EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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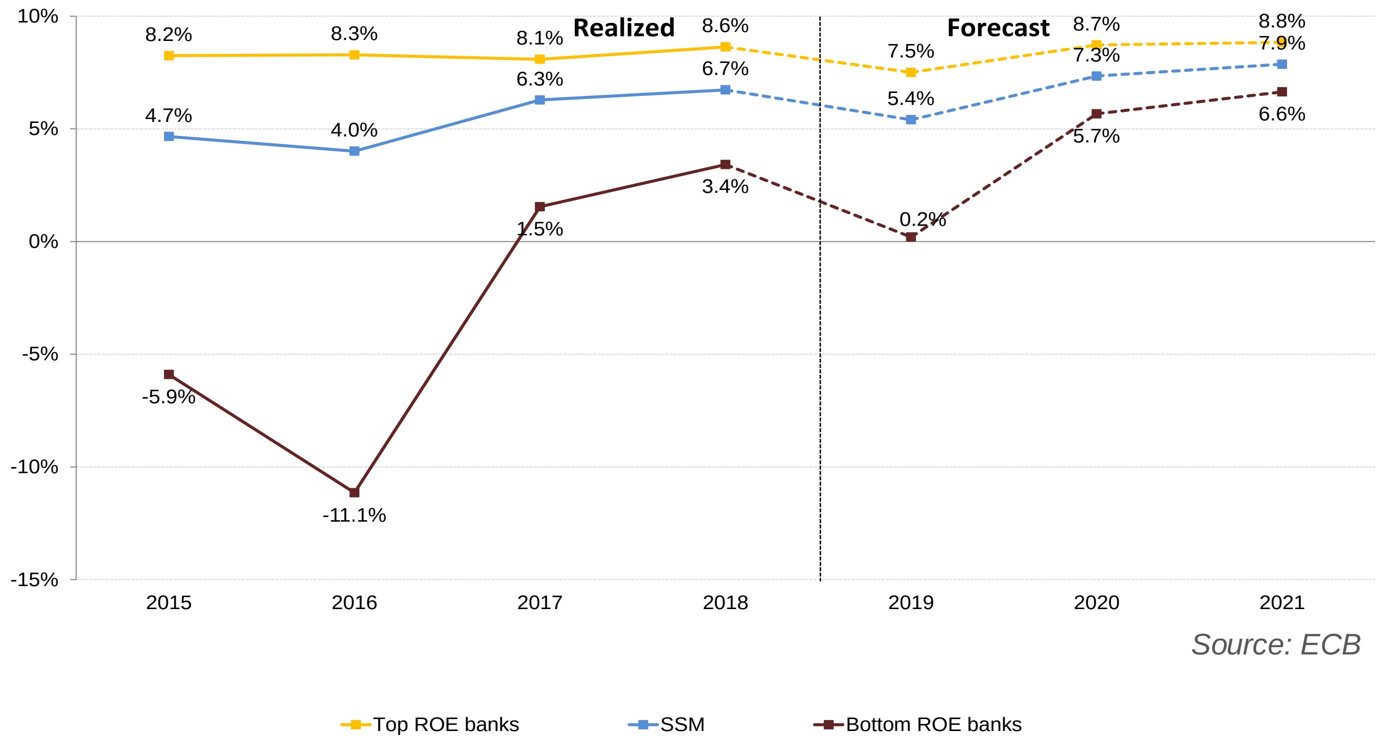
Is less more? Profitability and consolidation in the European banking sector

