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The future of banking in Europe

Drivers and consequences of further consolidation

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Executive summary

Some voices are defending the need for further consolidation as a way of fixing the problems remaining in the European banking system. While further consolidation has indeed some advantages and benefits, it also implies some drawbacks and costs. This paper discusses the implications of consolidation for financial stability, solvency, efficiency, competition, consumer protection, digitalization and systemic risk.

While the European banking system is dominated by a few large players, some medium-size banks still play a non-negligible role. The idea of further consolidation would imply either mergers between some of those large players, the absorption of medium-size banks by large banks, merger between medium-size banks or a combination of all of the above.

In terms of financial stability and solvency, consolidation could be seen as a mean for the weaknesses of some banks to be diluted in a merger as well as gaining market access through a larger size. However, the problematic banks could also end up cannibalising the healthy part of the merger. Besides, the merger of two vulnerable players cannot result in a healthier one. Moreover, additional consolidation does not seem to go in the direction of solving the too-big-to-fail problem.

One traditional argument for further consolidation relies on the potential economies of scale and efficiency gains. However, empirical evidence is far from being conclusive in this regards.

With respect to competition and the choices available for consumers, further consolidation will not necessarily lead to weaker competition. This is more so in the current context of digital transformation and the disruption of fintechs.

Overall, the effect of consolidation seems to be at least ambiguous. While some effects in terms of strengthening the financial system can be identified, further consolidation can also generate new weaknesses or exacerbate some of the existing ones as a by-product. Moreover, national financial systems still feature a number of specificities which makes a one-size-fit all consolidation approach difficult for achieving all of their intended goals.

Table 1 Summary of main the main effects of consolidation

Area / goal	Effect of consolidation
Financial stability and solvency	
Solve the weakness of a bank	Small banks: can be absorbed
	Two weak banks: no improvement but bigger problem
	Potential spill overs to absorbing bank
Reduce bank capacity	Rationalisation of branches and employees
	Not necessarily reduction in total credit
Increase resolvability of banks	Improved access to markets (MREL)
	TBTF exacerbated
Capacity of diversification	Larger banks: more capacity of diversification
	Less banks: lower diversification of the system
Efficiency	
Improved efficiency	Reducing inefficiencies when consolidating similar banks
	Scales economies unclear
Competition, consumer protection and digitalization	
Maintain effective competition levels	No direct effect on competition
	Only with very few banks or in specific cities/regions, competition may deteriorate
	Importance of contestability
	Fintechs
	Digitalisation: improved cross-border access
Systemic risk	
Reduce systemic risk	TBTF exacerbated
	Increased number of G-SIBs
	Not only size, but also complexity to be taken into account

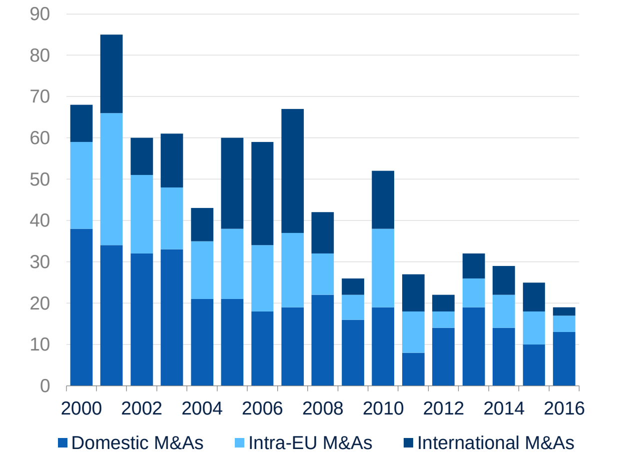
Source: BBVA Research

1.- Introduction

More than ten years have elapsed since the outbreak of the economic and financial crisis with the strike of the subprime crisis in summer 2007. The situation is now much more stable than during the financial turmoil observed on the wake of the collapse of Lehman Brothers (in September 2008) or during the peak of the European sovereign debt crisis (2011 and 2012). This being said, the still high levels of non-performing loans observed in a few banking systems, the delay in finalizing the Banking Union process, the recent resolution of Banco Popular in Spain and the liquidation of three Italian banks remind us that the problems in the European financial system are far from being solved.

