so, the framework does not provide any recognition of the progress made in the integration of the prudential framework in the EU, not even where, like in the Banking Union, institutional integration has been further enhanced.

On the **supervisory front**, the most recent evidence provided by the EBA Supervisory Convergence Reports[6] showed that most EU competent authorities establish processes that – while considering the specificities of local markets – are broadly in line with the guidance established at the EU level. However, the Reports also showed that a number of challenges remain, primarily in the areas of methodologies for the capital adequacy assessments and in the determination of institution-specific additional own funds requirements. The majority of respondents to the questionnaire identified the existence of divergent policies and practices relating to quantitative and qualitative supervisory requirements as very relevant factors hampering cross-border consolidation. Specifically, they also highlighted that increased transparency in the definition and communication of Pillar 2 requirements would positively extend to cross-border banking consolidation planning. In this respect, it is worth noting that cross-border consolidation may also be held back due to the regulatory treatment of the

[6] The EBA supervisory convergence reports can be found at https://eba.europa.eu/supervisory-convergence

mergers and the persistence of national protectionist approaches. In particular, the absence of a harmonised and predictable assessment regime of mergers, including the criteria to determine the capital requirements both in the steady state and in the transitional phase, may act to discourage cross-border M&A deals. Respondents to the questionnaire on the potential obstacles to M&A highlighted that there is a lack of clarity, transparency and comprehensiveness about the criteria to set Pillar 2 requirements to the new entity resulting from the merger. Respondents also pointed to the interaction between the national and EU frameworks, lending support to the argument for the importance of having a single EU merger assessment regime. Furthermore, they indicated that political influence still plays an (obstructive) role in cross-border consolidation.

Finally, **institutional factors** may play a key role in holding back cross-border consolidation in the EU. The fact that not even the Banking Union, within the EU, appears to be reaping the benefits of banking integration is to be explained, according to many commentators, by the lack of an accomplished institutional framework for risk-sharing in deposit insurance and the financing of resolution. These missing elements would contribute to explaining host authorities' tendency to defend local ring-fencing prerogatives, which in turn discourage cross-border banking. Respondents assessed both missing elements of the Banking Union as relevant for the purposes of carrying out cross-border banking, although neither of the two elements was flagged as very relevant.

4 Regulatory and institutional factors

4.1 Options and national discretions

The development of a Single Rulebook (i.e. a set of truly unified and directly applicable rules for all the banks operating in the EU) has represented a significant part of the major overhaul of the EU financial regulatory framework after the 2007-2009 crisis. The de Larosière report (European Commission, 2009) saw the development of a Single Rulebook as a key cornerstone for achieving a functioning single market for banking and financial services in the EU, on the assumption that a set of common rules is an indispensable element for considering the EU as a single jurisdiction.

While the Single Rulebook aims for maximum harmonisation, it also contains a relatively ample margin of flexibility, allowing for ONDs[7], largely to help banks and supervisors in the transition from a fragmented to a single regulatory space, and to reflect the need for a more proportional approach among a wide range of institutions[8]. Some ONDs are permanent, while others are going to be phased out, to allow for a gradual implementation of the new rules. Some ONDs address the *level* of capital requirements, while others refer to the *quality* of capital.

Since the establishment of the Banking Union and the setting up of the SSM, the case for maintaining those ONDs conferred by the legislature upon the national competent authorities seemed unjustified in the euro area, given the presence of a single supervisor. For this reason, the ECB-SSM deemed it indispensable to harmonise the ONDs within its remit and adopted an ECB Guide and Regulation in March 2016 (ECB, 2016a and ECB, 2016b)[9]. In its capacity as single supervisor, the ECB's ultimate goal was to remove ONDs' fragmentation effects to ensure all significant institutions are treated the same under its direct jurisdiction. This is a remarkable step forward for the banks under the ECB's direct jurisdiction. In respect of the whole EU regulatory space, however, fragmentation effects of the different applications of ONDs are still in place in respect of non-Banking Union Member States.

Regulatory fragmentation adversely affects not only the level playing field (see ECB, 2016c) but also the overall prudence of the framework and the comparability of capital ratios; it can also increase compliance costs. Recent research by Maddaloni and Scopelliti (2019) shows that "banks established

[7] 'Option' refers to a situation in which competent authorities or Member States are given a choice on how to comply with a given provision, while 'national discretion' refers to a situation in which competent authorities or Member States are given a choice whether or not to apply a given provision (ECB, 2016c).

[8] The CRD and the CRR combined include roughly 80 ONDs left to Member States or competent authorities; this number increases to more than 150 when the options and discretions that are applied by competent authorities on a case-by-case basis are also considered.

[9] ECB Regulation 2016/445 of 14 March 2016 is binding and addresses all horizontal ONDs applicable to significant institutions, while the ECB guide on options and discretions available in Union law, is addressed to significant institutions and sets out the ECB approach for the assessment of individual requests relating to the application of options and discretions provided in EU law.

in EU countries with less stringent prudential regulation (for either regulatory flexibility or supervisory discretion[10]) were more likely to require public support during the global financial crisis", suggesting that differences in the national implementation of regulatory standards could lead to excessive risk-taking by banks and result in negative spillovers on public finances. In both cases, in our opinion, this could lead to a less fertile ground for cross-border banking. Furthermore, as argued by Kudrna and Puntscher-Riekmann (2017), the fragmented application of the ONDs regime can impair the comparability of the key indicators of banking stability, in particular of capital ratios, because the quantity and quality of capital can differ across Member States, making it difficult to gauge the real capital strength of the banks, thus undermining the transparency in the outcome of supervisory actions. Finally, it is noted that, while the rationale for a different application of EU rules was also to avoid excessive burden for small local banks, a high number of ONDs adds a layer of complexity and costs, especially for firms operating across borders. In turn, this may lead to suboptimal allocation of resources and regulatory arbitrage[11].

All this points to the fact that achieving a balance between the needs of proportionality and flexibility for smaller institutions and the need to ensure a true level playing field is not easy or immediate. However, we agree that the instrument of a different application at the national level can hardly be seen as the most appropriate solution; rather, 'a thorough application of the principle of proportionality *within* the Single Rulebook' would be more efficient[12]. Otherwise, the contradiction of an EU regulatory space that remains uniform on paper while being subject to several 'localisms' will remain unresolved, ultimately affecting the achievement of a true single market.

4.2 Capital and liquidity regulation of cross-border groups

With due exceptions, Basel standards are traditionally implemented in the EU on all levels of prudential consolidation (i.e. individual, subconsolidated and consolidated levels).

The various levels of application of the requirements are considered complementary and not mutually exclusive, in that they allow for a more comprehensive and accurate supervision of risks. The application of the requirements at the individual level is consistent with the fact that liabilities have to be repaid by legal entities; it allows supervisors to focus on the risks created by individual entities, to identify threats to the wider group's stability and to ensure that own funds are appropriately distributed according to the distribution of risk. However, applying requirements at the consolidated (and subconsolidated) level allows supervisors to identify the overall risk generated by a banking group (subgroup), to monitor the contribution of each individual entity to that risk and to take a supervisory perspective, which may be more consistent with the way banking groups are managed, especially

[10] In Maddaloni and Scopelliti (2019), regulatory flexibility is defined as the possibility for national authorities to establish more favourable treatment for certain items, and supervisory discretion refers to the power of national authorities to authorise – on a case-by-case basis – more favourable treatment for specific credit institutions.

[11] See also ECB (2017d) and Kudrna and Puntscher-Riekmann (2017).

[12] See Farkas (2017) and Enria (2015).

where the capital, liquidity and risk are centrally managed and where the different groups' business lines do not correspond to legal entity structures.

In the context of this general principle, the EU implementation of the Basel framework acknowledges that, under specific circumstances, applying own funds and liquidity requirements at the individual level within banking groups may not be necessary, allowing for case-by-case exemptions (i.e. capital and liquidity waivers). Capital waivers are, however, made available only for individual group entities that are located in the same Member State as their parent company and, therefore, are not accessible on a cross-border basis. In the case of liquidity, provided that all the competent authorities involved agree that a set of conditions are verified, several group entities authorised in different Member States can be supervised as a single liquidity subgroup (within the broader group).

With the aim of limiting interconnectedness within groups and the extent to which group entities can be exposed to each other, the large exposure regime, which establishes limits to the exposures an entity can take vis-à-vis a given counterparty, is also generally applied to intra-group exposures, unless ad hoc exemptions are granted.

Requiring a banking group to place capital and liquidity resources under local supervision may affect the efficiency of the group-wide management of resources and have an impact on the group's cost of capital or funding. Furthermore, local requirements may also constrain the capability of the group to support one or more group entities in the event of idiosyncratic shocks through the redirection of capital or liquidity resources from more solid group entities. The intra-group implementation of the large exposures regime may also, to some extent, prevent the redeployment of large amounts of resources across entities of the same group. To the extent that they affect the efficiency and hence the costs of carrying out banking business via multiple subsidiaries, these regulatory factors may discourage consolidation strategies, on both a domestic and a cross-border basis.

From a cross-border perspective, the impact of these regulatory factors may be amplified by the fact that different authorities are in charge of exercising regulation and supervision in different Member States and consensus is needed. For pan-European groups, the fragmented implementation of such measures across jurisdictions adds to the previously mentioned frictions. From a cross-border perspective, these measures may also be used by host authorities with ring-fencing purposes vis-à-vis foreign-owned subsidiary, as the financial crisis has in some cases shown, and may more broadly affect the competitive position of banking groups in host markets.

While we cannot precisely quantify the amount of capital and liquidity resources potentially at stake in relation to the implementation of CRR/CRD requirements on an individual basis, recent estimates by the ECB (2018) show that the value of high-quality liquid assets held by non-domestic subsidiaries of globally systemically important institution (G-SII) banking groups in the Euro area in order to comply with the 100% liquidity coverage ratio (LCR) requirement amounted to approximately EUR 130 billion over the period Q3 2016-Q4 2017.

For these reasons, the existing regulation on the implementation of capital and liquidity requirements at the individual entity level and the intra-group implementation of the large exposures regime rank

high in the debate on the potential obstacles to consolidation and, in particular, cross-border consolidation.

4.2.1 Derogations on the application of prudential requirements on an individual basis: capital and liquidity waivers

CRR2 acknowledges that, under specific circumstances, the application of own funds and liquidity requirements on an individual basis may not be necessary, allowing supervisors to grant specific capital and liquidity waivers. In particular:

- waivers from individual-level solvency requirements (own funds, the calculation of risk-weighted assets, large exposures, qualifying holdings, securitisation, disclosure and leverage) are provided for in Articles 7 and 9 of CRR2 and in Article 10 of CRR2 for groups composed of a central body with affiliated credit institutions;

- waivers from individual-level liquidity requirements are provided for in Article 8 of CRR2 for a parent company and its subsidiaries, as well as for institutions belonging to the same institutional protection scheme.

An institution can be waived from solvency requirements at an individual level (Article 7) where, among other conditions, the institution and its parent company are under the same scope of consolidated supervision, no impediments are identified to the free movement of resources from the institution's parent company to the institution itself, and the parent company appropriately measures and monitors the risks stemming from the business of the subsidiary. Under these circumstances, it is considered that risk can appropriately be dealt with by requirements at the consolidated level. However, an additional, crucial, condition for the waiver to be granted is that the parent company and the subsidiary must be authorised and supervised by the same Member State, which excludes the possibility of exempting foreign subsidiaries of cross-border banking groups from individual-level solvency requirements.

Exemptions from the application of solvency requirements on an individual basis can also be granted to institutions permanently affiliated to a central body (Article 10); in the EU, these structures are typical of cooperative banking groups. In this case, the legislature made the granting of waivers conditional on a stronger type of support from the central body to each affiliate institution, requiring not only that affiliates and the central body fall under the same consolidation and that the central body has sufficient managerial control of the affiliates, but also that either the central body and the affiliates have joint liabilities or the central body guarantees the affiliates' commitments.

The exemption from the application of the liquidity requirements on an individual basis (Article 8 of CRR2) allows the identification of liquidity subgroups. A parent company and one or more of its subsidiaries can be waived from liquidity requirements at the individual level if, among other conditions, liquidity risk is adequately measured and monitored at the group or subgroup level, if contracts are in place ensuring the free flow of funds among the members of the liquidity subgroup and if no material practical or legal impediments exist to the fulfilment of such contracts. Where the

institutions that identify a liquidity subgroup are authorised in several Member States, and hence the waiver extends on a cross-border basis, all relevant competent authorities must agree on a set of conditions, including minimum amounts to be held by each waived entity and an unrestricted sharing of complete information.

The results of the questionnaire highlight the importance of cross-border waivers as a tool for more efficient management of capital and liquidity (Table 1). The majority of respondents confirmed that the lack of cross-border waivers for capital has very relevant implications for the efficiency with which capital can be allocated and transferred across the group. The vast majority of the respondents also identified the waivers to be either relevant or very relevant for a list of aspects of the group's activity, including (1) the structure of the banking group, (2) the mismatch between assets and liabilities in the group, (3) the cost of capital, (4) the group's overall profitability, (5) the group's business model and strategy and (6) the group's capability to support distressed entities.

Similarly, the waivers to the individual application of liquidity requirements were assessed to have very relevant implications for the group's ability to transfer and allocate liquidity and funding, as well as for the cost of funding for the group. The majority of respondents also highlighted that the waivers have relevant implications for the group's profitability, business model and strategy, the mismatch between assets and liabilities, and the group's capability to support a distressed group entity.

Table 1: Waivers granted under Articles 7, 8, 9 and 10 of the CRR (as of 2017)

Waivers		Number of competent authorities using the waiver	Number of waivers granted
Article 7	Waivers for subsidiaries	5	367
	Waivers for parent institutions		167
Article 8	Waivers where all institutions are authorised in the same Member State	9	381
	Waivers where all institutions are authorised in several Member States		17
	Waivers where all institutions are members of the same institutional protection scheme		21
Article 9	Waivers for parent institutions	5	240
Article 10	Waivers for affiliated credit institutions	5	327
	Waivers for central bodies		5

In November 2016, in the context of its proposal to revise the CRR, the Commission proposed that the waiver set out under Article 7 could be extended to the case of cross-border banking groups and that the conditions under which cross-border liquidity waivers could be granted should be made more objective. In particular, the Commission proposal extended the capital waivers to those cases where

the institution benefiting from the waiver and its parent company are not located in the same Member State. In turn, this proposal strengthened the conditionality attached to the cross-border case, by requiring that the parent company guarantee the subsidiary's liabilities under specific conditions and for an amount equal to the amount of the waived capital requirements. Similarly, in the area of liquidity, it was proposed that the conditionality applying to the cross-border cases be strengthened by requiring that, on a consolidated basis or on a subconsolidated basis, the subsidiaries of a group located in different Member States from their parent company in the liquidity subgroup benefit from guarantees on their liquidity outflows.

The Commission's proposal acknowledged that, given the progress made since the CRR first came into force, with particular regard to the establishment of a well-functioning Single Rulebook and of the Banking Union, pan-European banking groups should be put in a position to carry out group-wide capital and liquidity management policies in the EU by allowing conditional waivers to individual requirements on a cross-border basis. The proposal was, however, abandoned during negotiations with the European Parliament and the Council, leading to unchanged requirements on the granting of capital and liquidity waivers. Despite the progress made in terms of regulatory, supervisory and institutional repair in the EU, the negotiation saw the concerns of host Member States and national authorities prevail, and the proposal from the Commission was eventually not included in the adopted banking package. In all likelihood, concerns related to the potential fiscal national costs of supporting financially troubled foreign-owned subsidiaries in the absence of local capital and liquidity requirements played a key role.

Going forward, the EU should reconsider and do further work on regulatory reform proposals aimed at addressing the supervisory concerns behind host authorities' tendency to control capital and liquidity locally. However, the debate on waivers to individual capital and liquidity requirements could be taken forward within the boundaries of the current regulatory framework by further enhancing supervisory cooperation among home and host authorities and carrying out additional work on the features and use of the existing IGFSA framework (see section 4.6), as this is one of the few tools for mitigating the need for regulatory ring-fencing that are already available. Within the Banking Union, the completion of the institutional risk-sharing framework should be pursued to dispel host supervisors' concerns on the costs of financial distress arising with local foreign subsidiaries.

4.3 Treatment of intra-group exposures under the large exposures regime

The CRR specifies rules aiming to limit the maximum loss a bank could face in the event of a sudden counterparty failure to a level that does not endanger the bank's solvency. According to these rules, the sum of all exposure values (i.e. all on- and off-balance-sheet exposures in both banking and trading

books and instruments with counterparty credit risk) of the bank to a single counterparty or to a group of connected counterparties must not exceed 25% of the bank's capital[13] at all times.

As exceptions to these rules, some categories of banks' exposures are automatically exempted from any large exposure limit or may be fully or partially exempted at the discretion of the banking supervisory authorities.

Intra-group exposures are one of the categories that can be exempted. This category encompasses all types of intra-group exposures, including participations or other kinds of holdings, incurred by a bank to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as all those undertakings are covered by the same supervision on a consolidated basis. All group entities may be covered by this exemption, wherever they are located.

As a matter of fact, the application of a large exposure limit to intra-group exposures may prevent the ability of banking groups to support their entities in stress situations, whereas the exemption is considered consistent with the EU rules under the BRRD, especially with the ones allowing group entities to enter into agreements to provide financial support to any other party to the agreement meeting the conditions for early intervention.

Such limits may also result in treating intra-group exposures more severely than exposures to third parties despite the higher level of information on those exposures that is available to supervisors and the more in-depth supervisory risk assessment of those exposures.

Therefore, exempting intra-group exposures from any large exposure limit allows banking groups to optimise the allocation of liquidity within the group and enables more capital to circulate freely between group entities.

Such an exemption seems to be particularly appropriate for group entities that mostly depend on their parents for funding, and for those having no or limited access to central bank liquidity or operating in jurisdictions with less developed funding markets. The exemption also contributes to decreasing funding costs where group entities can get access to low-cost funding from their parents.

This notwithstanding, applying large exposure limits at the intra-group level may be perceived as an effective prudential tool for mitigating the risk of contagion, especially in a cross-border context, as well as a way to acknowledge the existence of potential impediments to transfer of capital between group entities. However, it could be argued that large exposure limits would not be the only way to deal with risks arising from intra-group exposures. Supervision on a consolidated basis already allows supervisors to deepen their understanding of complex, risky intra-group transactions involving two or more group entities, going beyond checking compliance with the large exposure rules through a better

[13] The capital base used for determining the limit is composed of the bank's Common Equity Tier 1 capital and its additional Tier 1 capital and Tier 2 capital (in the limit of a quarter of the capital base).

assessment of the threats that those intragroup transactions might pose to each group entity within the banking group.

Even though a vast majority of banking supervisory authorities across the EU already exercise their discretion for exempting intra-group exposures from the large exposure limit, exemptions are not granted to all banks. They are based on individual ad hoc decisions, resulting in varying approaches between supervisory authorities. The supervisory discretion is coupled with a national option allowing Member States to exempt intra-group exposures for a transitional period ending on 31 December 2028, which increases the risk of fragmentation across the EU. It is for this reason that the fragmented approach to granting this exemption is discussed among the potential impediments to the cross-border bank consolidation process in the EU.