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

Overview

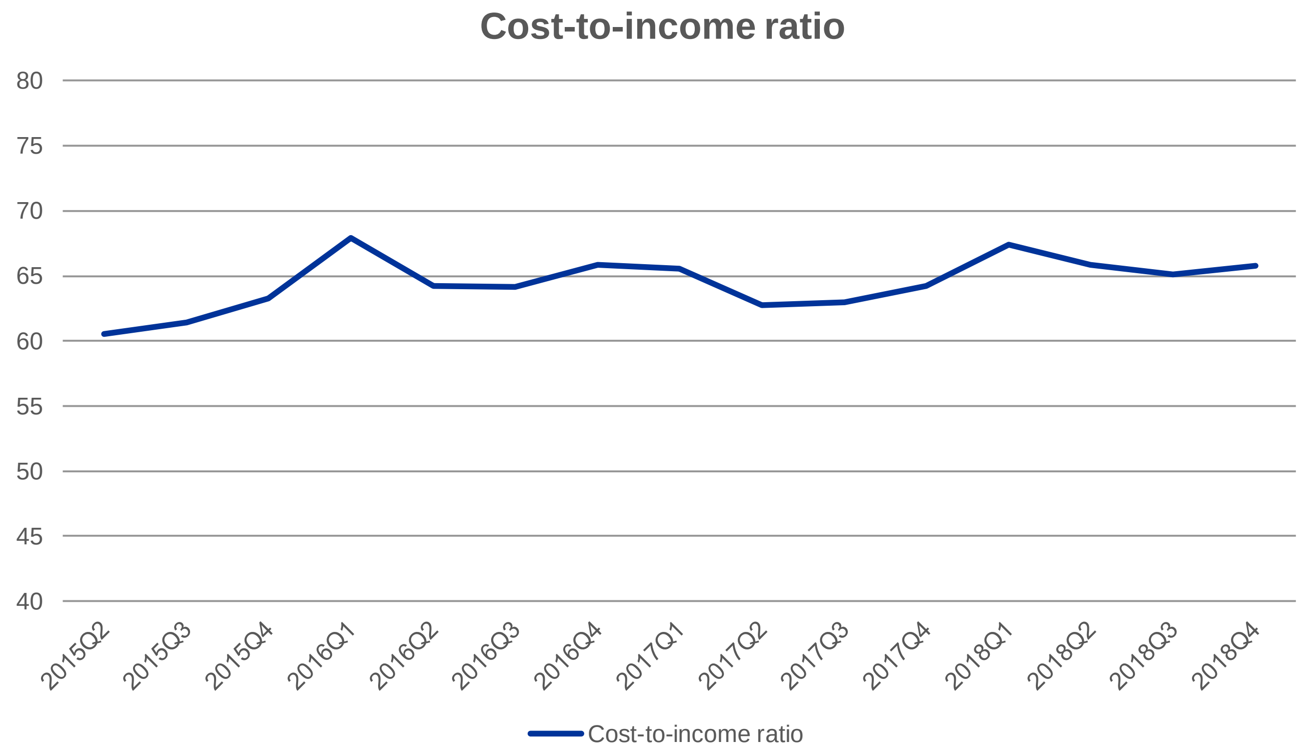
Overview

- **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)

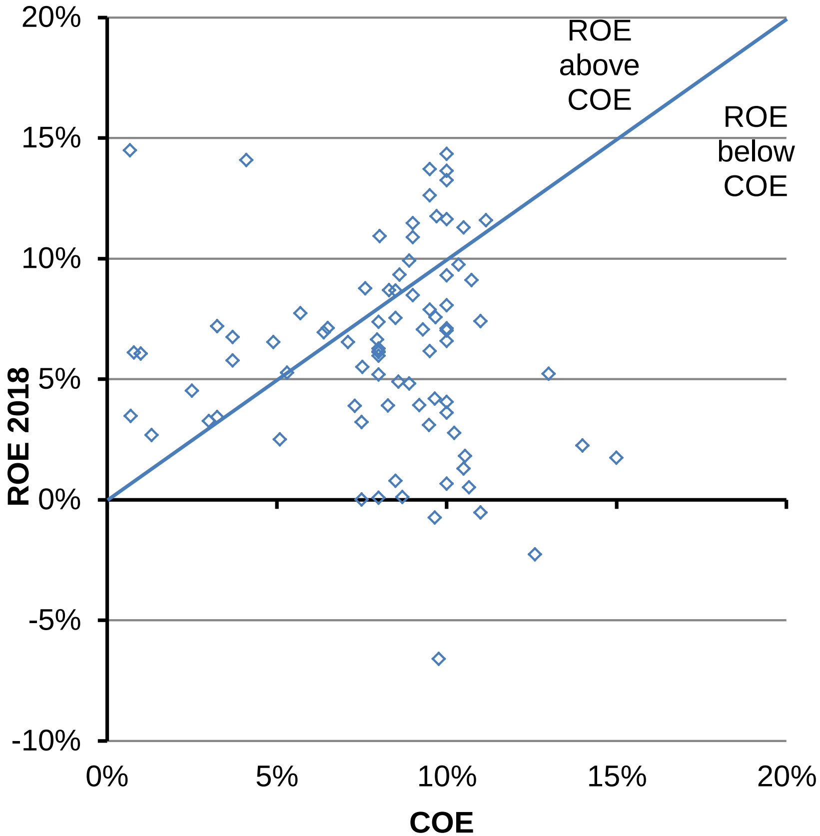


Source: ECB

- **…and slightly less cost-efficient**
  - In 2018, operating expenses slightly increased



