Andreas Dombret: Under pressure – is consolidation the solution for Europe's banking sector?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Conference "Doing M&A Deals around the World", Frankfurt am Main, 13 October 2016.

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1 Introduction

Ladies and gentlemen

About a week ago, the Nobel Prize in Medicine was awarded for work that is of indirect interest to the banking industry. Japan's Yoshinori Oshumi was honoured for exploring how human cells not only break down but also recycle cell trash that results, for example, from fighting diseases. Oshumi found that when this process, called autophagy, is disturbed, for example through ageing, this has serious repercussions on our health.

I think it is fair to say that this sort of mechanism was truly needed after the financial crisis revealed the damaging cell material within banks.

Eight years later, the question is whether the organisms of banks were capable of, and successful in, disposing of or recycling financial waste. Today, I will examine this question from a European angle. And I will also ask whether mergers & acquisitions may well be one of the healing mechanisms of the European banking system.

2 In bad shape? The status quo of Europe's banks

In the last few months, concerns about European banks spun out of control. While there was no panic, sometimes the media discussion made us almost feel as if there was.

Now, let's take a sober and realistic look at the facts. Over the course of this year, European banking stocks had to weather strong headwinds. While the overall European stock market, as represented by the Euro Stoxx 50 index, remained more or less unchanged, the Euro Stoxx Banks index dropped by more than 30%. At the same time, volatility of the bank stocks remains high, although that seems to be heavily related to post-Brexit jitters.

Such market movements suggest some sort of doomsday scenario. Is that justified?

Clearly not. Current concerns about the European banking sector are overstated. Yes, the sector is not yet ready to be successful in the new post-crisis environment. And market sentiment reflects just that. But – and that's where exaggeration comes in – the sharp movements do not take into consideration that the solvency of the sector in Europe is not in doubt.

In other words, while Europe's banks still struggle to come up with long-term strategies to succeed in the new, different and truly challenging economic environment, in the short to medium term they would pass any health check – as the recent stress test by the European Banking Association confirmed.

But banks also show traits and habits that can, in the long run, result in serious health issues – unless a change of lifestyle can be achieved.

Let's consider the health facts. EU banks have strengthened their capital positions – even if non-performing loans remain a problem for some institutes: The aggregate tier 1 capital ratio of the banks in the euro area today stands at around 15%. This exceeds pre-crisis levels in early 2008 by six percentage points. Another sign of good vitality and higher resilience is the improved ratio

of common equity to total assets. Before the crisis, European banks held around 3.6% of unweighted common equity; today, the average stands at 5.5%.

Banks also broadly meet the new health standards of sufficient liquidity – to be prepared for times of market distress.

And the euro area's new bank supervisor, the Single Supervisory Mechanism, has contributed to more rigorous supervision and to stronger banks.

So for the time being, the European banking sector is nowhere near the brink of collapse. The reform efforts of policymakers and bankers alike have led to substantial progress – even if important reforms, like ending the sovereign-bank nexus, remain to be finished.

However, being healthy is one thing. Being in outstanding shape, being prepared for whatever challenges the future may throw at you, is another. To reach that level of health, banks still have a lot to do.

At present, efficiency at euro area banks is too low, and many institutes still struggle with achieving a steady stream of sustainable profits with a minimum of volatility – although both, efficiency and profitability, do vary across individual countries and financial institutions. Profitability is not a goal in itself, but a means towards an end – and this end is the stability of a bank and its capacity to meet regulatory capital requirements. That's why supervisors are concerned about falling profitability. Efficiency, in turn, is a means towards the end of profitability – where increased cost efficiency improves the return.

To be in really good shape for the challenges that lie ahead, banks in the euro area must work on their operational efficiency and need to adapt their income sources. This is true for many, if not most, financial institutions.

So, the condition of the banking sector is healthy in general, but it clearly could be better. This is problematic, as banks face a truly demanding future, one that holds several large-scale tasks.

I will touch only briefly on each of these challenges.

The first lies in demographic change. The workforce is set to decline, while the number of non-working persons will grow. This will most likely be a burden on investment and on prospects for growth – which will both weigh heavily on banks' business. At the same time, customer cohorts will change substantially, forcing banks to adapt to new realities.