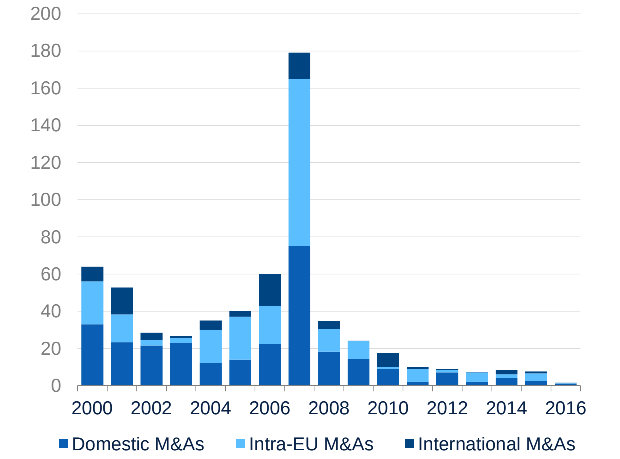
Merger and acquisition activity in the EU-banking sector has been on a declining trend since the high values recorded in 2007, both in terms of number of banks and transactions (Figures 1a and 1b). As an example, before the crisis there were around 60 bank M&As per year, which contrast with the data of the last 2 years, with 22 M&As on average. Some European authorities have stood up for further consolidation, particularly cross border consolidation, as an avoidable contribution to fix the remaining problems in the EU banking system. At the same time, the ECB itself indicates that the economic benefits of current integration levels should be assessed, suggesting that current or even further consolidation levels could entail some drawbacks depending in the presence of a number of obstacles to full harmonisation[1].

Figure 1a Number of bank M&As in the Euro Area



Source: European Central Bank and BBVA Research

Figure 1b Value of transactions of bank M&As in Euro Area



Source: European Central Bank and BBVA Research

In this note, we investigate what kind of issues could be (at least partly) solved through consolidation but also which problems could remain (or even be exacerbated). After presenting some broad features for the EU banking system, we have organised the discussion in four broad areas. Firstly, we analyse the implications of consolidation for financial stability and solvency. Secondly we look into potential efficiency gains stemming from consolidation. Thirdly, we present the impact in terms competition including the role of digitalisation and potential effects on consumer protection. Finally, we briefly discuss the implications in terms of systemic risk. Finally, we finish with some conclusions.

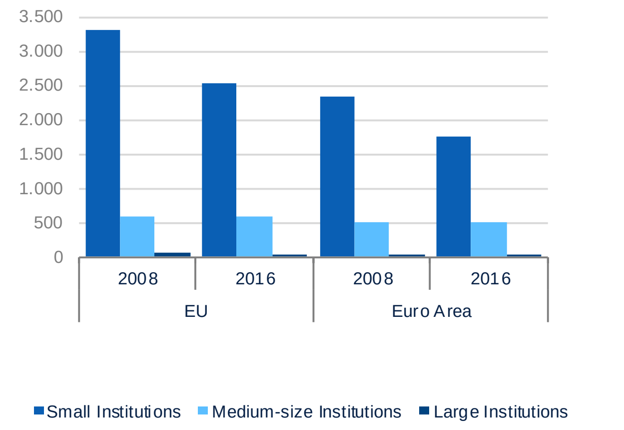
2.- Short overview of the European banking system

Before analysing the implications of further consolidation in Europe, it is important to understand which the current situation in European financial systems is with respect to some broad indicators such as the number of banks and its distribution by size as well as the level of competition.

1: For instance, national options and discretions in European banking regulation, national insolvency and consumer protection laws or the tax treatment of financial products and banks.