The majority of respondents to the questionnaire highlighted that the application of the large exposures regime on intra-group transactions has very relevant implications for the group's liquidity and funding management, as well as on the efficiency with which liquidity is allocated across group entities. The majority of respondents also flagged relevant implications of the large exposures regime on the group's structure, the mismatch between assets and liabilities within the group and the group's profitability.

Where they are exempted from applying the large exposures regime on intra-group exposures, banks may be encouraged to operate through branches rather than subsidiaries; the exchange of liquidity and capital between the head offices of branches' banks does not give rise to exposures, as branches do not represent a separate legal entity with respect to their head office. In general, the application of a large exposure limit may affect certain banking groups' business models, such as those built on centralised organisations, as it may have an impact on centralised treasury functions by making cash management less effective and reducing the possibility of economies of scale to cut costs.

To sum up, while the current regime already allows some exemptions in the application of limits to large exposures, we believe that the evidence collected shows that further work should be pursued in order to:

- streamline and simplify the governance of the large exposures framework in a cross-border context, particularly in relation to the number and type of authorities involved;
- achieve a regulatory outcome whereby exemption from the application of the large exposures regime on intra-group exposures is the norm, with authorities empowered to impose the application of this regime only in specific cases and under specific circumstances.

4.4 The macroprudential framework: related trade-offs

To ensure that the objectives of a sound macroprudential framework[14] are met, a very wide array of instruments has been introduced in the EU, whose governance involves a large set of diverse national authorities coordinated by the European Systemic Risk Board (ESRB). First, under the CRD, the macroprudential framework includes the following instruments: i) a countercyclical capital buffer, ii) a G-SIIs buffer, iii) an other systemically important institutions (O-SIIs) buffer, iv) a systemic risk buffer and ; v) macroprudential use of Pillar 2. Second, under the CRR, there is some flexibility at the national level in the application of stricter requirements on: i) own funds, ii) large exposures, iii) disclosure, iv) the capital conservation buffer, v) liquidity, vi) risk weights on exposures secured by real estate and vii) requirements on intra-financial sector exposures. Outside the CRD/CRR framework, Member States can impose additional macroprudential measures including borrowing limits (loan-to-value, loan-to-income and debt service-to-income caps) or liquidity measures.

In the context of cross-border banking and financial integration, the use of macroprudential instruments ensures a limited cross-border transmission of financial shocks and the stability of cross-border lending flows in times of stress. In this respect, the work done by Takáts and Temesvary (2019) finds that macroprudential measures implemented in borrowers' host countries prior to the taper tantrum (i.e. the 2013 surge in US Treasury yields) significantly mitigated the impact of the tantrum itself. However, specific aspects of the macroprudential framework may represent obstacles to cross-border banking via establishment, and hence may indirectly contribute to holding back cross-border consolidation.

As described by the EBA (2015), the EU macroprudential framework consists of a multiplicity of instruments whereby the same type of risk can be addressed with very different measures. This is notably the case for risk stemming from the real estate sector, where the related capital charges can be increased through either higher risk weights (Article 124 of the CRR for banks applying the standardised approach or Article 458 of the CRR for any banks) or higher loss given default (LGD) floors for internal ratings-based (IRB) banks estimating own LGD parameters (Article 164 of the CRR). In the latter case, some jurisdictions also used Pillar 2 requirements. In the context of cross-border banking, the use of a multiplicity of instruments may affect the efficiency of the calculation of capital requirements within a group, particularly where internal models are used. More broadly, the efficiency of product pricing, capital planning, dividend distribution and liquidity management may be affected by the complexity of the macroprudential framework.

The framework is also characterised by rather complex cross-border governance. First, different measures refer to different authorities; for instance, Articles 124 and 164 of the CRR refer to competent authorities, whereas Article 458 refers to designated authorities. Second, provisions on

[14] The macroprudential framework introduced in January 2014 (see ESRB, 2014) addresses the primary objective of preventing and mitigating systemic risks to financial stability. It does so by ensuring a list of intermediate objectives, which are the prevention of i) excessive credit growth and leverage, ii) excessive maturity mismatch and market illiquidity, iii) excessive concentration of exposures, iv) misaligned incentives and moral hazard

coordination/communication among authorities to ensure that micro- and macroprudential objectives are appropriately dealt with are very limited, which is of even more relevance in the context of groups operating across jurisdictions. Third, reciprocation[15] of macroprudential measures is only partially defined, in that, for instance, it is prescribed for Articles 124 and 164 of the CRR but not for Article 458. Complexity in the reciprocation decisions affects banking groups that operate across different jurisdictions. Given its cross-border governance, the macroprudential framework may affect the competitive position of banking groups within host jurisdictions, which may in turn affect decisions about group structures (i.e. the decision to operate through a branch-based structure rather than a subsidiary-based structure).

Such complexity does not appear to be solved even when looking at the Banking Union level, as the provisions on macroprudential capital buffers do not consider the Banking Union a single jurisdiction for banking. The extent of cross-border banking activity, which is one of the factors determining the systemic importance of institutions for the calibration of macroprudential buffers, is measured considering the various countries in the scope of the Banking Union as different jurisdictions. Given this, banking groups consolidating within the Banking Union face potentially increasing macroprudential buffer requirements.

Most importantly, also due to unclear boundaries between micro- and macroprudential objectives, the macroprudential toolkit may be used for ring-fencing purposes. Rather than responding to macroprudential concerns, locally enhanced own funds, liquidity or large exposure requirements that are formally under the umbrella of the macroprudential framework may actually address authorities' concerns on foreign institutions hosted within their jurisdiction. In this vein, macroprudential tools may be used to increase the amount of capital and liquidity that is 'trapped' at the level of individual institutions. Like any other measure aimed at ring-fencing capital and liquidity on individual entities of a group, macroprudential measures used with these objectives may undermine the efficient functioning of cross-border banking groups that operate in accordance with centrally managed capital and liquidity policies and, in this sense, may hold back cross-border consolidation.

While concerns about the increased level of capital required by banks in the post-crisis repair are quite familiar in the discussions with supervisors and regulators, the evidence collected in the questionnaire highlights that a majority of banks consider capital buffers a very relevant factor for their cost-benefit analysis of cross-border banking via establishment. The majority of respondents also highlighted the importance of the real estate-related provisions of the standardised approach for credit risk (Article 124 of the CRR) and the LGD input floors (Article 164 of the CRR).

The majority of respondents flagged the management of capital and liquidity resources, as well as capital planning and distribution policies, as very relevant dimensions affected by the complexity of the macroprudential framework, as well as the modelling of capital requirements and product pricing.

[15] Reciprocation is the recognition by a given Member State of a measure taken by another Member State.

Most respondents to the questionnaire did not formulate a specific view on the importance of the specific aspect of reciprocation of the macroprudential measures, although a majority of them highlighted that enhancing the harmonisation and centralisation of the governance in macroprudential matters would facilitate cross-border banking via establishment.

Over the past few years, progress has been made in improving the EU macroprudential framework. In particular, the adoption of the CRR2/CRD5 package addresses some of the drawbacks referred to in this paper, in that: i) it clarifies that Pillar 2 should not be used for macroprudential purposes, ii) it emphasises the role of the ESRB in streamlining coordination and enhancing information-sharing among authorities on macroprudential matters as well as in monitoring the potential overlap of policies' objectives; iii) it provides an additional methodology to calibrate the G-SII buffer, which considers intra-Banking Union exposures domestic exposures and iv) it introduces a systemic risk buffer that is able to address sectoral imbalances.

Notwithstanding this progress, and considered that the functioning of cross-border banking under the CRR2/CRD5 novelties remains to be assessed, there seems to be room for further improvements to fully reap the benefits of an efficient macroprudential framework (see also EBA, 2015). In particular, it will be key to:

- further enhance and standardise communication, notification and transparency on the features and rationale of proposed macroprudential measures: greater transparency will make authorities more accountable for the possible overlap between macro- and micro-prudential policy objectives and, most importantly, for the use of the macroprudential framework for mere ring-fencing purposes;

- further streamline/simplify the arrays of instruments affecting risk weights, particularly for risks stemming from the real estate sector, in the light of i) the progress made in bottom-up regulatory repair in the use of internal models and harmonising their supervision, ii) the forthcoming implementation of the aggregate output floor as an additional backstop measure and ; iii) the introduction of the sectoral systemic risk buffer, allowing, among others, real estate-related risks to be addressed;

- further centralise the governance of macroprudential policymaking at the EU level, beyond information-sharing and coordination, by potentially entrusting the ESRB with powers to issue legally binding instruments, beyond the comply-or-explain mechanism that currently underpins its warnings and recommendations.

4.5 Intra-group financial support agreements

As shown by the crisis, financial integration cannot simply be based on mutual trust. Where it is not accompanied by common and effective rules and institutions, financial integration can turn into sudden reversal events, retrenchment and ring-fencing behaviour by both banks and authorities. Home authorities may favour the withdrawal of resources from foreign markets, so as to protect

domestic stakeholders, while host authorities feel compelled to maintain maximum local control of liquidity and capital resources, so as to protect local fiscal resources and stakeholders in their jurisdiction.

The BRRD regime of the IGFSAs is an example of the EU's legislative approach to fixing ex ante potential home-host tensions of this type, by ensuring predictability of the flow of resources at different levels of a cross-border group in the event of financial distress. The IGFSA framework offers a recovery measure to upstream, downstream or sidestream losses, depending on which entity in a banking group is under stress, and may take the form of a loan, a guarantee or other collateral. IGFSAs provide a regulatory and institutional basis for intra-EU supervisory cooperation in order to avoid non-cooperative 'prisoner's dilemma' type games, where optimal strategies at the individual level yield suboptimal results at the group level[16]. IGFSAs should, in particular, pre-emptively reassure host Member States and supervisors that support will be provided to the foreign subsidiaries in their jurisdiction in the event of financial distress. This should, in turn, discourage local ring-fencing practices and therefore overcome potential obstacles to the optimal allocation of liquidity and capital within cross-border groups. To achieve this objective, the BRRD requires Member States to remove any legal impediment in national law to the effectiveness of intra-group financial support transactions.

Against this background, one needs to determine whether the IGFSAs legislative framework achieves its objectives and whether banks avail themselves of this instrument as a tool to avoid funds remaining trapped in one or more entities as a safety cushion in the event of a potential distress situation. Based on the findings of the EBA Report on recovery plan options[17] and on the anecdotal evidence collected in the context of the questionnaire, no bank included in the two samples reported that it used the IGFSA. As illustrated here below, however, this should be understood not as a sign of irrelevance of the IGFSAs' pursued objective, but rather as showing the potential inadequacy of the existing framework, arguably because of its excessive rigidity. Admittedly, according to the EBA Report on recovery options, some respondents reported that they have implemented other types of support agreements (i.e. not in line with the IGFSA requirements) between the parent and the subsidiaries. However, in most cases, the parent bank preferred to indicate – among the options available in the recovery plan – that it was willing to provide adequate assistance to any of the subsidiaries if the latter suffered from financial distress.

The findings of the questionnaire confirm the previous results. A large majority of banks reported that they have not set up IGFSAs, which are considered to be a constraint in going-concern, due to the complexity of the approval process (notably authorisation from both the home and the host

[16] One of the most recent well-known examples of coordination to avoid such non-cooperative actions is the Vienna Initiative programme, which was launched by the Austrian government and a number of EU multinational banks in the aftermath of the 2007-2008 crisis. Financial support to banks in Eastern Europe came from the EBRD, the European Investment Bank and the World Bank, while banks committed to maintaining exposures and to continuing to provide credit to local economies. Importantly, parent banks confirmed that they would keep subsidiaries adequately capitalised and provide them with sufficient liquidity. See De Haas et al. (2015) for a comprehensive review of the Vienna Initiative support package and its effect on credit supply.

[17] See EBA (2017).

competent authorities, approval by a bank's general shareholders meeting and supervisory verification of a number of conditions). Moreover, some banks reported that the need to comply with the conditions set out in Articles 23-25 of the BRRD (i.e. details for the calculation of the intra-group financial support amount, assessment criteria used by the competent authorities to allow an affiliated entity to provide intra-group financial support to another group entity, etc.) can place some restrictions on the employment of such arrangements. This might also lead to 'trapping' the funds ex ante in the host jurisdiction by requiring targeted support of a specific entity, thus preventing a more flexible use of funding, which is actually required in the context of a fast-developing crisis.

Therefore, while the EU legislature envisaged the IGFSAs as the most appropriate tool to address ring-fencing and pre-positioning of capital and funding, there is indeed evidence pointing to the fact that banks do not consider IGFSAs a suitable tool, precisely in the light of their current excessively rigid legislative design. It should be noted that the 'quasi-IGFSAs' set up by banks in the form of master agreements governing potential future financial commitments (guarantees and letters of comfort) intend to fulfil the same objective pursued by BRRD-compliant intra-group agreement. However, in as much as non-compliant, they do not provide the required degree of comfort that ring-fencing practices will not be implemented in case of financial distress. Given that they are not in line with the requirements of the BRRD, they may be challenged by the relevant supervisor or even by other entities of the group, in case more than one subsidiary enters into financial distress. Moreover, on the same grounds, they cannot be used to claim any liquidity waiver on an individual basis, nor can they fulfil the criteria for special treatment under the LCR. Therefore, while they are favoured by banking groups (as they achieve a more efficient use of resources within the group than the BRRD set-up), they cannot be considered adequate substitutes.

In summary, banks consider that the BRRD complexities and burdensome requirements, as well as concern about breaching other provisions (e.g. large exposures and liquidity), are impediments to setting up IGFSAs. They tend to substitute them with other forms of guarantees and support that are meant to achieve similar effects. However, these privately arranged measures might not achieve the same degree of legal protection granted by BRRD-compliant IGFSAs, especially during times of financial distress.

The IGFSA framework represents one of the most important existing legal/regulatory devices to govern home and host authorities' diverging interests and prerogatives in cases of financial distress. A well-functioning IGFSA framework, as a recovery tool, can, in principle, mitigate authorities' reluctance to introduce cross-border capital waivers and increase the use of existing cross-border liquidity waivers in a going-concern environment, thus counteracting the inefficiency of ring-fencing outcomes in cross-border banking. For this reason, we believe that all EU authorities involved should engage in further work on IGFSAs by, inter alia: i) taking stock of existing non-BRRD-compliant IGFSA practices in the market, ii) reviewing the effectiveness of the current conditionality behind the BRRD-compliant IGFSA framework and ; iii) reviewing regulatory incentives to put in place BRRD-compliant IGFSAs.

4.6 Resolution: internal minimum requirements for own funds and eligible liabilities

The distribution of resolution requirements within a cross-border group mirrors the territorially fragmented approach applicable to capital requirements and it is evidence of the persistent tension between home and host authorities. Pre-positioning of the resources available in resolution, similarly to that of own funds, potentially hinders cross-border groups' centralised management of funding, and may be considered a contributing factor in discouraging cross-border bank consolidation.

To ensure the internalisation of losses and the recapitalisation of the ailing bank without recourse to public financial resources, the resolution regime requires that financial institutions build up a minimum requirement of eligible liabilities and own funds to be written down and/or converted by the resolution authority when the bank reaches the point of non-viability (PONV) or enters into resolution. Such a loss-absorption and recapitalisation amount is issued to external investors by the group entity, which is the point of entry of the resolution group, and pre-positioned to each (material) subsidiary within that group in order to be written down at the PONV. The allocation of internal loss-absorption and recapitalisation amounts to (material) subsidiaries within the group supports the upstreaming of losses from the subsidiary to the parent and the downstreaming of capital from the parent to the subsidiary, which are key to the effective implementation of both resolution strategies[18].

The requirement for banks to build up a minimum loss-absorption and recapitalisation amount has first been developed for G-SIIs by the Financial Stability Board (FSB) and enshrined in the TLAC term sheet (FSB, 2015). This approach was also reflected in the BRRD, imposing a MREL to be maintained at all times by the financial institution. The 2015 FSB TLAC term sheet also envisaged the concept of 'internal TLAC' and its pre-positioning to material subsidiaries of the resolution group in accordance with a scale between 75% and 90% of the externally issued TLAC by the point-of-entry entity. The allocation of internal TLAC to (material) subsidiaries within the group supports the upstreaming of losses from the subsidiary to the parent and the downstreaming of capital from the parent to the subsidiary, which are key to the effective implementation of resolution strategies.

In implementing the TLAC term sheet into EU law, the BRRD2 provisions have also impacted aspects of the MREL regime, including the introduction of the concept of internal MREL.

The BRRD2 approach to internal MREL for intra-EU subsidiaries envisages the application of the same calibration set out for the determination of the external MREL and does not provide for any scaling range, ending up with 100% scaling and no room for circulation of resources within the resolution group. As regards the implementation of the TLAC term sheet on the allocation of internal TLAC by non-EU G-SIIs to EU material subsidiaries, CRR2 opts for a rigid scaling, equal to 90% of the externally issued TLAC. Moreover, the requirement that the amount of external MREL is equal to the sum of the amounts of the internal MREL, originally put forward in the Commission Proposal for the BRRD review,

[18] See also Gardella (2020).

is no longer included in the final version of BRRD2, with the risk of mismatches between the external – determined at the consolidated level – and the internal amounts. Finally, unlike the EU implementation of the TLAC regime, the internal MREL discipline does not distinguish between 'material' and 'non-material' subsidiaries, in principle requiring that internal MREL be pre-positioned in each subsidiary (which is not destined for insolvency). Even though mitigating interpretations are being worked out by resolution authorities to avoid imposing internal MREL in each subsidiary, divergent approaches and market fragmentation are possible.

Special waivers to the pre-positioning of internal MREL are provided for intra-state situations only, similar to the framework for capital waivers. Notably, a full waiver may be granted by the resolution authority when a) the resolution entity and the non-resolution entity are located in the same Member State and are part of the same resolution group, b) the resolution entity complies with the MREL requirement on a consolidated basis; c) there is no impediment to the transferability of funds or to the repayment of liabilities to the waived subsidiary and d) the resolution authority is satisfied with the prudent management of the subsidiary and other conditions set out in Article 45(f)(3) BRRD2. A partial waiver, allowing the liabilities to be substituted with collateralised guarantees, may be granted by the resolution authority when the subsidiary that is not a resolution entity and its parent undertaking are located in the same Member State and the parent undertaking complies with the external MREL at the consolidated level (Article 45f(5)). Such guarantees have to satisfy the conditions set out in that provision, including that they can be triggered when the subsidiary is unable to pay its debts or upon reaching the PONV.

The internalisation of losses is an essential pillar of the new resolution framework, and pre-positioning sufficient internal TLAC/MREL at the level of material subsidiaries aims to ensure that the banking group could resolve a failed subsidiary. Arguably, however, pre-positioning also amounts to immobilising resources that could be more efficiently used were the institution able to move the required amount internally within the group if needed. The overall regime on internal MREL laid down in BRRD2 signals that progress is needed to overcome national concerns in the event of an actual crisis. The outcome of the negotiations illustrated earlier arguably lags behind the internal TLAC term sheet and the Commission Proposal of the review of BRRD2, which envisaged a more ambitious project towards the establishment of the EU as a single jurisdiction. Admittedly, the balancing exercise, between host authorities' comfort against potential adverse fiscal impacts of bank failures and a smooth and cooperative set-up allowing for the transfer of capital and liquidity within the banking group, favours ex ante controlled ring-fencing to a significant extent.

