BANK FRAGMENTATION AND CONSOLIDATION

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Banking fragmentation and consolidation: enhancing a single market for banks

The COVID-19 pandemic is a strong reminder that cooperation and coordination provide a solid basis for reaching an effective response to common challenges on the European level. The coordinated monetary, fiscal and prudential relief measures showcase the positive impact of supranational action. The pandemic also pushed the frontier of European integration with the Next Generation EU providing for the largest-ever institutional bond issuance in Europe. However, the European Banking Union remains incomplete, and the banking market remains fragmented along national lines. Besides commercial considerations, regulatory obstacles continue to be an important factor impeding the emergence of a true single market for financial services in the European Union.

The recently published EBA stress test results show that even under a very severe scenario, the EU banking sector would maintain adequate capital levels. Nevertheless, those institutions with higher exposures towards the sectors most affected by the pandemic such as hospitality and travel, or with a higher pre-pandemic ratio of non-performing loans (NPL) are still vulnerable. Future divergence triggered by NPLs, defaults and insolvencies may drag on banks' balance sheets in the absence of a single banking market. Furthermore, profitability remains subdued and return on equity is still below the estimated cost of equity for many banks.

Beyond finalising Banking Union, actions can be taken to enhance cross border banking services in EU.

The pandemic has not yet proven to be a catalyst to push the Roadmap to complete the Banking Union beyond the finishing line. There is no rationale for Europe to keep the Banking Union resting on two pillars only. Proper risk and capital allocation need the foundation of a common deposit insurance scheme. Of course, we need to consider the remaining concerns from both sides, from European cross-border perspective as well as from Member States' perspective. However, after more than five years of negotiations, we would need to converge those concerns into a European compromise solution which may forcefully counter any erosion of trust in a single banking market in Europe.

Beyond the finalisation of the Banking Union, we should continue to exploit the existing framework to enhance cross-border activity within the EU. The use of waivers to allow for free flow of liquidity and capital within European banking groups should increase. A complete achievement of this objective can only be ensured through the mentioned legislative reforms, but some advancement may also be explored under the current framework. Options include the setup of internal support agreements between parent and subsidiaries within banking groups and the enhancement of the links between such agreements and the institution recovery plans. The flow of liquidity within the group may be eased if supervisors were able to use their early intervention powers before any more substantial crisis materialises. The assessment of group recovery plans should be the appropriate forum where supervisory and resolution authorities prepare for a cooperative and operable solution in case an emergency situation arises.

In addition to that, we must join forces with securities market regulators as the Banking Union and the Capital Market Union share many obstacles to reach their full potential. Banks and capital markets would need to play complementary roles to support businesses and citizens. We should capitalise on synergies between both if we would like securitisation to play a prominent role during the recovery. Added collaboration is also needed to assure that technological innovation in financial services becomes a catalyst to further increase in the provision of cross-border banking services within the EU.

Finally, building up the single market within the EU and implementing Basel III must not result in new fragmentation from global financial markets. European banks as much as European businesses rely on international business.

Global cooperation and assuring a consistent implementation of internationally agreed standards also remain key ingredients to the international level playing field.

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Market fragmentation in the Banking Union

As in the previous crisis, safety nets for banks remained completely national during the pandemic. The policy response resulted in banking markets fragmenting along national lines: cross-border banking groups were broken down, and ring-fencing measures were introduced to prevent local establishments from importing risks from other group entities and to ensure they remained viable on a standalone basis. Banks supported by government funds were asked to refocus their business on a domestic basis. This drop in cross-border banking within the euro area was the main driver of the fall in financial integration.

The present pandemic crisis, six years after banking union began, is thus a crucial test of the progress achieved. The results, while mixed, do have promising elements. On the one hand there is a degree of frustration that all these years of banking union have not brought about a substantial increase in integration, as measured by the ECB composite indicator of financial integration. But it is remarkable, however, that throughout the crisis the indicator for banking market integration – which captures the dispersion in comparable bank lending rates across the euro area (the lower the dispersion, the higher the level of integration) – has remained almost completely stable, in stark contrast to the steep decline seen during the great financial and sovereign debt crises.

