BANK FRAGMENTATION AND PROSPECTS OF FURTHER CONSOLIDATION

1. A more integrated EU banking sector would be beneficial both for the real economy as well as for banks' resilience

An industry representative noted that the Banking Union was designed in order to build a private risk-sharing environment needed for the eurozone to absorb shocks, in order to achieve a better allocation of liquidity, capital and resources for cross-border banking groups, and more efficiency in the allocation of resources to unlock growth potential for the eurozone. From a business perspective the Banking Union has created a brand of quality for Europe. It is a cause of happiness that it was created, and that the detail and credibility are being built up day-by-day, by the work of the ECB and the Single Supervisory Mechanism (SSM). The brand will exist more in the Europe of tomorrow, rather than in the Europe of before, and it is making sure that the lessons of the crash have been learned.

An official agreed on the importance of banking integration in the eurozone. This is valuable from the point of view of the industry and is the only way to put in place a meaningful risk-sharing mechanism. This is essential for ensuring the strength of the economic and monetary union project. There is indeed a political limit to public risk-sharing mechanisms; private risk-sharing mechanisms are needed, and it is not clear how these can be put in place without more banking market integration in the eurozone.

A central banker felt that the ECB needs an integrated financial market where capital and liquidity can flow freely, to reap the benefits of the scale and scope of the European market. More needs to be done here, but much has already been achieved.

An industry representative noted that the banking sector should be safe and able to address downturns in the economic cycle. This is the other challenge. The English have a marvellous saying: the proof of the pudding is in the eating. It is in the downturn that the quality of the Banking Union will be shown. The question is whether it will be more solid as a result of fragmentation, or more solid through trust in new institutions.

2. A fragmented banking landscape in the European Banking Union despite the implementation of the Banking Union

Whilst much progress has been achieved in terms of the European Banking Union, the banking market remains fragmented across Europe. This fragmentation carries with it a cost for the sector and for individual banks.

2.1. Much progress has been achieved

A central banker noted that the SSM has achieved a great deal. Compared to five years ago, there is now a single rulebook. More than 130 national options and discretions have been harmonised. A single Supervisory Review and Evaluation Process (SREP) has been put in place. A crisis management framework for non-performing loans (NPLs) has been introduced. A Targeting Review of Internal Models (TRIM) project has been launched to harmonise internal models. Many problems in the SSM and ECB's control have been solved.

Regarding market fragmentation, at the start of the SSM 5,516 financial institutions had balance sheets of around €24 trillion. Now there are 4,697 and still a balance sheet of €24 trillion. A consolidation of at least 20% has quietly taken place in the past five years. If this continues smoothly, the eurozone is on the right track.

The Chair noted that an impressive number of – mostly small – banks have disappeared unnoticed, so a consolidation is happening. However, when consolidation is talked about, it means another layer of banks, whereas here when the word comes up it means cases where legacy issues need to be addressed and where consolidation would mean a need to combine or restructure.

2.2. A fragmented banking market

An industry representative noted that fragmentation in the EU banking industry has increased since the launch of the Banking Union. In the euro-area the share of cross-border loans to households remains at barely 1%, the interbank market has dried up and cross-border deposits are below 2%. The EU banking system is also less concentrated than that of the US. Fragmentation has a cost for the economy: a non-optimal allocation of savings (which do not circulate within European countries) to the detriment of investment.

An official felt the numbers are not very positive in terms of the degree of market integration achieved. For instance, the proportion of cross-border operations in terms of loans or deposits is 6-8% of the total and has not increased since the inception of the Banking Union. The participation of foreign institutions in domestic jurisdictions is, on average, around 15%, which has also not increased. The number of cross-border mergers between banking institutions remains low and has not increased. Therefore, something is not working as expected. Some progress has been achieved in consolidation, but this does not necessarily imply integration.

An industry representative noted that normally, the signal should come from the authority to move to a more integrated market. There will be some complaints at certain levels, but the process will go on and adjustment will be made. Historical reasons have played a role, but history has to be interpreted. Mergers and acquisitions have not gone as far as they should. It probably falls on the authorities to give the indication.

The Chair summarised that it is possible that fragmentation is hindering free flows, and at the same time there has previously been expressed a feeling that trust is short between members of the Banking Union and beyond. There is talk about a single point of entry resolution approach and a consolidated market that needs to be underpinned, but there will always be some allocation of risk and capital within a group.

2.3. Fragmentation has a cost

An industry representative noted that fragmentation and ringfencing comes up time and again at Eurofi meetings, and the same problem is still being grappled with. In terms of what is fragmentation, a former managing director of the IMF once said, 'If people ask me what a giraffe is, I do not know how to define it but, when I see one, I recognise it.' Fragmentation has a cost, and when that cost is paid it is noticed.

