BANKING FRAGMENTATION ISSUES IN THE EU

Note written by Didier Cahen, EUROFI

While we have come a long way since the establishment of the Single Supervisory Mechanism (SSM), 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 in all parts of the euro area), and help to achieve a better diversification of risks thus contributing to private risk sharing within the Union.

Despite the challenges faced in recent years, many European countries' banking systems remain oversized and still have surplus capacity. Bank profitability continues to be hampered in Europe by overcapacity and a competitive environment, with revenues under pressure not just from their peers but also from new entrants from outside the sector, such as fintech companies. In addition, international or cross-border 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.

Consolidation through mergers and acquisitions is one way of tackling structural problems, by helping to unlock economies of scale and diversify revenues. Little progress has been made on this front over the past few years within the EU , with only a small number of – mainly domestic – deals taking place.

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 along national borders, not concentrated enough if we take a pan European view[1] 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*).

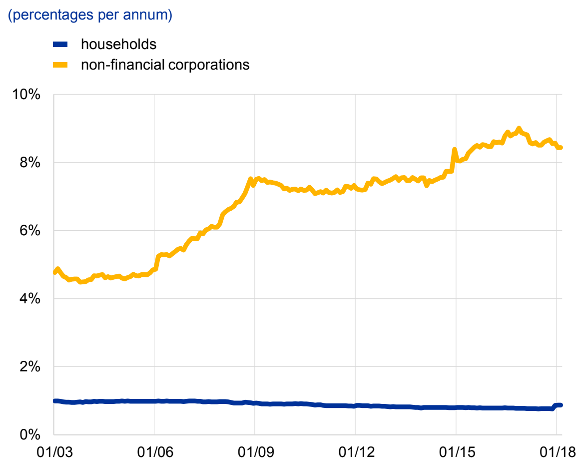
1.1.1 The share of cross-border deposits in the euro area from firms is also very low (around 6%) and has fallen slightly over the last few years. The level of foreign bank penetration is, overall, relatively low for a Banking Union

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

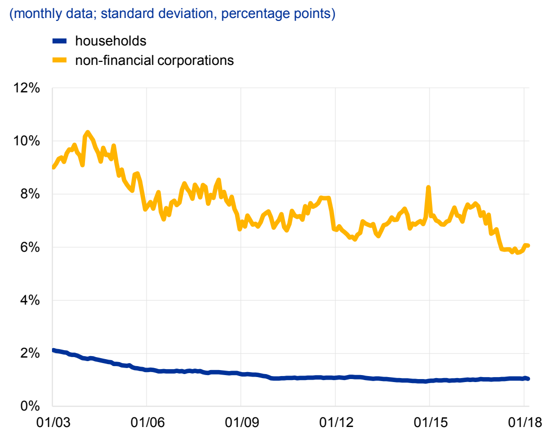


1. In some individual Member States it can be very concentrated already, this is why purely national consolidation will reach a limit at some point.

CHART 2.

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

Source: ECB (BSI)



1.1.2 Sovereign bank nexus on the rise

Moreover, despite the quantitative easing policy of the ECB, the doom loop between banks and their sovereigns is far from being resolved.

According to the ECB, between January 2020 and September 2020, euro area banks' exposures to domestic sovereign debt securities have risen by almost 19% in nominal amount – the largest increase since 2012[2].

The share of total assets invested in domestic sovereign securities varies across countries. At the end of September 2020, it was equal to 11,9% for Italian banks and 7,2% for Spanish banks, but close to 2% for French and German banks (*see Chart 3 below*).

CHART 3.

Euro Area Banks' exposures to domestic sovereign debt relative to total assets

Source: ECB Financial Stability Review of November 2020

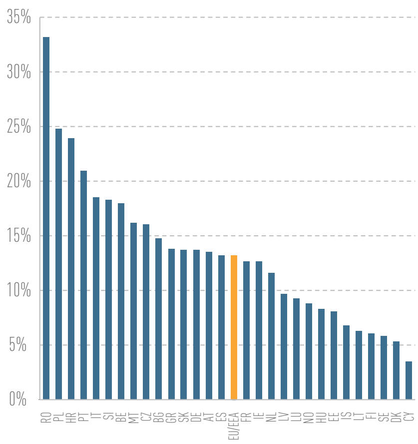
Note: Latest data from September 2020

The EBA report on the "Risk assessment of the European banking system" (December 2020) stated that in June 2020, sovereign exposures were close to 13% of the total assets. Banks in central and eastern European (CEE) countries and southern Europe generally reported a higher ratio of sovereign exposures to total assets than, for instance, their peers in the Nordic countries (*see Chart 4*).