This shows how the post-crisis financial reforms, together with the swift and fully unified public response to the shock, have created a stronger and more unified banking system, where centrifugal forces have been much less powerful compared with the past. These findings point to the possibility that banking union is indeed transforming the European banking market from a shock amplifier into a shock absorber. But we are not quite there yet. There is still a risk that in the event of a major systemic shock, European banking groups may be prevented from functioning as shock absorbers, since their capital and liquidity remain largely segmented in local pools in individual Member States.

As long as deposit insurance schemes remain at national level only, Member States will still have an incentive to ring-fence their banking sectors. Completing banking union by setting up a European deposit insurance scheme (EDIS) would be the most direct route to fostering integration. Since it is also clear that this scheme will take some time to materialise, we should take steps to try to advance integration as much as possible, building on the possibilities already offered by the present framework.

The aftermath of the pandemic offers us an opportunity to pursue pragmatic avenues to increase integration in the banking union.

As the driving force of the Single Supervisory Mechanism of the banking union, the ECB is ready to take this pragmatic route and explore all the possible avenues offered by the existing framework. We have already published our expectations regarding the prudential assessment of consolidation projects, which apply equally to all projects within the banking union. We have also shown our willingness to use the option of putting in place, in a prudent and progressive manner, the waivers that are already provided for by the liquidity coverage ratio and the net stable funding ratio. This includes making more use of recovery plans to build concrete mechanisms to ensure that banking groups can operationalise group-wide mechanisms of global risk management and support in a safe way, taking into account the legitimate interests of all the stakeholders involved.

We also stand ready to apply the revised regulatory standard related to the indicators of global systemic importance for cross-border activities in the banking union. In addition, we intend to use our exclusive powers in the field of establishing branches of European credit institutions in the banking union and the free provision of services by banking union credit institutions, to see how projects building more integration can be safely developed, taking full account of the legitimate concerns of all parties involved.

But supervisors can only play their part in this process of integration. Their role is to assess the projects and ensure that they are developed in a safe and sound way. But these projects themselves should always be built on an industry-driven, solid economic basis, and should be sustainable and well-managed. The real motor of integration can thus only be sound business projects, developed as a result of strategic thinking within the governance of the institutions, with a view to reaping the economic benefits of the further integration that the financing of the recovery will need to mobilise.

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Post-crisis reform is coming to an end: time to cater for sustainable growth

With vaccine rollouts extending, it seems the world may be finally starting to get the upper hand on the pandemic, providing much-needed optimism and the opportunity for policy-makers and regulators to focus more immediately on rebuilding their hard-hit economies while gearing towards a more digital and sustainable long term future.

This time, the banking sector has proven to be much better prepared in terms of resilience, capital, and liquidity than during the financial crisis. Overall, banks are now structurally healthier, which has undoubtedly helped them weather the pandemic without constraining credit to the real economy.

In the EU, various authorities, and in particular the ECB, responded swiftly to the pandemic by providing banks with regulatory and supervisory relief to encourage continued lending to the economy. Such decisive and coherent action, which helped calm markets and boost confidence, would not have been possible without having a single supervisor. The pandemic showed us not only how important the recent reforms are, but also reminded us that completing the Banking Union – and the Capital Markets Union – remains fundamental to improving the efficiency of the EU financial sector, as well as enhancing the financing options available for the real economy.

As a first positive step towards completing and strengthening the Banking Union, the EU should finalize the implementation of Basel III in a manner that is as consistent as possible with the internationally agreed Basel capital framework. This will help ensure a level global playing field and will limit the costs and risks of global regulatory fragmentation.

Adjusting business models to reflect stricter prudential requirements has incentivised banks to manage risk more efficiently. Yet, leverage and risk reduction have often translated into lower profitability, making cost reduction a top priority to ensure sustainability of business models through the cycle.