This territorial approach also applies to banking groups established in the Banking Union that are subject to the single supervision of the ECB and to the resolution jurisdiction of the Single Resolution Board (SRB). Understandably, collective action problems experienced in the course of the recent financial crisis suggest that host Member States should maintain a cautious approach. As a lesson learned from the crisis, however, the EU framework has significantly strengthened and institutionalised cross-border cooperation between authorities with the set-up of the SRB for the Banking Union and the procedural arrangements for the resolution colleges.

New impetus to a reassessment of the balance between home and host authorities, including TLAC/MREL pre-positioning, comes from both the EU – in particular in the context of the creation of the Banking Union[19]– and the FSB, where a debate on pre-positioning, flexibility and market fragmentation has recently been launched (see Quarles, 2019). The implementation of the intense cooperation and institutionalised exchange of information within the Banking Union and – at the wider EU level – within resolution colleges should provide increased reassurance to host authorities of the appropriateness of a more flexible approach and lower pre-positioning requirements. Building- on the progress made so far in the implementation of the EU crisis management cooperation framework, additional consideration should be given at the political level to further strengthening the institutional set-up in order to reinforce mutual trust and provide a more balanced allocation of resources within cross-border banking groups.

[19] Report of the High Level Working Group Chair of June 2019, available at: https://www.consilium.europa.eu/media/39768/190606-hlwg-chair-report.pdf

5 Supervisory factors

Rules are, by nature, non-exhaustive. Banking supervision requires some room for judgement and case-by-case assessment, and a certain degree of flexibility is inherent to the activities of supervisors and their decisions. From the single market perspective, based on the Single Rulebook, it is paramount that supervisory discretion is exercised consistently, in accordance with commonly agreed criteria and in a transparent manner. This ensures predictability of approaches and comparability of results in respect of institutions running broadly similar business models and with broadly similar risk profiles, even when they operate in different Member States[20]. The lack of predictability and comparability in ongoing supervision across Member States discourages cross-border banking, by increasing its complexity and potentially undermining the level playing field. Indirectly, these factors may act as obstacles to cross-border consolidation. Predictability and comparability are also key in relation to the supervisory treatment of the M&A transaction, in the specific context of M&A planning, where they directly affect cross-border consolidation decisions.

Over recent years, a common framework for conducting the supervisory process has been achieved through the Guidelines on the Supervisory Review and Evaluation Process (SREP) developed and updated by the EBA. These provide a common framework for the supervisory assessment of an institution's viability, providing a common operating manual for supervisors across the EU. Findings of the Reports on Convergence of supervisory practices[21] conducted over recent years testify to the significant progress in these areas.

The creation of the Banking Union has pushed supervisory convergence further, by making the ECB the single supervisor of all significant institutions across its membership. In a recent speech, former ECB President Draghi highlighted the achievements of single supervision in terms of improved correlation between SREP scores and Pillar 2 requirements. Within the SSM jurisdiction, such correlation has increased from just 40% in 2014 (the onset of the SSM) to around 80% in 2017, signalling increased comparability of supervisory outcomes (see Draghi, 2018b). To increase the transparency and comparability of supervisory outcomes vis-à-vis market participants, in January 2020, for the first time the ECB published the individual Pillar 2 requirements of significant banks under its supervision[22]. This voluntary publication occurred 1 year ahead of the new CRR requirement for large institutions to disclose their Pillar 2 Requirement on an annual basis.

[20] A clear example of how inconsistent approaches to the application of rules might have a far-reaching impact on market participants is the events of the first month of 2016, when the market for Additional Tier 1 (AT1) instruments came to an almost complete halt, largely for different supervisory approaches on the automatic restrictions from maximum distributable amount (MDA) to AT1 payments. Although the distribution of profits while breaching certain capital requirements was addressed in the CRD (Article 141), it was also subject to some degree of interpretation that led to uncertainty among investors and, consequently, disruption in the market.

[21] See the relevant web page: https://eba.europa.eu/supervisory-convergence

[22] With the exception of some institutions, as explained by the ECB: https://www.bankingsupervision.europa.eu/banking/srep/srep_2019/html/p2r.en.html

Such progress is reassuring and testifies to the improvements brought about by the post-crisis regulatory and supervisory financial architecture. However, the work is still not complete.

The latest EBA report on the convergence of supervisory practices (EBA, 2018b) has identified the methodologies for capital adequacy assessments, the risk-by-risk articulation of institution-specific additional own funds requirements, and the link between ongoing supervision, early intervention and resolution as challenging areas for supervisory convergence. In particular, the link between the prudential requirement (expressed as the total SREP capital requirement (TSCR)) and restrictions on distributions has been identified as one of the key areas requiring increased convergence. It is on that basis that, with the approval of CRR2, co-legislators clarified the stacking order of capital requirements and the triggers for the application of MDA, as well the actual calculation, thus removing this area of uncertainty[23].

The trade-off between the flexibility of the supervisory assessment and the predictability and comparability of supervisory outcomes affects cross-border banking and cross-border consolidation, particularly in relation to i) setting capital requirements and; ii) the supervision of internal models.

First, the opacity of supervisory practices not only concerns ordinary ongoing supervision, but may also negatively affect incentives to undertake cross-border consolidation. Accordingly, banks responding to the questionnaire have signalled that increased transparency in the definition and communication of Pillar 2 requirements would also positively extend to cross-border banking consolidation planning. From the perspective of ongoing supervision, a lack of transparency of or guidance on the supervisory approaches in respect of risk-by-risk requirements may add to the uncertainty and unpredictability. Currently, the capital add-on resulting from the SREP assessment is communicated by supervisors to banks as an overall requirement, without detailing the contribution of the different types of risks to its calibration. The absence of ex ante knowledge of the capital amount required by the supervisor for each risk is a source of uncertainty for financial and business forecasting including the undertaking of M&A deals.

In the specific context of merger planning, the opacity of the determination of Pillar 2 requirements may affect the predictability of post-merger Pillar 2 requirements of the new integrated entity. In the case of M&As, having a good degree of certainty about the final capital requirements is vital to understand if the consolidation envisaged is financially feasible. Undisputedly, the ultimate determination of the capital requirements of the new entity is a factor that might discourage the undertaking of consolidation projects.

Supervisors are undoubtedly aware of the need for more transparency in their communication with banks, as recently highlighted by the SSM Chairperson (Enria, 2019a)): 'We have to become even more transparent. We have to better explain our principles and policies. And we will do so, because only then will investors and creditors be able to anticipate our actions, develop trust and contribute to more stability.'

[23] See Regulation (EU) 2019/876 of the European Parliament and of the Council, available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019R0876&from=BG

Second, pan-European groups often apply internal models for the calculation of their capital requirements across Member States. Efficiency in the use of internal models is key for these players when it comes to loan pricing, the ability to attract customers and the profitability of a business line across markets with similar characteristics. Clearly, in the context of M&A processes, having inconsistent and potentially very different approaches to model approval and implementation adds to the complexity of integrating models developed in different institutions, in different jurisdictions and possibly at different times. In this respect, the harmonisation of approaches of internal models for credit, market and operational risk is another critical area of the current effort towards fostering convergence of supervisory practices. As the application of a variety of models in different entities within the same group can have significant effects on loan pricing, on the ability to attract customers and, ultimately, on the profitability of a business line, it is important that the regulatory framework and the supervisory expectations on internal model approval, implementation and monitoring are sufficiently comparable and predictable across jurisdictions.

Against this background, two recent initiatives are likely to bring more consistency and level the playing field in the supervisory approach to the assessment, approval and monitoring of internal models.

From the regulatory point of view, the EBA has developed regulatory standards aimed at harmonising the terminology and concepts for the consistent interpretation and application of the IRB framework, with the objective of tackling model-based variability of own funds requirements for credit risk due to the application of internal models. The objective of that roadmap was to enhance the robustness and the comparability of the internal risk estimates, to improve the transparency of the models and to harmonise the terminology and concepts for the consistent interpretation and application of the IRB framework.

From the supervisory standpoint, the recent targeted review of internal models (TRIM) undertaken by the ECB[24] is a major step in clarifying supervisory expectations with a view to 'reducing inconsistencies and unwarranted variability' when banks use internal models.

These initiatives should ensure that the integration of internal models in case of M&As can proceed more efficiently. Admittedly, neither the EBA roadmap nor the TRIM project addresses the specific situation of a banking consolidation. Nevertheless, these initiatives should provide comfort to supervisors that these models were structured consistently (ex ante), while giving banks reasonable certainty that models coming from different entities will be assessed according to consistent criteria (ex post). In turn, this should lead to a more stable and favourable environment for banking consolidation.

[24] For an overview of the TRIM project, see https://www.bankingsupervision.europa.eu/press/publications/newsletter/2018/html/ssm.nl181114_4.en.htm.

6 Institutional factors

As mentioned earlier in this paper, financial integration cannot be based on mere mutual trust among authorities. The post-crisis repair of the EU institutional framework, with the creation of the European System of Financial Supervision and, in particular, of the EBA, provided an institutional backbone for cooperation among banking supervisors. The framework is far from perfect and its functioning should be regularly monitored and evaluated.

Specific institutional aspects may contribute to making the regulatory approach to cross-border banking too complex. As discussed in relation to the macroprudential framework, for instance, the governance of macroprudential decisions may have to be simplified and further centralised at the EU level. In relation to the very important topic of intra-group financial support (see section 4.5) and, more generally, for the supervision and resolution of cross-border banking groups to function smoothly, with as little as possible recourse to ring-fencing policies, it appears to be key to strengthen the role of supervision and resolution colleges, as well as the EBA's mediation powers.

The Banking Union, which is the outcome of enhanced institutional integration within the EU, currently operates through only two of the three institutional pillars envisaged. Whereas the SSM and the SRM became operational in 2014 and 2016, respectively, the EDIS is still to be introduced. Furthermore, the SRM is not yet equipped with a backstop fund (i.e. a fund able to supplement the already existing Single Resolution Fund (SRF) in case of contemporaneous resolution of multiple large institutions, for example in the context of a systemic event). The Euro area Member States agreed that the European Stability Mechanism (ESM) is mandated to provide such a backstop and, at the time of writing, a broad agreement had been reached on revising the treaty of the ESM and work had begun on defining the amendments that would make that backstop operational.

A polarised debate held back progress on the completion of the EDIS and the backstop to the SRF, both measures being labelled as risk-sharing instruments. The more sceptical parties in the debate argued that – prior to progressing with risk-sharing devices at the EU or euro area level – further risk reduction efforts would be needed focusing on non-performing loan resolution and the reduction of the bank-sovereign loop, particularly in certain Member States. Parties more supportive of institutional progress argued that sufficient progress had been made in the area of risk reduction, particularly in very recent years, justifying faster progress towards a complete public risk-sharing architecture within the Banking Union.

The absence of progress on the side of the institutional Banking Union, and doubts on the actual functioning of the resolution framework when applied to large cross-border entities, were in turn used by bank supervisors and national authorities, particularly in host jurisdictions, as key arguments against the proposal of decreasing capital and liquidity pre-positioning at the level of individual legal entities. As has been explained in previous sections, in the context of the negotiations on the banking package, the European Commission's proposal to introduce cross-border waivers to individual requirements for

capital and internal MREL, while strengthening the existing framework for liquidity waivers, was eventually turned down.

Against this backdrop, the completion of the Banking Union is discussed as one of the key steps needed to unlock further progress in the integration of the EU banking sector and cross-border banking consolidation. Evidence from the questionnaire shows that both the launch of the EDIS and the introduction of a common resolution backstop fund are generally considered relevant by banking groups when it comes to carrying out cross-border banking, although none of these elements was flagged as very relevant by the vast majority of respondents.

However, the debate on the completion of the Banking Union may seem to be gaining more traction among supervisors and politicians than among banks and other market participants. The findings of the questionnaire highlight that regulatory and supervisory elements that have a clear and direct monetary impact on banks, such as capital and liquidity pre-positioning and the Pillar 2 requirement, are more neatly indicated as key subjects in the discussion on cross-border banking and consolidation.

In actual fact, in the light of the link described in this paper between institutional burden-sharing and the rationale of pre-positioning and ring-fencing policies, the completion of the Banking Union remains, in our view, a key trigger of financial integration in the EU, including enhanced cross-border consolidation dynamics.

Given the progress achieved with the regulatory, supervisory and institutional repair of the EU banking sector, culminating with the approval, in May 2019, of the banking package and the June 2019 agreement within the Eurogroup on a revised ESM treaty that introduces the common backstop fund to the SRF, the authors believe that political negotiations for the introduction and implementation of the EDIS should be given new impetus.

In the light of the role that a well-functioning cross-border market for M&As can play in the aftermath of shocks and financial distress, as one of the key adjustment channels a truly integrated jurisdiction for banking should offer, the EU should consider pushing institutional integration further by extending the jurisdiction of the Banking Union beyond bank resolution, to also encompass bank insolvency. As proposed by several commentators, including Restoy (2019) and Gelpern and Veron (2019), this could be done by entrusting the EU with an FDIC-like authority, in charge of managing the insolvency for all those banks that fall outside the scope of resolution. Such authority would, inter alia, centralise and coordinate the actions and support needed to ensure that banks under liquidation, or selected assets and liabilities of those banks, are smoothly transferred to healthy acquirers throughout the Banking Union, and not exclusively within the borders of the Member State where financial distress materialises.

Outside the Banking Union, institutional cooperation should be enhanced to overcome those home-host diverging prerogatives that currently contribute to holding back the free flow of resources within pan-European banking groups. The role of supervision and resolution colleges should be enhanced across policy areas, with EU-wide institutions such as the EBA playing an increasing role in ensuring convergence and mediating disputes.

7 Prudential assessment of mergers and acquisitions

This part of the paper focuses on the regulatory aspects of the execution of the transaction, focusing in particular on the approval process from the perspective of transparency and the predictability of the applicable requirements. After exploring whether the interaction between prudential assessment and the protection of national interests is a persistent potential obstacle to cross-border consolidation, this section will deal with the specific aspects of the prudential assessment, taking into account various merger transaction structures. In particular, it will be illustrated how the lack of a specific EU regime for scrutinising the merger implementation might be a source of uncertainty and a disincentive to cross-border banking consolidation within the EU.

7.1 Prudential assessment and national interests

The regulatory landscape for cross-border M&A transactions has significantly improved since the adoption of Directive 2007/44/EC[25] on the prudential assessment of the proposed acquisition of qualifying holdings in the financial sector. This directive was passed in the aftermath of a series of well-known cases in the early 2000s in which supervisory authorities and/or governmental entities leveraged on alleged prudential reasons to block the acquisition of 'national champions' by banks from other Member States (see Kerjean, 2008; Smits, 2008). Such prudential carve-outs were challenged by the European Commission, which argued that they actually amounted to a defence of national interests and were not covered by the specific clause of the EC Regulation on antitrust merger control[26]. It also argued that the carve-outs encroached on the European Commission's exclusive competence in antitrust matters[27] or that they lacked procedural transparency and created legal uncertainty in breach of the free circulation of capital and freedom of establishment[28]. In the light of

[25] Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector, OJ L 247, 21.09.2007, p. 1.

[26] European Commission, case IV/M.1616, *BSCH/Champalimaud* of 20 July 1999. In that case, the Portuguese Government vetoed the acquisition by the Spanish bank BSCH of significant stakes in the Portuguese insurance and banking sector, claiming that the group governance structure did not ensure sound and prudent management. The European Commission, which was responsible for the antitrust approval of the merger, cleared the transaction arguing that the prudential grounds raised by the Portuguese government actually amounted to a defence of national interest and were not covered by the prudential carve-out envisaged by Article 21(3) of the EC Regulation No 4064/89 on the control of concentrations between undertakings (now Regulation (EC) No 139/2004 of 20 January 2004).

[27] European Commission, press release IP/06/227 of 8 March 2006, relating to the Polish Government's alleged encroachment on the Commission's exclusive competence in antitrust matters by requiring the Italian bank Unicredit to divest its shares in the Polish bank BPH, despite the fact that the Commission had already authorised Unicredit's acquisition of BPH as part of its takeover of the German bank HVB.

[28] European Commission, press release IP/05/1595 of 14 December 2005, relating to the two attempted takeovers of Italian banks by other EU banks: one by Banco Bilbao Vizcaya Argentaria (BBVA) of Banca Nazionale del Lavoro (BNL), and another by ABN AMRO of Banca Antonveneta. These cases drew public attention to the way the Italian national supervisory authority dealt with the acquisition of stakes in domestic banks by other EU banks, in particular in respect of the lack of specified criteria

these experiences, the results of the 2005 European Commission survey on cross-border consolidation in the banking sector indicated that the misuse of supervisory powers in the approval of changes in shareholding was a significant hindrance to cross-border consolidation (see European Commission, 2005)[29].

Based on these precedents, the adoption of Directive 2007/44/EC on the prudential assessment of the acquisition of qualifying holdings aimed to ensure the effectiveness of the freedoms of establishment and of the movement of capital. The harmonised discipline exclusively focuses on the prudential aspects of the acquisition, expressly excludes Member States' 'national interest' considerations from the assessment and prevents golden plating the European rules with additional requirements. Leaning towards a technical and procedural approach was meant to level the playing field and create a more favourable environment for cross-border financial consolidation. Undisputedly, Directive 2007/44/EC marks a fundamental step forwards in ensuring that the financial sector reaps the benefits of the internal market. This notwithstanding, according to a significant number of respondents to the questionnaire, political influence still plays a role in cross-border consolidation[30].

In a cross-border context, merger structures inevitably entail the change of the head office, applicable law and supervisor (at least at the consolidating level) of the entity that ceases to exist. This final consequence would not materialise if both participating entities were significant institutions under the direct supervision of the ECB. From a supervisory perspective, the role of the ECB as a common supervisor of transactions between entities established in the Banking Union would enable potential supervisory conflicts to be mitigated in the interest of the whole EU, and ensure a smooth process. However, even within the common boundaries of the Banking Union, such jurisdictional changes are not politically irrelevant or neutral.

From the perspective of the Member State of the institution that ceases to exist and moves to another jurisdiction (where it is absorbed or contributes to the set-up of a new institution), the main concern is whether the new entity will continue to finance the local economy, and will not just reduce it to a funding jurisdiction subsidising business carried out elsewhere. An additional ground of political resistance may be the allocation of financial responsibility in the event of crisis management and resolution: despite progress made, 'traditional' ring-fencing concerns still exist. Changes in employment conditions are also likely to be a matter of concern and, for this reason, are expressly dealt with by the new directive on cross-border conversions, mergers and divisions[31].

used for the appreciation of prudential acceptability and the supervisory authority's power to refuse authorisation based on opaque concerns (e.g. regarding the 'stability of governance').

[29] The press release of the launch of the survey is available at: https://europa.eu/rapid/press-release_MEMO-05-131_en.htm

[30] According to the questionnaire results 38% of respondents 'agree' and 19% 'strongly agree' with the statement that 'elements of protectionism in the policies and procedures implemented by supervisory or other authorities of the target's Member State in the planning/preparatory phase of a M&A deal may pose impediments to cross-border consolidation'.