CHART 4.

Sovereign exposures as a percentage of total assets by country, June 2020

Source: EBA Risk Assessment of the European Banking System based on Supervisory reporting data, December 2020



2. ECB, Financial Stability Review, November 2020, page 60.

In addition to direct sovereign exposures, the loan guarantee schemes set up in many countries to support lending to the real economy during the pandemic potentially reinforces the sovereign-bank loop. Although the amount publicly guaranteed loans is comparatively low (EUR 378bn in March 2021 vs EUR 3.2tn of sovereign exposures in December 2020), these are concentrated on a few EU countries. Nonetheless, in contrast to direct sovereign exposures accounted at fair value through P&L or through other comprehensive income, or held for trading, publicly guaranteed loans are not subject to mark-to-market adjustments that might end up affecting banks' capital levels.

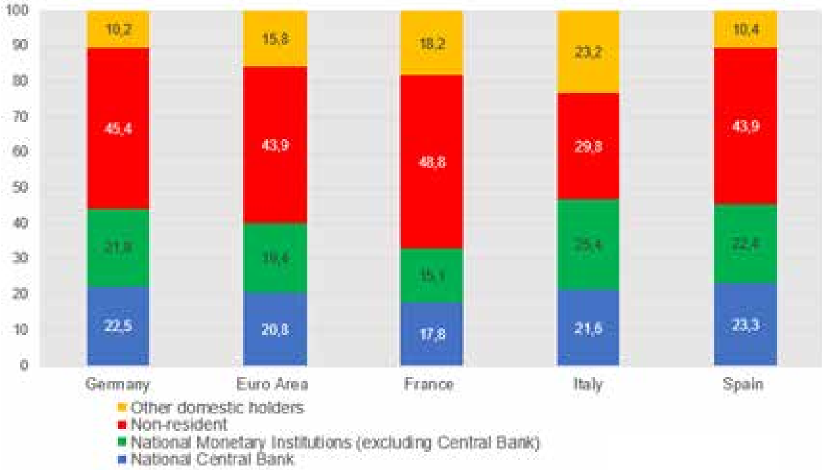
1.1.3 Sovereign-Central Bank loop is reaching significant levels

The asset purchase programs of the ECB mainly have contributed to this dynamic since 2015. Indeed, the share of government debt held by the National Central Bank has almost tripled in Italy and Spain between 2015 and 2020. As of December 2020, nearly 21,6% and 23,3% of the government debt was held by the Italian and Spanish Central Bank respectively (*see Chart 5*), from 7,5% and 8,3% in 2015.

CHART 5.

Holders of government debt in 2020 (% of Total Government Debt)

Source: ECB

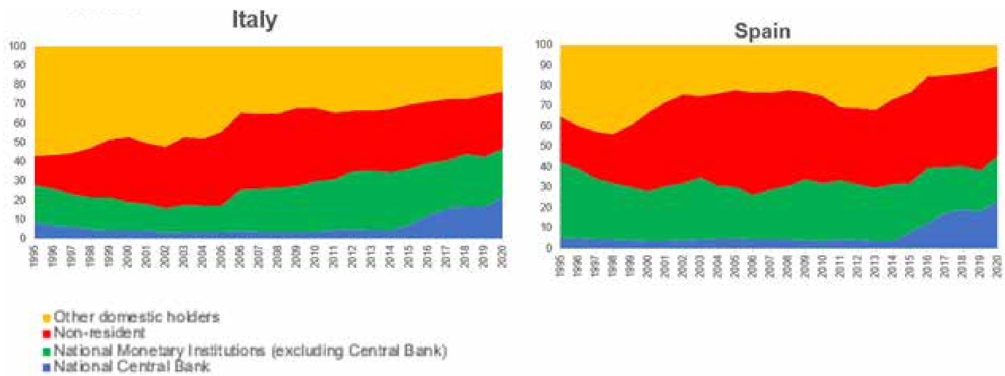


Over the past decade, the share of public debt held domestically has been rising in some EU Member States (*see Chart 6*). In Italy, the proportion of domestic holders has risen by nearly 8 percentage points, from 61,8% to 70,1% between 2010 and 2020. In Spain, it has been growing gradually to 56% since 2015.