Source: ECB

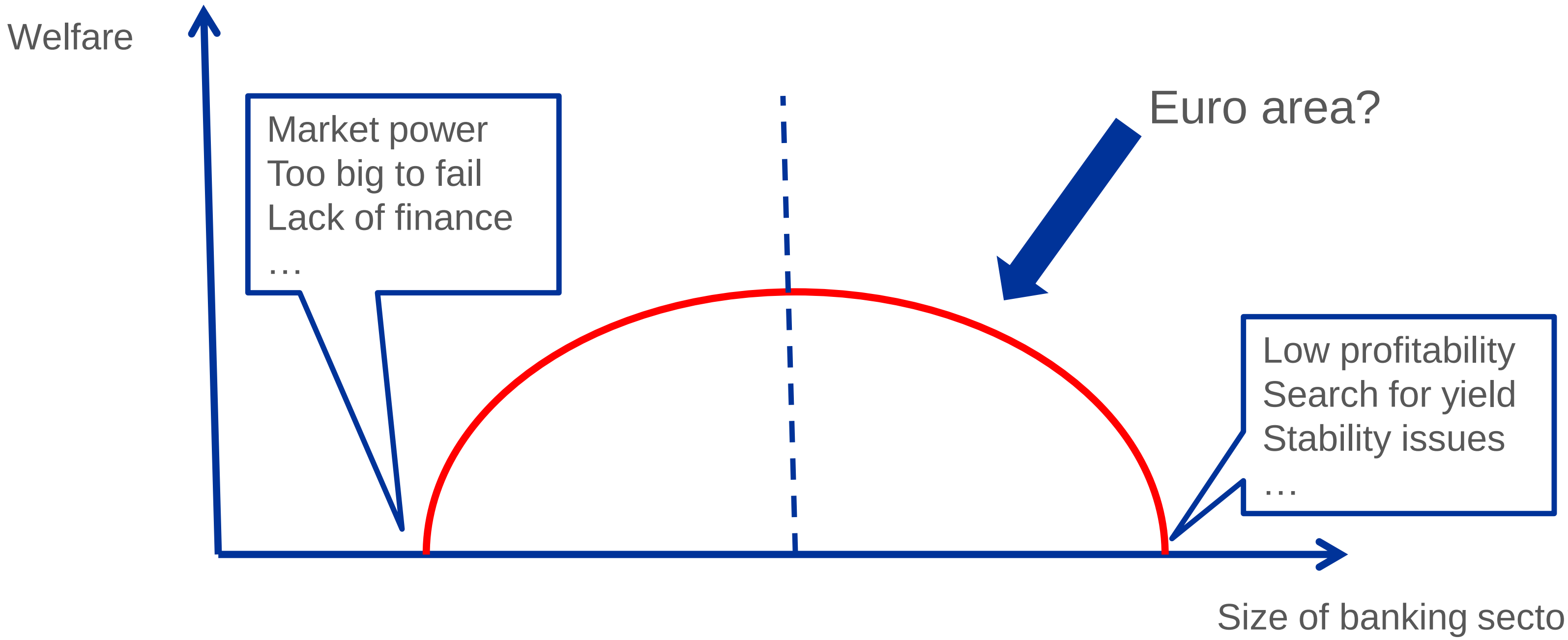


Sources: ECB and ECB calculations

- **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?

