FRAGMENTATION ISSUES IN THE EU BANKING SECTOR

While we have come a long way since the establishment of the Single Supervisory Mechanism (SSM) four years ago, the Banking Union is far from complete. An efficient banking Union would break the sovereign- bank vicious circle, foster a more effective allocation of resources across the Eurozone (e.g. companies would be able to tap wider and cheaper sources of funding), help to achieve a better diversification of risks thus contributing to private risk sharing within the Union.

Despite the challenges faced in recent years, with the emergence of new competitors and low levels of profitability, many European countries' banking systems remain oversized and still have surplus capacity. In addition, international consolidation processes have been few and far between, and this pattern has not changed since the launch of Banking Union.

The limited strength of private risk-sharing channels in the euro area reflects both the underdevelopment of capital markets and a highly segmented banking system at the national level. There is little progress in cross-border lending, especially in the retail markets, or in other words, in lending to households and firms. Expanding this foreign activity would be important for the sound working of the euro area.

1. The Banking Union is failing to provide the expected degree of financial integration

The existence of the SSM and the SRM have not had any marked impact on the banking industry's structure in Europe. Indeed, the banking sector in Europe is too fragmented, not concentrated enough and oversized.

1.1. A fragmented banking landscape in the European Union

Indicators are continuing to signal banking fragmentation in Europe. The share of cross-border loans to households and cross-border deposits from households remain negligible at around 1% (see chart 2). Direct cross-border loans to firms accounts for only around 8% and this figure has hardly changed since the creation of the Banking Union (see chart 1).

The share of cross-border deposits in the euro area from firms is also very low (around 6%) and has fallen slightly over the last few years. The level of foreign bank penetration is, overall, relatively low for a Banking Union.

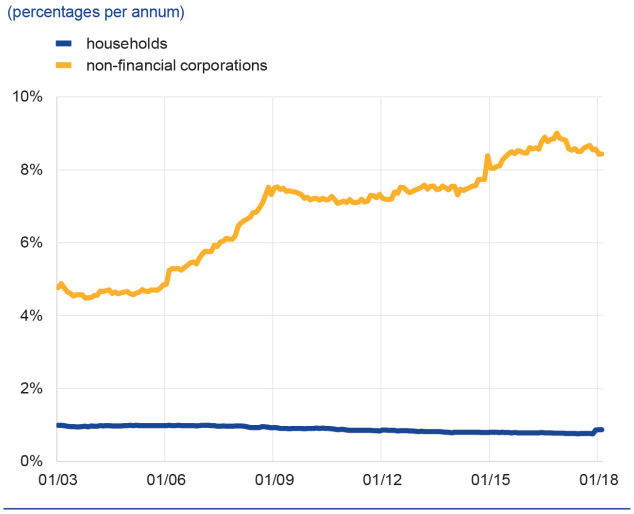
Moreover, despite the quantitative easing policy of the ECB, the doom loop between banks and their sovereigns is far from being resolved. According to EBA, on average, 65% of a medium sized bank's Tier 1 capital, is on the domestic sovereign, but in the whole distribution there are banks which have up to eight or nine times their Tier 1 capital on the domestic sovereign.

1.2. An Oversized banking system in Europe

The fragmented banking sector across domestic lines leads to overcapacities of the banking sector in many countries; according to the IMF[1], the European Union is particularly concerned by overbanking, i.e. an "overly marge banking sector that in the end affects the profitability of the banks in the system".