CHART 6.

Holders of Government Debt in Selected Euro Area Member States

Source: ECB



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[3], the European Union is particularly concerned by overbanking, i.e. an "overly large banking sector that in the end affects the profitability of the banks in the system".

1.2.1 Some indicators point to this excess capacity

The European banking sector still has too many banks with heavy cost structures competing for the same customers. A comparison with the United States after the Great Financial Crisis makes this extremely clear – between 2009 and 2011, the number of banks in the United States fell roughly three times as much as in Europe.

Efficiency indicators (*see Charts 7 and 8*) such as branches per population (60 per 100,000 inhabitants in Italy, 55 in France, 52 in Spain, 32 in Germany versus 25 in the United States in 2019) illustrate this overcapacity in Europe.

3. IMF, Global Financial Stability Report, April 2017.

Even though the cost to income ratio of US and EU banks do not differ significantly (65.9% for the US and 65.2% for the EU in December 2020), since December 2014, this ratio has fallen in the US from 71.8% to 65.9% whereas in the EU it has gone up from 62.9% to 65.2%.

CHART 7.

Cost-to-income ration of EU Banks, %

Source: EBA

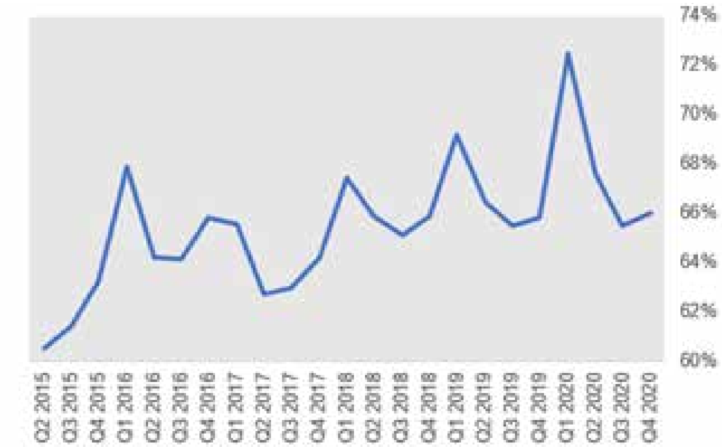
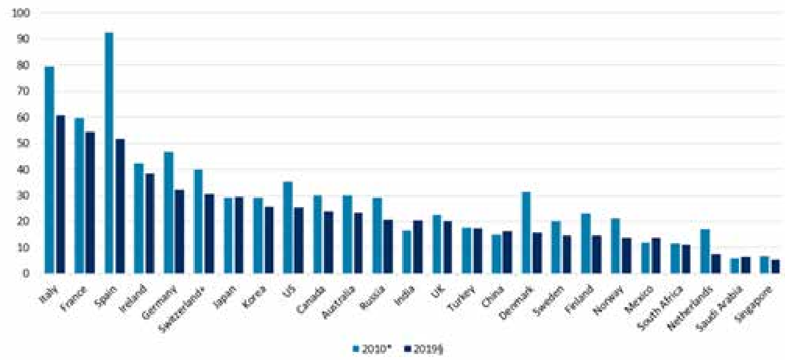


CHART 8.

Bank Branches per 100k Population

Source: IMF , Worldbank, S&P Global Ratings, (*) 2012 for China, (§) 2018 for Australia, 2017 for Norway, 2013 for UK. (+)Switzerland excludes branches of other deposit taking institutions for comparability over time.



Banks in Europe have to face a much more competitive environment than in the United States and therefore a much stronger pressure on their margins since the EU banking sector is not globally concentrated enough (*see 1.3*) notably compared to the US one.