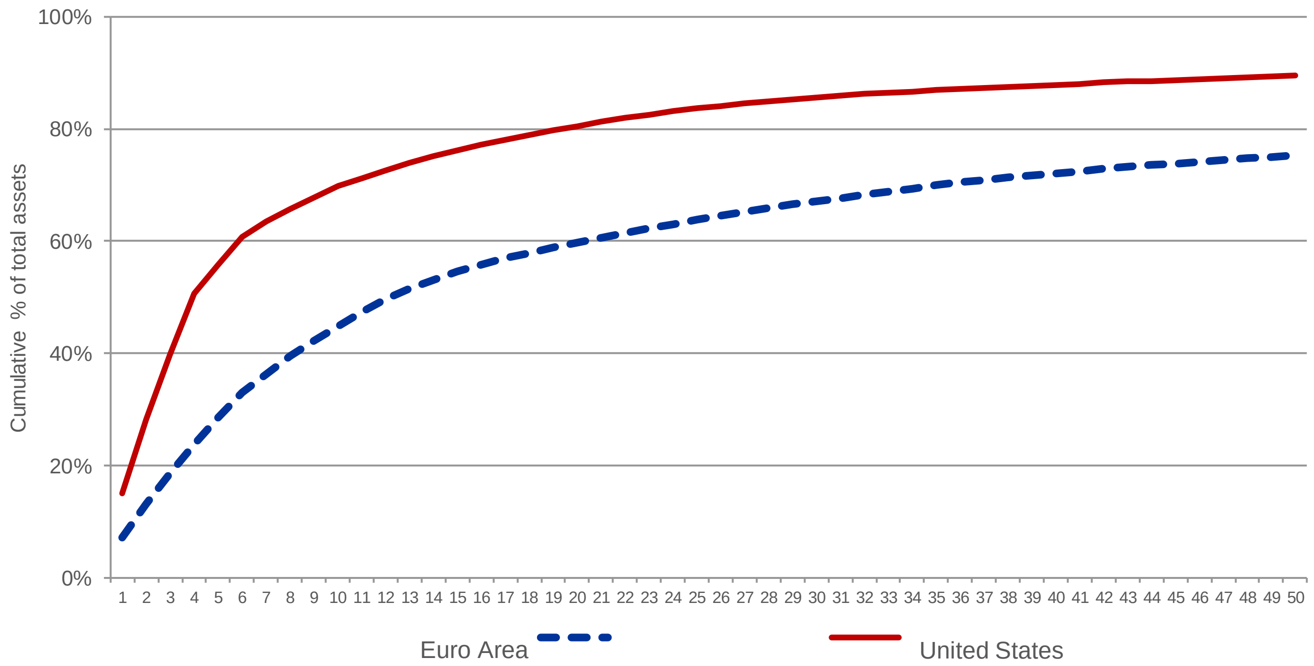
Overview

- **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



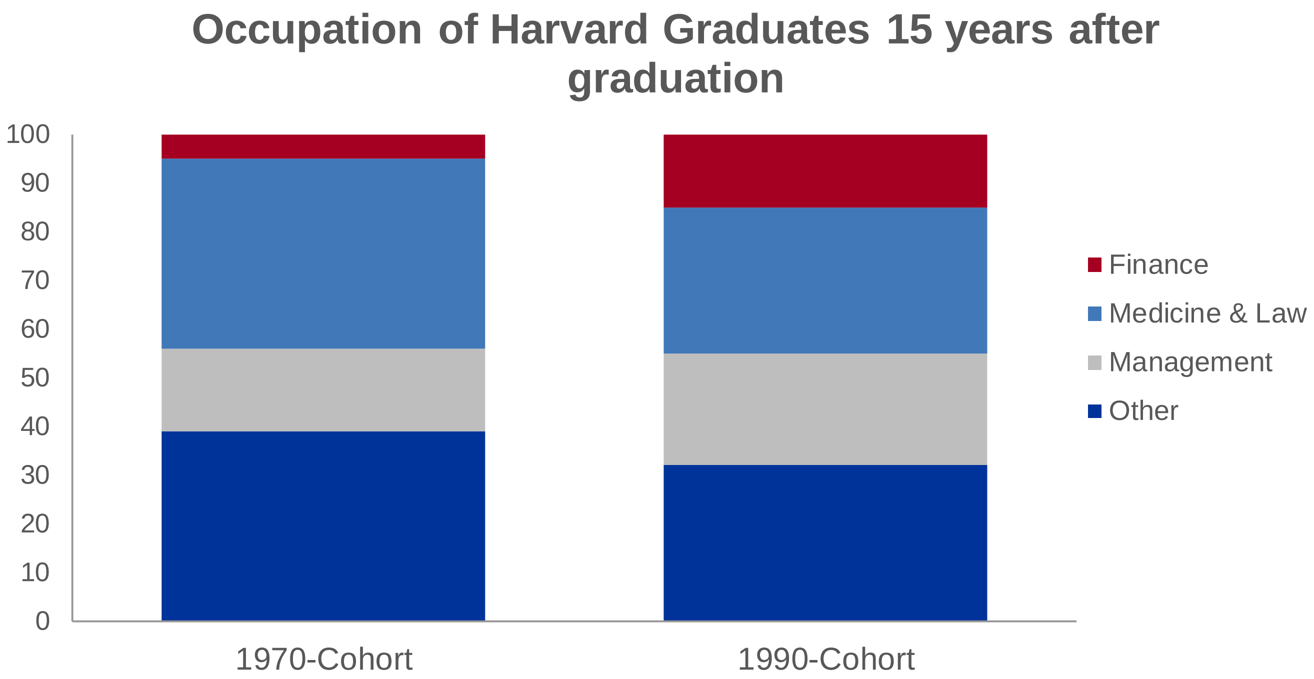
- **The first dimension of overbanking: too many banks**
  - Fierce competition, but only a few banks exit the market
  - Non-viable banks have an incentive to price aggressively and take on high risks in a gamble for resurrection