This all the more given the second challenge: Digitalisation. Even though it's a long time since the digital revolution back in 2002, when humanity began storing more information in digital than in analogue format, the challenges of digitalisation to the banking sector seem to be everywhere. That is because digital applications are increasingly becoming mass phenomena in our everyday lives. This changes consumer demand and rearranges the value chain of financial intermediation. Banks need to adapt to keep up with customers and to hold on to attractive parts of the new financial value chain. So far, they have fallen behind some of their new, agile fintech competitors.

Perhaps the biggest medium-term challenge is the ultra-low interest rates. They weigh heavily on banks with interest-focused business models. The difficulty to pass negative central bank rates on to private customers leads to deposits being a drag on income. This presents problems for many banks. Small and medium-sized banks used to be praised for their stable business models that relied on taking deposits and earning higher interest margins through lending on capital markets. In an ultra-low interest rate environment this virtue becomes a challenge. And this environment is here to stay. Fundamental economic factors as well as central bank guidance indicate that low rates will persist for quite some time.

Finally, there is regulation. Many complain that regulation has become tougher. But I would argue that to criticise this is to question putting a lock on the drinks cabinet after someone in the family is hospitalised for overindulging. Tougher rules and more stringent supervision are not only necessary: They were long overdue. Complaining about their negative implications is to confuse cause and effect. The light-touch approach before the crisis was simply wrong. We are correcting that mistake now. But of course, to get into shape to successfully comply with these new rules is a demanding task.

So, if we take a panoramic picture of the sector in Europe, what does it look like? Well, first of all, we see how the landscape has been cleaned up and dangerous areas secured. The European banking sector has made progress in improving both its solvency and its governance.

Yet, when we zoom into the picture, we see that the landscape is still dotted with contaminated spots.

Obviously, the reform progress is not over. A politician would probably stop now – thereby dodging the question on everyone's mind: What on earth does that mean?

Unfortunately, I have too much time left to stop just now.

3 What to do?

What to do, then, to complete the reforms in the European banking sector? What should banks do? What should policymakers do?

For one thing – many, if not most institutions must retool their business models. Until the financial crisis of 2008, the credit bubble allowed banks to inflate their income to unsustainable levels. This led them to build up capacities which, from the perspective of the real economy, were not fully needed.

Moreover, bubble-driven profits spared them from making their organisations lean and efficient. A study recently found for the US financial market that productivity gains in the financial sector from 1900 onwards were mostly concentrated in the area of secondary trading – while the productivity of primary market activities stagnated.[1]

In other words, banks need to fundamentally rethink their business models. Their goal should be to achieve, over the long run, a steady stream of sustainable profits with a minimum of volatility. For this, banks need to compete with fintech companies for customers with different demand patterns on the one hand, and open up new sources of income on the other hand. At the same time, they need to increase their operational efficiency considerably.

These changes to business models and operational efficiency are likely to bring about further cuts in the sector. We have seen this trend in Europe for some years now. Moreover, recent data and news releases on banks' plans to cut resources and reshape strategies indicate that this trend is ongoing. Thus, the sector is on a path towards a size and structure that will be sustainable in terms of the real economy's needs.

Yet to be clear, this can take many forms. We should not reduce this debate to a simple "we need fewer small banks" – more market players tend to be good for a functioning market. We should keep that in mind.

There is no need – or mandate – for supervisors to interfere with these market forces. What we can and should do is to finalise the reform progress that began in 2008, and to do so soon. And we will make sure that banks are put under close supervisory scrutiny.

4 What role for bank mergers & acquisitions?

So far, I have answered the question as to what banks and policymakers should do.

That leads to the question – certainly in this room, at least: What role can mergers & acquisitions play?

In the last few weeks, some have argued in public debate that competition in the banking sector is too high, which, in turn results in low profitability of banks. Quite often this was then linked to the number of banks being too high. But as I have pointed out in the past, the number of businesses in a market is not a problem per se.[2]

Nevertheless, I agree at least in part with the conclusion that mergers & acquisitions might be appropriate for some institutions.

