Cross-border bank consolidation prospects

©Bernd Roselieb BaFin

Felix Hufeld

President, Federal Financial Supervisory Authority, Germany (BaFin)

Cross-border mergers are no panacea

It is said that lawyers respond to any question with a firm “It depends”. And if one were to ask me whether increased cross-border consolidation between banks in the EU were necessary, that is precisely the answer I would give: because with mergers in particular, we must always consider the individual case. Where the aim is to turn two ailing banks into one strong institution overnight, mergers certainly do not provide all the answers. Besides, big is not always beautiful. Germany’s banking industry, for example, with its unique structure developed throughout its history, also has many small institutions that are nonetheless strong and economically sound. Often this success is due to a focus on a particular customer segment or business model. Apart from that, the bigger the institution, the greater the challenges for regulators and supervisors. The too-big-to-fail issue comes to mind here.

For each individual case, one must once again ask whether the planned merger will actually result in a business model that is viable over the long term and, consequently, yield a sustainable improvement in the companies’ financial position and results of operations in the foreseeable future. Within a reasonable period of time the synergies must balance out the expenses associated with the merger in addition to the weaknesses present in both institutions before their merger. And we are not talking about issues of competition law yet. Experience gained across numerous sectors suggests that the benefits of a merger are often overestimated ex ante, while the risks are underestimated. And this is seen regardless of whether the merger takes place at the national or European level.

Are cross-border mergers between banks in the EU possible? This question I can answer with a clear “yes”, and there are historical examples to prove it: in 2016, the French private bank Oddo acquired BHF Kleinwort Benson for around EUR 600 million and at the end of 2008, the French bank Crédit Mutuel took over Citibank Deutschland from the Citibank group for around EUR 5 billion. Similarly, the takeover of the Hypovereinsbank by the Italian bank UniCredit in 2005 in addition to the takeover of the BfG Bank by the Swedish SEB Group in 2000 can also be regarded as cross-border mergers.

When it comes to cross-border mergers, the phrase coined by German writer Erich Kästner is fitting: “Good only exists if good is done.” Decisions regarding possible mergers are the responsibility of the owners and responsible managers of the individual institutions. If the decision-makers reach the conclusion that a merger makes economic sense, nobody will stop them from going ahead with it. Not least financial supervisors. Structural policies in the financial sector are not our responsibility.

>>>

>>> Some experts are of the opinion that the legal and regulatory framework is key to cross-border mergers. This raises some interesting questions. On the one hand, it is quite clear that with greater harmonisation of EU law, cross-border mergers would more closely resemble domestic mergers and would therefore be easier to manage. On the other hand, I doubt that a bank in country A would decide not to merge with another bank in country B simply due to regulatory issues if the bank truly believed it had a good business case for proceeding with the merger.

It is the task of supervisors to monitor the market and, where necessary, adjust supervisory practice. Individual mergers only become a focus of supervisory activities when the plans are relatively concrete. Of course, supervisors primarily consider concrete plans to initiate a merger from the perspective of the supervisory requirements. This includes, next to many other considerations, an assessment of whether the business model is stable over the long term and whether the capital resources are adequate. But that is only the second or third step. Institutions must take the crucial first step themselves. ●

Elke König

Chair, Single Resolution Board (SRB)

Banking Union financial integration: time to consolidate trust

Extensive literature exists on the benefits of financial integration and consolidation of banks. From the perspective of the Single Resolution Board, whose mandate focuses on achieving banks' resolvability, having strong European banks is a natural aspiration. Where there is a solid business case, consolidation can bring economies of scale and increase profitability. It can improve diversification of risks within banking groups. It can also increase banks' access to capital markets and decrease their funding cost, ultimately facilitating their build-up of loss absorption capacity to meet the so-called Minimum Requirement of Eligible Liabilities (MREL).