Chart 1

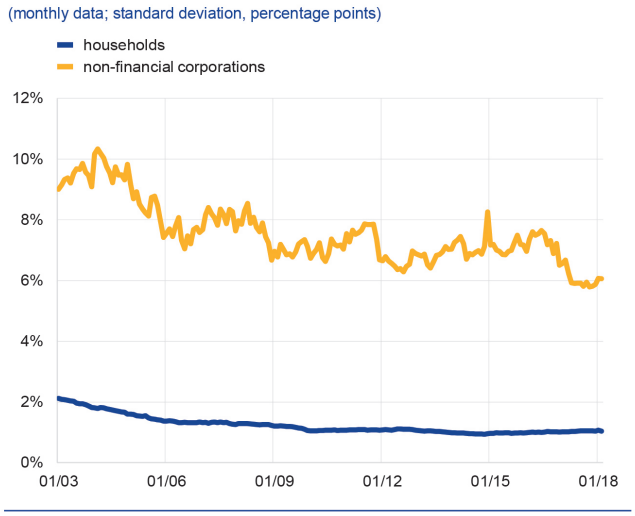
Share of cross-border loans in the euro area for NFCs and households



Source: ECB (BSI).
Note: Cross-border loans include loans to other euro area Member States for all maturities and currencies.

Chart 2

Share of cross-border deposits in the euro area for NFCs and households



Source: ECB (BSI).

[1] IMF, Global Financial Stability Report, October 2017.

Many indicators point to this excess capacity (see table 1). For instance, efficiency indicators – such as cost-to -income ratios (around 69% in the euro area, and 60% in the United States) or branches per population (44 per 100,000 inhabitants in the euro area and 26 in the United States) illustrate this overcapacity.

Table 1
Some comparative indicators of the US and Euro Zone banking sector

	Euro area	United States
Size of banking system (% of GDP)	280%	91%
RoE (avg 2013–17)	4.5%	9.0%
Cost–to–income	69%	60%
Branches (per 100,000 inhabitants)	44	26
Publicly traded banks (% of total assets)	52%	78%

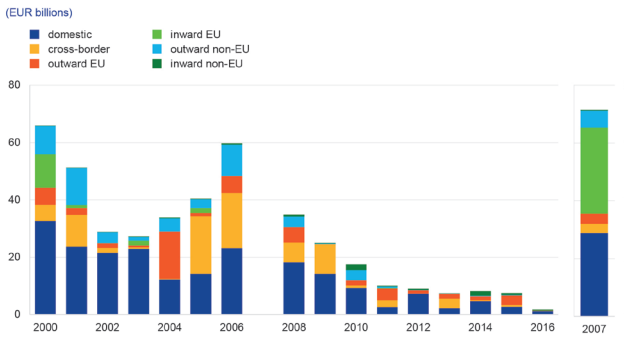
Source: F. Restoy, «The European Banking Union: Achievements and challenges", Fundacion ICO, 2018

Banks in Europe therefore have to face a much more competitive environment than in the United States and therefore a much stronger pressure on their margins. Moreover, lasting low interest rates have negative consequences on EU banks profitability - it compresses net interest margins - which penalizes them vis-à-vis their American counterparts. Indeed, the target federal funds rate is currently 2.25 - 2.5% in the United States while the ECB interest rate on the main refinancing operations (MRO) is at 0% since more than 4 years.

1.3. Not concentrated enough

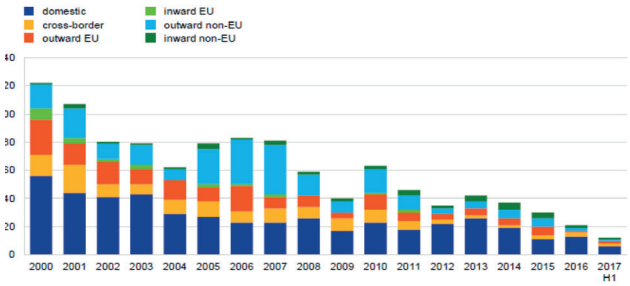
Bank Merger & Acquisition (M&A) transactions within the Euro Area have been on a steadily declining trend, both in terms of number and value, since the year 2000 (see charts 3 and 4). Cross-border merger and acquisition activity among banks within Europe have practically disappeared. Indeed, bank Merger and Acquisition within the euro area has been on a steadily declining trend both in terms of number and value, since the year 2000.

