# Andreas Dombret: Finding the right measure of consolidation in the banking sector

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank until 30 April 2018, at the Center for Financial Studies, Frankfurt am Main, 24 April 2018.

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## 1. Introduction

Mr Issing

Ladies and gentlemen

It is a great honour and pleasure to be here at the CFS this evening. It was here that I delivered my first speech to the public in 2011 – and today marks my last official speech as a member of the Bundesbank's Executive Board. In a sense, I have therefore come full circle.

As has the topic as well: this evening, I will be talking about consolidation in the banking sector. "Old hat", some of you will be thinking, "how fitting for a farewell speech". You are possibly not completely off the mark, but old hats can be in vogue as well – especially if they are as relevant to the future as consolidation in the banking sector.

There are two good reasons why I have chosen this topic. The first of these is: M&A is what characterised my career as a banker – it has thus always been one of my most important topics. The second reason is: consolidation will help to shape the banking sector of the future.

Let me begin with this statement: we must think the debate on consolidation further; we must think it anew. I would like to posit four theories.

- Theory one: the banking sector will continue to "shrink to health", in Germany and in Europe alike.
- Theory two: on the heels of this consolidation, mergers and acquisitions will lead to a concentration of the market on a reduced number of institutions. However, mergers should be undertaken with a view to creating institutions that will be stable in the long run. In mathematics, minus times minus equals plus – but it does not follow from this that two weak institutions will necessarily add up to a stable bank.
- Theory three: if the underlying economic conditions are good and if the euro area and the banking union offer the requisite environment, there will be more mergers and acquisitions going forward – initially within the German market, and, later, across borders in the euro area.
- And, finally, theory number four: those who think of consolidation and structural change only in linear terms and who are fixated on exploiting economies of scale overlook the future of financial intermediation. "Shrinking to health" and innovation have to be thought across the established limits of the banking industry – along new, digitalised value chains. And this does not necessarily lead us to a concentration of today's banking business in the hands of a small group of large banks.

## 2. Why are we talking about consolidation?

Let me begin with a question: why is there so much talk of consolidation in the banking sector? And why am I also talking today, in my farewell speech, about a topic as "old hat" as consolidation? There are four reasons for this.

First, because the financial sector, especially the banking sector and large banks in particular, dominated large segments of the economy in the 20 years prior to the financial crisis. A case in point is shown by the highly educated engineers, physicists and economists who developed complex financial products and risk management models – instead of building bridges or developing medical devices. These, but also many other bright university graduates, were sucked in by the financial sector because they could measure themselves against the best and could earn a lot of money – however, only thanks to a financial bubble. Although this bubble burst in 2008, overcapacity in the financial sector did not automatically go away, but has had to, and still has to, be gradually shrunk in a process that has been going on for years – much as it also took years to build up.

Second, in the past few years, we have been repeatedly found ourselves debating the topic of "overbanking" – the European economy's overdependence on the banking sector,[1] the bloatedness of the banking sector, its political influence, the size of its payrolls, the number of institutions. That, too, is a reason why I am talking about consolidation this evening. The extent quickly becomes clear if we look at the size of the banking sector relative to GDP: in Germany, for instance, it rose from less than 190% in 1993 to 360% in 2008, the year the financial crisis broke out.

But there's another, third reason: the banking sector is currently in the throes of fundamental transition. Because more and more financial services are being offered outside the traditional banking sector, fintechs and "shadow banks" are putting pressure on the banking sector to consolidate.

And, finally, there is a fourth driver of the debate on consolidation: the poor profitability of European and, not least, also German institutions. The earnings of German credit institutions have been falling for more than 15 years – by around 30% since 1999.[2] The persistently low interest rates have significantly exacerbated this situation. And the fact that interest rates are expected to remain low for the foreseeable future means that the outlook for profitability here and in wide swathes of Europe will be more on the gloomy side.

