Bank consolidation to continue picking up in 2021

Several banking markets in the eurozone are overbanked. Covid-19 is now impacting the resulting low profitability. Those profitability pressures, together with a change in tone from supervisors, are likely to result in more consolidation led by in-market transactions. And cross-border activity may get a boost

The lights from bank buildings are reflected in the river Main in Frankfurt, Germany

Europe's over-banking problem

Several banking markets in the eurozone are over-banked, pressuring profitability.

As of June 2020, EU banks reported an average return on assets of 0.03%. Looking at the euro-area banking systems, more than half reported return on assets (ROA) of at or below 0.1%. This low profitability is now being hit by increasing credit costs and pressure on the revenue side with rates staying lower for even longer because of the Covid-19 crisis.

One possible solution here may be increasing the sheer size of operations. Bank mergers and acquisitions may target synergies especially on the cost side but also in revenues. We could also see better geographical or product diversification or perhaps even larger organisations to better absorb the increasing regulatory and compliance costs. In our view, 2020 will likely mark a year of change for bank consolidation in Europe with another hit to bank profitability in the form of Covid-19 and a change in tone from supervisors.

Low profitability is now being hit by increasing credit costs and pressures on the revenue side

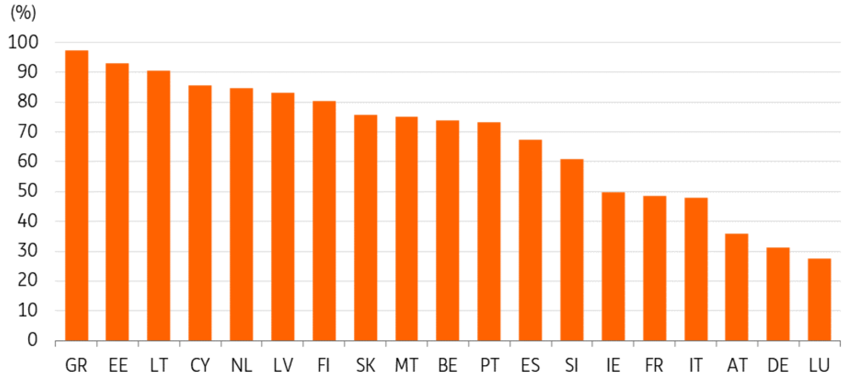
We've already seen several large-scale deals going through this year, including Intesa Sanpaolo acquiring its smaller rival UBI Banca in Italy, and CaixaBank merging with Bankia in Spain. Press reports also suggest Crédit Agricole could be interested in Banco BPM in Italy, while the heads of Swiss banks UBS and Credit Suisse are said to have discussed their options according to press sources. Deutsche Bank and Commerzbank merger talks collapsed early 2019 as the banks concluded that the "transaction would not have created sufficient benefits to offset the additional execution risks, restructuring costs and capital requirements associated with such a large-scale integration". What all these deals have in common is that they are all largely domestic.

We think domestic deals will continue to take the lead but the larger the combined share of the five largest banks in a given country, the less likely we consider domestic M&A to be

We think domestic deals will continue to take the lead and consider in-market transactions to be more likely in certain areas. In the past decade, the market share of the five largest banks has increased, notably in Greece, Spain, Cyprus and Italy. These are areas that have either experienced a full-blown banking crisis or at least substantial issues for parts of the banking sector. In 2019, the five largest banks in 14 Euro area countries represented more than half of the domestic banking market share, as you can see in the chart below. Furthermore, in nine countries, these five largest institutions hold at least 75% of that market.