Moreover, like cross-border capital markets, cross-border banks can play the important role of reducing risks through private risk sharing within the Banking Union. Indeed, cross-border banks are better equipped to withstand and absorb idiosyncratic shocks that may affect one or another Member State. Beyond the perspective of banks and Member States, it is important to look at this topic from the perspective of the investor too. Financial integration could lead to more efficient markets and provide financial services users with better choices.

This being said, consolidation within the banking sector should not be seen as a panacea or a short cut to avoid necessary reforms. In this sense, it is crucial for a resolution authority that consolidation facilitates rather than hinders the resolvability of a bank, in line with the Single Resolution Board's resolvability expectations.

Overall, the advantages of banks' consolidation seem therefore evident. In addition, the establishment of the institutional infrastructure of the Banking Union can also be seen as a favourable element: although the third pillar, common deposit insurance, is yet to be built, a single supervisory mechanism and a single resolution mechanism are up and running.

In spite of all of this, financial integration within the Banking Union is still lagging behind. Several studies have found multiple causes behind this trend. Market >>>

>>> factors surely play a prominent role. However, there are also challenges that could be addressed by policy-makers and regulators.

Among these, EU legislators and regulators should keep up the momentum on the clean-up of banks' balance sheets. The harmonisation of relevant legislation, such as insolvency proceedings, could also contribute to remove barriers for the cross-border consolidation of banks.

Finally, yet importantly, rule-makers and regulators should resist the temptation of ring-fencing capital and liquidity resources, as this can lead to suboptimal location and rigidity in the deployment of such resources. Regrettably, the recently agreed banking package does not mark a step forward on this aspect. Rather, it runs the risks of, first, fragmenting decision-making within the Banking Union on external MREL, and second, ring-fencing of internal MREL.

The Single Resolution Board already invests and will continue to invest significant resources to reach joint decisions with national authorities on resolution plans, calibration and location of MREL, and bail-in playbooks. Such day-to-day cooperation should increase mutual trust within the Banking Union, and ultimately be reflected in a future revised regulatory framework.

In a word, Rome was not built in a day. Just like in the United States, where financial integration took decades, it is not surprising that the road for Banking Union integration is still long and winding. However, the direction of travel should remain clear, and the need to consolidate trust along the way should be high on everybody's agenda. ●

Fernando Restoy

Chairman, Financial Stability Institute, Bank for International Settlements (BIS)

Lack of banking integration: is it all regulation?

At least so far, the existence of the SSM and the SRM have not had any marked impact on the banking industry's structure. For example, the share of cross-border loans to and deposits from non-banks in the euro zone remains low – around 8% and 6%, respectively – and has fallen slightly over the last few years. In the same vein, the share of domestically owned banks in the national banking systems remains high, at 83%, roughly the same as in 2014, before the SSM's establishment.

The first set of obstacles is related to Europe's lack of a comprehensive single rulebook. Much EU banking legislation is still in the form of Directives, rather than Regulations. More importantly, European banking law includes options and discretions for national authorities, again leading to different rules across countries (Nouy 2018).

The second group of impediments relates to the general regulatory treatment of internationally active banks. Typically, those institutions are subject to stringent capital requirements associated with the complexity and greater systemic importance arising from their interconnectedness. At the same time, regulations (under Pillar 1, Pillar 2 or stress tests) fail to fully acknowledge the potential prudential benefits associated with the geographical diversification of exposures.

The third category of regulatory obstacles relates to the treatment in European banking legislation of cross-border groups. In particular, pan-European banks that control subsidiaries in different member states must, in principle, satisfy liquidity and loss absorption requirements at the level of both the subsidiary and the consolidated balance sheet. Since economic integration is far from satisfactory and financial >>>

>>> stability remains largely a national policy objective, prudential safeguards in host jurisdictions seem unavoidable.

In any event, even if regulation may not provide sufficient support for the integration of the banking market – and some adjustments could be helpful in that regard – it may be the case that the main obstacle preventing faster and deeper integration is the genuine absence of significant profit opportunities for banks in other European jurisdictions.