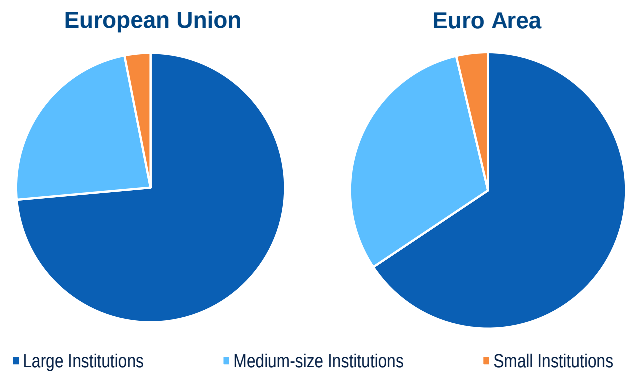
According to ECB statistics, the number of banks in the EU has declined from almost 4,000 in 2008 to a bit more than 3,000 in 2016. This trend has been observed in both small banks and large banks[2], but the number of medium-size banks has remained stable or even increased slightly (Figure 2). Although there are only 22 large banks, they concentrate up to 74% of total assets in the EU (65% in the euro area). Medium-size banks, with 23% per cent of total assets (31% in the euro area) can still play a significant role in the banking system. However, small banks, despite their large number, play a very limited role with a negligible 3% of total assets of the banking system (Figure 3).

Figure 2 Number of banks per size class



Source: European Central Bank and BBVA Research

Figure 3 Total assets of banks per size class

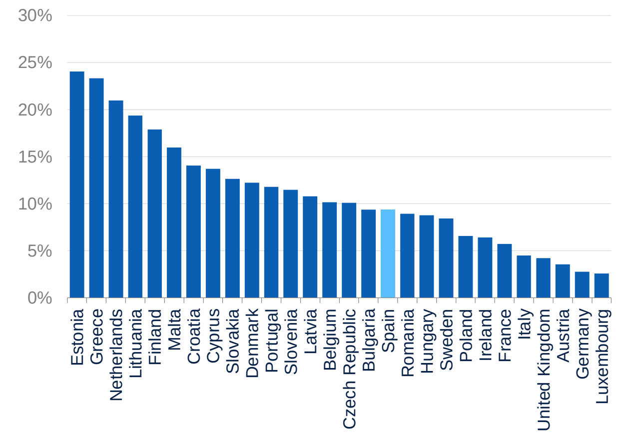


Source: European Central Bank and BBVA Research

Two generally used measures of concentration are the CR5, which shows the percent of market share in terms of total assets of the 5 biggest banks, and the Herfindahl-Hichsmann Index, which weights banks' size in relation to the overall industry. According to European data, concentration differs significantly across countries. The large countries (Germany, UK, France and Italy) tend to have relatively atomised banking markets, a similar situation is observed in some countries with a long banking tradition (Luxembourg, Austria and Ireland). On the other hand, the banking sector in countries like Greece, Estonia, Lithuania and the Netherlands are highly concentrated in a few major players (Figures 4 and 5). In line with the reduction in the number of banks, bank concentration has been on an increasing trend in the last decade. The average CR5 for the euro area climbed from 42% in 2006 to almost 50% in 2014.

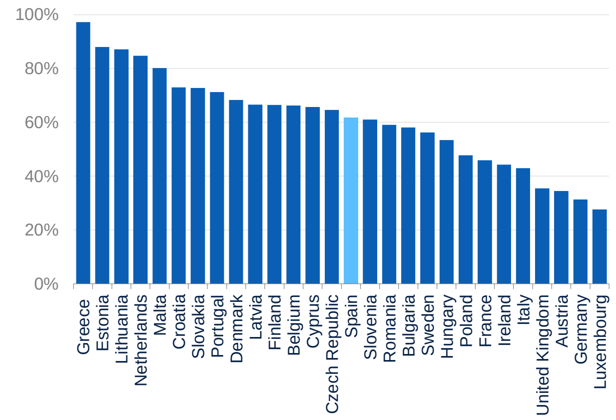
2: According to ECB methodology, banks are classified as follows: large banks are those with total assets larger than 0.5% of the total system, medium-size banks those with a size between 0.005% and 0.5%, and small banks those with totals assets below 0.005%. As a reference, those thresholds corresponded in 2016 and for the Euro Area to circa €120 billion (0.5%) and to €1.2bn (0.005%).