[31] European Parliament position of 18 April 2019 (available at: http://www.europarl.europa.eu/doceo/document/TA-8-2019-0429_EN.pdf) and Council agreement of 6 November 2019 (available at: https://data.consilium.europa.eu/doc/document/PE-84-2019-INIT/en/pdf).

From the perspective of the 'acquiring jurisdiction', concerns about the participating entity's asset quality and the impact of the potential adverse sovereign loop remain significant factors.

7.2 Transparency and predictability of the regulatory regime for merger and acquisition deals

The regulatory setting governing the execution of cross-border deals, albeit significantly improved since the adoption of Directive 2007/44/EC, remains suboptimal, since it deals only with the acquisition phase, and does not fully cover the assessment of the actual merger and the integration of the participating entities. This gap affects the transparency of the supervisory approval process and the predictability of its outcome, and potentially leaves room for national protectionist approaches. Clarifications provided by some respondents to the questionnaire indicate that there is a lack of consistency in the assessment of different deals, as well as a lack of transparency and communication, including between the buyer and seller. Such comments point, in particular, to the absence of clear and transparent criteria to determine post-merger Pillar 2 and add-on requirements.

Taking into account the impact of supervisory requirements on the organisational and financial feasibility of the M&A project, ex ante knowledge of the supervisory approach is obviously crucial for financial institutions to develop realistic and credible M&A plans. The absence of a fully-fledged EU prudential framework for the merger assessment is therefore a significant gap for firms when developing their M&A plans and a risk to business executives when embarking on new acquisitions.

The transparency and predictability of the prudential assessment are also relevant for the interaction with market disclosure obligations when at least one of the parties involved in the merger is a listed entity. Institutions' reputational interests and the protection of investors' reliance would require that the disclosed information at the moment of the notification to the supervisor of the proposed M&A project is, at least in principle, in line with supervisory expectations for both the steady state and the transitional phase. A lack of clarity on the supervisory criteria may adversely affect financial institutions' reputation if the disclosed plans are not in line with expectations.

By comparison, EU antitrust merger control, which is a longstanding EU policy relying on an established EU harmonised regulation, authorities' practice and judicial case law, has reached significant levels of efficiency, thus supporting EU market integration. According to statistics, of the 414 merger proposals notified in 2018, 366 cases (i.e. 88%) have been considered compatible and approved by the Commission (DG-COMP) in the first phase or in the simplified procedure with no additional requirements, and only 17 had additional commitments[32]. Although antitrust and prudential regulation policies are too dissimilar to make a proper comparison, such data show the high level of predictability of the antitrust regime and the related significantly high number of notified and cleared cases by

[32] In 2018, four merger cases were found to be compatible further to the completion of the second investigation phase without commitment, and six with commitments. No merger proposal has been rejected (see the EU merger statistics published on the Commission's website: http://ec.europa.eu/competition/mergers/statistics.pdf).

authorities. Along the same lines, the introduction of Directive 2005/56/EU approximating corporate law rules relating to cross-border mergers led to an increase of 173% in cross-border mergers between 2008 and 2012 according to data reported by the Commission[33]. Such data provide evidence that clarity and predictability of the legal and regulatory requirements significantly facilitate cross-border transactions, and *a contrario* the lack of a framework is a relevant contributing factor to the low level of deals.

7.3 Merger and acquisition deal structures and supervisory entry points

Despite the absence of a specific EU regime for the merger assessment, the supervisor is not divested of its formal role to scrutinise the deal and, in particular, the acquisition phase. It is therefore worth exploring the available legal hooks and the related scope of assessment.

Supervisory entry points for the prudential assessment of M&A deals are strictly linked to their financial and legal structure. The choice of the consolidation form will depend on a case-by-case assessment, taking into account, among other elements, the objectives pursued by the parties, the financial and organisational specificities of the involved participants, tax incentives, etc. For the purpose of the following analysis, the term 'M&A deal' covers banking consolidation in the form of merger by absorption, merger by incorporation and the acquisition of an entity to transform it into the acquirer's subsidiary.

Mergers by absorption entail the takeover and integration by the acquirer of an entity, with the latter ceasing to exist without any liquidation proceedings. In the case of absorption of a small entity by a large institution, the number of shares (if any) that the shareholders of the target would receive in exchange for their shares[34] will probably not give rise to qualifying holdings. Conversely, in the case of mergers between equals, depending on the equity exchange ratio, the merger may give rise to an increase in or the acquisition of qualifying holdings. In both cases, the integration of the absorbed entity might (also) have an impact on the scope of the acquirer's banking licence in those Member States where the authorisation is not universal (i.e. covers all activities listed in Annex I to the CRD) but is issued on an activity-by-activity basis. In this case, where some of the activities performed by the absorbed entity are not covered by the absorbing entity's authorisation, the acquirer's authorisation would need to be extended and a specific application would need to be filed with the supervisor.

In banking practice, it is often the case that the actual merger between the participating entities is preceded by the acquisition of the target and its transformation into the acquirer's subsidiary. This structure allows the subsidiary to first be integrated within the group and for an adequate merger timeline to be developed, including all relevant aspects of the business, financial and operational

[33] Proposal for a Directive of the European Parliament and of the Council amending Directive (EU) 2017/1132 as regards cross-border conversions, mergers and divisions, 25 April 2018, COM(2018) 241 final, p. 5.

[34] The deal may also involve a cash payment to the target's shareholders. The swap deal, however, may be a way to ensure risk-sharing among the target's shareholders.

integration. This would require prior notification to the target's supervisor in accordance with Article 22 of the CRD and the performance of the prudential assessment. The latter is carried out in accordance with the five criteria set out in Article 23(1) of the CRD, namely relating to (1) integrity, (2) professional reputation, (3) financial soundness, (4) sound and prudent management of the target institution and (5) anti-money laundering concerns, as specified in the European supervisory authorities' joint guidelines on qualifying holdings[35].

Unlike mergers by absorption, mergers by incorporation entail the establishment of a new entity resulting from the merger of the parties involved and the simultaneous cessation of such participating entities. From a regulatory perspective, the case of a merger by incorporation with the establishment of a new operating company (i.e. a credit institution) is rather straightforward in terms of applicable regulation: the newly incorporated entity will have to be authorised[36] in accordance with the requirements and the procedure set out in the CRD as implemented in national law. In the context of the licensing procedure, the supervisor would not only assess the soundness and prudence of the steady phase of the merger project, but also require an implementation plan covering the transitional phase, which would have an impact on the determination of a capital add-on for the risks linked to the transitional phase[37].

A merger by incorporation may also be implemented by setting up a parent holding company and via the subsequent bids over the participating company. The scenario of the incorporation of a parent operating company in conjunction with the transfer of assets and business to the newly established parent by the participating entities should also be considered as a potential structure.

It is also worth underscoring that, in the cases of both merger by absorption and merger by incorporation, the ceasing to exist of the absorbed or of the participating entity (or entities) would also require the withdrawal of the authorisation of the ceasing entity by the competent supervisor. If there were different supervisors in a cross-border context, such an operation would need to be implemented in a coordinated manner with the supervisor of the resulting merged entity, with a view to ensuring a smooth transitional phase and having regard to business continuity, depositors' protection and financial stability.

The acquisition of qualifying holdings would also entail a change of control in the downstream shareholding chain. The application of the qualifying holding regime entrusting the target's authority with the jurisdiction over the prudential assessment may not be ideal in a cross-border merger where

[35] These joint guidelines on the prudential assessment of acquisitions and increases of qualifying holdings in the financial sector, 20 December 2016 (JC/GL/2016/01), are available at: https://esas-joint-committee.europa.eu/Pages/Guidelines/Joint-Guidelines-on-the-prudential-assessment-of-acquisitions-and-increases-of-qualifying-holdings-in-the-banking,-insuranc.aspx. The main elements of the procedure applicable to the prudential assessment include the identification of the subjects bound to notify the proposed acquisition, the information required and the timeline for the completion of the supervisory assessment (i.e. 60 days since the filing of a complete application).

[36] The ECB (2019a) has clarified the ECB's practice of requiring the new entity resulting from the merger to be expressly authorised, rather than allowing one of the merging entities to transfer its old authorization. Depending on the structure used for the transaction, this could be only a temporary vehicle or an instantaneous vehicle, which could also be exempted from authorisation requirements.

[37] ECB Guidance, p. 19.

the participating companies have subsidiaries in several jurisdictions, either within or outside the EU. The decentralised control of the proposed acquisition lying with the target supervisor may carry risks of conflicting assessments or, at any rate, may not be efficient to the extent that it requires several applications to be filed with the various target jurisdictions. A single, or at least a coordinated, approach between the consolidated and the individual supervisor should be made possible at the regulatory level in order to ensure the efficiency and consistency of assessments.

The financing of the merger may also be a matter falling within the scope of the supervisory assessment. For instance, where the acquiring entity needs to launch a capital increase to fund the acquisition of the target, it may be the case that the jurisdiction where it is established imposes the supervisory clearance of any change in the institution's bylaws. In that case, a double supervisory intervention would be required: first, to assess the amendment of the institution's statute to enable the capital increase to finance the share purchase and, subsequently, to assess the proposed acquisition of qualifying holdings.

Unlike EU law, some national laws (e.g. in Belgium, Greece, Italy and the Netherlands) do provide for a specific regime for the supervisory assessment of the merger. The advantage of such regimes is that they provide predictability to the acquirer. Still, the decentralised approach and the interaction with other national or EU legal systems – for instance the need to coordinate with the supervisor of the ceasing entity as regards the withdrawal of the authorisation – is likely to raise issues of coordination with the laws of other jurisdictions claiming to be competent for at least some aspects of the transaction, ultimately giving rise to legal uncertainty. In addition, the national source of such legislations makes the EU playing field uneven, as regards the scope and type of the required assessment, as well as potential conflicts of laws. The negative impact of the absence of an ad hoc EU merger assessment regime is also reflected in the responses of the majority of respondents to the questionnaire, pointing out the lack of clarity, transparency and comprehensiveness of the interaction between the national and the EU frameworks[38].

As a residual consideration, should the transaction not give rise to any EU or national supervisory entry points as illustrated earlier, the supervisor would still be able to assess the merger plan from the perspective of the exercise of its ordinary supervisory powers, in particular with regard to the effects of the transaction both on the financial soundness and on the sound and prudent management of the absorbing institution. Clearly, this route is not ideal, as, in principle, it does not necessarily operate ex ante and needs to be built up on a case-by-case basis, including the process, timeline and substantive requirements, providing little certainty and predictability to the parties involved.

7.4 The post-merger transitional phase: risks and regulation

The overview in the previous section confirms the initial view that there is a multiplicity of legal and regulatory sources supplying hooks for the exercise of a supervisory assessment of the acquisition

[38] See the results to Question 15(b) of the questionnaire in the annex to this paper.

phase of an M&A deal. This confirms that acquisitions are prudentially assessed, but also shows the patchy EU approach to the prudential assessment of the merger, as regards the financial and operational integration of the participating entities, associated risks and impact on capital. The current state of play therefore may raise criticism about insufficient ex ante knowledge and/or regarding clarity about supervisory expectations relating to a merger assessment. While it has to be appreciated that the ECB has recently provided clarification on some aspects of the merger assessment (see Enria, 2019c, Enria 2019d and ECB, 2019b), this paper advocates the need for more comprehensive supervisory guidance about the substantive and procedural requirements applicable to merger assessments.

Such guidance should cover both the supervisory expectations about the steady phase in terms of the business and financial plan, the organisational structure and governance arrangements, and the transitional phase of the merger by laying down assessment criteria of the merger execution plan. The transitional phase presents specific risks that need to be identified and addressed.

The appropriate handling of the transitional phase where the actual integration occurs is also critical both from the supervisory perspective and in terms of the achievement of business and operational synergies. It is therefore crucial for stakeholders to receive clear regulatory and supervisory guidance about the requirements of the post-merger execution plan in order to adequately calibrate the merger project. The integration between the participating entities affects all aspects of the merger project – the programme of operations, capital and funding, the organisational structure, IT systems and data migration, and internal governance arrangements – and constitutes indispensable support for the achievement of the expected business and operational synergies underpinning the merger. The criticality of the integration of the IT system in reaching the projected M&A gains has been confirmed both by additional comments in the questionnaire and by a survey conducted globally across banks and financial institutions by Ernst & Young (2017)[39]. Taking into account the considerable investments to be undertaken ex post to adjust the systems to the new requirements, ex ante guidance would help optimise resources and plan the process more efficiently.

In this respect, the guidance should cover the need to ensure operational resilience in the transitional phase, having regard to the transition of IT systems, data migration, compliance with reporting requirements, etc. The guidance should highlight the need for the participating entities to set up appropriate solutions, taking into account the specificities of the participating institutions (size, the complexity of business, the complexity of internal models and of IT systems, etc.). For instance, the need for and the features of dedicated transitional service agreements between the buyer and the seller should be accurately considered and assessed. These would aim to ensure that, during a transitional phase, the old infrastructure remains fully operational while a new one is implemented. It is acknowledged in practice that negotiating and agreeing upon these arrangements can be time-consuming and can slow down the consolidation process; however, such arrangements are often one essential condition for the efficient integration of different entities or lines of business and should,

[39] The results show that operational stability is the top priority for 37% of respondents in relation to the post-closing period in the first 100 days of an acquisition deal.

therefore, be the object of adequate expectation by the supervisor. Similarly, the bidder's previous experience with integration of an external entity should also be duly taken into account to assess, for instance, the risks and the timeline of the expected finalisation of the integration. The guidance should also consider the internal model integration if the merging entities apply advanced models or when only one of applies advanced models and the other applies standardised models.

This brief overview of the issues to be addressed in the transitional phase confirms the complexity of the merger transaction and the risks associated with the integration phase. Their appropriate identification would allow banks to indicate the envisaged mitigating measures in the merger plan, although the complexity of the implementation phase would still require the imposition of a capital add-on to serve as a buffer to cover all of the risks that are typical of this potentially unstable phase. Now would be an opportune moment for additional guidance to be developed on the criteria for determining such capital add-on, clarifying the exclusion of any double counting (see Mersch, 2019), what risks should be covered, the related calibration, whether the buffer should be commensurate to the whole transitional period and to the meeting of certain milestones, and its reassessment at the first available SREP exercise. Additional clarity is also needed on the determination of the overall Pillar 2 requirement imposed on the merged entity, including if and to what extent synergies are taken into account and at what point in time. In this context, more predictability is also needed in the light of the significant impact on the financial plan and on the prudential treatment of the accounting bad will (i.e. the gain resulting from the acquisition of assets at a price lower than their fair value), in particular whether it should be counted to reduce own fund requirements. The recent clarification provided by the ECB, which has not excluded a partial counting to the extent that it does not affect the institution's sound and prudent management, is a welcome development (see Enria, 2019b). Considering the specific circumstance under which such a clarification has been provided, however, additional guiding criteria for the relevant assessment could be further developed.

7.5 Way forward on merger and acquisition prudential assessment

In the light of the findings of the overview in the previous sections, two conclusions can be drawn, the first relating to the prerogatives attributed to national law and national authorities and the second relating to the need to increase the transparency and predictability of the merger assessment.

In respect of the first point, the EU legal framework on antitrust merger control still gives significant competence to national authorities in the context of the prudential carve-outs. This is still the case in Article 21(4) of the EU antitrust merger control regulation, pursuant to which Member States may take 'appropriate measures to protect legitimate interests other than those taken into consideration by the EC Merger Regulation and compatible with the general principles and other provisions of Community law'. Among these, prudential regulations are considered legitimate interests and, as illustrated earlier, have provided Member States with a powerful point of leverage to obstruct, in various ways, takeover projects by foreign players in order to protect 'national champions'. The Commission, in the *BSCH/Champalimaud* case, has acknowledged that the progressive EU harmonisation of the prudential regulation has reduced the relevance of this national power. In the light of the progress made in deepening the internal market of financial services with the development of the Single Rulebook, the

step-up of the European System of Financial Supervision and ultimately the establishment of the Banking Union, it is arguable that the competence to raise and assess consistency with prudential concerns should no longer rest at the national level but should be moved to the EU level. In particular, this should be entrusted to the ECB where the merged entities are headquartered in the Banking Union (see Angeloni and Lenihan, 2015). In cases of mergers between institutions based in Banking Union and in non-Banking Union Member States, the power to raise prudential concerns should rest with the ECB and the national competent authorities of the non-Banking Union Member State and – in case of disagreement – the EBA should be empowered to mediate between the authorities. This competence would be in line with the EBA's existing competence in this domain. Regulation (EU) No 2010/1093 establishing the EBA already provides that, upon request of one of the competent authorities involved, the EBA may issue an opinion on the prudential assessment of M&As[40]. The proposal to confer on it an express power of mediation between the authorities involved in the prudential assessment of M&As would streamline this competence, further deepening the internal market consistent with prudential regulatory requirements.

The recent directive on corporate cross-border conversions, mergers and divisions amending Directive (EU) 2017/1132 is also worth mentioning. In an effort to curb abusive practices of cross-border corporate mobility, it entrusts competent authorities of Member States (to be designated at the national level) with the scrutiny of the potential abusive nature of cross-border operations (mergers, conversions and divisions). While it can be assumed that the legislative intent was to mimic the Court of Justice rulings in leading cases relating to the abuse of law in cross-border corporate mobility, the impact in the banking sector of the shift from ex post judicial control to ex ante administrative scrutiny may need further assessment. In particular, it should be clarified that it should not be a shortcut for the reintroduction of national interest concerns that have already been banned by Directive 2007/44/EC. The clarification set out in recital (57) that 'this Directive does not affect Union legislation regulating credit intermediaries and other financial undertakings and national rules made or introduced pursuant to such Union legislation' may provide some comfort; however, the inaccurate wording that has been used might not completely rule out concerns.

In respect of the need for transparency and predictability of the merger assessment, an express regime should be introduced covering the supervisory expectations relating to both the steady state and the transitional phase. It should also lay down the information requirements for the merger assessment application and the applicable procedure and timeline. The coordination of the various authorities

[40] Article 34(2) of the EBA Regulation states: 'With regard to prudential assessments of mergers and acquisitions falling within the scope of Directive 2006/48/EC, as amended by Directive 2007/44/EC, and which according to that Directive require consultation between competent authorities from two or more Member States, the Authority may, on application of one of the competent authorities concerned, issue and publish an opinion on a prudential assessment, except in relation to the criteria in Article 19a(1)(e) of Directive 2006/48/EC. The opinion shall be issued promptly and in any event before the end of the assessment period in accordance with Directive 2006/48/EC, as amended by Directive 2007/44/EC. Article 35 shall apply to the areas in respect of which the Authority may issue an opinion.'

involved should be adequately covered, including the interaction relating to the withdrawal of the authorisation. To achieve that, it is suggested that the CRD be expressly amended to introduce supervisory assessment and procedure requirements.