1.2.2 The profitability of many EU banks remains a concern

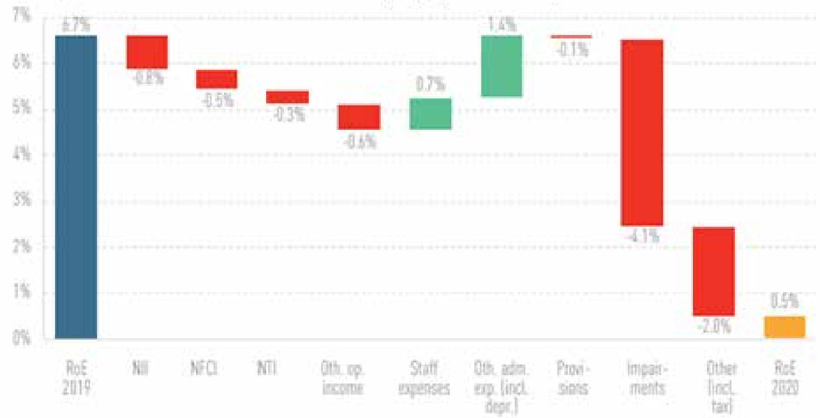
Since the Global Financial Crisis, average profitability levels have been below the estimated cost of equity, which is estimated at between 8% and 10%. The profitability of European banks has fallen from 6,5 % at the end of 2018 to around 2 % at the end of 2020. Although the estimated cost of equity of US banks is not materially different, during this period, their return on equity has only fallen below 9.5% in some quarters of 2020[4].

The Covid- 19 outbreak has only heightened the profitability challenge. In June 2020, the EBA stressed that the average return on equity (RoE) of EU banks stood at 0.5%, down from 6.7% in June 2019[5]. The decline was largely explained by the surge in impairment costs and, to a lesser extent, by the contraction in revenues. In contrast, operating expenses have registered a positive contribution to the RoE due to their contraction YoY (*see chart 9*).

CHART 9.

Contribution to the fall in RoE of the main profit and loss (P&L) items, calculated as a ratio to total equity (2019-2020)

Source: EBA based on Supervisory reporting data



4. E. Fernandez Bollo, Consolidation in the European banking sector: challenges and opportunities, 11 June 2021.

5. EBA, Risk assessment of the European Banking System, December 2020 & New-York Fed, Quaterlyu Trends of the US Banking Sector.

While the first quarter of 2021 has seen a rebound of profitability, (see the EBA quarterly Risk Dashboard) RoE rose to 7.6% in the first quarter from 1.9% in the year ending 2020, this was driven by fee and commission as well as trading income and low cost of risk in the context of the massive public support programmes for the economy. The net interest margin (NIM) significantly contracted from 133bps to 124bps, ranging from 75bps up to 302bps among countries, adding pressure to net interest income, which still represents more than 50% of EU banks' net operating income.

Intense competition and lasting very low interest rate environment in several EU countries have resulted in a rather subdued increase in banks' revenues over the past few years. According to the EBA, in 2020 the sharp GDP contraction and the lingereing low interest rate environment drove net operating income (NOI) down by 3.2%.

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. As shown by the charts below (*see Chart 10.a et 10.b*), the trend in US and European bank profitability has diverged over the last years, with US banks constantly more profitable than their European counterparts (at least twice as much).

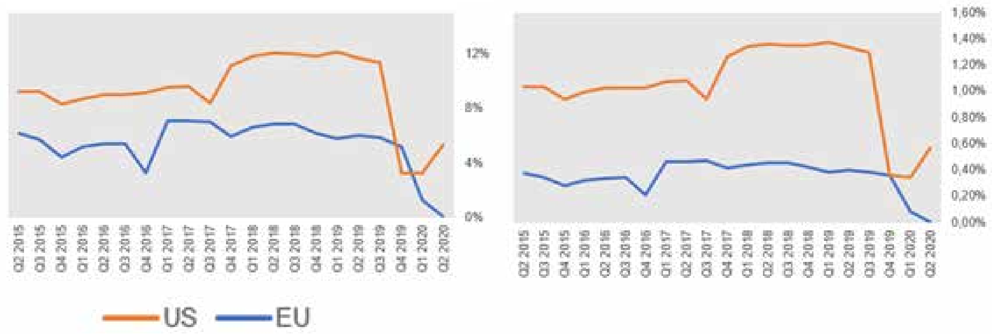
CHART 10.

Selected Profability Indicators of EU and US banks

Source: ECB, Fed

a. Return on Average Equity for US and EU Banks, %

b. Return on Average Assets for US and EU Banks, %



Interest rates in Europe have been lower for longer, negative, and the yield curve much flatter than in the US, creating a major drag on banks' biggest revenue source, net interest income. In addition, quantitative easing (QE) and the associated rise in bond and equity markets had a greater – more positive- impact in the US with its larger capital market.