Overbanking should, in principle, make the industry ripe for some consolidation. However, this is more likely to take place at the domestic rather than a cross-border level. In fact, the excess capacity in domestic banking sectors in the euro zone acts as a natural barrier to the entry of new (foreign) competitors.

Another obstacle to cross-border merger activity is the banking sector's structure. In the euro zone, many banks operate under only limited market pressure. For example, only 30% of the significant banks in the euro zone (those directly supervised by the SSM) are publicly traded companies. Most of the non-listed banks in the euro zone are savings, regional or mutual (cooperative) banks. A large portion of those banks do not typically follow standard profit-maximising objectives and cannot be taken over by ordinary commercial banks through ordinary M&A activity. Under those conditions, European banks typically see little scope for entering foreign retail markets where well established incumbents can sustain competitive pricing policies.

It is possible that, over time, technological innovations could facilitate the provision of cross-border banking services and enhance competition in the deposit and credit market as well as in the provision of payment and other ancillary services. Yet, at least in the short term, the incentives for traditional banks to expand their operations abroad are likely to be further eroded by uncertainty as to the scope and nature of the disruption that new fintech and big tech companies will bring.

As a consequence, significant cross-border consolidation of Europe's banking industry would probably need to be preceded by domestic consolidation to reduce overcapacity and help restore sustainable profitability. But even if that were achieved, any significant integration may first need a substantial reorganisation of the domestic banking sectors with the aim of trimming the market presence of mutual and savings banks to levels more comparable with those seen in in other jurisdictions. ●

Reference: Restoy, F (2018): "The European banking union: what are the missing pieces?", public lecture at the ICMB, Geneva, 16 October.

Jean Lemierre

Chairman, BNP Paribas

What are the impacts of bank fragmentation in the EU?

European banking has been going through a massive transformation since the financial crisis. Capital and liquidity buffers have been considerably increased, strengthening financial stability. European Supervisory Authorities have been created for banks, markets, and insurance. Over the last five years, the Banking Union has further transformed the landscape, with harmonized supervisory practices and a single resolution authority and a resolution fund to deal with distress situations. Europe now has common stress-tests, more credible internal models via TRIM, harmonized deposit insurance and ambitious common approaches on subjects such as >>>

>>> NPL reduction or Sustainable Finance. No doubt that such an achievement is commendable.

However, Banking Union is still not there. Financial integration has reversed, compared to the trend observed during the first decade of the Euro:

- Direct cross border loans and deposits are minimal, as banking remains a "multi-local" business, based on local laws and tax rules, even if digitalization may challenge this.
- The interbank market has dried-up. Pre-crisis, the main source of cross-border flows was simply that deposit-rich banks with limited lending opportunities were lending to low-deposit banks with higher lending opportunities. This natural reallocation of savings to investments has been eliminated, not only because "banks did not trust each other", but mostly because regulators, to cut the contagion risk, dis-incentivized banks to lend to each other, through the LCR rules. The structural mismatch between loans and deposits is now intermediated by the ECB, as a "first resort" lender. Even intragroup cross-border flows are constrained by large exposure limits and the solo application of LCR.
- Cross-border M&A could also foster private risk sharing and diversification. But the GSIB buffer and solo application of capital and liquidity ratios (a major EU gold-plating, as the BCBS only requires application at consolidated level), cancel the potential synergies in a cross-border deal. The solo application of NSFR will worsen this situation.

Such reduction of cross-border flows should be seen as a source of vulnerability for the common currency, and urgently addressed.

From the banks' point of view, the negative consequences are clear:

- Lack of economies of scale to invest in technology and risk management.
- Lack of competitiveness vs non-euro zone players and with new entrants, not submitted to similar constraints.
- Poor profitability and lower capital formation to comply with ever increasing regulatory requirements.
- As a result, low attractiveness for investors, with all EU listed banks having Price to Book below 1.

