Is less more? Profitability and consolidation in the European banking sector

Presentation at the CIRSF Annual International Conference 2019, Lisbon, 4 July
## Overview

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1. The profitability of European banks

- Euro area banks have become slightly more profitable…
  - Return on equity (RoE) increased from 6.3% in 2017 to 6.7% in 2018
  - Main driver: lower impairments
  - Core business also improved (net interest income and net fee and commission income at highest levels since 2015)

![Graph showing the profitability of European banks from 2015 to 2021.](source: ECB)
1. The profitability of European banks

• ...and slightly less cost-efficient
  o In 2018, operating expenses slightly increased

Source: ECB
1. The profitability of European banks

- But overall, profitability remains subdued…
  - Price-to-book values for most banks are still below one
  - For many banks, their RoE is still below their cost of equity (CoE)
  - Is the recent improvement in profitability a stable trend?
  - Is “Japanification” a risk for the euro area?

Sources: ECB and ECB calculations
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2. Is overbanking a problem?

- **Overbanking is often put forward as a reason for low profitability**
  - Banking is a good thing in principle, but you can have too much of a good thing
  - You can also not have enough of a good thing
  - The relationship is non-linear and there are many dimensions of overbanking
2. Is overbanking a problem?

- **The first dimension of overbanking: too many banks**
  - Fierce competition, but only a few banks exit the market
  - Non-viable banks have an incentive to price aggressively and take on high risks in a gamble for resurrection

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**Cumulative share of total assets for the largest 50 banks in the Euro Area & United States**

*Sources: S&P Market Intelligence and ECB; data as of end-2018*
2. Is overbanking a problem?

- The second dimension of overbanking: the banking sector is too large compared with other sectors
  - Paying excessive wages might drain talented people from other sectors ➔ inefficient allocation of resources

*Occupation of Harvard Graduates 15 years after graduation*

2. Is overbanking a problem?

• The third dimension of overbanking: the banking sector is too large compared with other sources of funding
  o Bank-based economies perform slightly better
  o In crises, however, they suffer more and take longer to recover

Share of bank and non-bank financing in total non-financial corporation financing in the euro area and the United States

(cumulated transactions, percentages)

Sources: ECB, Federal Reserve System.
Note: The latest observation is for the first quarter of 2016.
2. Is overbanking a problem?

- **The fourth dimension of overbanking: banking assets are too large**
  - This might imply that the economy is over-indebted
  - Arcand et al. show that growth suffers once credit to the private sector exceeds 100% of GDP

![Graph showing loans to the private sector as a share of GDP]


*Sources: ECB and ECB calculations*
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3. Is consolidation a solution?

**Consolidation through deleveraging**

- Euro area banks have deleveraged
- In doing so, they relied mostly on reducing assets and less on increasing capital
- They also mostly reduced assets abroad

![Graph: Total Assets, Tier 1 Capital and Leverage Ratio](source: ECB)
3. Is consolidation a solution?

**Consolidation through failure**

- 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.
- The Single Resolution Mechanism is thus an important step in the right direction.

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**Graph: Banks resolved in the EU and the United States**

3. Is consolidation a solution?

Consolidation through mergers and acquisitions (M&A)

Benefits of M&A

- Economies of scale and scope ➔ banks might become more efficient and more profitable (the empirical evidence is mixed, however)
- Opportunity to scale up technological innovation
- After a crisis, consolidation can help to mop up excess capacity

Costs and challenges of M&A

- Governance issues are amplified
- Challenge of integrating cultures, IT systems and other structures
3. Is consolidation a solution?

Additional benefits of cross-border M&A

- Banks could diversify their portfolios across borders ➞ become more resilient
- The sovereign-bank nexus would be weakened
- Private risk-sharing would improve ➞ the entire banking system would become more stable

Consumption risk-sharing in the euro area and its channels: % of shock smoothing

Source: ECB (2018), Financial integration in Europe, May
3. Is consolidation a solution?

What do we see in terms of M&A?

• In Europe, M&A activity has been on a downward trend for some time
  o The few deals we see are mostly domestic (which is already a step in the right direction)…
  o …and among smaller institutions

Bank M&As in the euro area - number of transactions

Sources: Dealogic and ECB calculations
Why is there so little consolidation?

- The banking union should facilitate consolidation and cross-border M&A
  - There is a level supervisory playing field across the euro area
  - The ECB takes a neutral stance towards M&A; we assess each project put forward by banks purely on technical grounds
  - Regulatory uncertainty now coming to an end with the completion of the reform process

- But the market remains fragmented…
  - Countries are still ring-fencing liquidity and capital at the national level → limited benefits from being a cross-border bank
  - Despite the single rulebook, the regulatory framework remains fragmented (as do tax and insolvency laws, for instance)

- …and uncertainty is still high
  - e.g. about bank valuations (e.g. non-performing loan ratios still high in many countries)
3. Is consolidation a solution?

What can be done?

• Make ring-fencing obsolete by improving risk management and introducing pan-European safety nets
  o The agreement on the backstop for the Single Resolution Fund was an important step
  o But we also need a European deposit insurance scheme (EDIS) to create more trust and lessen the need for ring-fencing
  o Make intragroup financial support agreements part of banks’ recovery plans

• Continue harmonising the regulatory framework

• Continue cleaning up banks’ balance sheets
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4. Conclusion

To conclude:

• The optimal size of banking sector is hard to gauge
  o It seems clear, though, that the European banking sector is still too large
  o So there is a need for consolidation

• However, this is not about:
  o Creating ever-larger banks; it’s about more efficient banks. The banking sector needs to be diverse
  o Policymakers determining the structure of the banking sector; ultimately, that is up to market forces
  o Seeing only cross-border mergers. They would certainly be a sign of a truly European banking market. But also in a truly European market, domestic mergers might make sense from a cost-efficiency viewpoint