Yves Mersch: Future-proofing the European banking market – removing the obstacles to exit

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the S&P Global's European Financial Institutions Conference, Paris, 21 November 2019.

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Consolidation seems to be something of a buzzword. It is associated with discussions of the profitability of banks, with debates on overbanking or the optimal size of a banking area, and with issues of competition.

From a prudential supervision perspective, I'm concerned about efficient market functioning and sound banking structures. And as a central banker, my goal is to maintain a smooth transmission mechanism.

Facilitating bank failures

Between 2008 and 2012, spurred by the crisis, we saw more than four times as many US banks fail than EU ones. That was not because European banks were healthier than their US peers. The fact that only a few European banks failed during the crisis was not proof of their resilience either. It was proof of governments' willingness to support ailing banks with taxpayers' money: between 2008 and 2017, state aid granted to EU banks for their recapitalisation amounted to €1.5 trillion. That corresponds to around 10% of EU GDP in 2017, half of which was ultimately used to help ailing banks.

Governments feared systemic consequences if banks were to fail. After all, the collapse of Lehman Brothers had triggered the global financial crisis. Being afraid of something similar happening again is understandable. But bailing out banks is not the best response to such fears.

First, it perverts banks' incentives. It means that any bank considered systemically relevant enjoys implicit, cost-free insurance – and the bar for systemic relevance was often not all that high in political terms. Thus, such banks were prone to moral hazard; they were prone to taking on too much risk, which promised higher returns – and made failure more likely. Banks did not necessarily care though. They would reap the returns, while taxpayers had to bear the risks. The political economy consequences of the bailouts are still being felt today.

Second, bailing out banks prevents the non-viable ones from exiting the market. Instead, they drag on and put pressure on margins for other banks. The sector does not consolidate, profitability remains subdued, and that gives rise to new risks. For one, weak banks might gamble on being rescued and take on even more risk; others might go in search of yield with the same result. Next, unprofitable banks lack the means to build up capital buffers, which renders them vulnerable. And finally, banks may not be able to cover their fixed costs, which would depress investment in areas such as digitalisation.

Consequently, one of the goals of post-crisis reforms was to allow banks to fail again. With this in mind, the Single Resolution Mechanism was set up in Europe. This provides a framework under which banks can fail in an orderly and well-managed manner. This was certainly a big step in the right direction.

But was it big enough? I would argue that we still do not have a truly European approach for handling troubled banks. Even though we have a European resolution mechanism, much of the action still takes place at the national level – with all the differences that entails. Since it was entrusted with banking supervision, the ECB has only declared very few institutions "failing or likely to fail". And only one of those was resolved by the Single Resolution Board. The others were liquidated under national insolvency regimes.

The Single Resolution Board decides whether it is in the public interest to resolve a bank that is deemed failing or likely to fail, or whether the bank in question should be liquidated instead. If the bank is to be resolved, this is done in accordance with the framework laid out in the Bank Recovery and Resolution Directive, the BRRD. But that framework depends on how the home country of the bank in question has transposed the BRRD into national law. And such transposition differs from country to country. If the bank in question is to be liquidated, this is done at the national level, according to national laws. And national laws differ a lot. National insolvency and bankruptcy laws are a case in point. I won’t deny that there are valid reasons for those differences: legislating for insolvency and bankruptcy deeply reflects the social contract of Member States in their cultural and historic diversity. When it comes to the liquidation of banks that are part of a banking union, a more harmonised approach to liquidation would be appropriate. Legislators are now considering whether to add a liquidation tool to the European banking toolbox. Such an administrative liquidation framework would foster a more European approach.

Furthermore, improvements to the crisis management framework would help a banking union reach its full potential. This might include harmonising the creditor hierarchy, introducing a general depositor preference and removing the overlap between supervisory and early intervention measures from the relevant European legislation.

Facilitating bank M&A

Outright failures are one way for non-viable banks to exit the market. Mergers and acquisitions provide a second option. Nonetheless, we are seeing very little consolidation – either within, or even less so, across borders. There are several reasons for that.

Uncertainty plays an important role. For a long time, the fear of a euro area break-up kept banks from engaging in cross-border adventures despite the long recovery. This fear should have receded in the same way that regulatory uncertainty has. But there are also other sources of uncertainty. Digitalisation, for instance, puts a question mark over the value of large branch networks. In the future, scale might become less of an issue for physical distribution capacity.

And then there is uncertainty about bank valuations, which are low across the board. Potential M&A targets might not want to sell at what they consider a rock-bottom price; at the same time, potential bidders might lack confidence because of their own low valuations. In general, many banks still focus on deleveraging and cleaning up their balance sheets as a prerequisite to focusing on growth. This illustrates that consolidation cannot be the panacea. Merging two weak banks will not magically produce one strong bank. Likewise, when a bank that is in good shape takes over a weaker one, this may not necessarily result in a strong institution, but could actually lead to a larger, less healthy bank. Structural inefficiencies are best dealt with at the level of the institution in which they originate. We should not expect them to simply evaporate in the course of a merger.

But obstacles to consolidation stem from more than just divergence in national insolvency and tax laws. I have also heard questions regarding the implementation of existing regulations, such as capital treatment of liquidity waivers, the application of the new discretion on GSIB methodology, the impact of NPL disposals on internal model parameters, and the interaction with resolution strategies.

The transposition of EU laws into national laws has also provided loopholes allowing preferential treatment. Many countries protect their domestic banking markets by ring-fencing capital and liquidity. Unresolved home/host issues may discourage cross-border M&A activity, because they prevent banks from freely allocating capital and liquidity across the entire banking group. While a European Deposit Insurance Scheme might reduce the incentives for governments to restrict the free flow of capital and liquidity,[1] host countries argue in favour of preventing healthy institutions in one country from “bleeding out” to unhealthy parts of a group in other countries. Furthermore, decision-makers might want to keep banking services in their country for consumers whom they don’t want to see losing access to such services.

We could try to alleviate such concerns through group-wide guarantees which take into account such concerns to avoid misalignments between financing and decision-making across borders. If contractual arrangements are not considered sufficient, maybe publicly endorsed standardised templates on the triggering and functioning of waivers, and information-sharing could bring us closer to a fully functioning European banking market that would also benefit consolidation.

Some argue the ECB should look much closer to home for unwarranted obstacles to consolidation. I would not exclude to revisit our assessment criteria, also about the treatment of NPLs in M&A. And what about the capital we require merged entities to hold? Do our requirements appropriately reflect the synergies reaped by mergers? As a supervisor, we step up our scrutiny of merged entities, at least at the start of their life, as we recognise the operational risk challenges posed by merging complex structures. That should not lead to double-counting, though. To go as far as to allow for a temporary reduction of post merger capital levels would however need robust arguments. Our risk-aversion is not meant to block market-driven consolidation initiatives – and should not be understood as such.

Conclusion

Ladies and gentlemen,

By reaping synergies, consolidation may help banks to address one of their most pressing challenges: how to reduce costs. That does not mean though that consolidation is the answer to everything. And it might not always be in the consumer interest.

As a supervisor, we take a neutral stance. We assess merger and acquisition proposals solely on technical grounds. It is for markets to decide whether or not consolidation takes place, and to what extent. Market forces should, however, not be undermined by unnecessary obstacles. While it is up to individual banks to futureproof themselves, policymakers and legislators can provide the right conditions. Seven years after the banking union was first proposed, it is about time for a single European banking market.

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[1] See Mersch, Y. (2018), “Europe: a work in progress – political integration and economic convergence in Monetary Union”.