Figure 4 Concentration: CR5, 2016, percentage



Source: European Central Bank and BBVA Research.

Figure 5 Concentration: Herfindahl-Hichsmann Index, 2016, percentage



Source: European Central Bank and BBVA Research.

The financial crisis has also led to a retrenchment of banks in their core countries and a reduction in the recourse to wholesale funding. Similarly, an increase in the retail orientation of banks can be observed across EU countries, particularly from the liabilities side. As a consequence, banks has become more alike each other so that potential consolidation operation might be easier than before the crisis.

Through this short overview we can observe how there is a variety of banks from different sizes and how the distribution is very different across countries. However, not only the size, but also the complexity is important; and most medium-size banks are already rather complex. With this background in mind, we can make some observations about the implications of potential integration from a number of points of view.

3.- Financial stability, solvency and consolidation

On the wake of the financial crisis, markets, authorities and new regulation have requested banks to improve their capital positions. At the same time, the central banks implemented unprecedented expansionary monetary policy to support the access to credit (including to interbank markets) and the lender of last resort function, but this also put pressure on interest margins. In this context, the solvency of the EU banking system has significantly improved with the capital ratio increasing from 8.9% in 2010 to 15.5% in 2016[3].

This being said, throughout the crisis we have seen a number of banks that became insolvent or were on the brink of becoming insolvent. In a few cases, the banks were liquidated or resolved. However, in the majority of cases, banks were merged or absorbed by other banks. This last summer we have witnessed two outstanding examples: in Spain, Banco Popular was resolved and absorbed by Banco Santander; in Italy, Intesa Sanpaolo took over part of Veneto Banca and Banca Popolare di Vicenza, which were liquidated.

3: Data according to the EBA Risk Dashboard. The data for 2010 is measured using a slightly different capital definition ahead of the introduction of the CRR/CRD.

In these two cases, the acquiring banking group was about ten times larger than the absorbed ones (Banco Santander has €1,350 billion of total assets compared to €150 billion of Banco Popular; Intesa Sanpaolo has €725 billion compared to about €60 billion of combined size of the two absorbed banks). Although the size of these banks may appear to be relatively "small", they should be put into the perspective of other industries. For instance, Inditex, the company with the largest capitalisation in the Spanish stock exchange has €20 billion of total assets; similarly, ENI, the Italian company with the largest capitalisation has €140 billion of total assets.

Some authorities defend the need to reduce bank capacity in Europe, which is considered to be "overbanked"[4]. For example, the ESRB proposes policies in order to reduce excessive private credit. Those policies vary from removing preferential fiscal treatment of debt to controlling banks' size by more aggressive anti-trust policies. M&A operations can improve the use of branches and employees, but it is unclear that it will reduce credit, except for the mutual interbank positions between the two merged entities.

"Medium-size" banks are more resolvable than large banks, but the *too-big-to-fail* (TBTF) problem has not been overcome yet. The consolidation of existing banks, particularly when one of the large banks absorbs additional competitors goes clearly in an opposite direction of reducing TBTF. Moreover, while the weaknesses of a medium-size bank may be diluted within the balance sheet of a very large bank, consolidation is not necessarily a positive outcome to confront a problematic bank. Merging two banks with difficulties will only result in a bigger problem down the road as witnessed in some Spanish mergers. Also it is not clear that a troubled bank can be so easily absorb or whether it could even destabilise a large absorbing bank.

Increasing the resolvability of banks requires access to markets, key to the performance of issuances of instruments eligible for MREL requirements. It would be interesting to investigate whether an improvement in banking wholesale funding can be observed following the consolidation experienced in Spain. On the other hand, having access to markets could lead to contagion effects as recently experienced in Spain (e.g. from Banco Popular towards Liberbank). In this case, non-listed banks may benefit from being sheltered from such contagion effects. However, the trend observed in the Spanish financial system is to increase the number of banks that are listed (e.g. Unicaja raised capital through an IPO on June 2017).