As a consequence, the EU should focus on sector consolidation, which could play a key role in creating the capacity to reduce costs and clean up NPLs. To achieve that, we need a regulatory environment fostering the circulation of capital and liquidity within European cross-border banking groups. The ECB's guidance on the prudential treatment of mergers and acquisitions is an important step in providing greater transparency. However, several obstacles to consolidation remain to be addressed:

Regulation should foster capital and liquidity movement within European cross-border banking groups.

First, harmonisation of rules is crucial. The EU should use the opportunity coming from the review of the CRR, CRD and BRRD to remove or reduce excessive room for national discretion and goldplating of European rules. A greater use of regulations could be particularly relevant for this purpose. Even if more operationally cumbersome, we should eventually aim for a more uniform insolvency framework in the long term, which would also support a common securitisation market.

Second, we need to solve the conflicts between host and home authorities that often causes the emergence of national ring-fencing practices. On the one hand, the use of capital, liquidity and MREL waivers should be expanded to treat the Banking Union as a truly single jurisdiction from a prudential perspective. On the other hand, we should also address the concerns of national supervisors of seeing parent companies failing to support local subsidiaries in times of stress. Recent proposals from the ECB go in the right direction.

Finally, a true European deposit insurance scheme (EDIS) is a fundamental building block to a fully-functioning Banking Union. As long as deposit insurance remains national, the resolvability of larger cross-border groups will remain hard to operationalize. In turn, this will continue to incentive ring-fencing in going concern as well.

A true European cross-border banking sector should be fully integrated, alongside deep and liquid capital markets, to reap the benefits of the single market. With fewer, stronger players and improved profitability, the EU banking sector must play an even greater role in financing the transition towards carbon-neutrality. With the end of the global reform of the regulatory framework on sight, it is now time to reflect on the lessons learned and take the necessary action to support sustainable growth. In doing so, regulators and supervisors should create favourable conditions for cross-border consolidation so that banks can continue to serve global customers and markets and increase the overall sum of available credit to the economy.

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An effective European banking market as a key driver to allocate resources efficiently

From both a theoretical and experience based perspective taken from other currency and federal unions, it is clear that integrated and well-functioning banking markets play a crucial role in allocating capital efficiently across the economies, both in "normal times" and as shock absorbers in a crisis environment. But for that to happen (private money becoming counter-cyclical), we need integrated financial markets and a significant emphasis on (cross-border) mobility of capital and liquidity. This is particularly true in a post pandemic scenario characterized by different speeds of recovery from the crisis across countries.

First, the lack of fully harmonized banking rules prevents European banks to compete effectively with US peers as the EU banking system is fragmented, resulting from a sum of national entities rather than as a single integrated system. Such a perception weakens its ability to attract international investors. This is also reflected in the supervisory dimension.

The current split of supervisory tasks between SSM (i.e. direct supervision of Significant Institutions) and NCAs (direct supervision of Less Significant Institutions) may be a source of differentiated supervisory practices. To cope with this issue an extension of SSM competencies may be envisaged, for example by bringing under the supervision of the SSM not only the legal entities of a banking group but also the legal entities the group has a significant participation in.

A more integrated EU banking sector requires harmonization of European rules that still reside with local regulators and that impair the efficient management of cross border banking groups, supervision.

Two opportunities to reduce ring fencing practices and supervision inefficiency without requiring legislative changes (which would be difficult to put in place in reasonable time) would be the relinquishments of the liquidity requirements and a possible application of the Pillar 2 requirements at consolidated level only (P2R and P2G). In this respect, we would have expected the ECB – during the recent consultation of its options and discretions policies review – to be more proactive in enhancing waivers from the liquidity requirements at cross-border level.

Integrated and well-functioning banking markets play a crucial role in allocating capital efficiently across the economies.

Furthermore, it is essential – as the EC and SSM chair continue to support – to put in place the third pillar of the Banking Union (namely EDIS, i.e. European Deposit Insurance Scheme) which is not yet in place due to a lack of consensus among member states. It is undisputed that the establishment of an EDIS would grant stronger and more balanced protection for EU depositors.