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

- **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



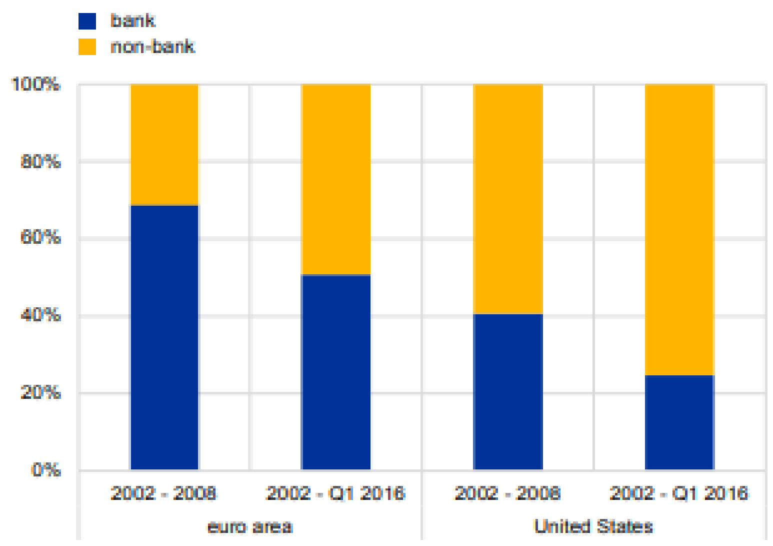
Source: Goldin, C. and Katz, L. (2008), "Transitions: Career and Family Life Cycles of the Educational Elite", American Economic Review, *Vol. 98, No 2, pp. 363-369*

2. Is overbanking a problem?

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

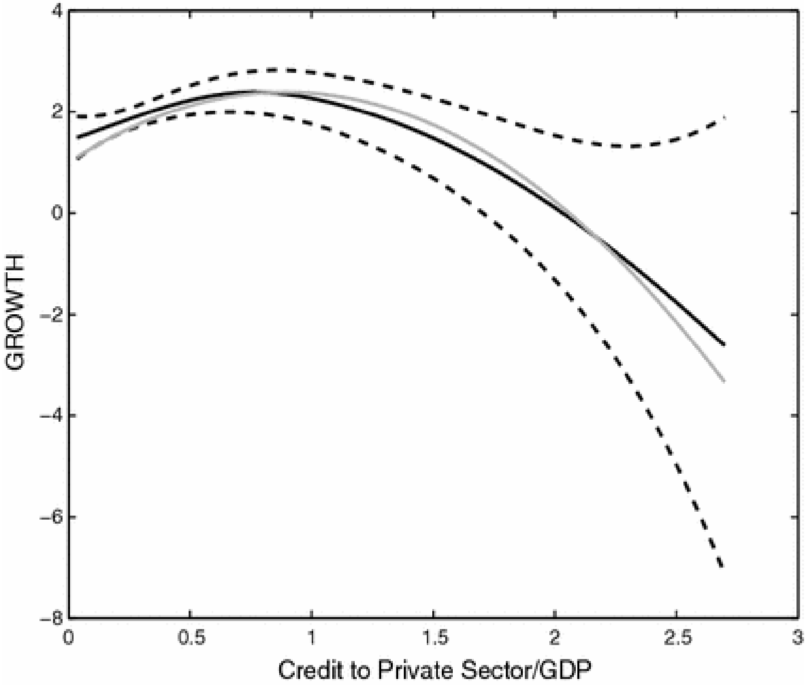
Share of bank and non-bank financing in total non-financial corporation financing in the euro area and the United States

(cumulated transactions, percentages)