In this context, two divergent approaches to diversification should be considered. Diversification is generally understood as a robust mean to mitigate risks (e.g. shocks and cycles). The consolidation of banks provides opportunities for geographical diversification, particularly for cross-national entities. However, consolidation restricted to European countries may yield limited benefits as EU Member States tend to be highly interconnected with very similar economic cycles and important contagion effects. Moreover, they are subject to the same interest-rate environment and the same monetary policy, thus, the diversification of profitability is limited. Moreover, if the Banking Union progresses further, banks should have access to a European market without having to own a local player. A better geographical diversification would need to include banks from other regions like Latin America, Asia, Australia or Africa; however, this does not seem to be on the table.

4: Advisory Scientific Committee. *Is Europe Overbanked?* European Systemic Risk Board (ESRB) – No. 4/June 2014.

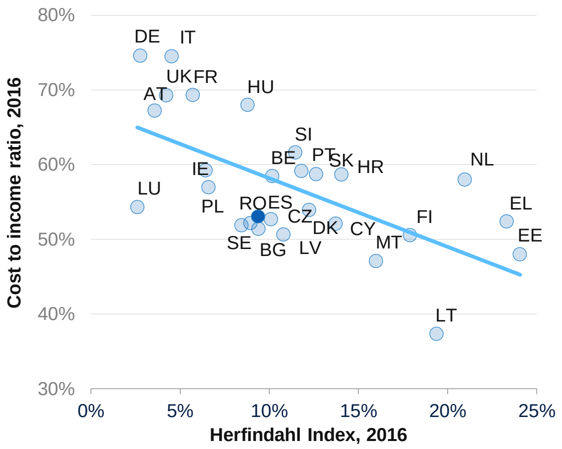
Aiming at a diversification of the system through niche banks or specialised banks (e.g. building societies) could be an alternative approach. This would go against further consolidation. Moreover, the number of those types of banks is currently very limited and, therefore, insufficient to generate the benefits of diversification. Having said that, those banks would be more vulnerable to problems in their market segment.

Despite the single rulebook and a single supervision across the euro area through the Banking Union, banks continue to operate in very different national ecosystems. For instance, the role of shadow banking and fintechs may be very different in each country. However, direct comparisons (performed by regulators or analysts) among the banks supervised by the SSM are not to be discarded. This can put pressure on banks to evolve towards business models that can be perceived to be more robust or efficient under a simplistic approach of neglecting the actual ecosystems of each bank.

4.- Efficiency and consolidation

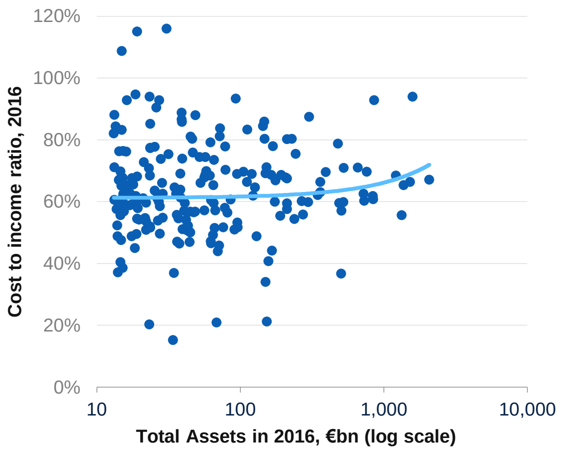
The traditional argument in support of consolidation stem from the synergies and the economies of scale that can be obtained after a merger. This is particularly relevant for Europe, where an excess of leverage and banking capacity can still be observed in specific countries. Consolidation can lead to efficiency gains when there are (geographic) overlaps between the two entities to be consolidated as a number of cost-cutting measures can be easily implemented. However, sometimes mergers can be used as a subterfuge to overcome strict labour legislation (e.g. about restriction to large layoffs) rather than being driven by actual business synergies.

Figure 6 Efficiency vs Concentration



Source: European Central Bank and BBVA Research

Figure 7 Efficiency vs Size (EU banks)



Source: European Central Bank and BBVA Research

Cross-national mergers or acquisitions can provide a mean for a bank to enter into a new market, but there may be difficulties to obtain efficiency gains from banks without previous overlaps[5]. Moreover, although decreasing, cultural and linguistic barriers could reveal non-negligible.