The activation of EDIS is crucial to reduce the vulnerability of national Deposit Guarantee Schemes to large local shocks, as the level of depositors' confidence in a bank would not depend on the bank's location but on its own individual strength thus weakening the link between banks and sovereigns.
Though we are firm supporters of a fully-fledged EDIS - with full loss mutualization - we acknowledge that a step-by-step approach is most likely to succeed. In this respect, we would also welcome the creation of a hybrid EDIS (i.e. with only liquidity support) as this may represent a key intermediate step to unlock the discussions around long-standing issues, such as ring fencing of capital and liquidity. However, the progressive mutualization of losses in the steady state should remain the ultimate goal to achieve an equal level of protection for all depositors, completing the Banking Union.

Finally, we understand that a reassurance to host countries - with regards to the minimization of the losses to be faced by an ailing subsidiary located in their territory - is needed. It could thus be worth exploring a waterfall payment scheme that sets out how available funds should be distributed to the subsidiaries in host countries in times of crises. However, such allocation of capital and liquidity within entities of a group should be defined only in the event of a resolution and applied by the SRB only for those banks likely to fail or failing.

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Fragmentation/ consolidation: are prospects improving for a single banking market?

EU banks are sometimes compared unfavourably with their American and Asian peers. Overcapacity, persistent pressure on profitability, and lower cost-efficiency, have brought the market valuations of European lenders well below their book value.

One reason for this may be that reaping the full benefits of the single market has proven difficult. Financial markets remain highly fragmented along national lines. According to an ECB report published in 2020, financial integration in the euro area was strong until 2015; thereafter, cross-border price differentials have become volatile, while cross-border banking activity has remained low and stable.

Similarly, cross-border M&As in Europe's banking sector is weak. Deals are fewer than might have been expected following the creation of the Banking Union. A genuinely pan-European banking market still appears a long way off, despite all the progress that has been made.

The most rapid advances have been seen on the regulatory front. The first two pillars of the banking union, supervision and resolution, have been built effectively. The establishment of first the EBA, and then the SSM, have implied a broad-based cross-border harmonisation of the regulatory framework and have greatly increased the consistency and transparency of the supervisory approach.

Seen from this angle, the European regulatory landscape has improved beyond recognition compared to what it was ten or twelve years ago, when first the Great Financial Crisis and then the sovereign debt crisis struck. The self-defeating attempts by many EU supervisors to protect their own national banking systems from the effects of the crisis by erecting capital and liquidity barriers along national borders actually contributed to making the crisis worse.

Along with a single set of rules, a single decision making process and a single set of common practices, the very fact of different national supervisors becoming accustomed to working together for years within a coherent system has changed the supervisory framework immensely, and mostly for the better.

Despite all this progress, the regulatory framework is still fragmented in some important ways.

On the specific issue of mergers, the recent ECB Guide on the supervisory approach to consolidation has increased transparency and clarified supervisory expectations, thus removing potential obstacles to successful deals within the euro area. A key element of the Guide is that the supervisor will adopt a neutral stance in the treatment of mergers, without imposing higher Pillar 2 capital requirements to credible integration plans.

However, despite all this progress, the regulatory framework is still fragmented in some important ways. National discretions remain in some key areas. Macroprudential tools, especially macro capital buffers, have sometimes been used to ring-fence national markets. The third pillar of the Banking Union, common deposit insurance, has proven to be an elusive goal.

The completion of the Banking Union is a priority. By providing a uniform degree of insurance for all retail depositors, the European deposit insurance scheme has the potential to disentangle confidence in banks from their headquarters' location, a key impediment to integration. In my opinion, it is also high time to revise national discretions and improve the macroprudential framework, in order to simplify and streamline the regulatory system, while preserving national leeway wherever it is really needed to adapt the framework to local conditions.

The roots of regulatory fragmentation, however, extend well beyond banking regulation. Progress towards a capital market union would also be beneficial. In a more integrated framework, banks would no longer need to develop local expertise for each national market. They would increase their cross-border holdings of assets and, crucially, could count on a wider investor base.