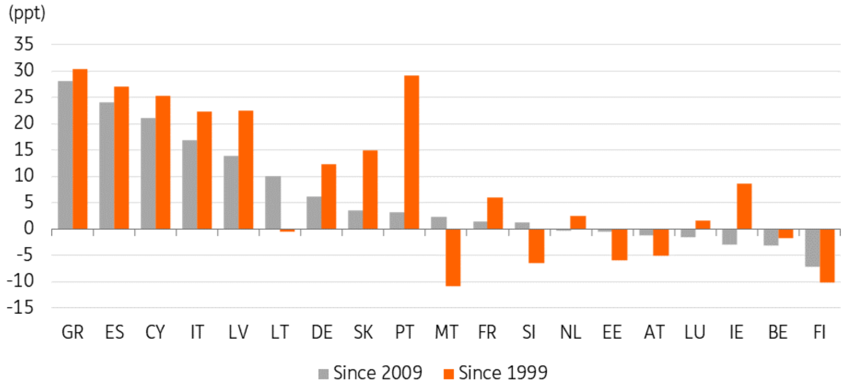
The larger the combined share of the five largest banks in a given country, the less likely we consider domestic M&A to be. The lowest sector concentration is in countries such as Luxembourg, Germany, Austria, Italy, France and Ireland. So in our view, in these markets' banks would stand to benefit the most from domestic M&A activity.

Combined market share of five largest credit institutions in each country as of 2019



Source: ECB, ING

Combined market share change for five largest institutions



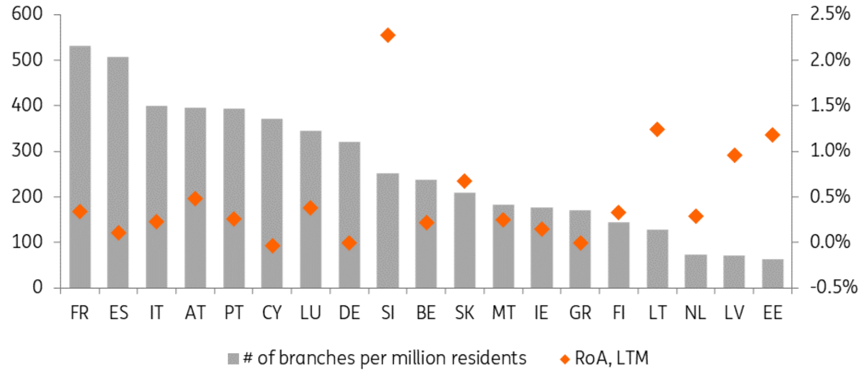
Source: ECB, ING

A move to domestic consolidation

Domestic consolidation may reduce the number of bank branches, which could support bank profitability in the country.

As we show in the chart below, the number of bank branches per number of residents is among the highest in France, Spain, Italy and Austria. Germany ranks closer to the middle compared with the rest of the eurozone. The Netherlands, being a small country geographically, has a concentrated banking sector and this goes some way to explain its position towards the end of the table as a country with the fewest bank branches per person.

Number of bank branches per residents vs RoA



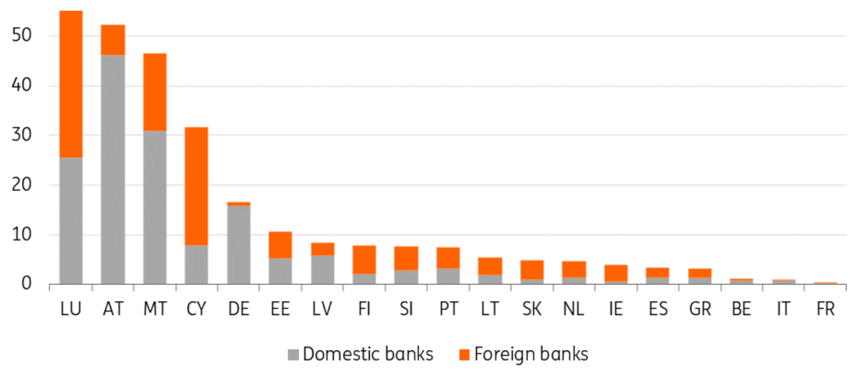
Source: ECB, Eurostat, EBA, ING

Eurozone banking systems are also split by the number of banks per country and the presence of foreign banks.