8 Conclusions

Cross-border consolidation in the banking sector can be beneficial to the European financial system and the broader economy, as it can result in increased efficiency of financial intermediation, wider citizens' access to existing and new financial services across Member States and improved competitiveness of the EU on global financial markets, with particular regard to the challenges and opportunities stemming from financial innovation and technology. It is, however, because of its beneficial implications on financial integration, risk-sharing and banks' profitability that cross-border consolidation has recently taken a prominent role in the European debate on the deepening of the Single Market and completion of the Banking Union. The financial crisis showed that, in the absence of EU-wide appropriate rules and institutions, financial integration can act as a shock amplifier rather than a shock absorber, leading to sudden reversals, retrenchment and ring-fencing. Despite the deep repair of the EU regulatory, supervisory and institutional frameworks carried out in response to the crisis, the sluggish trend in cross-border consolidation does not seem to have reverted to sustainable levels.

Recent evidence from the EBA risk assessment activity shows that banks see the costs/riskiness of consolidation and the complexity of M&As as the two primary obstacles to consolidation[41]. Regulation and the supervisory stance on consolidation come third in the list of perceived obstacles to M&As. Prudential regulation and policy are therefore not the silver bullet to achieve financial integration in the EU; however, they do appear to play a role. Against this backdrop, and in the light of additional survey evidence collected among banks with a specific focus on prudential policy, this paper provided a review of and mapped those elements of the post-crisis EU regulatory, supervisory and institutional prudential frameworks that may act as direct or indirect obstacles to cross-border consolidation. The aim of the paper is to highlight all authorities involved in the direction of those prudential policy areas that may need further discussion and work if the Single Market and the Banking Union are to become a truly single jurisdiction for banking.

Within the regulatory framework, two broad categories of potential obstacles can be identified: i) ring-fencing and pre-positioning of resources at the local level, which lean against centralised (group-wide) strategies of capital and liquidity management; and ii) fragmentation of the regulatory framework, ultimately endangering the comparability of institutions and businesses across countries.

One of the key benefits of a Single Market in banking is the possibility – for cross-border institutions – to carry out group-wide capital and liquidity management strategies across different jurisdictions. Enhancing financial integration to fully reap the benefits of the Single Market and increase efficiencies is therefore crucial for promoting cross-border consolidation from the perspective of risk-sharing and risk reduction policies. To this extent, the lack of cross-border waivers to capital requirements at the

[41] EBA report on risk assessment of the European banking system, November 2019, available at: https://eba.europa.eu/risk-analysis-and-data/risk-assessment-reports

individual level and the stringent conditions to apply cross-border liquidity waivers have relevant implications on the efficiency of transfer and the allocation of funds across a pan-European group. Similarly, the distribution of resolution requirements (MREL) within a cross-border group mirrors this kind of territorially fragmented approach; waivers to internal MREL are provided, but for intra-state situations only. Key in this area are IGFSAs, which the EU legislature also envisaged, in the context of recovery planning, as a tool to provide both home and host authorities with legal certainty over the intra-group flow of resources during a phase of financial distress. Our questionnaire and anecdotal evidence show that banks do not consider IGFSAs a suitable tool in the light of their current excessively rigid legislative design, and tend to replace them with other forms of guarantees and support meant to achieve similar effects. However, as these privately arranged measures might not guarantee the same degree of legal protection granted by BRRD-compliant IGFSAs, the incentive for host authorities to control capital and liquidity at the local level cannot be entirely removed. It is also for this reason that the Commission's November 2016 proposal envisaging the possibility of including cross-border intra-EU MREL and capital waivers was abandoned in the course of the negotiation on the banking package.

As work continues to accomplish an efficient risk-sharing institutional framework within the Banking Union, it seems very important that all EU authorities involved engage in further work on the legal and regulatory conditions that may support trust and legal certainty among national authorities so to clear the way to the introduction or the application of cross-border waivers to individual capital and liquidity requirements, such as the conditionality framework included in the Commission's November 2016 proposal for waivers. As things stand, IGFSAs are one of the few already available tools to provide legal certainty in cases of financial distress. For this reason, it is paramount to soften the requirements for concluding IGFSAs and to increase their effectiveness, thus providing incentives to banks to implement BRRD-compliant agreements.

Fragmentation partly arises from the existence of a number of exceptions to common rules. The first example is given by the relatively ample margin of flexibility within the EU Single Rulebook, allowing Member States to adopt certain ONDs. While this flexibility had been conceived to cater for the need for a more proportional approach among a wide range of institutions, their large number adds a layer of complexity and costs, especially for firms operating across borders. To this extent, the current practice of different applications at the national level of common rules to address the needs of proportionality and flexibility for smaller institutions can no longer be seen as the most appropriate solution; instead, it would be more efficient to apply the principle of proportionality directly within the Single Rulebook. The new task regarding proportionality that the review of the European supervisory authorities assigns to the EBA should also be developed in this direction.

Fragmentation also arises from the multiplicity of macroprudential instruments, whereby the same type of risk can be addressed with different measures in different Member States. The determination of regulatory capital, and all the decisions linked to that, may become particularly complex for banking groups willing to operate a given business across Member States. The rather complex cross-border governance of the current macroprudential framework may affect the competitive position of banking groups within host jurisdictions, in turn having an impact on the choice over group structures (i.e. the

decision to operate through a branch-based structure rather than a subsidiary-based structure). Finally, since the limits between microprudential and macroprudential objectives tend sometime to become less clear, the macroprudential toolkit may be used as an additional instrument of ring-fencing. While the adoption of the CRD5/CRR2 package addresses some of the above criticalities, further progress should be made in enhancing communication, transparency and the rationale of proposed macroprudential measures. Moreover, the wide array of instruments by which the macroprudential framework can affect risk-weights should also be streamlined, simplified and preferably kept to a top-down perspective (i.e. less intrusive with respect to IRB rules), particularly in the light of the progress made in the bottom-up regulatory repair in the use of internal models and in a more harmonised supervisory approach to internal models. Finally, the governance of macroprudential policymaking at the EU level should be centralised and strengthened further, beyond simple information-sharing and coordination among the numerous authorities involved.

The existence of a common regulatory framework alone is not enough to guarantee that the benefits of operating in a single jurisdiction can be easily reaped. A consistent application of these common rules and an adequate institutional setting are also of paramount importance to ensure the predictability of approaches and the comparability of results for institutions running broadly similar business models and with broadly similar risk profiles but operating in different Member States. In turn, the predictability of approaches and the comparability of results are key preconditions for cross-border consolidation.

This paper shows that, despite the progress made in recent years in achieving a supervisory convergence of practices across the EU, a number of supervisory approaches are not yet fully consistent, in particular with respect to the link between the prudential requirements and restrictions on distributions, and to a more transparent approach when setting risk-by-risk requirements. Accordingly, respondents to the questionnaire have signalled that increased transparency in the definition and communication of Pillar 2 requirements would also positively extend to cross-border banking consolidation planning.

This paper indicates that the absence of a uniform and transparent EU-wide supervisory assessment regime over the actual merger, including the determination of the capital requirements, may be a contributing factor to the low level of M&A deals in the EU. Evidence from the questionnaire indicates a lack of clarity, transparency and comprehensiveness regarding the criteria to set Pillar 2 requirements to the entity resulting from the merger. The paper also shows that the interaction between legislative and regulatory regimes of the home and host jurisdictions in the context of the merger supervisory assessment is an additional factor of complexity, supporting the view of the desirability of a harmonised EU assessment regime. Furthermore, the paper indicates that, despite legislative progress in the assessment of the acquisition of qualifying holdings, political influence may still be a relevant factor in cross-border consolidation.

The importance of completing the institutional framework for risk-sharing in deposit insurance and the financing of resolution may seem to be more critical within the debate of the completion of the Banking Union among supervisors and politicians than among banks and other market participants.

Evidence from the questionnaire shows that both the launch of the EDIS and the introduction of a common resolution backstop fund are generally considered relevant by banking groups when it comes to carrying out cross-border banking, but none of these elements was flagged as very relevant by the vast majority of respondents. On the other hand, regulatory and supervisory elements having a clear and direct monetary impact on banks, such as capital and liquidity pre-positioning and the Pillar 2 requirement, seem to be the most relevant factors that banks consider when discussing cross-border banking and consolidation.

However, the fact that the completion of the Banking Union ranks lower in the factors that banks consider potential impediments to cross-border consolidation should not be underestimated or easily dismissed. It is precisely the incomplete nature of risk-sharing within the Banking Union and the progress towards full implementation of the resolution framework that lead bank supervisors and national authorities to argue against decreasing pre-positioning at the level of individual legal entities. Therefore, while it may not be directly seen as a crucial factor by banks, the completion of the Banking Union may well be considered as one of the key steps needed to unlock progress in the integration of the banking sector, as well as in cross-border consolidation, as the progress in risk-sharing will progressively reduce the incentives for ring-fencing and pre-positioning.

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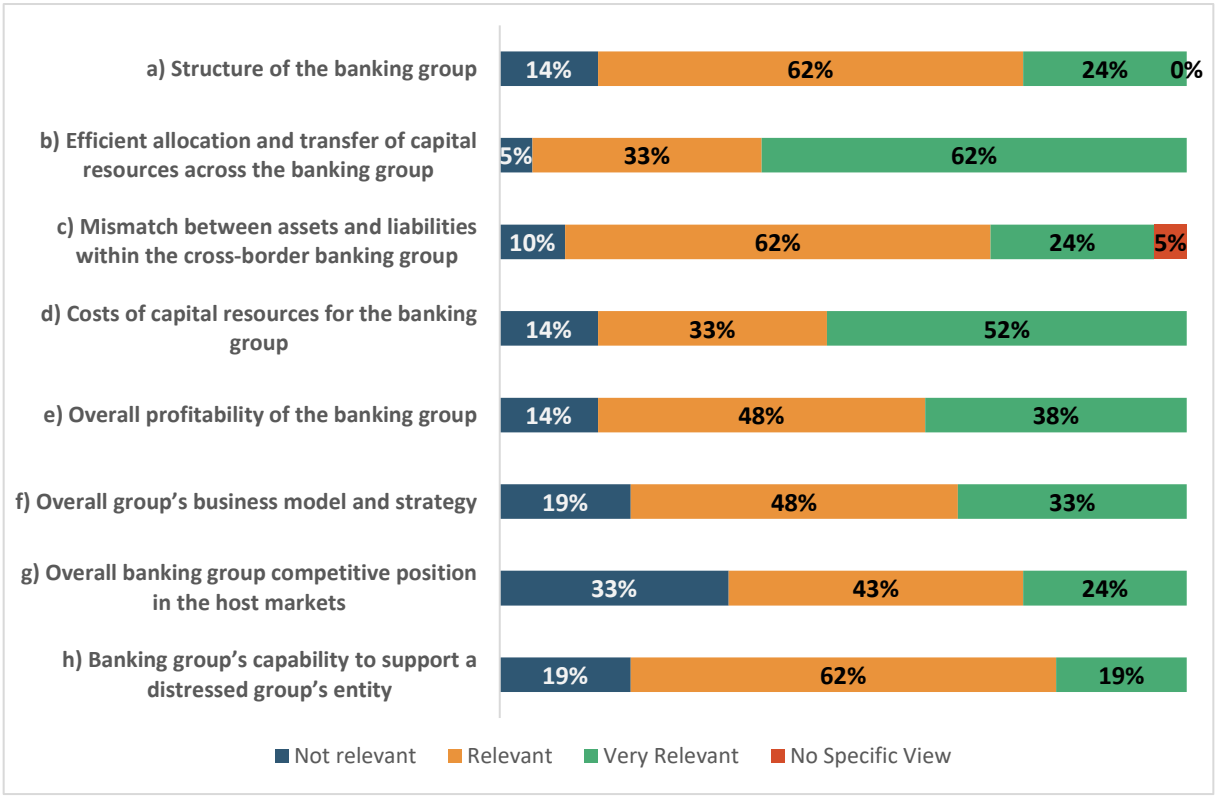
10 Annex: questionnaire

Technical note: the questionnaire was submitted in Q4 2018 to 43 banks belonging to 15 jurisdictions (Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Hungary, Italy, the Netherlands, Norway, Portugal, Spain and Sweden) as a voluntary exercise. In total, 21 banks provided answers (49% participation rate), which were collated in Q1 2019 together with some interviews conducted by the authors with some of the respondents.

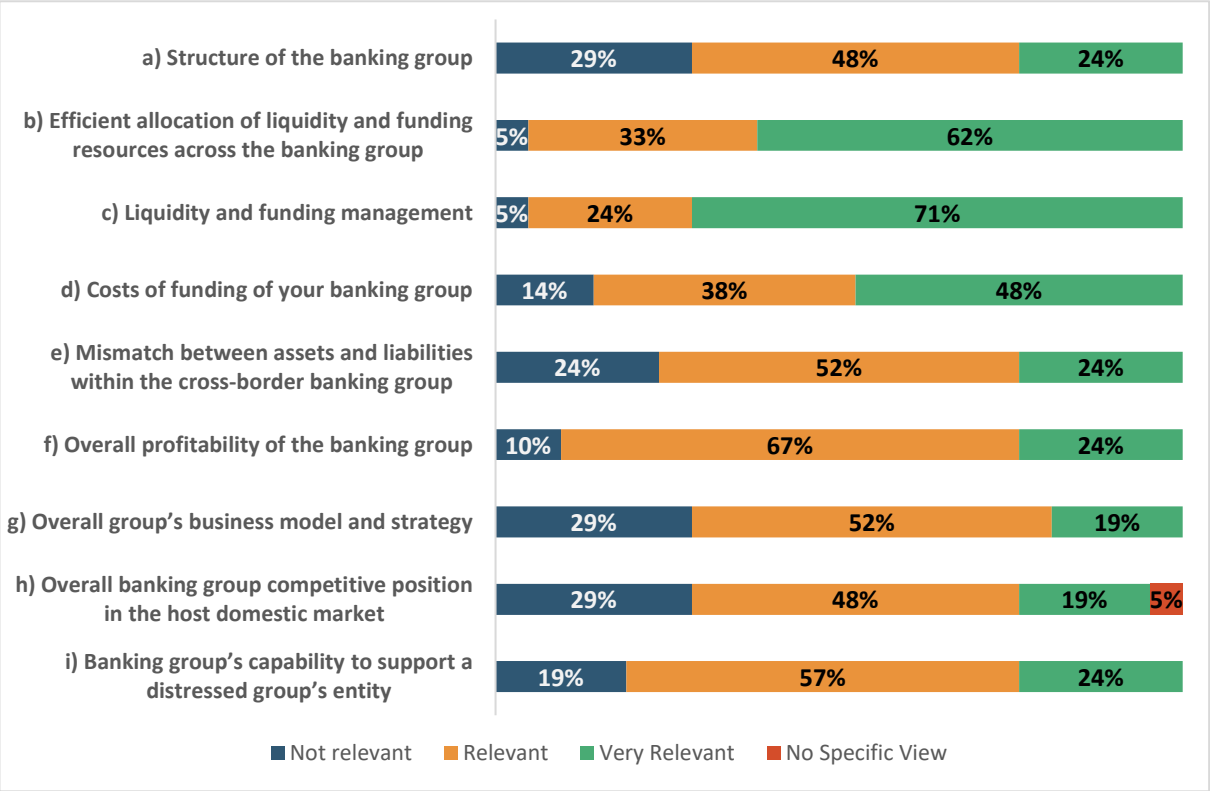
a) Capital and liquidity solo-level waivers

This section of the questionnaire focuses on the solo-level requirements on own funds and liquidity, aiming to assess the implications of such requirements on various aspects of the activity of a cross-border banking group.

Question 1: According to the CRR, prudential requirements have in principle to be applied on a solo basis. Waivers to own funds requirements are envisaged only when the parent and the subsidiary are established in the same Member State, they fall under the same scope of supervision on a consolidated basis and where other conditions set out respectively in Articles 7 and 10 CRR are met. No waiver to the solo application of own funds requirements is envisaged when the subsidiary and the parent undertakings are established in two different Member States. Please assess the relevance of the absence of cross-border waivers for the following aspects of the group's activity:



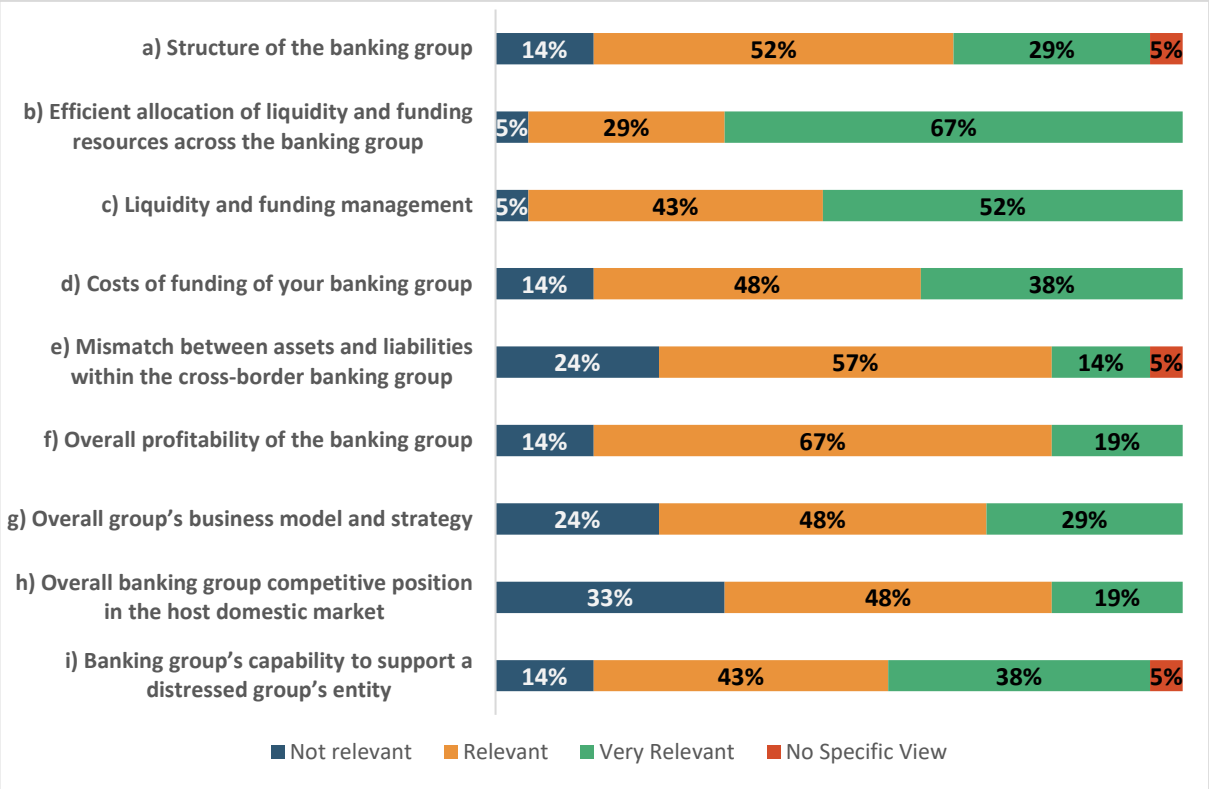
Question 2: Article 8 CRR envisages waivers, in full or in part, to liquidity requirements to an institution and to all or some of its subsidiaries located either in the same Member State or in a different Member State, allowing the institutions under consideration to be supervised as a single liquidity subgroup so long as certain conditions are met. Regardless of whether the waiver has been applied to your group, please indicate the relevance of such waiver for the following aspects of the group's activity:



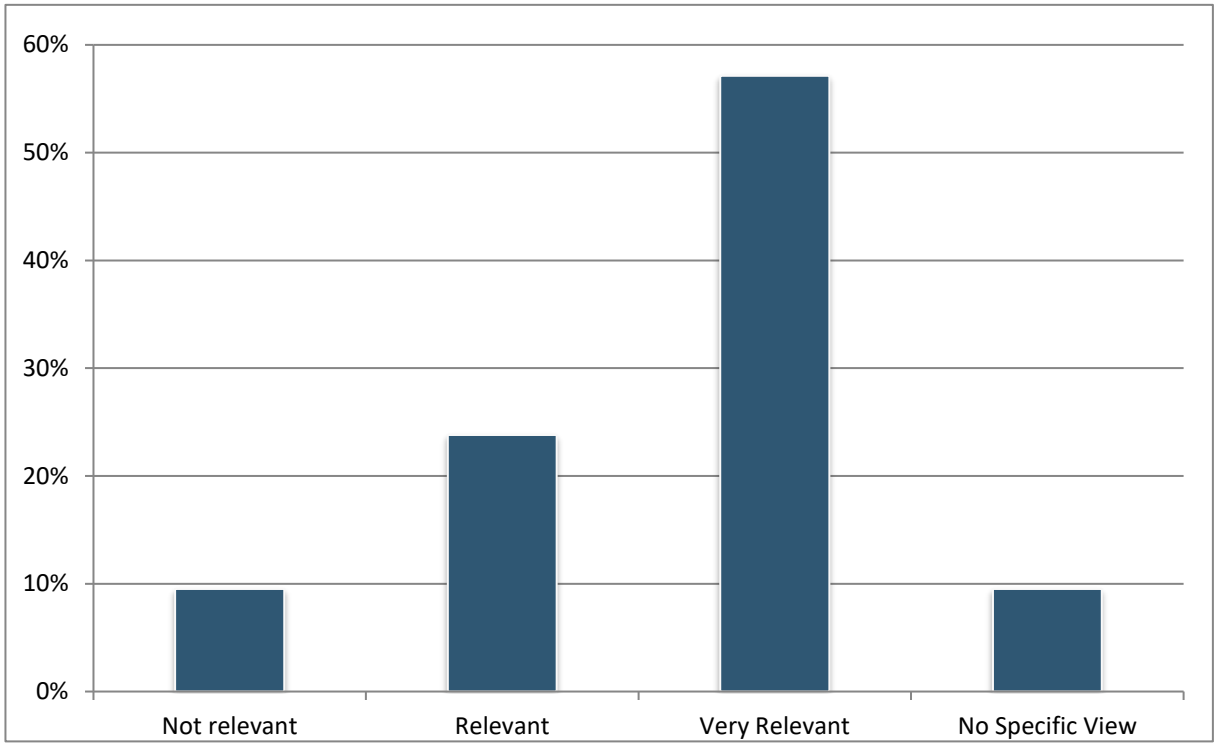
b) Large exposures intra-group regime

This section of the questionnaire focuses on the application of the large exposures regime on intra-group positions within cross-border banking groups.

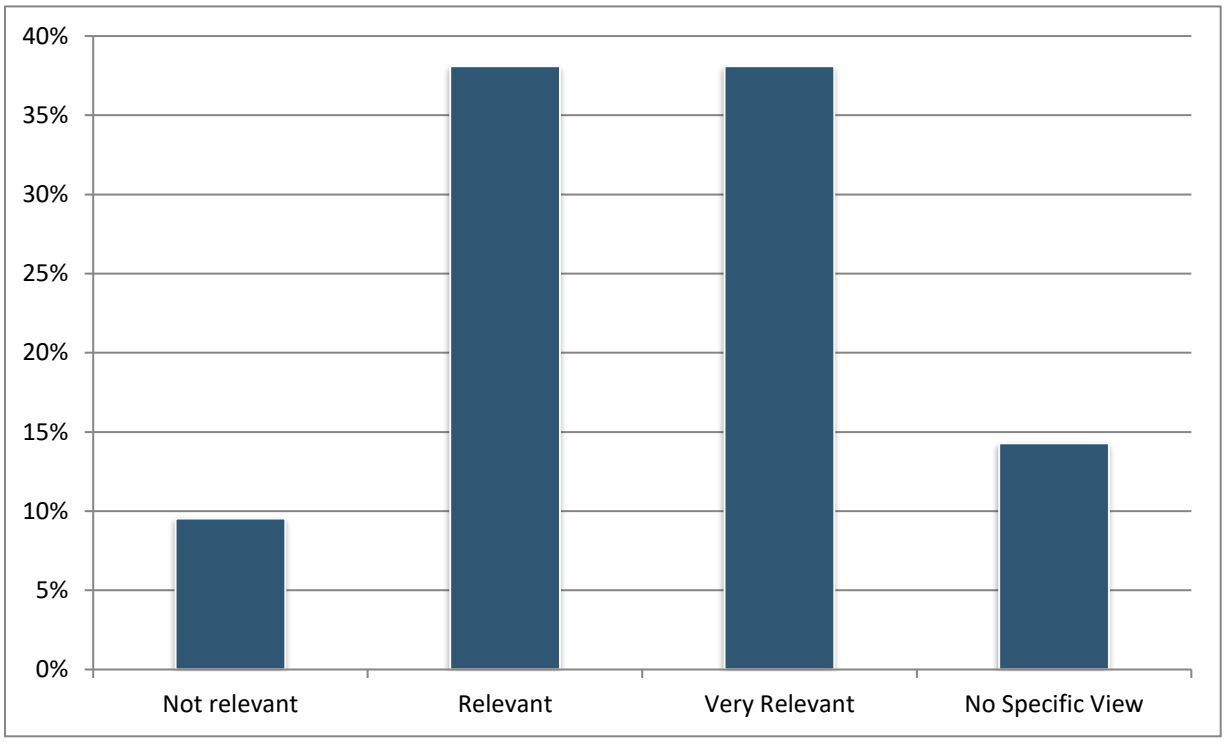
Question 3: The CRR large exposures regime envisages waivers for intra-group large exposures only when the parent and the subsidiary are subject to the same supervision on a consolidated basis, including in cross-border cases, provided that the conditions set out in the relevant provisions are met. Regardless of whether the waiver has been applied to your group, please indicate the relevance of the application of such cross-border waivers for the following aspects of the group's activity:



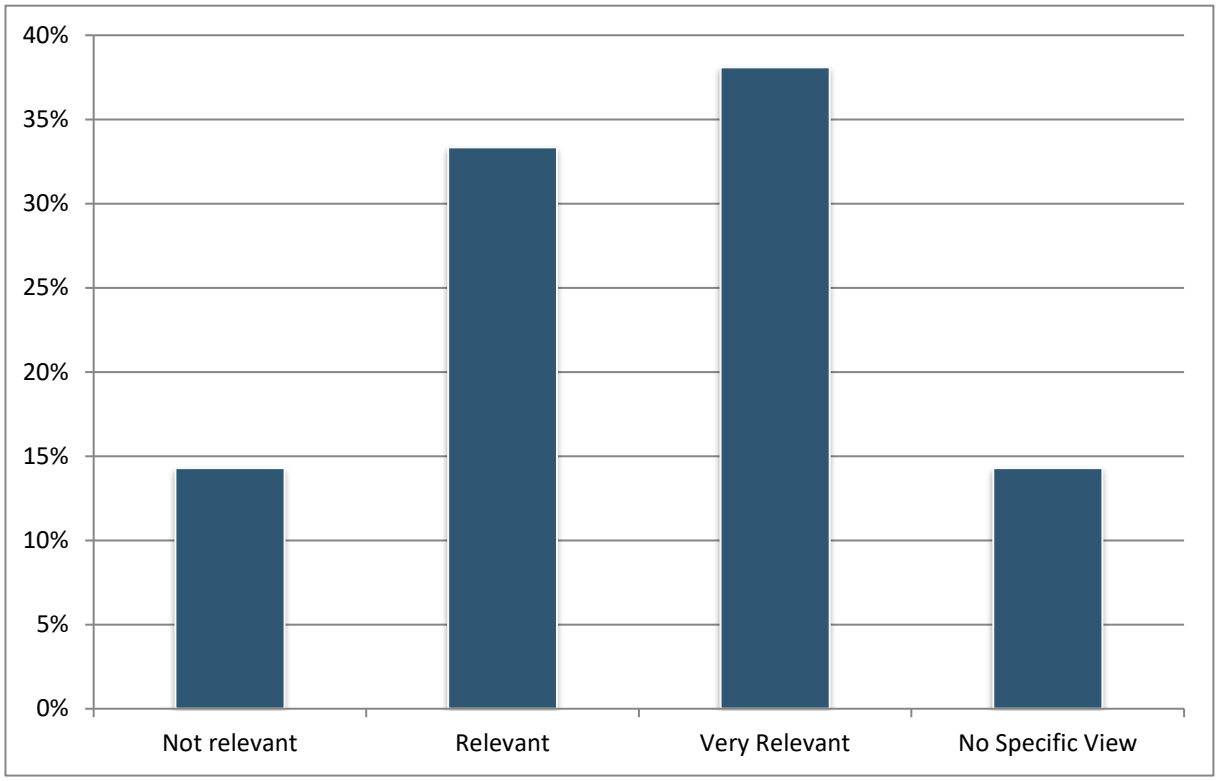
Question 4: To what extent does the own funds buffer applicable to G-SIIs and O-SIIs affect the incentives to expand cross-border activity via cross-border M&A transactions?



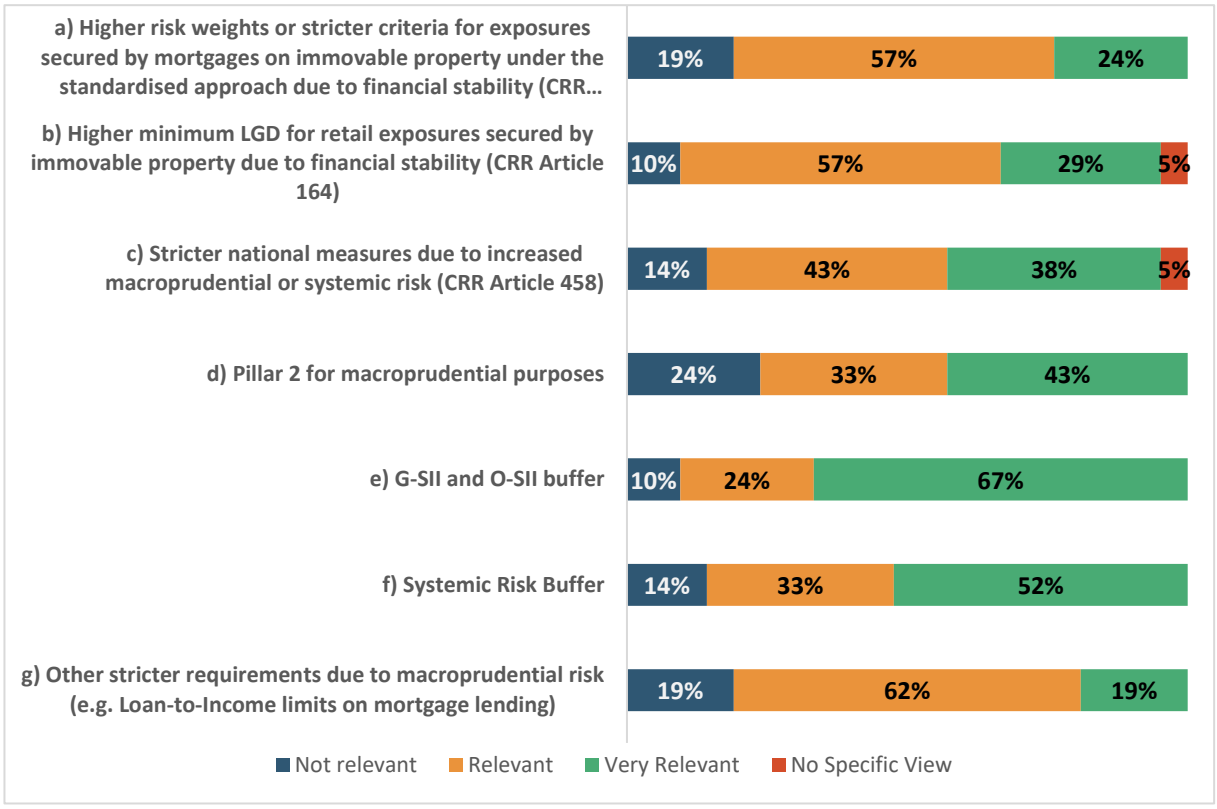
Question 5: To what extent the other requirements applicable to G-SIIs or to O-SIIs, as the case may be, affect the incentives the incentives to expand cross-border activity via cross-border M&A transactions?



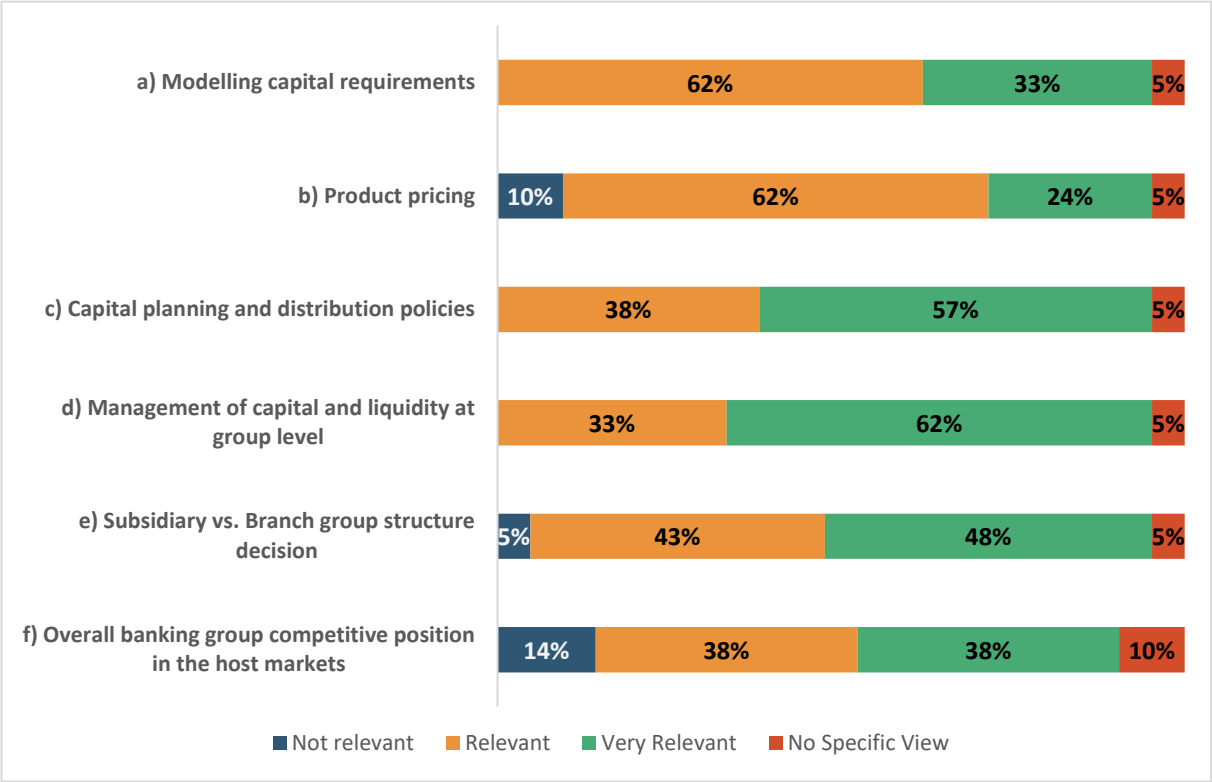
Question 6: To what extent does the methodology to determine the G-SII and O-SII classification affect the incentives to carry out cross-border banking? In particular, how relevant is the fact that cross-jurisdictional assets and liabilities within the European Union are not considered as domestic assets and liabilities for the incentives to carry out cross-border banking activity and cross-border consolidation?



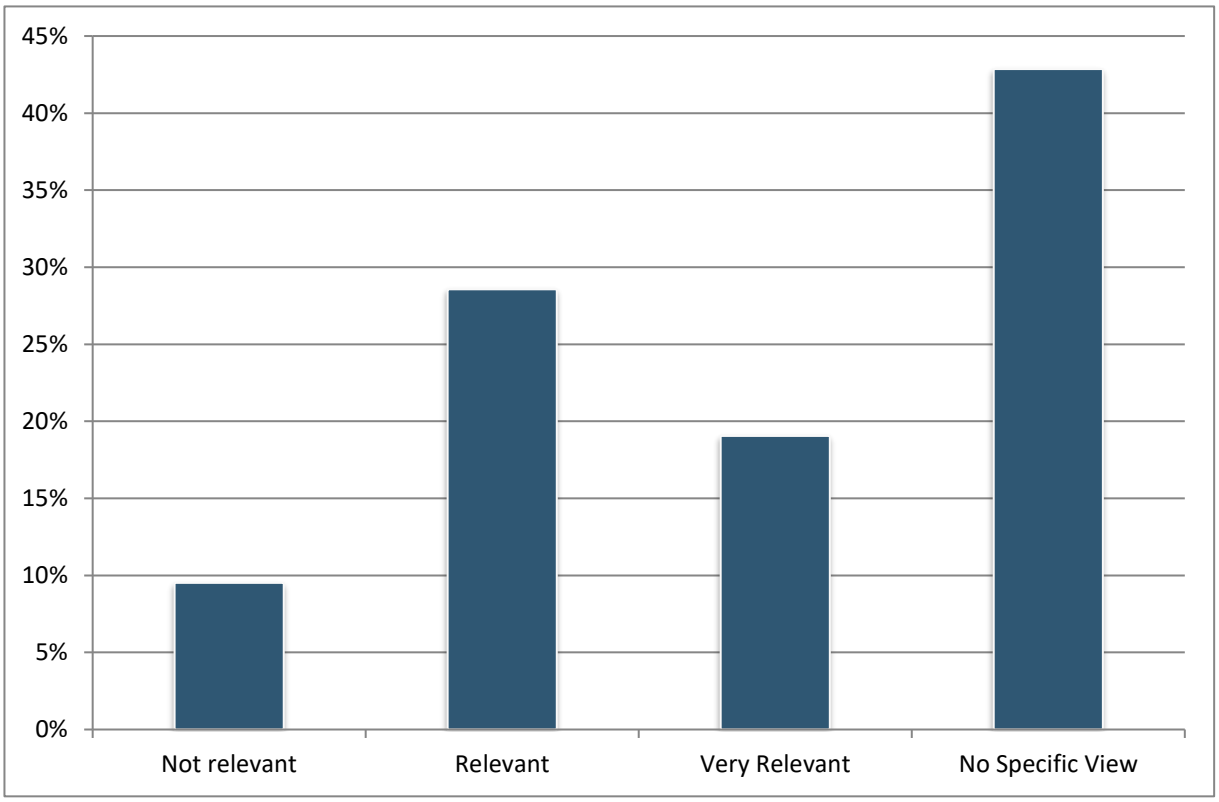
Question 7: Please indicate the relevance of the following macroprudential rules for the cross-border banking activity carried out via subsidiaries established in a Member State other than that of the parent:



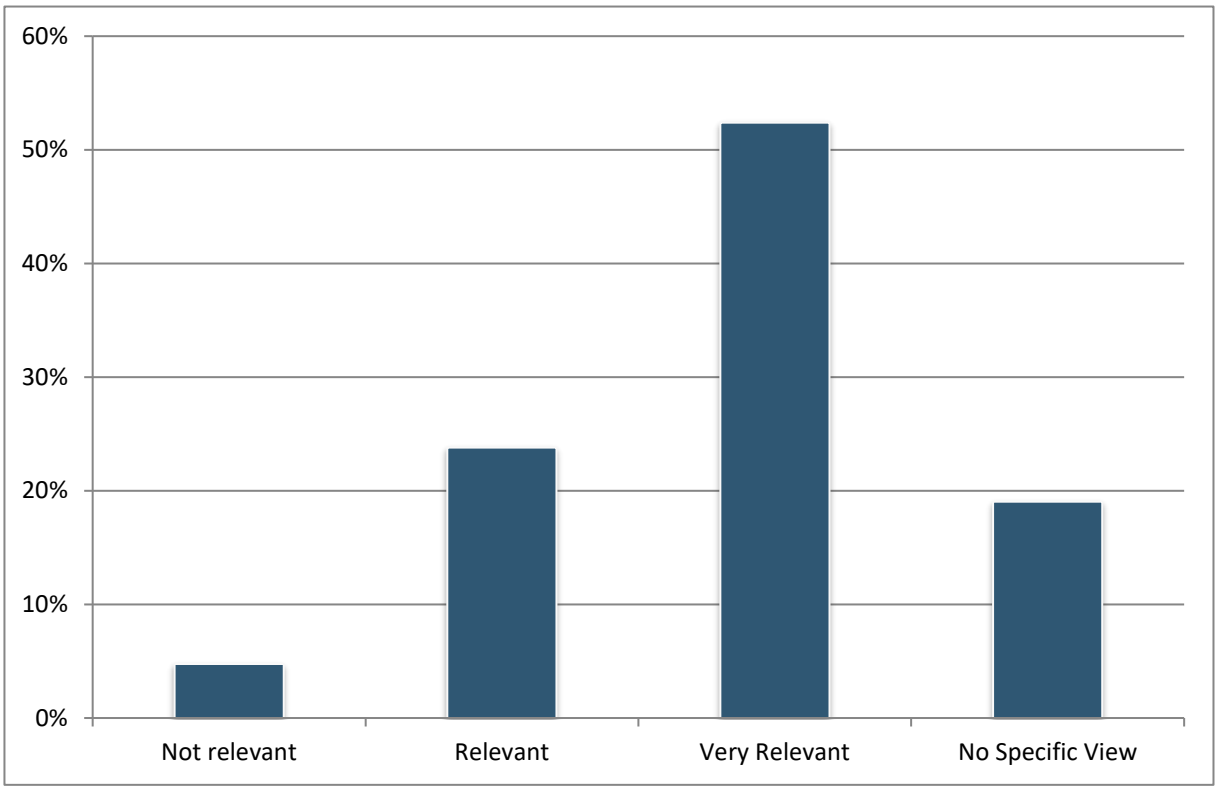
Question 8: Please indicate the aspects – if any – of the cross-border banking activity carried out via subsidiaries established in a Member State other than that of the parent, to which macroprudential policies may be considered to add complexity:



Question 9: The current framework on reciprocation of macroprudential measures poses obstacles to cross-border banking carried out through subsidiaries established in a Member State other than that of the parent.



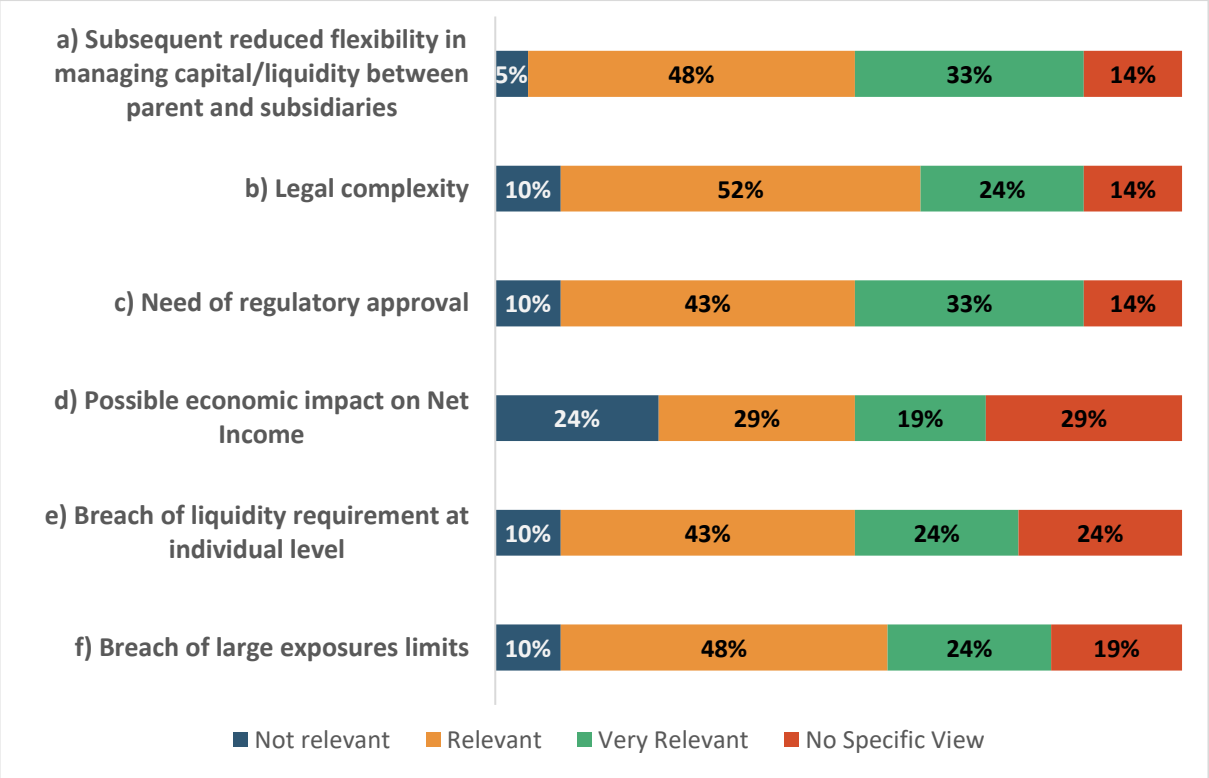
Question 10: A more harmonised and centralised governance of the macroprudential framework at the European level would facilitate cross-border banking carried out via a subsidiary established in a Member State other than that of the parent.



c) Intra-group Financial Support Arrangements

The BRRD provides for the possibility to enter into Intragroup Financial Arrangements as a way to cope with the financial distress of subsidiaries in the recovery phase. Regardless of whether your banking group has such arrangements in place, the Questions aim to assess the potential obstacles to their conclusion and implementation.

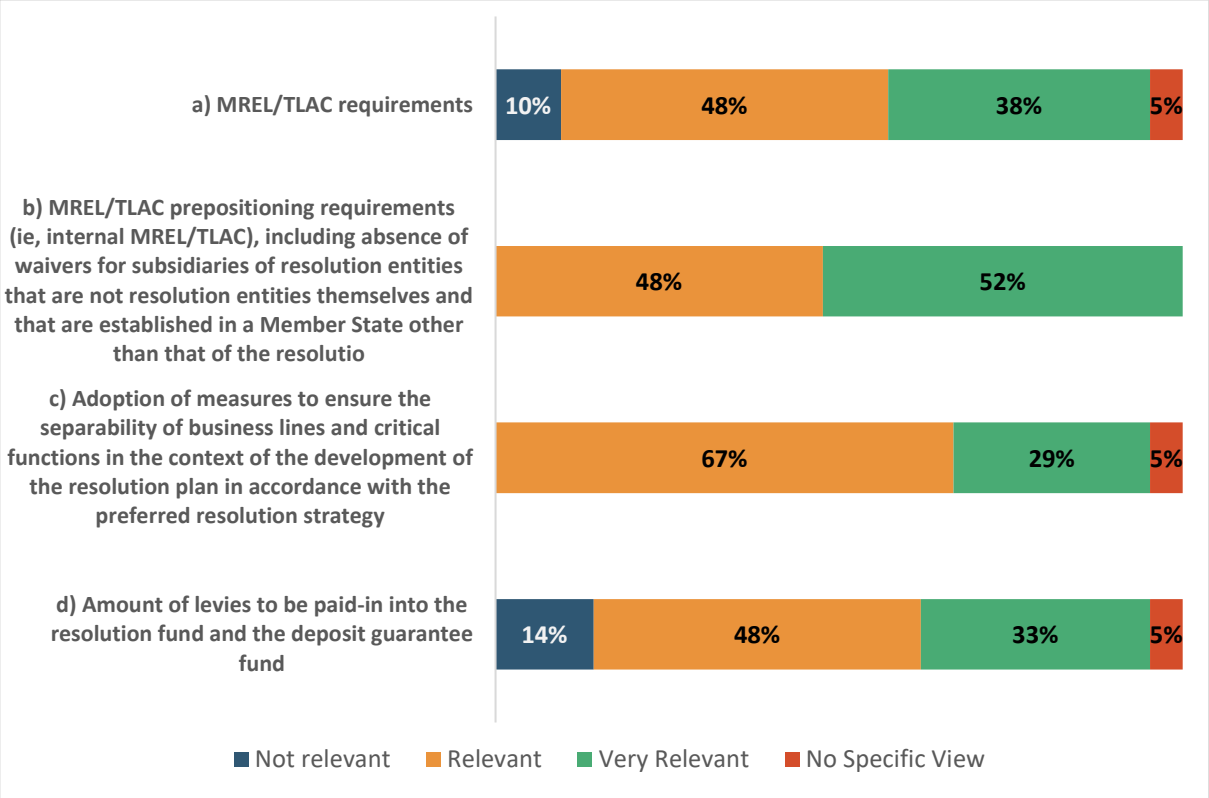
Question 11: Article 19 BRRD provides that a Group Recovery Plan may include the use of Intragroup Financial Arrangements. Please indicate the relevance of the following elements on the feasibility to conclude and implement such arrangements



d) Resolution regime

Resolution requirements, in particular in the planning phase, should be factored-in in going concern. This Section of the questionnaire aims at assessing the impact of selected resolution requirements on the cross-border banking activity carried out through subsidiaries established in a Member State other than that of the parent.

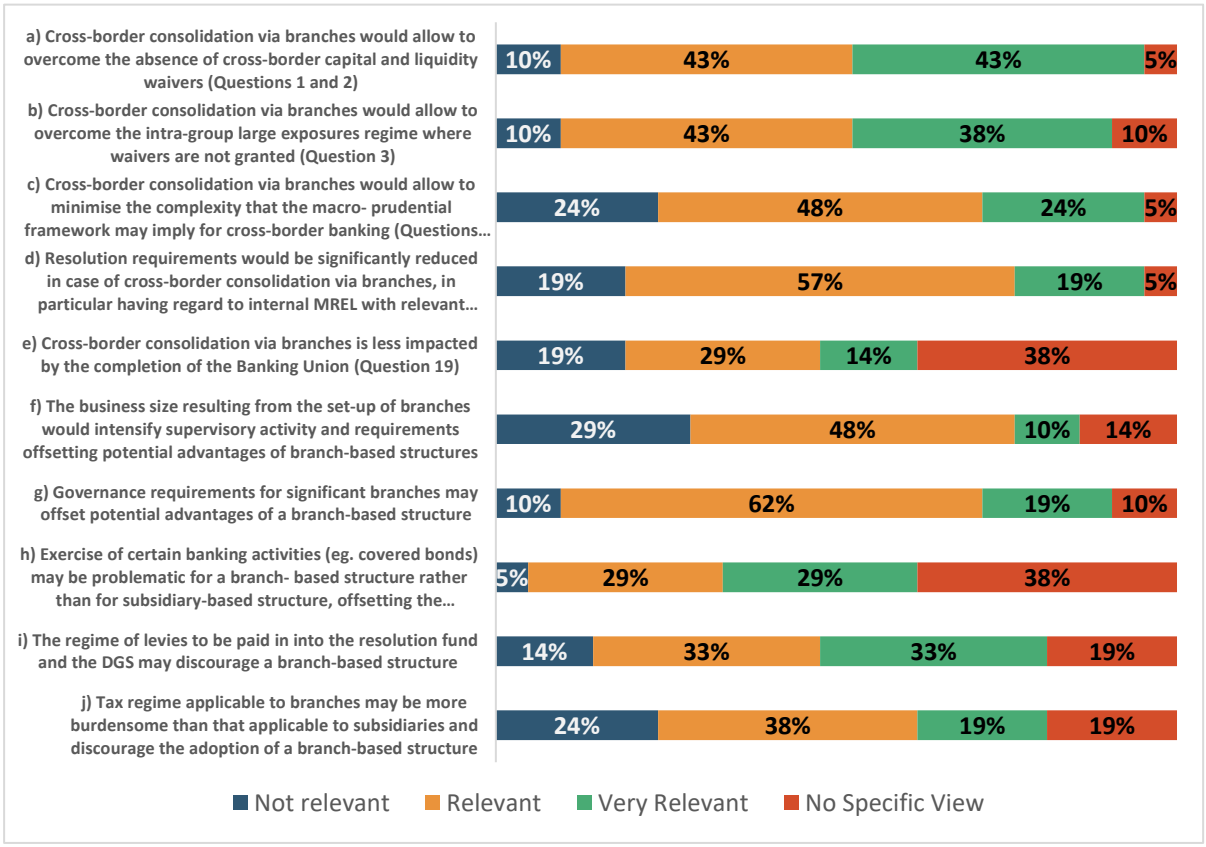
Question 12: Please indicate the relevance of the following factors in the cross-border banking activity, carried out via subsidiaries established in a Member State other than that of the parent:



e) Branches v. subsidiaries (cross-border structures)

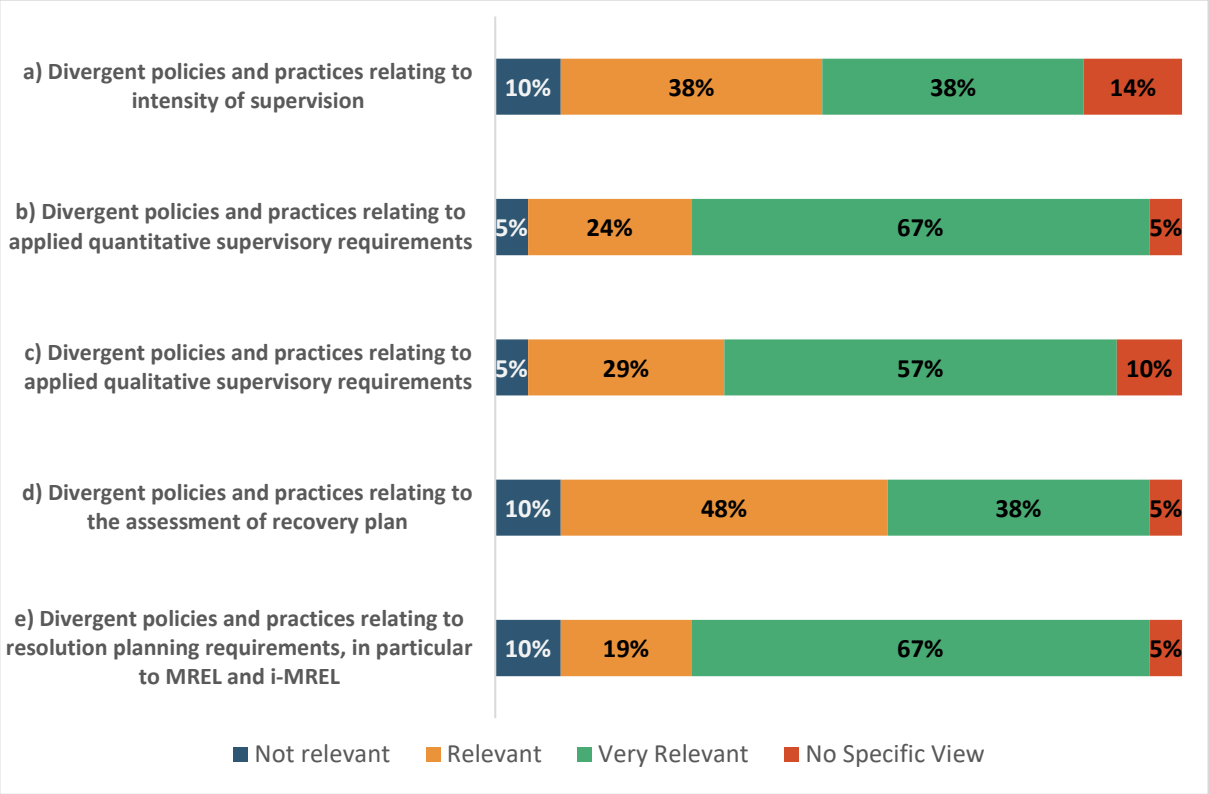
On the backdrop of the regulatory overview provided in Questions 1 to 12, this Section aims to assess whether a branch-based structure might be more attractive strategy than a subsidiary-based structure in order to carry out cross-border banking via establishment and cross-border consolidation. In particular, it investigates whether or not a branch-based structure makes the potential regulatory impediments mentioned in the previous Sections of the questionnaire less relevant. Also, it investigates whether specific 'con' factors may play a role in the choice of a branch-based structure.