Overall, there is little evidence about actual economies of scale in banking or that mergers will lead to cost savings. (Figures 6 and 7).

5.- Competition, consumer protection, digitalization and consolidation

The process of consolidation leads necessarily to a lower number of players in a market. As explained by Álvarez et al. (2017)[6], a reduction in the number of banks does not necessarily mean weaker competition: the relationship between industry concentration and competition is not straightforward and in most cases the main factors that appear to affect competition have little or nothing to do with concentration. In a similar vein, Ratnovski (2013) argues that more than concentration, competition depends on the contestability of the market[7]. This being said, when in a specific country the number of bank players becomes very limited, competition may potentially be affected in specific towns or regions.

Concentration is a variable that must be taken into account in order to explain the degree of competition in a banking sector. However, other variables have even more direct impact on the industry's competition level, such as market contestability, the business cycle, the strength of the institutional and regulatory framework and the historical inheritance of the country.

Market contestability is defined by the lack of entry or exit barriers, the inexistence of sunk costs and that incumbents and new entrants have access to the same technology. In Spain, many foreign banks have tried to enter the market but only the cases of ING Direct and Deutsche Bank managed to consolidate their position. However, the digital transformation and the appearance of fintech are changing the financial landscape. The role played by fintechs in the financial ecosystem in each country, the regulatory divergence between banks and fintechs and the capacity of large banks to adapt to the digital transformation play a new role in the contestability of markets.

Moreover, besides banks and fintechs, the role of markets and shadow banking in providing financial services should also be taken into account.

Overall, new fintech operators as well as the improved access through digitalisation are increasing consumer choice and its market power.

5: A rare exception could be a digitally advanced bank that takes over a bank in another market for its portfolio of customers.
6: Álvarez, J. M., Deblas, C., Izquierdo, J. F., Rubio A. and Zurita, J. (2017). The impact of European consolidation on credit prices. Working Paper No. 17/08.April 2017.
7: Ratnovski, L. (2013). Competition Policy for Modern Banks. IMF Working Paper WP/13/126.

6.- Systemic risk

One of the main concerns surfaced by the economic and financial crisis was the interconnection between sovereigns and their banks; particularly due to the institutions that were considered too-big-to-fail (TBTF) and that would ultimately need to be bailed out by their respective governments if they were to enter into trouble. Besides the potential risk for sovereigns, TBTF banks could have a perverse incentive to incur in more risk than if they were not benefitting from an implicit State guarantee or benefit from lower funding costs. In this context, one of the objectives of the reforms promoted by the FSB was to put an end to the TBTF. However, it is unclear that this goal has been achieved. On the wake of the recent resolution cases in Spain and Italy, it seems that the bail-in tool is not fully working and that its implementation is not homogeneous across countries.

It is clear that consolidation does not contribute to solve TBTF. If banking consolidation continues, there will be potentially more G-SIBs in the euro area. Under the current regulatory framework, SSM countries cannot be treated as a single jurisdiction for the purpose of calculating G-SIB buffers, which could lead to higher capital requirements for European banks than for US cross-state banks. This means that both the Banking Union and the regulatory framework should evolve in order to continue the development of financial integration in Europe.

The role of stricter requirements for SIFIs (e.g. buffers) and the role of proportionality (for smaller banks regarding reporting requirements but not necessarily regarding governance) should also be considered. This being said, variables such as complexity matter more than the size.

7.- Conclusions

Some voices are defending the need for further consolidation as a way of fixing the problems remaining in the European banking system. While further consolidation has indeed some advantages and benefits, it also implies some drawbacks and costs. We have discussed the implications of consolidation for financial stability, solvency, efficiency, competition, consumer protection, digitalization and systemic risk. In most of these areas, the effect of consolidation is at least ambiguous as it can strengthen the system in some aspects; however, further banking consolidation can also generate new weaknesses or exacerbate some of the existing ones as a by-product.

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