Not surprisingly, Luxembourg tops the charts here; the number of banks per person in Austria is also relatively high. Of the larger players, Germany stands out as having a high number of banks per person with the majority of those being domestic.

From a banking efficiency point of view, Germany and Austria could well benefit from consolidation which would result in fewer banks and branches.

Number of banks per person



Source: ECB, ING

The column for Luxembourg is cut and the total number for Luxembourg is c196

Cross-border deals

Cross-border deals are more likely to involve large banks that target new markets.

A bank could acquire an existing player with a strong enough market position in a given country to increase economies of scale and geographical diversification, among other things. Or perhaps banks with matching geographical profiles could merge to increase their combined market share, find synergies and improve efficiency. Acquiring better digital capabilities, extending customer base, improving product diversification or perhaps improving the asset and liability match by merging with a complementing entity are other cross-border merger drivers. An important consideration for cross border mergers will probably continue to be the hunt for greater size, especially since banks are now facing tougher competition from big tech platforms.

Banks face tougher competition from large big tech platforms

Cross-border deals have been hindered by the difficulty in finding necessary synergies. This may have been driven by an expectation of (too) high capital requirements for the combined entity and the difficulty of moving liquidity and capital between countries in larger banking groups due to local rules. Perhaps low equity valuations also have a dampening effect on activity.The Banking Union has not been finalised. The particular reluctance of domestic authorities to support M&A activities from a regulatory and supervisory angle may also be playing a role here.

The tone may be changing though. The ECB published a draft guide on the supervisory approach to the banking sector's consolidation in July this year. The central bank indicated that well-designed and well-executed consolidation can help address the overcapacity and low profitability problems that have been damaging Europe's banking sector since the financial crisis.

The guide outlines the ECB’s expectations on three important areas in relation to bank consolidation: the setting of capital requirements and guidance, the treatment of 'bad will' and the use of internal models by newly formed entities.


Andrea Enria, Chair of the ECB's Supervisory Board

A change in tone

So, let's take a look at those three things:

- Firstly, the starting point of setting capital requirements for the new entity will be a weighted average of the current requirements, possibly adjusted on a case-by-case basis. This could prevent banks assuming that a larger size would automatically lead to higher

capital requirements, which could mean that large scale mergers may look more attractive.
- Secondly, the ECB indicates to recognise from a prudential perspective 'badwill' that can be used for booking higher provisions, transaction or integration costs or perhaps investments. This is an important consideration as most Western European bank shares are currently trading well below their book values, making the treatment of 'badwill' an important consideration. Support from the regulator for banks for recognising 'badwill' makes conducting acquisitions substantially more attractive in the current market circumstances.
- Thirdly, the existing internal models can be temporarily used also in the new entity subject to certain conditions. This should reduce unwanted volatility in capital requirements in case of consolidation.

Separately, Andrea Enria, who's the chair of the ECB's Supervisory Board, and Edouard Fernandez-Bollo, a Board member, wrote early in October about the importance of focusing on actions needed to foster the integration of banking activities within the banking union. They highlight that around €200bn of high-quality liquid assets are not transferable in cross-border subsidiaries of significant credit institutions due to the liquidity coverage ratio at the subsidiary level, reducing the effectiveness of centralised liquidity management.

> *The ECB now seems to be pushing harder towards bank consolidation*

In essence, they propose that banks could incorporate as part of their resolution planning clear group support agreements for subsidiaries in terms of liquidity. In exchange, they would receive a cross border liquidity waiver. This could result in more efficient liquidity management at the parent entity level as liquidity could be moved easier between the subsidiaries and the parent entity if that were needed.

In our view these general principles laid out in the ECB's draft document and Enria's blog post point towards the same thing: the ECB now seems to be pushing harder towards bank consolidation in Europe with the aim of improving banking system profitability. For those banks considering such consolidation, the message is encouraging even if only in a draft form.

That said, we consider the most important consideration behind bank M&A to remain whether the entities are a good match and the combination adds value. Now perhaps on top, the supervisor seems to be more accommodative.

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