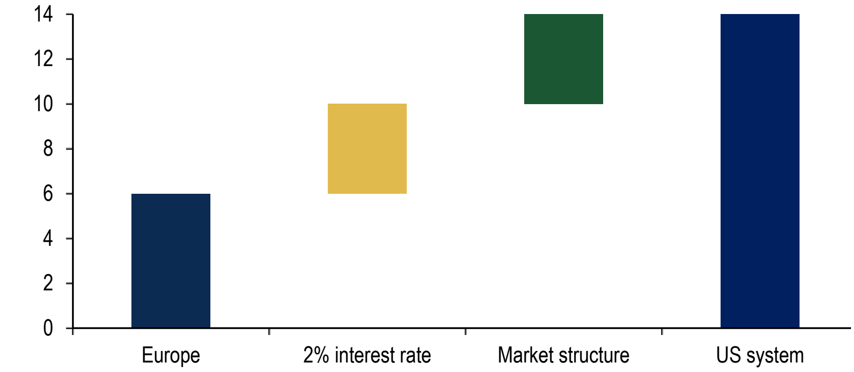
The Chart 11 issued by Bank of America Securities[6] shows their estimate of the drivers of the yawning profitability gap between the euro banks at a 6% ROE in 2019 and the US at 14%. About half is the difference in market structure: absence in Europe of a genuine securitisation market and of a single capital market. The other half is simply the 200 bp gap in interest rates.

The European financial market remains small and most of the financing in Europe is provided by the banking sector. The situation is the opposite in the US. This entails a major bias in the implementation of the prudential regulation. Indeed the EU banking sector is more impacted by the Basel prudential framework than the US one and this lead to a lower profitability: US banks can transfer the risks to public structures (Freddy Mac, Fanny and Ginny Mae) or private investors through securitisation. In addition to that, a large part of their profits comes from fees on market operations which have limited impacts on their balance sheets. It explains for instance that with a total assets similar to BNPP, JP Morgan had a net profit 3,5 times higher in 2020. Basel 4 is going to aggravate the situation according to many representatives of the EU banking sector.

CHART 11.

Return on Equity diferential between the EU and the US (%)

Source: BofA Estimations



6. Bank of America Securities Global Research, "Fit for an island continent", February 2020.

According to the ECB, the outlook for bank profitability remains weak. Despite recently improving market sentiment towards euro area banks, market analysts still expect profitability to recover only gradually, projecting a ROE of 3% and 6% for 2021 and 2022 respectively, given higher provisionning needs and lower expected operating income, while Return on Equity of large US Banks is currently projected to reach about 12% by 2022[7].

Euro area bank valuations remain low when compared with those of their peers around the world, particularly those of US banks and even with the recent surge in European bank valuations the gap with the US system has widened, not narrowed. The number of banks with negative rating outlooks also remains elevated. This reflects the uncertain outlook for corporate insolvencies as well as the persistent challenges to bank profitability from low interest rates and competition from technology firms (*see Chart 12 below*).

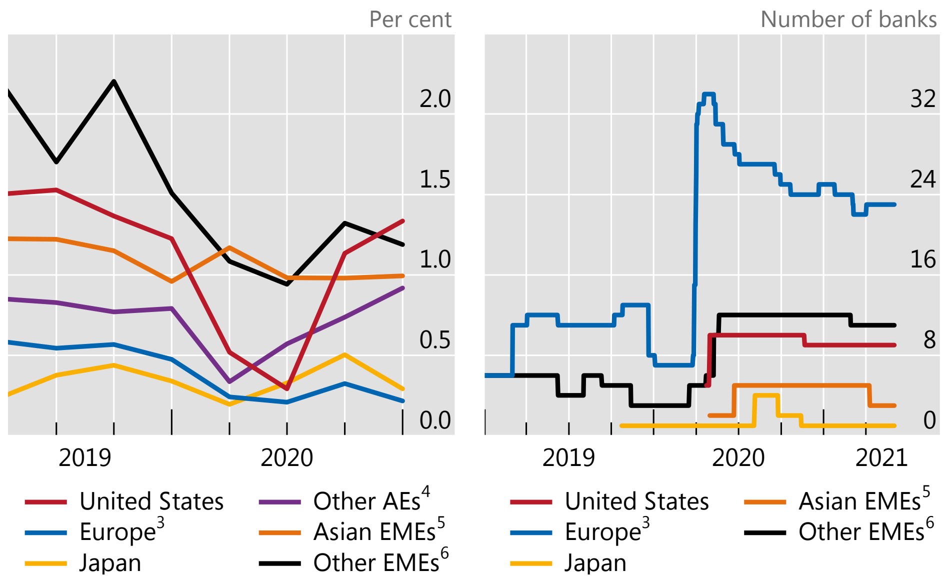
CHART 12.