Germany is particularly affected by the low level of interest rates because most German institutions have business models which are highly dependent on interest rates. The recent low-interest-rate survey conducted by the Bundesbank and BaFin has shown that small and medium-sized German credit institutions are expecting a 9% drop in their profits [3] from 2016 to 2021; this represents a whopping 16% decline in the return on assets over the same period. [4]

One major cause is growing competition in the low-interest-rate environment. Over 70% of institutions are expecting intensified competition from other banks and savings banks. And as many as 85% are expecting increasing competition from fintechs.

I am therefore not truly surprised that M&A has been a topic in the European and the German banking sectors since 2008. Indeed, many market observers are probably surprised at how slowly consolidation is progressing.

But where are we now in this process? Since 2008, we have seen a moderate, continuous process of downsizing in Europe: the ratio of banks' assets to GDP was, at the end of 2016, well below its 2008 levels. More precisely, it dropped from 350% to around 260%. Measured in terms of the enormous rise prior to the financial crisis, it is quite conceivable that the downsizing process will continue further, although it has stalled somewhat of late.

Another measure of consolidation in the banking sector is the number of branches and employees per capita of the population. From 2008 to 2016, the average number of inhabitants served by a branch rose by nearly one-third; over the same period, the average number of inhabitants per bank employee rose by one-quarter. And the number of institutions in the euro area has also already dropped considerably, by nearly 30%: from 6,062 in 2008 to 4,385 at the end of 2016.[5]

There is little doubt that this process will continue. How far this process will go, however, nobody can say – though there has been no shortage of attempts to predict the number of German or European institutions in 2050.

And thus, my first hypothesis was that, in the years to come, we will likewise see a moderate shrinkage of bank balance sheets and transaction volumes in the euro area – albeit, of course, with a certain variation from one country to the next. The number of employees and branches per capita, too, will continue to decline. These trends will be driven further by the digitalisation of financial services. And the number of institutions itself will keep falling. One of the reasons, to which I will come in a second, is mergers. The other is that there will be market exits which, I hope, will be carried off without any political intervention and in an orderly fashion under the resolution regime.

There is little doubt that this downsizing process is “shrinking to health” – difficult as the repercussions will be for institutions and their employees. Out of cost-efficiency considerations, if nothing else, overcapacity which is no longer needed has to be either downsized or deployed to other profitable purposes. And, from a macroeconomic perspective, it is particularly necessary to want a financial sector that is not inflated but efficient.

### 3. The role of mergers & acquisitions

What is more doubtful, however, is the weight that each of these three different consolidation approaches will have. What share will the shrinking of existing institutions have? How many of them will exit the market? How many of them will merge with other institutions?

My personal take on this – which dovetails with the second hypothesis I mentioned at the beginning of my speech – is that an increase in M&A activity, and thus a higher level of market concentration, can make sense from both an economic and a commercial perspective; that said, long-term success will be reserved for initiatives which ultimately bring forth a stable credit institution running a sustainable business model.

Why am I making this point so emphatically? Because M&A has a mixed track record in the banking sector, if you measure it in terms of profitability, stability, market power and customer satisfaction.

Some see bank mergers as a kind of magic formula for driving consolidation forward. They’re so optimistic because of the economies of scale which typically arise when identical activities are combined and the synergy effects which can be harnessed when complementary operations are fused. And it does indeed appear that mergers unleash positive effects in reality, not just in theory – a meta study conducted last year by the ECB concluded that M&A tends to generate positive economies of scale, even if they would not appear to be overwhelmingly large. [6]

However, increased M&A activity can also be problematic, because this form of consolidation drives even more market share into the hands of a small number of market participants. And large institutions are, first, not just particularly susceptible to poor governance; they can, second, also present a risk to financial stability – I’m talking about the too-big-to-fail problem here. [7]The bigger banks become, the more closely they need to be supervised and the better the resolution options need to be formulated.

Third, concentration in the market can lead to an agglomeration of market power, and thus to a lower quality of services and higher prices.[8] The ECB’s paper discovered that the market power of credit institutions in the euro area has increased since the financial crisis.