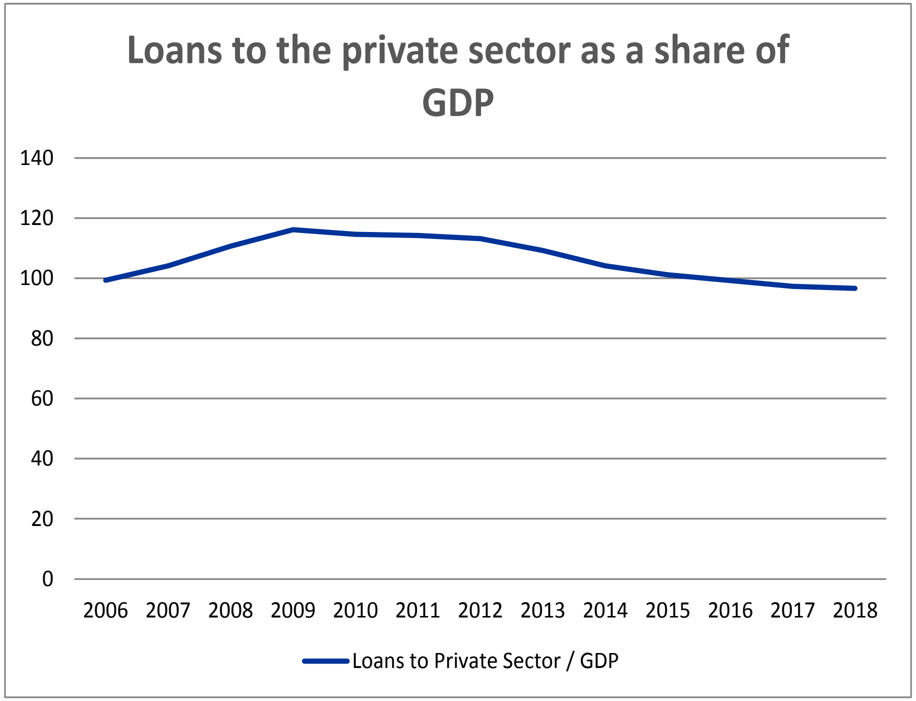


Sources: ECB, Federal Reserve System.
Note: The latest observation is for the first quarter of 2016.

- **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



Source: Arcand, J.-L., Berkes, E. and Panizza, U. (2015), "Too much Finance?", Journal of Economic Growth*, Vol. 20, No 2, pp. 105-148*