Question 13: A branch-based structure may be considered more attractive strategy for cross- border banking and consolidation than subsidiary based structure. Please indicate whether this is a sound alternative, by expressing the relevance of the following elements on a potential move to 'branchification'.



f) Supervisory approaches

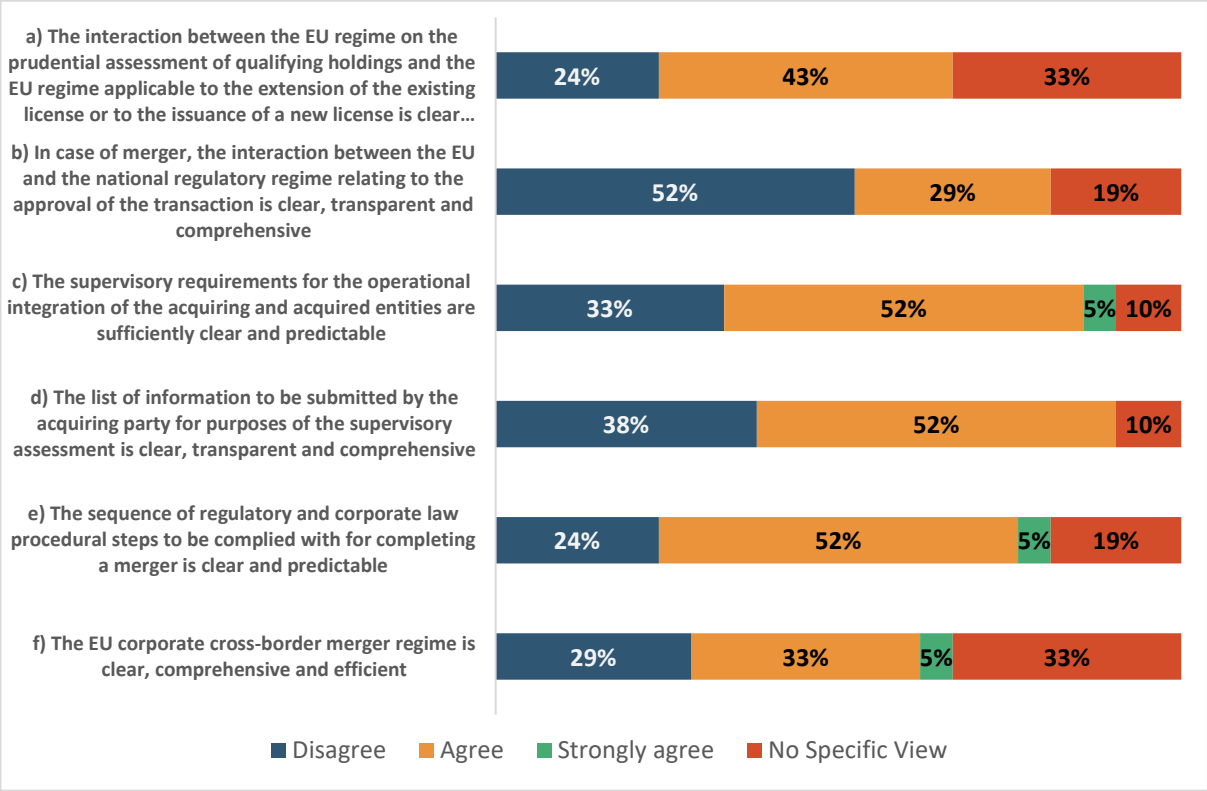
Question 14: Convergence of supervisory practices has improved since the development of the Single Rulebook and the establishment of the Banking Union, divergent policies and requirements, however, are still in place. By focusing on specific regulatory aspects, this Section aims at establishing to what extent potential divergences in supervisory approaches may be an obstacle to cross-border consolidation.



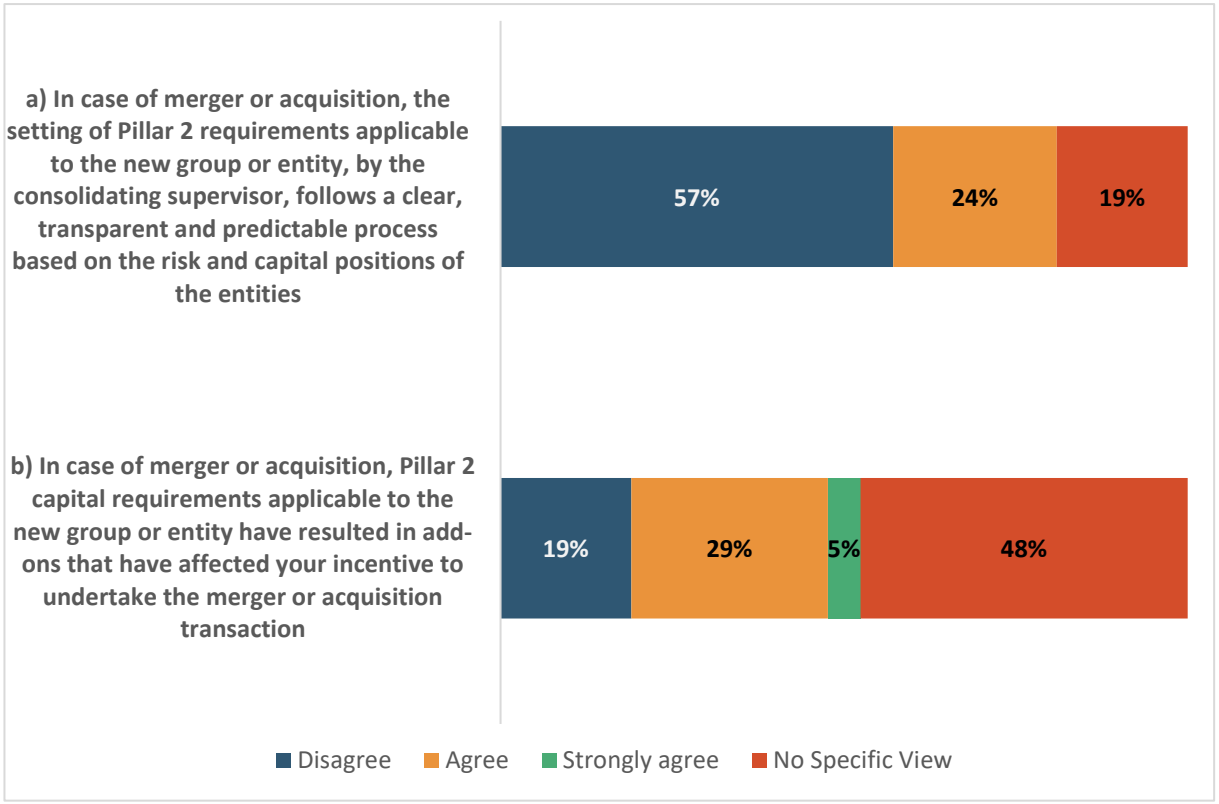
g) Prudential assessment process

According to EU law, proposed acquisitions of qualifying holdings in a credit institution, investment firm or insurance company are subject to a prior prudential assessment. This Section of the questionnaire aims to assess whether the current EU regime relating to the assessment of the proposed acquisition is sufficiently clear, transparent and comprehensive or whether, in particular having regard to mergers that may also entail the extension of the existing licence or the issuance of a new licence, clarity, transparency and comprehensiveness are not sufficient at this stage.

Question 15: Please provide your assessment of the following statements:

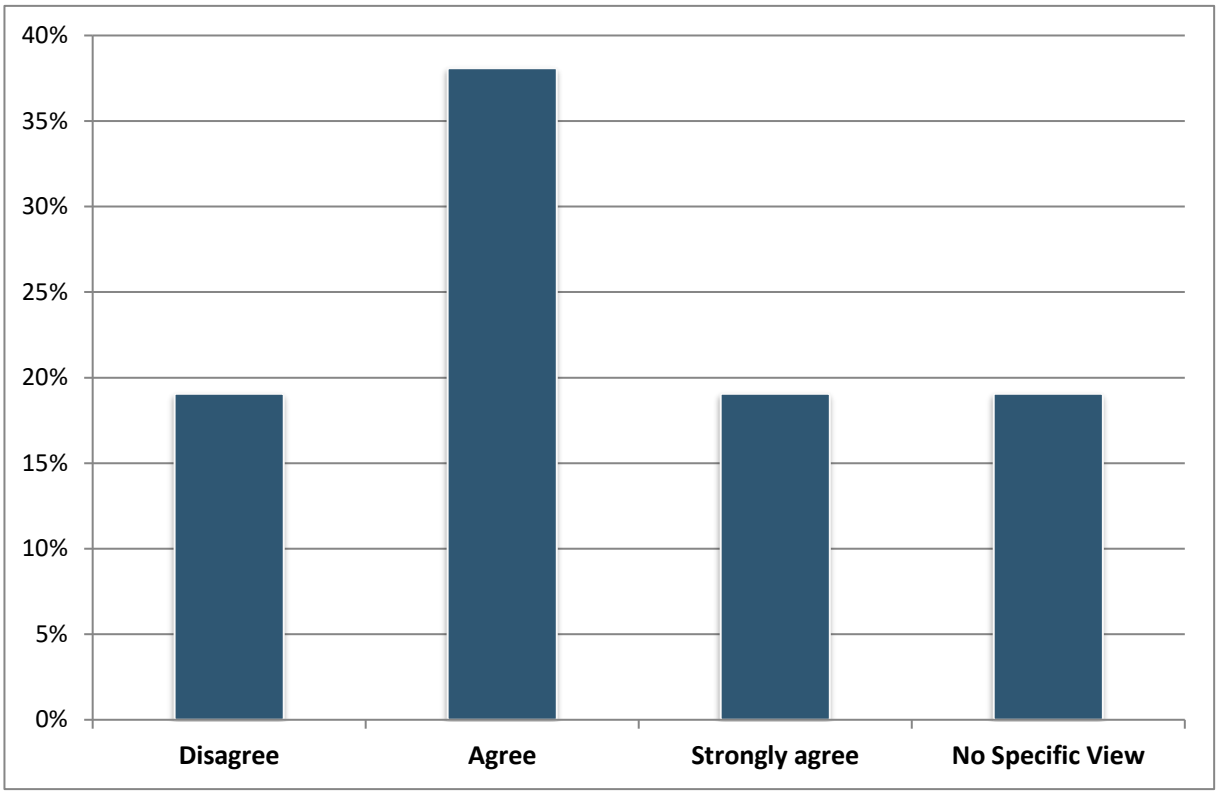


Question 16: Please provide your assessment of the following statements:



Question 17: Please provide your assessment of the following statement:

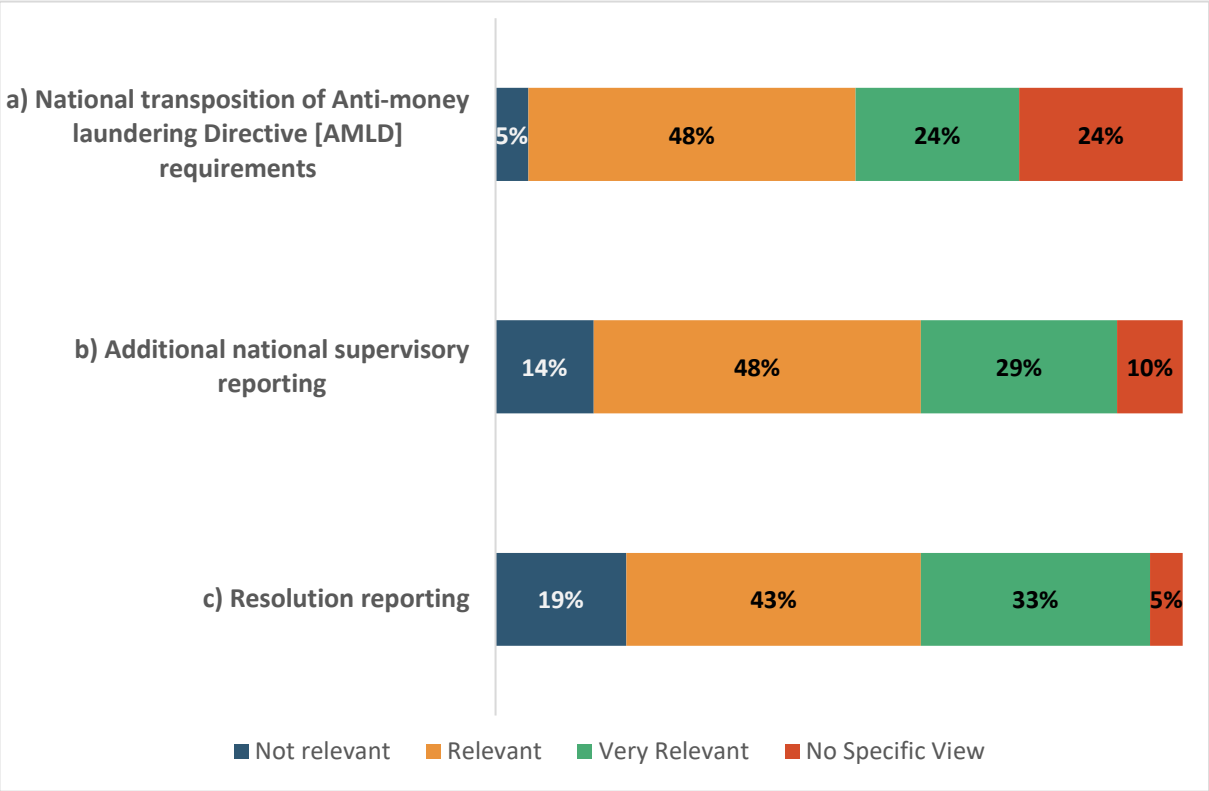
On the basis of your M&A experience (either as potential bidder or target), you believe elements of protectionism in the policies and procedures implemented by the supervisory and other authorities of the target entity's Member State in the planning/preparatory phases of an M&A may pose impediments to cross-border consolidation.



h) Other prudential regulatory and supervisory elements

This Section of the questionnaire considers other regulatory aspects that may impact on the cross-border banking activity through a subsidiary and aims to assess their impact.

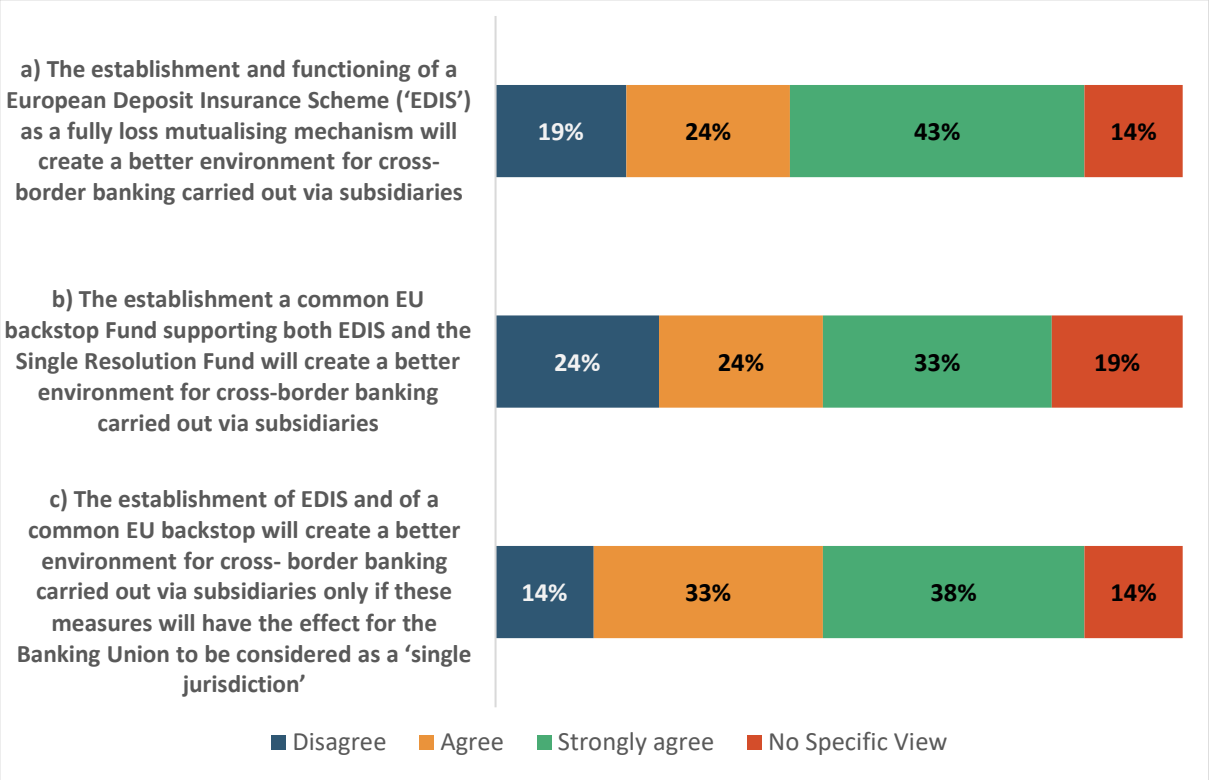
Question 18: Please indicate the relevance of the following elements for the cross-border banking activity carried out via subsidiaries established in Member States other than that of the parent.



i) Completion of the Banking Union

This Section of the questionnaire focuses on the potential impact of the completion of the Banking Union on cross-border banking consolidation.

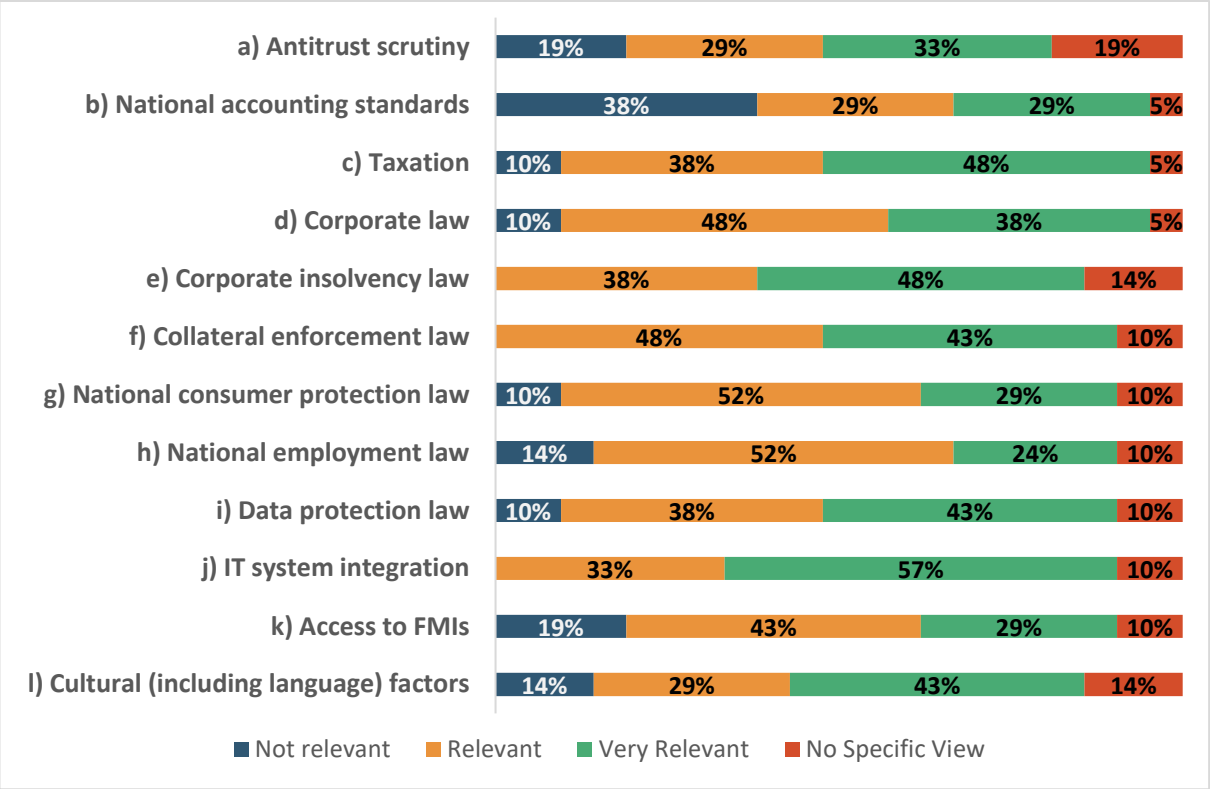
Question 19: The completion of the Banking Union will create a better environment for cross-border M&A in the banking sector. Please provide your view on the statements below:



(l) Other legislative and non-legislative elements

This Section of the questionnaire focuses on other legislative and non-legislative elements that may be considered obstacles to cross-border banking consolidation.

Question 20: Please indicate the relevance of the following elements for the cross-border banking activity carried out via subsidiaries established in Member States other than that of the parent:



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