Overall, according to the ECB's meta study, it cannot be concluded beyond doubt which empirical factor has more of a bearing – the positive efficiency gains, or the problems which the heightened concentration causes for customers and financial stability.

So there is conclusive evidence, it would seem, that M&A is not a magic bullet. Any merger or acquisition has a certain likelihood of failing. Only well-thought-out M&A transactions stand a genuine chance of success. It's quality that counts, not quantity.

Now some of you might be thinking that's all very well – but what are the hallmarks of a well-thought-out and successful merger? Those of you who've just pulled out your pen and paper will be in for a disappointment because there is no ready-made solution.

That said, I would nonetheless like to share with you four minimum conditions which I consider to be important for mergers and acquisitions in the banking sector:

- The first applies to any strategy, but it is particularly relevant to M&A: an M&A transaction is more likely to succeed if it is planned, purposeful, and done out of conviction rather than compulsion.
- Second, M&A transactions in the banking sector need to be examined analytically in order to quantify as accurately as possible whether and to what extent economies of scale and synergy effects can indeed be harnessed. Complementary mergers in which business operations and/or regions fit together perfectly can fall flat, but they can also be blessed with success if they are based on detailed analysis upfront.
- Third, they are far-sighted – that is to say, they consider which problems might arise and look at how other mergers panned out.
- Fourth, they are creative – in other words, they look beyond the confines of existing business operations. In a market gripped by structural change, this calls for a great deal of creativity – imaginative solutions which think outside the limitations of the banking sector of old. Dovetailing complementary business operations, which I mentioned just now, can also be a successful approach across traditional sector boundaries.

## 4. The future of M&A in Germany and Europe

The question now is this: how many successful and well-thought-out mergers are we likely to see in Germany and Europe?

That is what my third hypothesis is all about. Given good economic conditions and a reformed banking union, there may well be more M&A activity in future – both within the German market initially and later across national borders in the euro area.

That's because institutions will gradually emerge from crisis mode and the period of regulatory reform over the past ten years in which they had better things to do, to put it crudely, than simulate strategic M&A options. This creates huge potential.

The more accommodative the current economic environment is and the more regulatory uncertainty recedes, the greater that potential will be. Basel III was concluded at the end of last year, and the plan now is to implement it in full in the EU, the USA and the other member states. Implementation of these final, major reform elements introduced in response to the financial crisis will push back regulatory uncertainty once and for all. That is why it is so important for the Bundesbank, and for me personally as well, that we now set about preparing implementation in the EU, even if the European elections will soon be upon us, so that we can swiftly wrap up the process once the elections are over.

In my view, this gradual reduction of economic and regulation uncertainty opens up a window of opportunity, above all in Germany, for more mergers and acquisitions. At this point, let me remind you of one of the most fascinating findings from the latest low-interest-rate survey: nearly 50% of small and medium-sized German credit institutions can see a prospect of mergers and acquisitions over the medium term.[9]

But that will call for creative and unconventional solutions within the German banking sector as we know it – solutions that are needed not just by private institutions but by their public-sector counterparts as well. The latter have a public mandate, making them an important pillar of the German economy. And they should stay that way – which is also why this pillar needs to be refreshed.

Specifically, the Landesbanken spring to mind here. Something like two months ago, the first sale of a Landesbank to private investors was set in motion, bringing a long and arduous journey to a close. This transaction is a novelty for the German banking sector.

It was a forced sale, admittedly, but it shows that a transaction like this is doable – yes, it is possible to sell a Landesbank to private investors, and even at a price that many had considered impossible beforehand. With a little luck, this story will be a prelude for bigger solutions in the Landesbank sector. The market environment, in any case, is still exceptionally favourable.

As a banking supervisor I will always take a neutral stance when it comes to structural policy. Industrial policy is out of bounds for central banks, and rightly so – even if that's a view not everyone would agree with. That said, I would like to take this opportunity to encourage banks and savings banks to explore fresh and creative avenues – before problems force them to do so.

