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Banking Consolidation in Europe

(The Per Jacobsson Foundation, Lucerne – June 4, 2000)

According to the European Banking Federation, at the end of 1998, there were 2955 commercial banks in Western Europe (namely, members of the EU, plus Island, Norway, and Switzerland). These 2955 banks had total assets of 9144 billion euros, ran 99 456 branches and employed 1.84 million workers.

To this already large number of commercial banks should be added that of other deposit- taking institutions like savings banks, mutual banks and cooperative banks. All in all, the Euro zone (i.e. the eleven members of the European Monetary Union) had more than 7000 deposit-taking institutions at the end of 1998.

It should therefore be no surprise that hardly a day passes without some mergers or other strategic moves being announced by European banking institutions. Last year was a bumper year with four large deals of a unit value in excess of USD 10 billion, each of them creating entities with market capitalization between 30 and 55 USD billion :

- In January 1999, the merger between Banco Santander and Banco Central Hispanoamericano created BSCH ;

- After a six-month long battle against Société Générale which started in February, BNP is merging with Paribas, leading to the 1st bank in France and the 2nd in the Euro zone in terms of market capitalization ;

- In October, Banco Bilbao Vizcaya (BBV) and Argentaria announced their intention to form BBVA ;

- At the same time, Bank of Scotland, launched an unsolicited bid on Natwest, the outcome of which was finally overcome by the competitive offer of the Royal Bank of Scotland ;

- In the meantime, Banca Intesa took over 70 % of Comit ;

There is no sign that the consolidation process is abating. Just take a copy of the FT dated January, 19th, 2000. You could read :

- that ABN Amro is about to close one in six of its branches in the Netherlands to redeploy resources to electronic banking. On the same page, you could also read that Citigroup is buying Schroders's investment bank activities ;
- that the merger between two Portuguese banks – Banco Espirito Santo et Banco Portugues - was announced (a week earlier Banco Commercial Portugues and Banco Mello had decided to merge).

Then, early March 2000, came the announcement of the planned merger between Deutsche Bank and Dresdner. But on April 5, the Euro 33 billion merger collaped.

And on April 3rd, we learned that HSBC -the second bank in the world by market capitalization- was to acquire Credit Commercial de France in an agreed bid.

After two hectic years, the year 2000 has thus already started on a very strong footing, which raises three questions :

- Why are we seeing so many restructuring operations in the European banking sector ?
- Which are the different forms taken by these transactions and is there a predominant one ?
- Why haven't we seen more cross-border operations ?

I will briefly address these three questions, before trying to gauge what all that holds for the future.

I am afraid that in the course of what follows I will have to jump time and again from one definition of Europe – the Euro zone (i.e. members of the EMU) – to another, which may or may not include other EU members -like Britain- or even non-EU members, like Switzerland. This will be for the sake of clarity and accuracy.

I- WHY SO MANY RESTRUCTURING OPERATIONS ?

THE RATIONALE FOR M&A : TOO MANY LARGE NATIONAL BANKS, NO BIG EUROPEAN BANK

1-The European banking sector remains very fragmented : deposit-institutions, both large and small, are still numerous. Admittedly, the total number of deposit-taking institutions is still three times larger in the US (22.140) than in the Euro zone (7.040), although the two zones are comparable in terms of GDP and population. But, on the one hand, the legal framework in the US (McFadden Act) pushed in that direction for a long time by preventing multistate banking and, on the other hand, the speed of the consolidation has been faster there than in the Euro zone : since 1980, the total number of deposit-taking institutions has fallen by 39% in the States, versus 25% here in Euroland. According to FITCH IBCA, there were 13 « major »[1] commercial banks in the USA, i.e. a third of the 44 « major » commercial banks operating in the Euro zone at the end of 1998. In short, it might be said that the USA has many small banks -and particularly very small-, but relatively few large banks, while Euroland is rich on both counts. Another way to express the differences between the two sides of the Atlantic is to note that the average headcount in US deposit-taking institutions was 87 at year-end 1997 versus 290 in the Euro zone.