A Capital Market Union, in turn, entails some minimum element of harmonisation in the trinity of tax, company and bankruptcy law. It is not for me to assess the political likelihood of anything happening on these fronts. It is, however, fair to observe that without some progress in legal harmonisation, it makes little sense to lament the lack of a truly continental basis for the European banking sector. One could also observe that, in fact, the second pillar of banking union is in itself an inchoate harmonisation of bankruptcy law, and could work much more smoothly if a more sweeping process of convergence took place.

Much remains to be done, including on the supervisory front, where integration is most advanced: but without a more harmonised general framework, the responsibility for which falls well outside the remit of supervisory authorities, fragmentation cannot be entirely avoided, and – specifically – cross-border M&As will be unable to achieve their full economic potential.

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Banks must embrace cross-border consolidation to lead Europe out of the pandemic

The global economy is on a mergers and acquisitions tear, with more tie-ups in the first half of 2021 than in any year this century. Flush with cash and able to borrow at rock-bottom rates, companies around the world are seizing the opportunity to reimagine, reorganize and refashion themselves for the post-COVID-19 economy.

Except for European banks, that is.

In the United States, the market share of the five largest banks has increased to over 60% from 40% in the decade following the global financial crisis. But in Europe, which has experienced anemic economic growth, the industry remains highly fragmented, with the largest five banks still controlling just 20% of the market and no bank operating on a truly pan-European basis. In fact, many have started to streamline their country footprints and business lines in an effort to rein in cost.

Yet European banks stand at the precipice of an enormous opportunity. By supporting the recovery from the COVID-19 pandemic and helping to tackle some of the big issues facing Europe's economy, such as the transition to a carbon-neutral future, the industry can regain a strong sense of purpose, increase profits and ensure its ongoing relevance all at the same time.

Many of the industry's best opportunities for growth and cost reduction present themselves at a European level, making the need for European champions ever more pronounced -- particularly during a time when US competitors use the excess profits from their home markets to fund international expansion.

The European Central Bank has long supported consolidation and is putting considerable effort into removing burdens and challenges from a supervisory perspective. For example, in January it announced it would relax Pillar 2 capital requirements in case of consolidation, recognize bad will as capital and allow banks to use internal risk models during the transition period of a merger or acquisition.

The ECB has long supported consolidation and is trying to remove supervisory burdens and challenges.

But plenty of stumbling blocks to consolidation remain. The lack of a European deposit insurance scheme, for example, forces banks to manage country-by-country deposits. This extends to liquidity and capital pools and hence overall balance sheets -- a hugely inefficient and costly burden that makes it difficult for banks to combine across borders.

Yet perhaps the biggest hurdle to European bank mergers isn't regulatory or structural – it's strategic. New fintech and big tech challengers continue to emerge and many of the more established players are moving from one trick ponies toward offering broader banking services. Meanwhile Europe's universal banks are still dealing with hard-to-update legacy technology and suffer from costly operating models across too many markets, products and client segments. They also suffer from huge compliance costs, much of which fails to deliver any economic benefit.

Make no mistake: consolidation alone will not solve the European banking problem or close the valuation gap to US firms and fintech players. Banks need to rid themselves of their "compliance mindset" and use consolidation to shift toward an "innovation mindset". This will require a willingness to embrace what has worked in other industries.

Regulators can help in that regard by allowing more flexibility in terms of the senior leaders they deem fit and proper for the banking industry. Most if not all European banks lack the necessary post-merger integration skills, given the dearth of meaningful M&A in Europe over the past few years. Banks will have to draw on expertise from other industries – and regulators should support this.

There are glimmers of hope that a new era of deal-making could be at hand. The pandemic has allowed banks to make operating model changes that few would have been willing to try in normal times — closing branches, requiring all staff to work from home, redesigning processes virtually overnight.

Many of Europe's banking leaders understand the appeal of cross-border consolidation, and some are likely to start to act over the next 12 months. A strong divergence between leaders and laggards will spur more activity as the laggards seek to catch up.

But the longer banks wait, the greater the chances that this historic opportunity to reshape themselves for the next decade could slip away.