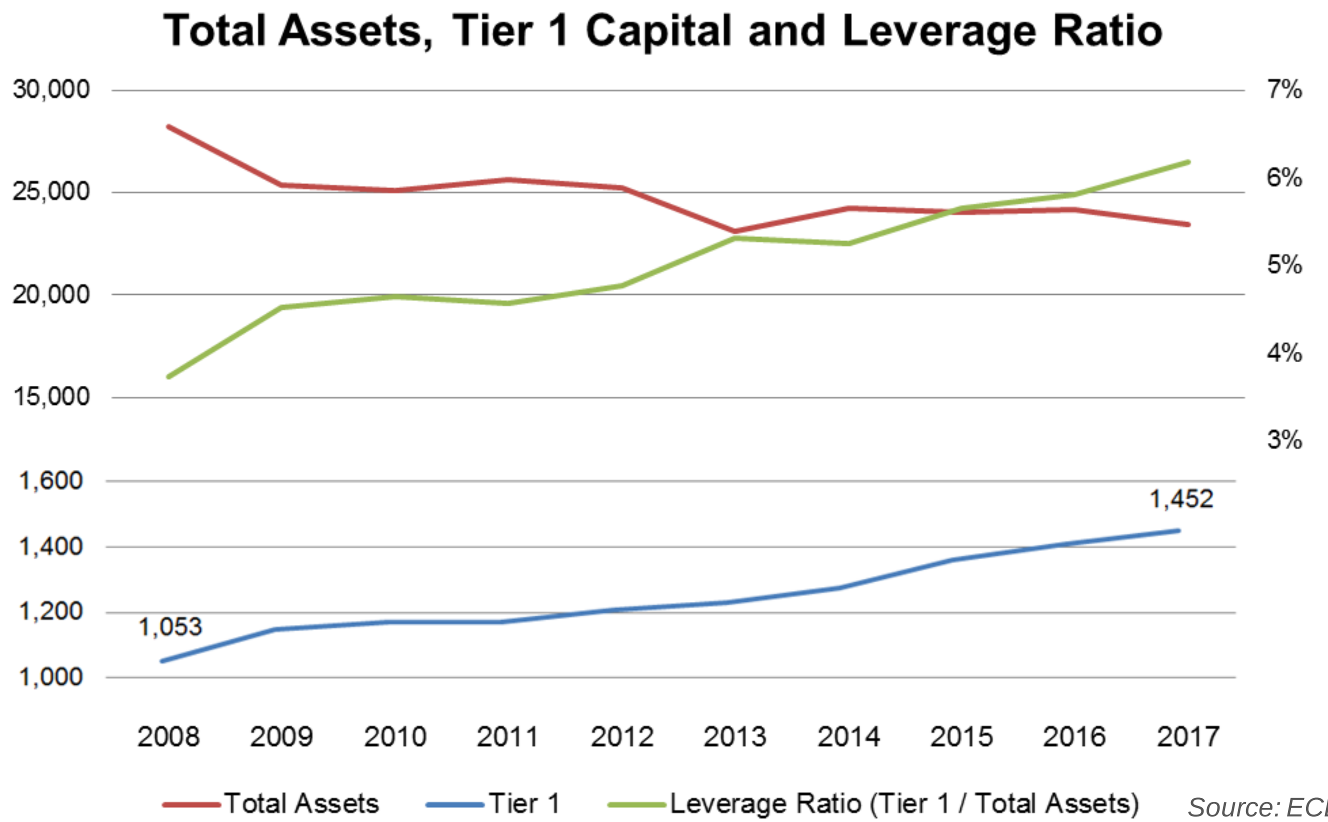


Sources: ECB and ECB calculations

Overview

Consolidation through deleveraging

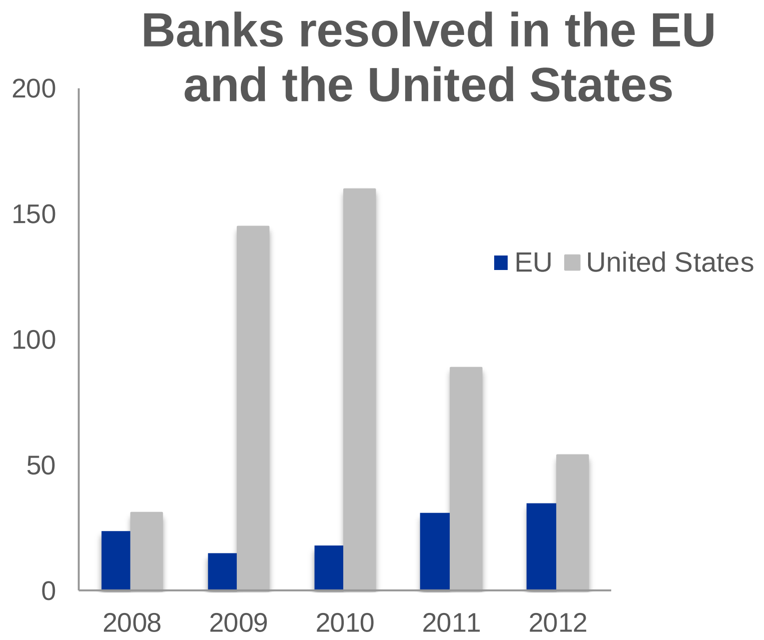
- Euro area banks have deleveraged
- In doing so, they relied mostly on reducing assets and less on increasing capital
- They also mostly reduced assets abroad



Source: ECB

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



Source: FDIC and Open Economics. Pagano, Marco, et al. *Is Europe Overbanked?*, No. 4. Reports of the Advisory Scientific Committee, European Systemic Risk Board, 2014.