2-The European banking industry is increasingly exposed to global trends. One of them is the increased competition from American banks, who compare favourably in terms of revenues and costs.

The following table(2) gives average indications over the years 1996 to 1998 concerning the "major" banks in the US, the Euro zone, France, Spain, and the U.K.

	United States	Euro area	France	Spain	UK
(1) Net interest margin	3.22	1.68	0.93	2.66	2.19
(2) Non-interest income	2.65	1.19	0.89	1.36	1.75
(3) = (1) + (2) Total income	5.87	2.86	1.82	4.02	3.95
(4) Operating costs	3.80	1.98	1.26	2.67	2.59
(5) Loan loss provisions	0.39	0.31	0.24	0.39	0.22
(6) = (3) -(4) -(5) Pre-tax profits	1.67	0.57	0.32	0.97	1.13
(7) = (4) / (3) Cost/income ratio	64.8%	69.2%	69.1%	66.4%	65.6%

[1] The concept of « major » bank is a judgemental concept based on a qualitative assessment, by FITCH IBCA, of a number of quantitative criteria the absolute value of which differs from one country to the other.

- Over the years 1996 to 1998[2], the average return (as measured by pre-tax profits) on total assets at « major » banks in the Euro zone (0.57%) has been on average a third of that achieved by US « major » banks (1.67%). This poor showing stems basically from lower revenues ;
- The net interest margin at « major » banks in the Euro zone (1.68%) has been on average half of that earned by US « major » banks (3.22%). More interestingly, interest margins on both sides of the Atlantic have kept on diverging since the mid-eighties : rising in the US, falling in Europe ;
- Furthermore, non-interest income at « major » banks in the Euro zone (1.19%), while rising rapidly in 1998, has been less than half of the US level (2.65%) ;
- All in all, total banking income (net of interests paid to customers) is on average 2.86% at « major » banks in the Euro zone, a half of what they are at US « major » banks (5.87%). But operating costs are significantly higher in the US than in Europe. One can also remark that there are significant differences within Europe : for example, banking income in Spain is more than twice larger than in France;
- The existence of a large sector of non-commercial banks (like savings banks, mutual and cooperative banks), does not play a small role in accounting for the difficulties encountered by European commercial banks. It is often argued that the non-commercial banks distort competition by not having to pay for the cost of their capital. Furthermore, commercial banks are often forbidden to takeover non-commercial banks while the opposite is allowed ;
- Turning now to the cost to income side of the equation, it appears that the cost to income ratio at « major » banks in the Euro zone (69.2%) has been on average 4.4 percentage points above the US level (64.8%), even though a noticeable convergence has taken place towards the end of the period ;
- The price for tougher competition and less efficiency is a less exuberant increase in market capitalization : while the capitalization of US banks has increased fourteenfold from its low of 1990 to 1999, that of Euro banks has « only » increased fivefold, despite an historic wave of privatizations (both measures are given in dollar terms). Obviously, the glass can been seen as half empty : if the recovered profitability of US banks is the benchmark, then there must be a lot of room for improvement in Europe.

3- Another reason for concentration is to be found in <u>deregulation, disintermediation and technological innovations</u> which tend to erode traditional distinctions between financial intermediaries. These very powerful trends open the door to non-bank players like insurance companies, e-brokers, large retailers (Tesco, Sainsbury). E-commerce tends to turn financial products into commodities, i.e. low margin, high-volume products. The same forces also push

[2] Source : BIS quarterly report, 30/06/1999

traditional banks to broaden the scope of products and services they offer to their clients (electronic banking, complementary services to bank account management).

4- The introduction of the Single Currency only exacerbates further these forces. As a consequence of the Euro, the domestic market becomes paneuropean. Actually, it had already largely done so for wholesale banking. The same can be expected in retail banking, even tough there remain many national specificities (regulatory, tax, legal) that still fragment the market.