Chart 3
Bank M&As involving euro area banks – value of transactions



Sources: Dealogic and ECB calculations.
Notes: "M&As" refers to transactions where 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 national borders of euro area countries. "Cross-border" M&As involve euro area targets and non-domestic euro area acquirers. "Inward" refers to M&As by non-EU or non-euro area EU banks in the euro area and "outward" indicates M&As carried out by euro area banks outside the euro area.

Chart 4
Bank M&As - number of transactions in the Euro Area (ECB 2017)



The EU banking system is much less concentrated that the US one: the market share of the top five US banks within the United States was more than 40% in 2016, whereas the market share in the Eurozone of the top five European banks stands at more or less 20%.

In 2018, there were only $5,0 bn of mergers between European banks, the lowest level for man than a decade and a tiny fraction of the €193,8 bn of such deals done on the eve of the financial crisis in 2007, according to date from Dealogic[2].

2. Why have we seen such a decline in banking M&As?

For three major reasons:

- Until now, the largest banks (GSIBs) are penalized in terms of their capital requirements in proportion of their size (G-SIB buffer). One can understand why they do not wish to be bigger given these disincentives. At the same time, regulation fails to fully acknowledge the prudential benefits associated with the geographical diversification of exposures;
- Furthermore, in an environment where digitalization and fintech challenges may be seen as a higher priority in a time of business reassessment, the largest banks are reluctant to absorb banks burdened with NPLs all the more so since a European securitization market is still underdeveloped due again to regulatory constraints. One can add that another obstacle to merger activity is the structure of the banking industry: only 30% of the significant banks in the euro zone (directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the Eurozone are saving banks, regional banks or cooperative banks;
- Lastly the EU legislative prudential framework does not recognize trans-national groups at the consolidated level but as a sum of separate subsidiaries ("national or solo approach") notably due to the insufficient trust of Member States vis a vis the institutional set up of the Banking Union. Moreover, ring-fencing policies (capital, liquidity, bail-in instruments, leverage ratio...) by host supervisors, applied to subsidiaries of transnational banking groups, which are located in their countries, discourage large EU banks to increase the number of their subsidiaries in the EU.

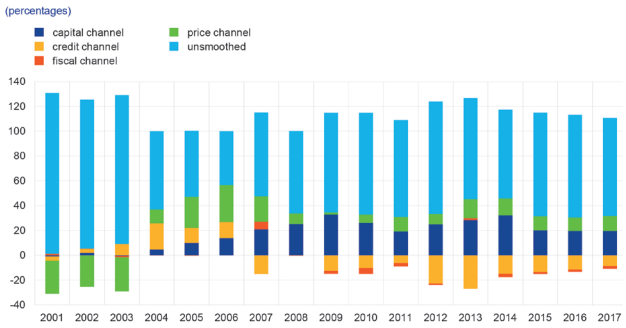
[2] Two- thirds of Europe's banking consolidation in 2018 was from domestic deals, such as Banco Santander's takeover of Banco Popular for €1 in June or Intesa Sanpaolo's acquisition of two failed domestic rivals in Italy's Veneto region for a token price. The value of European cross-border deals done in 2017 exceeds all such deals agreed in 2018.

Finally, in the current political context, no State would be happy to see the disappearance of one of its banks due to a takeover by a bank in another European country.

3. Overall, since 2007, the credit channel (i.e. cross-border lending and borrowing) has been acting in the euro area as a sock amplifier rather than a shock absorber (see chart 5)