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

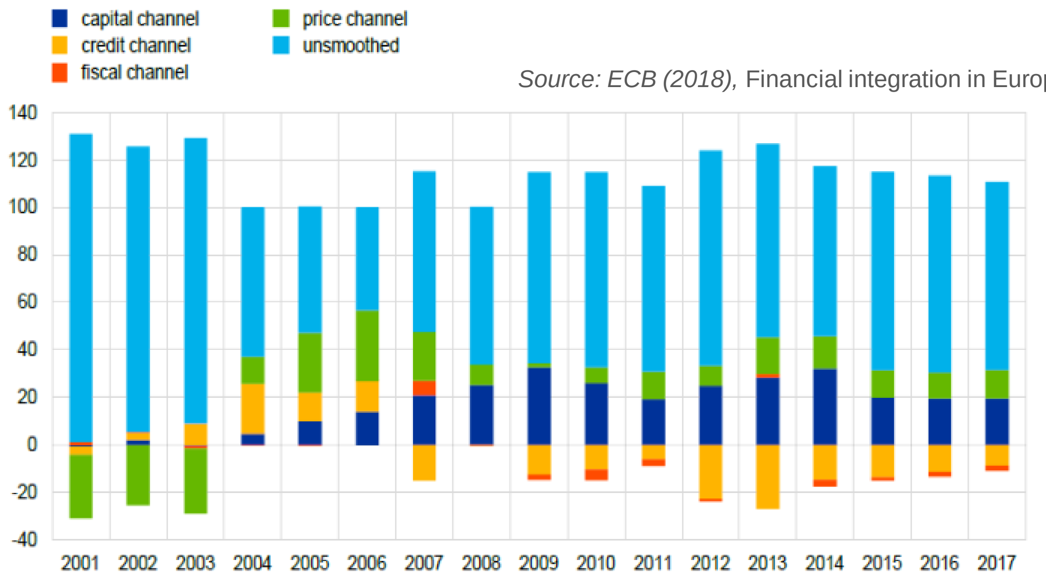
Costs and challenges of M&A

- Governance issues are amplified
- Challenge of integrating cultures, IT systems and other structures

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

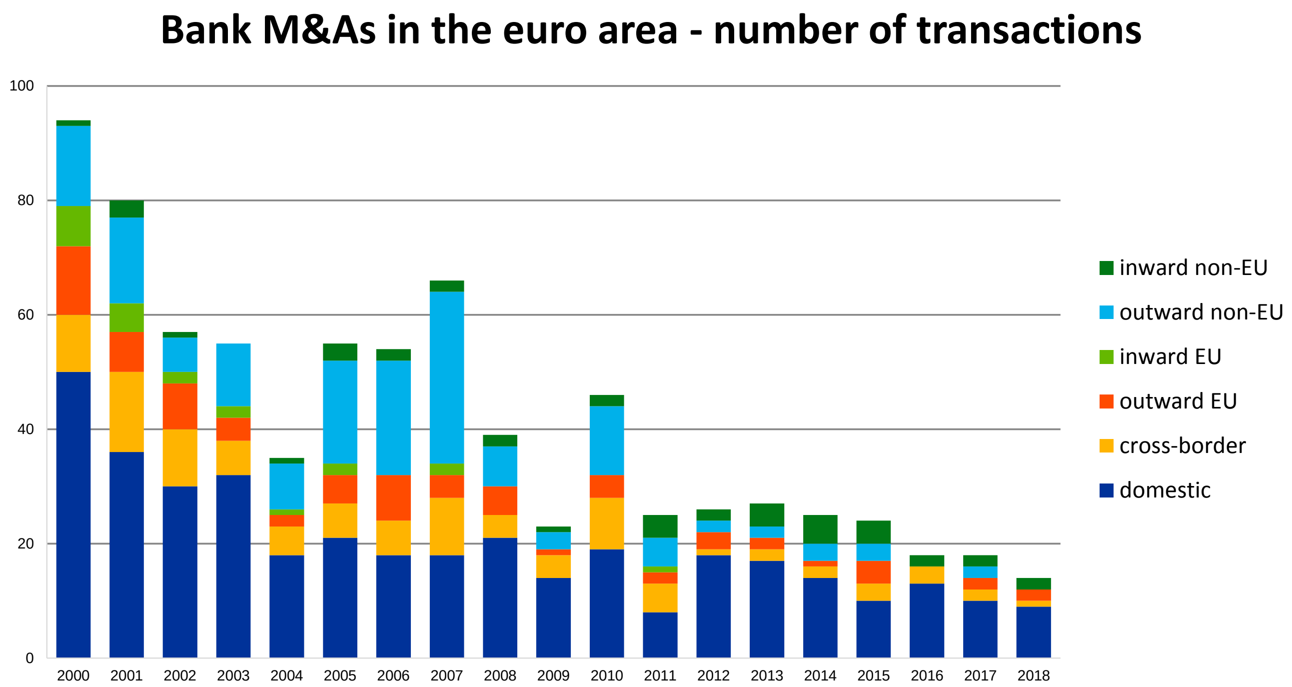
Consumption risk-sharing in the euro area and its channels: % of shock smoothing



Source: ECB (2018), Financial integration in Europe, *May*

What do we see in terms of M&A?

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



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)

What can be done?

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

- **Continue harmonising the regulatory framework**

- **Continue cleaning up banks' balance sheets**

Overview

To conclude:

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

- **However, this is not about:**
  - Creating ever-larger banks; it’s about more efficient banks. The banking sector needs to be diverse
  - Policymakers determining the structure of the banking sector; ultimately, that is up to market forces
  - 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