5- For various reasons, economic development argues in favor of an ever larger critical size (in terms of assets or market capitalization) :

- Clients of banks (in wholesale banking) have changed in size, because they (corporate, insurance, other banks) have been merging for some time. The wave of mergers in the non-banking sector calls for -or can influence- mergers between banks.
- As long as the costs of managing larger and more complex organizations do not exceed the transaction costs[3] that would otherwise be incurred, size makes it possible to achieve economies of scale, through revenues synergies (« cross-selling » of products) and/or cost-cutting. Conventional wisdom has it that such cost-cutting efforts are required given the increasing costs of state-of-the-art technologies (information technology). It would pay to spread such costs over a larger base in capital-intensive areas like information collection and processing, back-office operations, telecommunications, custody. Yet, this point may be rather controversial as an essential feature of the IT revolution is the rapid fall in the costs of hardware and software. Some analysts contend that the IT revolution is actually lowering the cost of entry into the banking market.
- In a context where, margins tend to fall due to excess capacity -case of most of European countries-, volumes have to be increased.

6- These general statements need to be qualified. In some areas, a high degree of convergence and integration had been attained even before the introduction of the single currency : the market is already very much paneuropean. Most of the cost synergies are indeed concentrated in some activities like investment banking, asset management, custody, wholesale payment, credit cards. But it is not evident that commercial banks with no experience in investment banking and asset management can achieve substantial economies of scale when they extend the range of their activities to new lines of businesses.

[3] « Transactions costs » refer to the real costs which have to be incurred to operate through the markets. Ronald Coase explained the existence of firms by reference to transactions costs : firms exist because they help to save transaction costs through a centralised decision-making process.

7- <u>Specific partnerships are often seen as an alternative to M&A's</u> : they presumably deliver the same technical benefits, while minimizing the traumatic side of mergers. Yet, it can also be argued that the more a bank is tied up in a web of partnerships in a rapidly changing environment, the more it risks to run into conflict of interests, the more it looses degrees of freedom. The jury is still out and will probably remain so for some time.

8- Be what it may, <u>most banks seem to favor a twofold M&A strategy</u> :

- Firstly, they are keen to defend their position in the domestic stronghold against potential foreign competitors, which leads them into mergers with national competitors.
- Secondly, in a more offensive way, they seek to establish bridgeheads in the paneuropean market by acquiring interests in foreign institutions. Such interests consist of at least large minority positions, but in some cases majority or even full-ownership is attained. The aim of such moves is to deter similar ones by competitors and to increase market shares.

Needless to say, the general fall in interest rates and the resultant overall rise in share prices have facilitated M&A's in making shares of the bidders an attractive currency to the shareholders of the targets. As a matter of fact, most of the deals we have seen are all-share deals.

II- WHICH ARE THE DIFFERENT FORMS TAKEN BY RESTRUCTURING IN THE EUROPEAN BANKING INDUSTRY ? IS THERE ANY DOMINANT ONE ?

DOMESTIC MERGERS HAVE BEEN PREDOMINANT

1- By and large, restructuring has taken place at a national level between European retail banks through « friendly » deals. This is actually the only thing on which the different data sources I have consulted can agree : on average, they attribute at least two thirds of the aggregate value of M&A's to national deals. But this aggregate value is a matter of discussion : for 1998, it varies from 110 Euro billion, according to Crédit Agricole to 182 USD billion, according to WSJ Europe quoting Thomson Financial Securities. Be what it may, these are large figures. Over the last two to three years, M&A's in the banking sector account for a very substantial slice of all M&A's in Europe (almost 30% on average).

2- The aim of these national mergers has been presumably to strengthen domestic operators, to breed « national champions » up to the point where they can successfully cope with European competition and cross-border mergers.

The following table shows deals with a unit value in excess of 1 USD billion[4], as compiled by Thomson Financial Securities.