Outlooks for the Banking Sector

Source: BIS Annual Economic Report, June 2021

a. Profitability (ROA)[2]

b. Banks with negative rating outlooks[7]



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 14 and 15*).

1.3.1 The banking system in the EU is much less concentrated than the US

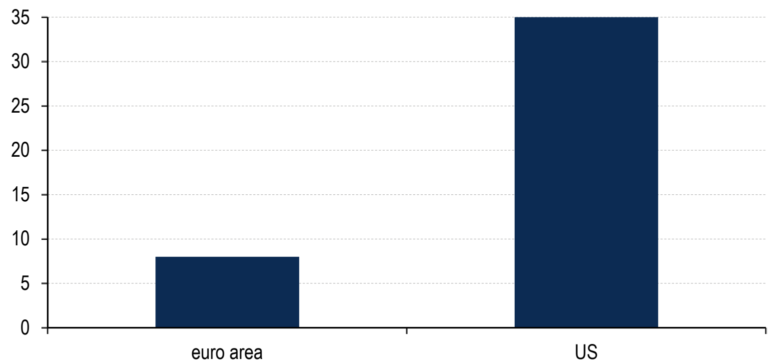
The market share of the top five US banks within the United States was more than 40% before the Covid crisis, whereas the market share in the Eurozone of the top five European banks stands at more or less 20%.[8]

Moreover Chart 13 shows that the top 3 banks account for over one third of primary current accounts, while the equivalent for the euro area is two-thirds smaller - and that is heavily dependant on Credit Agricole 's unusually high deposit share in just one market, France.

CHART 13.

Top 3 banks: current account market share (%)

Source: BofA Global Research



7. Luis de Guindos, Euro Area Banks in the Recovery, 28 June 2021.

8. Compared with other jurisdictions, only a few banks exited the market in the euro area. Many banks were bailed out and kept alive due to a lack of European crisis management tools. This underlines the need for further review of the EU bank crisis management.

1.3.2 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

Cross-border merger and acquisition activity among banks within Europe have practically disappeared until 2019. Indeed, bank Merger and Acquisition within the euro area has been on a steadily declining trend both in terms of number of transactions and value, since the year 2000.

Compared with pre-2008, the post-crisis period is characterised by a predominant proportion of 'domestic' transactions (*see Chart 15*). The EU Commisssion added[9] that in recent years, more euro area banks were acquired from outside the euro area than from within.

One might need to admit that domestic M&A is presumably a key component to improve profitability: this way synergies can be realised quickly and quite for sure. Latest transactions in ES and IE would all fullfill this purpose.

CHART 14.

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

Source: ECB calculations based on Dealogic

This chart is extracted from the EBA Staff Paper: «Potential Regulatory Obstacles to Cross Border Mergers and Acquisitions in the Banking Sector» (February 2020)

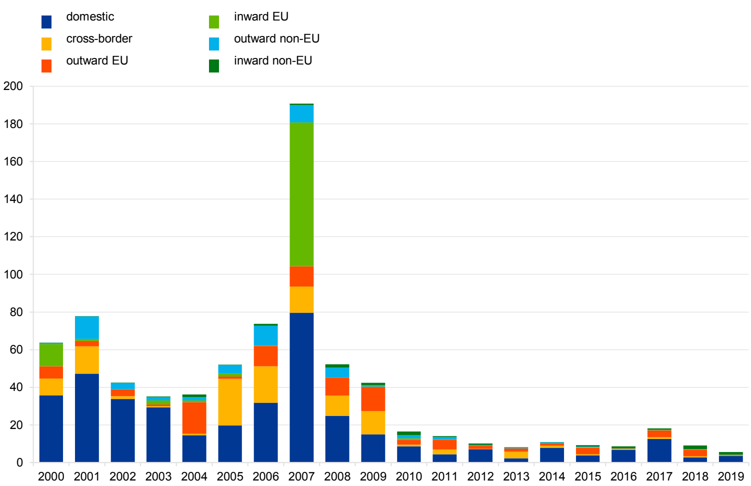
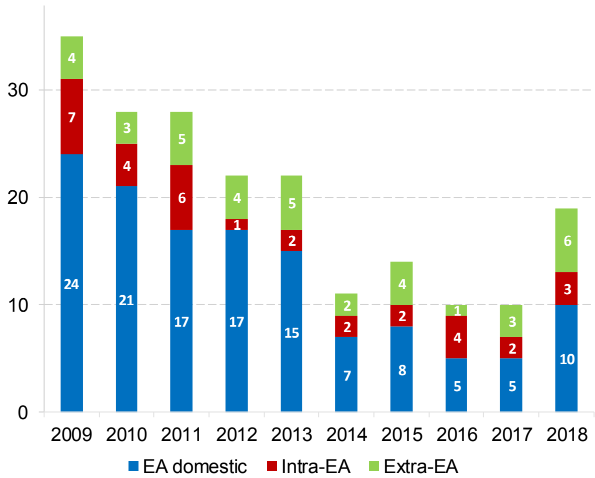