Even more the ring-fencing of capital and liquidity prevents the market to find a proper equilibrium and translates into excessive discounts on asset values in weaker States.

The recent talks about the need for another TLTRO illustrate the difficulty in which the Euro-area finds itself. A TLTRO is certainly needed, especially given the considerable shortfall to be created by the implementation of NSFR and the need for banks to comply in a short period of time with the MREL SRB policy. But it will only kick the can further down the road, with cheap liquidity putting pressure on loan margins and maintaining bank profitability low.

To exit this trap, Europe has to effectively rebalance the share of banks and capital markets in the financing of the European economy. This was the aim of the CMU project, not delivered so far. Its main pillar, the relaunching of securitization, is not going to materialize given the excessive complexity of the "Simple, Transparent, and Standard" framework.

Europe should quickly revisit its rules as the CMU is the only way to reduce the banks' reliance on Central Bank liquidity and restore proper asset pricing and risk mutualisation.

In this time of European elections, we should all remember the four freedoms at the core of the European Union, including the free movement of capital. A strong and integrated European economy needs a strong and integrated financial sector to support its growth and competitiveness. ●

Korbinian Ibel

Director General, DG Micro-Prudential Supervision IV,
European Central Bank (ECB)

Further harmonisation needed to overcome financial fragmentation

One of the founding aims of the banking union was to overcome the fragmentation of the financial sector, aiming to restore financial stability and lay the basis for economic recovery after the recent crises. Since the establishment of the Single Supervisory Mechanism, substantial progress has been made to ensure a level playing field among euro area banks and to promote the integration of the European banking sectors. It is clear that there is still some way to go, however. As the ECB report on Financial integration in Europe (May 2018) shows, integration measures have not moved substantially, in particular for retail banking, despite collective efforts by regulators and supervisors to harmonise the framework.

In a more integrated European banking market, savers have more options when investing their money and companies can tap more sources of funding. Risks can be shared across borders, smoothing idiosyncratic shocks to individual Member States and allowing banks to better balance the needs of customers in different locations and stages of the economic cycle. This helps the EU economy to become more stable and more efficient. At the same time, enhancing market integration –where suitable – can also support a more robust banking sector. While it must be left to market forces to determine which corporate operations make sense economically, European legislators and supervisors need to ensure that the framework does not unnecessarily impede market developments, enabling banks to operate and grow across borders: both organically and by merging across borders.

While some of the factors leading to fragmentation may be due to differences in preferences for service provision across member states, other factors lie in the hands of regulators. The current regulatory framework still imposes a number of impediments to cross-border consolidation in the EU – complicating the management of bank capital and liquidity within cross-border groups and hindering the prospects for cross-border mergers.

Many of the regulatory impediments can be addressed by further harmonisation, including unwarranted Member State options and discretions, such as the treatment of intra-group exposures under large exposures rules. Other impediments would need to be addressed by policy changes, such as the absence of cross-border capital waivers within the EU; or the lack of recognition of the banking union in the international G-SIB methodology framework. Of course, any such policy changes need to be coupled with appropriate prudential safeguards. Additionally, more work is required on other policy areas that differ across the euro area and may discourage further integration, but are outside of the scope of banking regulation. For example, tax codes and legal systems, including insolvency law.

Going forward, it is also important to make efforts to cut down the uncertainties in banks' business environment. This means banks need to continue the work on legacy assets and on the reduction of NPLs, which will reduce uncertainty around banks' assets and make, for example, cross-border mergers more attractive. But this also means ensuring regulatory certainty and consistency. Here, the full, timely and consistent implementation of the Basel III reforms into the EU framework is crucial.

In summary: a more integrated European banking sector will be beneficial for the real economy as well as for banks' resilience. While much progress has been achieved already in reforming conditions, the level of integration of euro area banking markets still remains limited. We should continue to move towards a more harmonised framework and in particular towards completing the banking union, helping to create conditions to reap benefits from the single market. ●