Chart 5

Consumption risk sharing in the euro area and its channels



Source: ECB calculations. Notes: The chart displays, by year, the contribution of capital markets (via cross-border ownership of productive assets), credit markets (via cross-border borrowing and lending), fiscal tools (via public cross-border transfers), and relative prices (via changes in the domestic consumer price index relative to the euro area average index) to the smoothing of country-specific shocks to real GDP growth. The respective contributions are calculated using a vector-autoregression (VAR) model whose parameters are estimated over a ten-year rolling window of annual data, applying the Asdrubali and Kim (2004) approach enhanced for relative price adjustments. The bars display the share of a one-standard-deviation shock to domestic GDP growth that is absorbed by each respective risk-sharing channel. The shares are computed on the basis of the cumulative impact of the shock on the variables capturing each risk sharing channel over a five-year horizon. Year-to-year variations in the shares reflect changes in the re-estimated model parameters. The remaining portion represents the portion of the shock to country-specific real GDP growth that remains unsmoothed and is fully reflected in country-specific consumption growth. The individual bars may fall below 0% if one or more of the channels involved has a dis-smoothing effect on country-specific consumption growth. All bars together total 100%.

Whereas they used to be mostly cross-border in the pre-crisis period, they have increasingly become of a domestic type. Furthermore, as unveiled in research by Raposo and Wolff (2017), domestic M&A transactions have become increasingly of a 'controlling participation' type, whereas cross-border transactions have become increasingly of a 'minority participation' type. Certainly, all of this was, to some extent, driven by the post-crisis inward-looking bank restructuring strategies put in place by supervisors and Member States.

According to A. Enria[3], overall, since 2007, the credit channel (i.e. cross-border lending and borrowing) has been acting in the euro area as a shock amplifier rather than a shock absorber.

Private risk sharing has indeed been impaired in the euro area, and a fortiori in the EU. This should be a concern, as it is through risk-sharing channels that the overall system becomes, at the same time, more resilient and more productive.

4. What are the consequences of this geographical nationalization of the European Banking system and regulatory framework?

As explained by Jacques de Larosière in a speech delivered in October 2018 at the European Financial Committee, the consequences of this fragmentation are severe and notably mean:

- Weak profitability of banks (in 2017, the return on equity was 3,9% on average in the European Union as opposed as 9,5% in the United States) at a time of particularly rapid technological innovation. Only banks with healthy profits can invest in technology, talent and scale;
- Reducing costs through economies of scale is more difficult and in addition, there is much less transfer of technology and knowledge;
- Competitive disadvantage for Pan-European banks versus US ones, which benefit from a large domestic base;
- The EU resistance to asymmetric shocks is weaker (in the United States the capital and credit markets absorb alone more than 50% of the consumer impacts; in Europe is only 10% because of the lack of capital mobility and of credit which stay within national borders. In total, including the fiscal element, more than 2/3 of the shocks are absorbed in the US whereas it is only 1/5 in Europe.

Conversely further banking integration would foster resilience against economic shocks. A geographically diversified loan book and deposit base make banks less vulnerable to domestic banks and thus reduce the volatility of their lending and income streams; private risk sharing via the banking channel would thus be made possible by a higher degree of risk diversification enabled by diminishing the domestic bias, be it in the shareholding of banks, in the attribution of credit or in the detention by banks of domestic sovereign debt.

It is evident that « ring fencing » is a significant contribution to explain these consequences. If we continue to condone ring-fencing and hinder cross-border banking consolidation, the risk is to see banking groups split into branches instead of subsidiaries.

Despite remarkable achievements in terms of balance sheets cleaning, regulatory harmonisation, and deepening institutional integration within the Banking Union, where the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are up and running, financial integration is lagging behind. The Banking Union is failing to provide the degree of financial integration that we would have expected. Rather than smoothing idiosyncratic shocks to individual Member States, the banking sector still operates as a shock amplifier.

If the EU wants to keep up with the US and China economically as well as politically, it must break out this downward spiral and strengthen its banking industry. Only competitive and profitable banks can take on the risks necessary to finance sustainable growth. This is why a financial integration agenda for the Banking Union should rank high among the priorities of legislators and authorities for the next five years. ■

[3] A. Enria, "Fragmentation in banking markets: crisis legacy and the challenge of Brexit", Speech, BCBS-FSI High Level Meeting for Europe on Banking Supervision 17 September 2018.