CHART 15.

Bank M&A in the euro area: number of transactions

Source: Dealogic



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[10]. 2020 was also stable in respect of deal value and number of transactions compared to 2019 according to Dealogic.

1.3.3 Cross-border bank activity differs significantly between Member States

Cross-border bank activity differs significantly between Member States, with foreign banks having a strong or even dominant market position in most central and eastern European (CEE) Member States and a small position in the largest Member States.

9. EU Commission, Financial Stability and Integration Review 2020 (EFSIR), March 2020, see chapter 4.

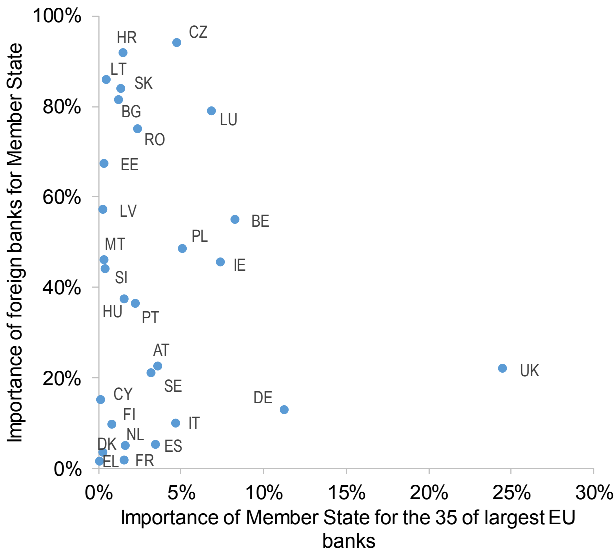
10. Two- thirds of Europe's banking consolidation in 2018 was from domestic deals, such as Banco Santander's takeover of Banco Popular for €1 in June or Intesa Sanpaolo's acquisition of two failed domestic rivals in Italy's Veneto region for a token price. The value of European cross-border deals done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

CHART 16.

Market Share of Foreign Banks in EU Member States and share of Banks' income earn in EU Member States

Source: ECB and banks' annual reports. DG FISMA calculations

Note: The x-axis report the percentage of banks' total operating income in 2018 that was earned in a certain Member State, excluding the bank's home market. The y-axis reports the percentage of a banking sector's total operating income in Member States that was earned by foreign banks in 2018, except IE (Q4-2017 data) and LT (Q1-2019 data).



The report of the Commission cited above (*see Chart 16*) suggests three clusters: (i) Member States with a share of foreign banks higher than 65%, as is the case in seven CEE Member States and Luxembourg; (ii) the largest euro-area Member States plus Denmark, Cyprus, Greece and Finland, where foreign banks have a market share below 15%; and (iii) all other Member States where foreign banks have a share between 15% and 65%.

The analysis at country level suggests that cross-border banks are significant in CEE Member States and lack significance in the larger Member States. However, the view from the banks' perspective leads to a different assessment. For large EU banks, a significant share of operating income stems from large Member States, while the share of operating income from CEE Member States is small. This also holds if the residence of the large banks is taken into account: a significant part of their foreign profits originates from large Member States and a small part of their profits comes from the CEE Member States.

The comparison of banks' geographical income distribution between all banks, large banks, and foreign large banks reveals that France and the Netherlands have a disproportionally low share derived from foreign banks; while Belgium, Luxembourg and Poland have a disproportionally large share derived from foreign banks.