Thomson Financial Securities Data	**Total**		**European targets**			**Non-European targets**	
	Number of deals	Value in USD billion	Number of deals	Value in USD billion	% of total	Number of deals	Value in USD billion
1990	11	18.8	11	18.8	100.0%	0	0.0
1991	9	23.3	7	19.2	82.4%	2	4.1
1992	2	9.0	1	5.7	63.3%	1	3.3
1993	3	5.2	3	5.2	100.0%	0	0.0
1994	3	5.7	3	5.7	100.0%	0	0.0
1995	14	40.7	14	40.7	100.0%	0	0.0
1996	14	29.6	11	21.7	73.4%	3	7.9
1997	25	77.9	20	66.5	85.4%	5	11.4
1998	38	181.8	35	176.6	97.1%	3	5.2
1999	21	143.0	21	143.0	100.0%	0	0.0

3- Figures compiled by Crédit Agricole give an additional insight. Of all the deals announced or completed in 1998, only a third were domestic, but their aggregate value was 63% of the total. In short, what we are seeing is a combination of a few very large domestic operations on the one hand, together

[4] Source : Thomson Financial Securities – Wall Street Journal

with numerous small cross-borders operations, as if banks were testing the ground before embarking on larger cross-border deals.

4- Indeed, we have seen many cross-borders acquisitions of minority interests in large institutions, or majority interest in minor institutions. The minority interests acquired in major institutions are sometimes very small, sometimes more substantial. The web of cross-holdings resulting from this process is becoming increasingly intricate. To name but a few of these links :

- ING has taken a substantial stake in BHF
- San Paolo is controlling small banks in France: Banque Vernes, Banque française commerciale, Banque Morin-Pons
- ABN Amro has built up controlling stakes in Banque OBC, Banque Demachy-Worms, Banque NSM, Banca di Roma
- Deutsche Bank has a small stake in Caritro (Cassa di Risparmio Di Trento e Rovereto)
- Crédit Agricole has a substantial interest in Banca Intesa
- BSCH has a web of relations with San Paolo IMI, Commerzbank, Banque Commerciale Portuguaise, Royal Bank of Scotland, Société Générale
- BNP-Paribas has a stake in the Cassa di Risparmio di Firenze

5- These forays in foreign territories have encountered mixed results leading sometimes to retreat. Such was the case for :

- Comit sold its French network to Crédit du Nord
- Dresdner Bank sold Banque Morin-Pons to Banco San Paolo
- Citibank sold its French network to Banques Populaires and Banque Baecque-Beau
- Midland sold its French network to Woolwich
- While Natwest and Barclays basically stopped their operations in France

Which certainly tells how lucrative is the banking market in France !

6- Leaving aside a small number of successful cases, like Dexia, Fortis and Meritanordbanken, full-scale cross-border mergers do not seem to have yet been great successes. In fact, they look more like small-medium size acquisitions than real mergers. Of course, the recently announced acquisition of the medium size and profitable Credit Commercial de France by HSBC brings a new dimension to the issue.

7- Finally, we have also seen the establishment of new links between the insurance sector and banks. Given the complexity of the « bancassurance issue », I will just mention it in passing. Insurance companies tend to have higher PE’s than banks and they are eager to control distribution channels for their products. Rather than building up a new distribution network from scratch, it does make sense for them to gain access to retail banking networks.

8- If we try to combine a business line dimension with the geographic one, we can identify four types of moves :

a) Large players have acquired local and profitable niches
- *General Electric bought Crédit de l'Est and SOVAC*
- *AXA acquired Banque Anversoise d'Epargne (ANHYP)*

b) Networks that are domestic but diversified in terms of clients and/or products have been the targets of buyers seeking (i) to build on geographic complementarity, (ii) to increase market share, (iii) to broaden their supply of products, (iv) to achieve economies of scale by merging branch network or information systems.

- *Lloyds took over TSB*
- *Credito Italiano and Carimonte formed Unicredito*

c) International development has been the name of the game for very specialized banks or credit institutions like General Electric Services, Cetelem, and Dexia

d) Geographic extension has also played a role in terms of diversification and growth for large universal banks with international ambitions.