And, as I outlined earlier, we have seen that adjustment in the euro area has already progressed in terms of the number of banks, employees, branches and balance sheet volumes. Thus, the question that arises is: How much more room is there for viable mergers & acquisitions?

Before I answer this question, let's look at how successful banks were in the past when merging.

Generally speaking, when the businesses of two organisations are combined, you would expect higher cost efficiency from economies of scale on the one hand and income synergies from cross-selling and complementary business lines on the other.

What we see in Europe, and also in Germany, is that on average the potential is less than that typically hoped for. The track record for mergers & acquisitions in the banking sector is mediocre.[3] On average, we see that banks were only modestly capable of achieving the desired cost reductions and higher profitability.

That, of course, does not mean that mergers are bad per se, but rather that it depends on the merits of each individual case. Are the institutions a good match? Are gains in operational efficiency possible? Will the increased size even result in less efficiency due to governance problems?

Successful mergers or acquisitions depend on whether synergies are viable. Ultimately, it's about careful decision-making with the long-term strategy in mind – but that also requires time for a painstaking, extensive analysis of whether the expected synergies and efficiencies are actually realisable with the two particular organisations concerned.

Beyond analysis and efficiency, mergers or acquisitions is about people. If you forge incompatible cultures into one company, this is unlikely to generate synergies and economies of scale. Rather, it will lead to governance problems.

But, consolidation can be fruitful, when banks find the right partners. Successful cases show that regional or business line compatibility provide a great source of synergies.

Selected acquisitions and sales of business lines can be a good instrument to strengthen a solid and focused business model. Again, careful analysis of the viability of synergies and efficiency improvements are a precondition for any such transaction.

One aspect strikes me as being very important. Merging ailing institutes with healthy ones is certainly no panacea. Certainly not in the eyes of bank supervisors. It may even entail risks for the healthy party of the merger. While mathematically two minuses make a plus, this is not at all the case with mergers. Moreover, creating further institutes that are too big to fail is certainly not an attractive option that would be accepted by supervisors.

Likewise, mergers & acquisitions cannot absolve banks from dealing with the economic challenges I discussed earlier. Whether merged or not, becoming more efficient and profitable is an inescapable challenge for many institutes.

Essentially, mergers & acquisitions may very well be a part of and support the banking sector's adjustment process, but it cannot be the main carrier of it. It can help where healthy institutions see the possibility to create synergies in a new environment, but it cannot, and should not, solve problems.

This implies that careful management decisions are key. And management, in turn, will rely on the astute advice of professional mergers & acquisitions specialists.

5 Conclusion

Ladies and gentlemen

Europe's banking sector is healthy. But when the market sneezes, expect some banks to catch a cold. If we want to prevent unjustified contagion, then we need first to stay calm. We should take the time to consider the facts instead of piling on what is clearly exaggerated sentiment.

And yet we live in challenging economic times. To do business successfully and sustainably in this environment is an enormous task.

Many banks are facing problems created by demographic change, digitalisation, ultra-low interest rates and enhanced banking regulation; and many have begun to address their efficiency and profitability problems.

But clearly, they are not yet up for a marathon with a good finishing time. There remains a lot to be done.

Reorienting business models and optimising organisational efficiency will be one part of the fitness regime. Another will be structural reorganisation in the sector. Mergers & acquisitions will continue to play an important role here, too. But only the link-up of healthy players is likely to lead to stronger teams – although, even this cannot be taken for granted. Putting weak athletes together will certainly not lead to high performance.

I now look forward to a fruitful discussion.

Thank you very much for your attention.

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[1] T Phillippon (2015): Has the US Finance Industry Become Less Efficient? On the Theory and Measurement of Financial Intermediation. American Economic Review 105(4): 1408–1438.

[2] AR Dombret (2016): Gibt es zu viele Banken? Der Sektor nach der Finanzkrise. Vortrag bei der Generalversammlung der Österreichischen Bankwissenschaftlichen Gesellschaft in Wien.

[3] E.g. A Behr & F Heid (2011): The success of bank mergers revisited. An assessment based on a matching strategy. Journal of Empirical Finance 18: 117–135.