But we also need to take a look beyond the German horizon. Because in a currency and banking union, one could be forgiven for wondering whether we need more cross-border mergers in the euro area.

The management of the SSM took quite a clear line on this topic in a recent speech. [10]Cross-border mergers and acquisitions within the SSM are rare, it was said, and the degree of concentration across the SSM banking sector, and particularly in a number of member states, is too low. [11]According to the ECB, this is due not least to the political and supervisory obstacles that still persist in the euro area.

Even if there is some evidence to suggest that cross-border mergers and acquisitions tend to be more successful and have less of a negative impact on competition,[12] I currently see national mergers as a more promising avenue for tapping synergy gains. In my view, only once these synergies have been harnessed will institutions think more along European and cross-border dimensions.

For now, cross-border mergers in the euro area will probably be few and far between. That's because mergers and acquisitions across national borders are exceptionally complex transactions on account of the cultural and lingual barriers they need to transcend. A lack of clarity surrounding the future regulatory framework for a cross-border project makes it more difficult still to gauge whether the complexity of governance across cultural areas is something that can be organised while still making a profit.

### 5. Conditions and limits to European mergers and acquisitions

Additional reforms are necessary before any further progress can be made here. I don't just mean the completion of the banking union, but it is especially necessary. We have an opportunity – and also an obligation, in my view – to establish the banking union on a firmer foundation. This is why the EU must succeed in reducing the excessive risks still latent on many banks' balance sheets. We can do this first by scaling back existing non-performing loans and preventing the build-up of new ones. I firmly believe that in this matter there are no alternatives to the ECB guidelines. The foundation of the banking union can then be fortified by putting an end to the preferential treatment of sovereign bonds, third by building up loss-absorbing capital, TLAC and MREL, and fourth by harmonising insolvency regimes. As a second step further down the line, we should then discuss how we can create a strong European reinsurance system for deposit protection that intervenes when national schemes are unable to cope – but only then. If we manage to do this, we will make the banking union more stable and more credible.

There is, of course, a "but" to all this, because I can see the danger that, as supervisors, we might go too far. I see the danger of overestimating the opportunities of M&A strategies and underestimating their risks. We cannot expect scale and synergy effects to simply materialise across cultural areas, nor can we act as though the banking union is already completely supranational today – in many places there will also be national security hurdles over the coming years. And that is as it should be.

My concern is that European mergers and acquisitions may be misused for political interests. Here I am referring to potential attempts to create European champions that could then supposedly take on large competitors from other parts of the world. I consider this type of thinking questionable. We must not now make the error of replacing the misguided ideology of national champions with a no less misleading ideology of European champions. This will not lead to growth and more jobs, but it may result in ossified structures and risks to financial stability.

Ladies and gentlemen, consolidation is essential and fundamentally good for the banking sector, but neither national nor cross-border mergers and acquisitions should be seen as a means of escaping the digital revolution and structural change.

## 6. What will the digital revolution mean for the future of financial intermediation?

The last part of my speech today will address these fundamental changes. That isn't to say that too little is spoken about digitalisation – one would be hard pressed to find a business section of a newspaper or a conference programme today that doesn't mention it. We do have a tendency, however, to overstate short-term trends – just think of Bitcoin and fintech start-ups – while we underestimate and think too little about long-term trends.

Who among you has a clear idea of how digitalisation will alter banking and the banking sector's structure in the medium and long term?

Luckily, when we consider this, we don't have to start from scratch. We have been working on this for quite a long time on the Basel Committee's Task Force on Financial Technology. An initial result of this has been the development of five scenarios of how digitalisation could change the banking sector, and I'd like to share these five visions of the future with you now.

Let's start with the least disruptive scenario: the "better" bank. In this scenario, institutions that are already established on the market are successfully modernising and becoming digitalised. They continue to maintain good customer relations and carry out banking services themselves. Though established institutions are under considerable pressure to reduce their costs and to modernise extensively, they also have in-depth knowledge of the market, a broad customer base and high capacity for investment. This suggests that established banks are able to reinvent themselves piece by piece during their day-to-day operations and ultimately hold their own in the market.