- *HSBC and ABN/Amro have sought to build on a strong local presence in foreign markets*
- *By acquiring Bankers Trust, Deutsche Bank is showing its ambition to be a global investment bank*
- *BBV and Banco Santander have focused on becoming dominant players in Latin America*
- *But a few others like Barclays, Natwest, Lloyds have streamlined their portfolio of activities and focused on their lucrative domestic market*

III- WHY HAVEN'T WE SEEN MORE CROSS BORDER DEALS ?

OBSTACLES TO CROSS-BORDER DEALS

1- Throughout Europe, the banking industry continues to be seen as a strategic sector which remains under close surveillance of the national authorities. Regulation, supervision and lender of last resort operations remain indeed national responsibilities. Furthermore, since capital markets are still less developed in Europe than in the States, the banking sector plays a much greater role (in a ratio of at least 2 or 3 to 1) in the allocation of savings and credit.

On top of that, at a national level, and leaving Germany and Italy aside, the banking market is actually three to four times more concentrated in Europe, than in the States. The top five deposit-taking institutions in each European country easily account for 40 to 55% of total banking assets, against 17% in the States. The top ten institutions share 60 to 80% of the market, versus 26% in the States.

2- In banks like in other industries, top managements, staff and trade unions show some reluctance towards full-scale cross-border M&A's, although, as we have seen recently, things are changing.

3-The problem is exacerbated by the absence of a European corporate law, which leaves no choice but to elect one of the national laws. Along the same vein, the EU lacks a directive on takeover rules inspired, for instance, by the British model and addressing such issues as minority shareholders, trading in bidder's and target's shares, corporate control, timetable …The lack of common rules definitely adds to the many uncertainties which surround M&A's.

4-Large cash transactions are hardly feasible under current conditions. European banks currently trade at an average of 2.5 book value (3 to 4 in the USA). Even in the least profitable markets, banks trade above book value. If a bank trading at 2.5 book value were to be paid in cash, the acquiring institution would have to amortize the goodwill, the excess of the price over the book value, namely 60%, against its shareholder's equity. Few banks are financially strong enough to afford large cash transactions.

5-In cross-border deals, cost-cutting is more difficult to materialize for central functions as information systems, tax systems, products lines tend to remain national. In particular, Europe remains divided by its payment habits : some countries prefer checks while others favor giros. If the European consumer undoubtedly exists, European banking services remain largely to be invented. The main benefits of M&A's are rather to be reaped in the form of asset size, increase in market shares, and diversification of revenues.

6-The web of cross-holdings which exist between European institutions may also be an obstacle to hostile bids. Until the proposals to change the capital gains taxation in Germany, there was another obstacle to the unbundling of that web of cross-holdings.

8-Finally, last but not least, the rapid development of Internet and electronic banking may make cross-border deals less profitable to the extent they involve traditional « bricks and mortar » retail banking networks. It remains to be seen :

- whether traditional banks will add Internet distribution to their panoply (i.e. brand, capital and customer base), potentially by-passing part of their traditional sales force,
- or whether Internet-only providers will seize a very substantial share of the retail banking market (at the cost of adding physical channels and personal touch to their strategy),
- or whether some segmentation will take place[5].

The answer will depend on cost and creativity (i.e. « open finance », « mutual-fund supermarkets, « integrated personal financial management », « total balance sheet approach », « dynamic refinancing », « mass customization », « e-commerce portal »).

9-The above mentioned obstacles or issues are present in all European countries. Further difficulties exist or existed in some countries. In France, for example, the privatization process was not completed until recently: its importance superseded any other considerations for private sector operators. The profitability of private commercial banks is dented by the mutual sector, which is very large in France. And the implementations of synergies in the face of large restructuring is slowed down by the rigidity of labor markets and the sensitivity to layoffs.