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

For five major reasons:

- The single banking market is not yet a reality although banking regulation has become more uniform in the EU through the single rulebook and the ECB clarified its supervisory approach to consolidation[11]. Indeed, a number of traditional factors such as legal systems, language and traditions remain and fragment banking markets. The EU Commission adds that "differences in taxation, borrower protection, or anti money laundering provisions at member state level result in bank -specific entry and adjustment costs that discourage cross-boder banking". Forexample, there is no single EU-wide loan registry, as is the case in the US.

  This fragmentation along national lines puts new cross-border market entrants at a disadvantage. In particular, banks that want to expand and diversify their activities throughout the EU have to create local service units in each member state, which reduces economies of scale. Finally, improving the profitability of the EU banking sector is only possible on a country-by-country basis, through national mergers. New and innovative players have no choice but to develop a specific business case for each member state. The opportunities promised by the single market of (retail) financial services are not materializing.

- Furthermore, 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, impose higher costs and discourage large EU banks to increase the number of their subsidiaries in the EU since scale effects through the centralisation of capital and liquidity cannot be achieved.

11. ECB Banking Supervision, Guide on the supervisory approach to consolidation in the banking sector, January 2021. This guide clarifies particularly three key prudential issues that are often discussed in this context: how the ECB sets Pillar 2 capital requirements for newly formed entities; how it treats badwill from a prudential perspective; and how it treats and assesses internal models..

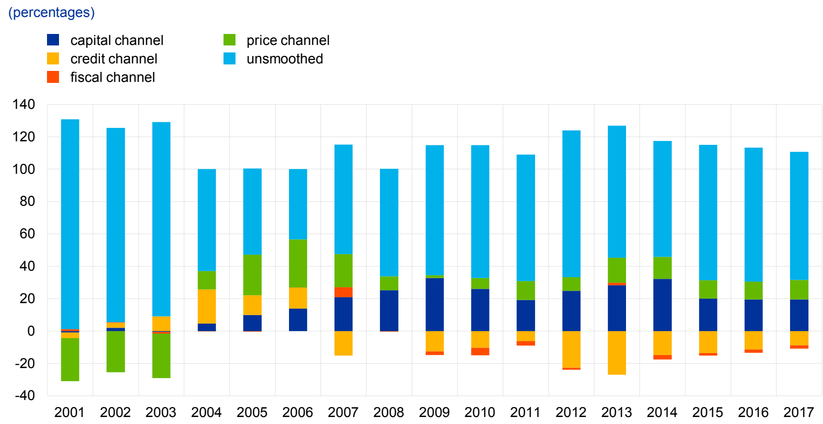
- Digitalization and fintech challenges may be seen to have overpast the aim of consolidation.
- Another obstacle to merger activity is the structure of the banking industry: only 30% of the significant banks in the euro zone (directly supervised by the SSM) are publicly traded. companies. Most of the non-listed banks in the Eurozone are saving banks, regional banks or cooperative banks;
- 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 shock amplifier rather than a shock absorber (*see Chart 17*)

CHART 17.

Consumption risk sharing in the euro area and its channels, %

Source: ECB calculations



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[12], 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. Analysts expect euro area banks' return on equity to recover only gradually, reaching 6% by 2022. Bank profitability in the euro area is expected to trail well behind that of large US banks, whose return on equity is currently projected to reach about 12% by 2022. 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.

12. 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.

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, we could 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 coming semesters. It is essential to give to the markets the message that the path to further integration is still there to ensure that the banking system will be in the future able to finance the necessary tranformation of the economy, to address the challenges and opportunities of both digitalization and climate change. Furthermore, EU legislators should make sure that the implementation of Basel III does not affect the financing capacity of EU banks. There is indeed a serious gap between the impact recently measured by EBA and G20 that the reform should not lead to a significant increase of capital requirements.

Baron Louis, Minister of Finance in France said to his government around 1820:
- *"Faites-moi de la bonne politique et je vous ferai de la bonne finance",* which can be translated as *"Make good policies, and I will bring you good finance".*

We could say under his tutelage and inspiration:

"Do the structural reforms, eliminate excessive disequilibria, converge our economies symmetrically, show a little more kindness on risk sharing and I will bring you Banking Union".

In other words, it is not the Union that makes the Force, but the Force that makes the Union: only strong Member States – which have corrected their fiscal imbalances and are effectively converging economically among themselves – will make Europe stronger.