Scenario two concerning the “new” bank tells a different story. In this scenario, established banks founder due to their structures, which have evolved over many years and turn out to be legacy risks. New banks – small start-ups or those founded by tech giants – then take over their business. Free of legacy risk and designed specifically for a digital and interconnected world, these new banks can offer their services more cheaply and are more attractive to customers – they are quick, innovative and state-of-the-art.

But the sector could change even more radically, as scenario three – the “fragmented” bank – shows. In this scenario, banking business becomes fragmented and the value chain is broken up. Universal banks are history, regardless of whether they are “old” or “new”. Instead, a large number of specialised providers emerge, offering individual financial services. From the customer’s perspective, this fragmentation wouldn’t necessarily be a disadvantage and it wouldn’t be visible at all if the providers offered their services on joint platforms – dubbed the platform economy.

Scenario four is similar: the “invisible” bank. As in scenario two, established institutions in this case are unable to keep pace with the new competitors when it comes to customer relationships. Nevertheless, they don’t disappear from the market, but maintain a background role as a service provider. In this role, they carry out the tasks that are only possible with a banking licence or that require specialist knowledge – risk management, lending or deposit business, for example. We can already witness this type of cooperation today when tech companies present themselves to customers as service providers, while the settlement side of transactions is carried out by established financial institutions. Payments and credit platforms are two such cases in point.

This leaves us with scenario five: disintermediation. In this scenario, established banks are no longer relevant market participants and nor are they replaced by new banks, because the intermediary role of traditional credit institutions is simply no longer needed. Here, innovative technologies take on the task of connecting end customers with each other directly. This may sound rather far-fetched at first, but we are seeing at least some attempts in this direction already: for example, lending via P2P platforms or business financing via crowdfunding.

Ladies and gentlemen, these are five scenarios, five visions of the future of how digitalisation could change the banking sector, though there are of course others. Personally, I believe we will see a mix of these scenarios as the banking sector evolves.

On the one hand, customer needs will be key to developments – consider, for example, the smartphone generation, many of whom have never set foot in a bank branch. In the second stage, how financial service providers respond to these needs will be crucial. Joint ventures and M&As may play an important role here by speeding up the change processes. Small fintechs that do not have any legacy risks are by their very nature more agile and can more easily develop innovative products and business models. Established banks have a solid customer base and strong marketing channels, which means they can bring promising concepts to the wider market within a short time frame. In many cases, although not all, it would appear that the secret is in the mix.

And that’s why my fourth theory was that the process of designing structural change in general, and M&As in particular, cannot be linear. Instead, it must be dynamic. Whilst placing hope in scale effects, we must not forget one thing: the most important factor in the success of a market economy is its growth dynamic, which, unlike in a planned economy, is the result of many decentralised decisions by a variety of market players. This system gives rise to high levels of innovation and efficiency.

By the same token, clever M&A strategies also permit and seek out creative ways to break up enterprises – by which I mean selling off certain portfolios or business units. They are not limited to one sector, they take a service-based approach, and they follow the new, digital value chain.

And we must even go one step further. If digitalisation reaches all corners of the economy – think of “Industry 4.0” –; if today’s forms of economic cooperation undergo a complete change because the technological revolution also facilitates revolutionary cooperation forms, which financial services will still actually be in demand at that point? What form can they be offered in? How could they be linked to other services?

To put it another way: if the economic structures change as the world becomes increasingly digitalised, how will the demands placed on the banking and financial industry and its structure change? What will the enterprises of the future want from the financial sector? Does the digital revolution of economic structures also mean a revolution for the financial market?

Although questions like these are still faint whispers from the future, we can already hear them today, and they are becoming ever louder. This is clear from cases such as the music streaming provider Spotify going public, for example. In doing so, the company that revolutionised the music industry through its streaming services is flying the flag for a revolution in the financial industry, too. The IPO took place with minimal assistance from investment banks and the issue price was not set in advance, but instead was determined through a free market process. Spotify’s IPO was not, in itself, by any means a revolution in the financial world. But it was the first step along the way. And it won’t be the last – of that I am sure.