CONCLUSION

At the end of 1999, Western Europe had almost 50 banks with a market capitalization in excess of 5 Euros billion, not to mention a few additional large non-listed institutions. Half of those listed banks had a market capitalization in excess of 15 Euros billion. Most of them, if not all of those institutions would probably claim that Europe is or will be their domestic market. But it is also notable that no bank in the Euro zone has a size, a width of services and a worldwide reach that makes it truly comparable to the greatest and very few "global" financial institutions of the United States.

[5] Net.B@nk, a virtual bank opened in 1996 in the USA, claims its operating expenses to be half those of comparable traditional banks.

Therefore, the challenge for the European banks will be :

- to improve on their efficiency by rationalizing costs and trimming redundant networks;

- to expand growth internally and through partnerships and acquisitions;

- to strengthen their operations in high value added areas such as structured finance, corporate finance, cash and asset management and securitization.

The ambition is for the largest and best run of these banks to offer to their clients global services to cover the whole spectrum of banking requirements.

These goals cannot be achieved by applying automatic rules or doctrines. One reason is that changes are running too fast. As a prominent CEO in London said a few weeks ago : "It is hard to be clear about strategy at a time of rapid change". Fashions are also dangerous : they move from one idea to another without much research or evidence : for instance, a few months ago analysts were stressing the virtues of retail banking, but now they seem to have changed their minds…

The key to success is adaptability. In this respect, the question of M&A versus partnerships is still an open one and depends very much on circumstances.

There are obviously many positive feed-back effects between M&A and share prices. Yet the risks of over-extension should not be underestimated, all the more so when cross-border deals are involved[6]. Successful M&A eventually depend very much on the ability of management to conceive well thought-through strategies, to develop synergies but also to combine cultures and to motivate teams.

Merging banks is in fact a very difficult art with more failures than successes. It requires extreme care, a clear methodology and a strong leadership from the highest levels of management.

Concerning the adaptability great attention has to be paid to the development of the internet in financial activities and its impact on banks strategies.

[6] According to a recent report by KPMG (The Economist, December 4th, 1999), of more than a 100 large cross-border deals (banks and non-banks) around the world between 1996 and 1998, only 17 % added value, the creation of value being measured by comparing movements in share prices with those of competitors in the first year after the merger.

On-line banking, on-line brokerage are profoundly changing the present institutional setting. The internet is not only a user-friendly way to offer services to clients, it is also a powerful tool to increase efficiency and to reach new clients with less investment costs than those involved in expanding traditional branches.

The question is not : “will commercial banks add internet facilities to their existing panoply ?” but : “how to become, in all aspects, full financial internet players?”. To stay on top, European banks must become themselves internet banks.

The growth of internet banking will induce European banks to improve profitability. Indeed, new internet banks -which can “pick and choose” most valuable clients and trim margins- will put more pressure on traditional banks to reduce costs in order to maintain profitability.

Some forecasts are impressive : European banking on the internet could rise from 20 Million clients in 2000 to 55 Million by 2003. Under those assumptions a third of new savings business would be done on the internet. Margin reduction seems therefore inevitable.

I believe European banks will develop a multi-pronged strategy :

- cross border acquisitions where synergies can be realized by rationalizing networks and information systems in particular, but also where profitable markets can be reached (for instance, retail networks in those emerging countries where banking systems are still largely inefficient) ;

- partnerships where it is more efficient to use existing networks in order to market specific services in which one of the partners holds a competitive edge (cf. partnerships by special service companies like Cetelem or Locabail);

- internet activities (in this respect the recently announced alliance between BBVA and Telefonica and their launching of an on-line banking venture is of significance. I should also stress that e-Cortal and BNP.Net are leaders in their respective markets ;

- eventually becoming truly global in terms of investment banking through internal and external growth (here the recruitment of very competent bankers is of the essence).

So, we have new and exciting challenges ahead of us on the way to European banking consolidation. Saving resources, keeping freedom of maneuver and reaching out towards profitable markets will, as always remain the key principles of action.