There is a sentiment of resignation to the presence of fragmentation. It is perhaps an issue of collective responsibility; not only of the regulators, but of the regulated. At a national level, local banks tell regulators that new regulations need to be interpreted in the light of domestic realities. Everyone is an accomplice in the current status.

The reason that fragmentation is a problem is that it impoverishes the value of the brand of the Banking Union. It also creates problems for banks that have become pan-European and feel under pressure to revert to a more nationally orientated approach. If there is complacency about the reversal of the pan-European model for banks, it should be made more explicit, as it would mean a very radical change of attitude.

2.4. Anti-Money Laundering is also a cause of concern

An industry representative noted that it is difficult for investors to understand that behind the brand name there are money laundering stories. It is a common challenge, and a brand that is managed together. The banking sector is more to blame, but it is a joint story. For a few weeks the question that investors have been raising is why this is happening in the Banking Union. The challenge is to maintain the high quality of the brand.

A central banker felt that it is not just a brand name that has been created, but it has been filled with substance. Anti-money laundering (AML) raises concern. The ECB is not directly responsible for AML, but it affects the ECB's credibility with investors. This is an argument for the ECB to focus on tough, fair and intrusive supervision, to protect the ECB and the banking market. No banking market exists without a strong supervisor.

3. Explaining fragmentation in the Banking Union

The Chair questioned whether cross-border is therefore helping rather than hindering. At the end of the Asset Quality Review (AQR), it had been suggested that this would be the start of the mergers, but this has not been seen. There are many reasons, including regulatory ones but also inherent business reasons.

3.1. Regulation is one of the explanations

An official noted that one could see the causes of fragmentation as an introduction to the remedies that are envisaged. The first focal area is regulation. The single rulebook is not yet complete, despite the progress made at the level of the SSM. Indeed, European banking law includes options and discretions for national authorities leading to different rules across countries. It is also true that the Banking Union is not complete. There is still the absence of a European deposit insurance scheme, which is important.

Another group of impediments relates to the prudential regulatory treatment of international banks. It has been suggested that regulations penalise European banks with international businesses, as they are seen as more systemic and as having been more complacent. Those institutions are subject to stringent capital requirements associated with the complexity and systemic importance due to their interconnectedness.

A number of elements in regulation could be revisited to see whether they are necessary for guaranteeing the solvency of financial institutions. When it comes to issues such as capital charges on complexity, it is not difficult to see banks with international business as normally more complex. The case could be made however that there are benefits from the geographic diversification of exposures, which may not be sufficiently recognised in prudential regulation. This is not part of Pillar I capital requirements, and so is not normally considered in terms of Pillar II in the context of SREP. Moreover, in stress tests, for the adverse scenario, it is assumed that there are parallel shocks affecting all relevant jurisdictions, thereby minimising, by construction, any positive effect of diversification. Benefits associated with the geographic diversification of credit exposures not being recognised in prudential regulation could be investigated at the global level.

Ringfencing by definition can be a cause of fragmentation. It could, to an extent, also be seen as a consequence of a lack of economic or political integration in a context of lacking a fully integrated economic area, without sufficiently powerful risk-sharing mechanisms or a common deposit guarantee scheme, and where financial stability is a competence at a European as well as domestic level. This provides a rationale for domestic authorities to try and keep sufficient room for manoeuvre in order to achieve their own objectives. It may be necessary in order to make progress on economic and political integration and further European integration, to discuss the safeguards that could be introduced at the level of subsidiaries in different jurisdictions. This is complex and includes many economic and political factors that need to be weighed, but fragmentation will not be solved by deciding to waive liquidity or capital requirements at a subsidiary level.

3.2. Business case issues are another source of explanation

The Chair noted that more transparency and harmonised rules would unlock the merger or consolidation process, and potentially increase investors' appetites. This has not happened. The Chair wondered if mergers only happen if there is a business case and a clear idea, whether it is more than just working in the same ecosystem, or transparency, and whether a fair value proposition is required.

An official felt that regulation is not the only cause. There is an issue to do with the business case, and whether there is really a business case for more pan-European banks and whether any value is added to banking institutions in Europe by becoming pan-European and starting to invest in other eurozone jurisdictions.

4. Possible way forward

The Chair noted that there will imminently be a new European Parliament and Commission, which offers an opportunity to formulate a wish list of ideas to be taken up. The Chair invited the panellists to share their policy priorities for the incoming Commission, to see more cross-border risk-sharing via the banking channel, or more cross-border investments in a broader market.