## 7. Conclusion

Ladies and gentlemen, during my time as a member of the Bundesbank’s Executive Board, I devoted a great deal of energy to guiding the banking sector through its recovery process. When I gave my first speech at the CFS in 2011, I talked about financial stability. I discussed what challenges the German banking system was facing and how financial stability could be ensured. Although we have made considerable headway over the last few years, we are still a long way from our destination.

With this in mind, my first theory this evening was that contraction and consolidation will help assist the recovery of the sector in the future, too.

In my second theory, I outlined the role I expect mergers and acquisitions to play going forward. In Germany and Europe, I expect to see a concentration of the market on a smaller number of larger institutions. This will depend on well-thought-out strategies and will separate the wheat from the chaff.

I am certain that – as I mentioned in my third theory – we will see more of this type of merger if we create positive economic conditions, including a stable banking union in a stable euro area. Under these conditions, I assume that, in future, we will see more M&A activity within Germany to begin with, and then across borders within the euro area, too. Despite this, the stability of the bank market hinges on it remaining fragmented in many areas – in terms of size and business models, to be clear.

And, finally, theory number four: I hope that, in future, we will spend less and less time discussing consolidation within the old conceptual confines. In a digitalised economy, not only will the ways in which financial services are provided be radically overhauled; there will also be a structural change in the demand for services. We have no idea what financial services will actually still be in demand at that point, or by whom.

Banks and savings banks therefore cannot simply carry on as before. If they want to remain a meaningful part of the financial services industry in the future, they must run their established business more efficiently and more innovatively and, at the same time, ask themselves how heavily they want to rely on the established banking structures making a recovery.

While these mammoth tasks are being performed, supervisors must not work against the institutions, but must support them. Even if we are first and foremost responsible for financial stability, it is just as important not to curtail economic growth disproportionately. It was always my aim to find this balance and encourage dialogue about it.

On that note, I now look forward to a lively debate with you.

Thank you very much for listening.

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1 ESRB (2014), Is Europe overbanked?, Reports of the Advisory Scientific Committee, No 4, June 2014.

2 AR Dombret (2017), The cake's getting smaller. Consolidation and reorientation in the German banking sector. Speech delivered on 30 March 2017 at the Fifth Annual Conference on Integrated Performance and Risk Management of the Frankfurt School of Finance & Management.

3 Decline in the profit for the financial year before tax.

4 AR Dombret (2017), Opening statement at the press conference on 30 August 2017 presenting the results of the low-interest-rate survey conducted by the Bundesbank and BaFin.

5 European Central Bank (2017), Report on financial structures, October 2017.

6 An overview can be found in European Central Bank (2017), Financial integration in Europe, Special feature: cross-border bank consolidation in the euro area.

7 See L Laeven, L Ratnovski, H Tong (2016): Bank size, capital and systemic risk: some international evidence. Journal of Banking & Finance, 69(S1): pp 25–34.

8 See European Central Bank (2017), Financial integration in Europe, p 48.

9 AR Dombret (2017), Opening statement at the press conference on 30 August 2017 presenting the results of the low-interest-rate survey conducted by the Bundesbank and BaFin.

10 See D Nouy (2017) Too much of a good thing? The need for consolidation in the European banking sector. Speech at the VIII Financial Forum, Madrid, 27 September 2017; ECB (2017), Financial integration in Europe.

11 Although the banking sector has contracted significantly since 2008, the same period has seen a decline in the number and volume of M&A transactions in the EU, above all since 2013. The slight increase in sector concentration observed up until 2014 has since even given way to a gentle decline. Further details can be found in ECB (2017), Financial integration in Europe, Special feature: cross-border bank consolidation in the euro area.

12 See European Central Bank (2017), Financial integration in Europe, pp 50–51.