4.1. A need to reconsider the solo approach

The EU prudential framework does not recognize trans-national groups at the consolidated level but a sum of separate subsidiaries ("solo approach"). For instance, the Liquidity Covered Ratio (LCR) which is designed to ensure that banks have the necessary assets to face short-term liquidity disruptions, is calculated on a solo basis since liquidity excesses in one subsidiary cannot be used to compensate for possible shortages in other ones. More generally, this solo approach maintains a domestic focus in the way prudential requirements (capital, liquidity, bail-in instruments) are imposed on banking subsidiaries across the eurozone despite the implementation of the Banking Union.

An industry representative noted that there is a need to remove discretion in EU regulations that allow member states to limit exposures of subsidiaries to their holdings, as if they were third-party banks. This is mostly in respect of large exposure limits. There needs to be a change to the existing regulatory framework; whereby capital and liquidity requirements need to be met at both consolidated and solo level. There then needs to be a reconsideration of the amount of loss-absorbing capacity to be requested from banking-group subsidiaries, and the question of the internal Minimum Requirement for own funds and Eligible Liabilities (MREL) for subsidiaries to consider.

There were many changes at the Central Bank level. The Banking Union has come a long way, but there should be a forum of dialogue between the SSM, the Single Resolution Mechanism (SRM) and the ECB on the problems confronting the Banking Union. There are a number of requirements from the SSM and the SRM, and it is necessary to gauge whether there is an integrated capital market to satisfy those requirements without creating problems, which poses a challenge for the ECB in terms of ensuring sufficient liquidity to accommodate all of the issues.

A central banker felt that in terms of dealing, there is a strong dialogue on prudential matters between institutions regarding the SSM, the SRB and the Commission. Much has been achieved, and the SSM is willing to do more whenever it can to generate a more integrated and efficient market. There is a long wishlist, first of all concerning the regulation of derivatives.

4.2. The real debate is about trust

A central banker noted that the SSM are supervisors, not a super-ministry for industrial banking policies. The SSM cannot be expected to orchestrate cross-border mergers. It is neither their mandate nor their role and would be an overextension of their authority if they tried. The SSM's role is to make sure that a merger leads to healthy institutions. This is why they will sometimes ask questions in a merger where there is a great deal of bad will-creation for additional capital. A merger has certain restructuring costs that need to be covered and takes a great deal of management concentration away from clients. Here, too, a capital buffer is needed.

'Fit and proper' has different definitions in different countries. In some countries the SSM has a say in mergers, and in others it does not. This makes no sense. If there is trust in the SSM, then it is very difficult to argue against capital and liquidity waivers. The only argument against them is a lack of trust, but what is arguably needed is the completion of the Banking Union, so that the national state is not paying. What is also needed is the completion of the Capital Markets Union. There cannot be a functioning Banking Union without a functioning Capital Markets Union. The harmonisation of insolvency and other laws is therefore required.

An industry representative noted that care is needed when speaking about cross-border, as there is market consolidation, especially in investment banking. What is meant when saying there is no cross-border is in reference to specific operations that M&A bankers prefer. In practice, there is much market-share consolidation in the hands of some European banks, but mainly of non-European banks. This is a crucial question, as there is consolidation and there is a strategic debate behind it. A very senior supervisor once advised, 'If you want to avoid fragmentation, please create branches and transform your subsidiaries into branches.' Supervisors have much discomfort with existing fragmentation. The real debate is not about cross-border operations, but about trust. On trust and distrust of banks, by definition, supervisors do not trust banks, or they are not doing their job. It is normal for banks to challenge supervisors, as it is the only way for them to be sure that they are at the cutting edge of appropriate management.

The new Commission should prioritise consistency. It should try to fix and define the home-host debate, as banks need to know what may happen in the future. Dividends are paid amongst groups and capital is allocated, so discussions cannot keep on happening. The framework and the rules of the game need to be understood. The allocation of MREL, capital, and the capacity to adjust liquidity are extremely important questions in the setting up of a bank. Supervisors are right to ask banks to be clear, but banks need a better understanding of the rules. The Commission should sit down with stakeholders and try to arrange things in such a way as to increase clarity and reduce fragmentation. If mergers are desired, large balance sheets will be required. This means a capital surcharge, or the risk of a capital surcharge. It is difficult to explain to shareholders taking the execution risk of a merger at the same time as paying a capital surcharge. What needs to be in place is an efficient, functioning securitisation system. If assets cannot be shifted outside the balance sheets of European banks, there will be increasing capital surcharges. The level of securitisation in Europe is lower than before the crisis, and hence consistency is needed.