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# Cross-Border Consolidation in the Financial Services Industry in Europe
## Developments, Obstacles & Policy Initiatives

**Conference organized by CEPS and sponsored by PricewaterhouseCoopers LLP**

*26 June 2006*

*Conference Report*

*Prepared by CEPS Research Team*[1]

The report is largely a transcript of what was said at the event. Therefore, the views expressed are those of the speakers and not the views of either CEPS or PricewaterhouseCoopers. Full conference materials are available at HTTP://MAIL.CEPS.BE/CEPS_PWC_CONFERENCE26062006/ and the programme is reproduced in an annex at the end this report.

### INTRODUCTION

The debate on cross-border consolidation in the financial services sector has gained momentum in Europe after the recent large acquisitions in UK, Italy and Germany and the frantic race to acquire key banking institutions in the new member states. Almost seven years after the introduction of the euro in 1999, it seems that pan-European financial groups are beginning to emerge. According to European Central Bank data, there has been an increase in foreign ownership in the EU banking sector over the past years. At the same time, however, there are large divergences between individual EU member states: while around 70% of the domestic banking-sector assets in the new member states – which are not yet members of the Eurozone – are foreign-owned, the cross-border dimension is almost negligible in the Euroland.

It is premature to assess the economic benefits of the recent consolidation wave in the financial industry, but the recent large cross-border acquisitions have served to renew the public debate on whether this may mark the start of cross-border banking integration in the EU. However, numerous obstacles hamper the development of a smooth European financial integration process. These obstacles were surveyed by the European Commission in October 2005, and range from the multiple supervisory requirements for cross-border activity and the legal impediments to corporate expansion and reorganisation, to the difficulties of selling the same products across multiple countries and possible political interference, all of which limit the full exploitation of benefits from the Internal Market. At the same time, cross-border consolidation is not the only means to grow across borders: alliances, joint ventures and organic growth could also offer alternative strategies to managers wishing to expand. In light of these developments, EU policy-makers are facing new challenges. Not only will they need to tackle the remaining policy-related obstacles to foster the integration of the European

[1] Rym Ayadi, Research Fellow and Head of Financial Institutions Research Program and Martin Saldias Zambrana, Research Assistant. They wish to thank Nick Page, Partner at PWC LLP, for his helpful comments, and Ana Porumbrica, for her contribution to the conference report and support during the conference.

financial market, while preserving fair competition but also to strengthen cross-border arrangements in the area of financial stability.
The Centre for European Policy Studies and PricewaterhouseCoopers LLP hosted on 26 June 2006 a high level conference on “Cross-Border Consolidation in the Financial Services Industry in Europe: Developments, Obstacles & Policy Initiatives”. This conference sought to bring together policy-makers, academics and high-level industry representatives to discuss the state of financial services consolidation in Europe; its economic rationale and implications; the remaining obstacles to cross-border consolidation and integration; the alternative strategies to external growth across borders and the policy initiatives taken –or to be taken- in response to these developments.

To introduce the conference, Onno Ruding, Chairman of the CEPS Board of Directors and Former Vice Chairman of CitiGroup, reminded its main objectives. In particular, he highlighted to the benefits of diversification of cross-border consolidation, the remaining obstacles such as the diverse consumer protection rules in Europe, and the role of policy makers to remove the barriers to consolidation and integration.

He emphasised that cross-border consolidation is a common feature in Europe, but its future development varies across countries and strongly depends on the strategies of their domestic players. He reckoned however, that there is no consensus concerning the desirability of this growth alternative and urged the conference participants to exchange their views order to draw adequate conclusions and policy recommendations

## STATE OF PLAY, OUTLOOK AND ECONOMIC RATIONALE AND IMPLICATIONS OF CROSS-BORDER CONSOLIDATION IN THE FINANCIAL SERVICES INDUSTRY

The opening session of the conference consisted in four presentations. Philip Lowe, from DG Competition, addressed the role of the European Commission – DG Competition in promoting further integration in the EU financial markets. Recent trends and outlook in cross-border consolidation in the financial services sector in Europe were summarized by Nick Page, from PricewaterhouseCoopers LLP. The economic rationale of cross-border consolidation and micro- and macro- economic implications were tackled the by the two academic-focused presentations by Ingo Walter, from NYU Stern School of Business, and Rym Ayadi, from CEPS.

### *Philip Lowe*
*Director General, DG Competition, European Commission*

Philip Lowe started with an overview of the integration process in the EU financial markets. First, the drivers of the recent development were mentioned, some facts of the integration process were shown and some competition concerns related to the recent banking inquiries[2] were addressed to illustrate the role of DG Competition in promoting integration in the financial industry. Finally, the obstacles to cross-border consolidation and important initiatives to overcome them were discussed. To sum up, he highlighted the role of the European Commission in promoting further integration through cooperation with national supervisors.

As background, Philip Lowe emphasized that integration and competition in the EU banking industry have been boosted by a large number of drivers, such as the recent developments in technological and financial innovation, deregulation, financial liberalization, the Single Market and the European Monetary Union. In view of these developments, Philip Lowe considered the role of competition policy a key to ensure a fair, secure and competitive European financial market. Not only does a coherent and consistent competition policy benefit consumers through a wider choice and better quality of products at a lower price but also it contributes to promote capacity for innovation and entrepreneurship in line with Lisbon Agenda.

[2] Available at http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/

To illustrate the developments in the integration process of financial services, Philip Lowe provided the following inventory on M&A activity in Europe, as a means to achieve it:

- The number of M&A in the banking sector stands for one third of the overall activity at present;
- Between 2000 and 2005, cross-border mergers in the banking sector rose by around 100%, driven by market opportunities abroad; however, not yet fully comparable to domestic consolidation;
- The restructuring process has been recently more intense in new Member States, absorbing a considerable proportion of the local financial sector; and
- Intra EU consolidation activity is more intense as compared to other geographical areas. It accounts for nearly 30% of worldwide transactions.

DG Competition frequently launches inquiries to enhance competition in financial markets. It has been looking very closely to several areas and is expected to intervene when necessary. As an example of these activities, Philip Lowe conveyed the **findings of the financial services sector inquiries in payment markets from a competition perspective.** The results of those inquiries are the following:

- **On payment cards**; there is a strong push towards a single market in payments services, especially in the euro area through the Single European Payments Area (SEPA). There are competition concerns due to an existing significant market power in the payment cards industry for banks. If national infrastructures are replaced by an international scheme, the market power concern could increase if only current market players are considered. Therefore, the Commission is closely following the developments in this area and, for instance, proposed the participation of non-bank entities in this market to enhance competition in many Member States.
- **On other payment schemes**; the single European direct debit instruments should be a desirable initiative. However, it should not bring to an end the efficient national schemes nor create monopoly rents. Essential market infrastructures cannot be used to extract rents, given that payments are consumed with other transactions and that the demand of payments is very inelastic. Rents in this area create an implicit tax on commerce with a major economic impact.

As far as financial integration through cross-border consolidation is concerned, Philip Lowe next tackled the **obstacles that hamper** deeper integration in the banking sector. These obstacles, which ranged from non overlapping fixed costs implying the lack of sufficient cost synergies to offset the M&A cost to differences in tax treatment, employees' hostility and consumers' perception have been highlighted by the respondents to a recent survey launched by the Commission.

Philip Lowe put emphasis on **government interference for protectionist purposes** as an important barrier. Under the current supervisory provisions, national authorities may intervene to protect illegitimate interests based on the prudential rule exception contained in the Banking Directive. This issue may be delicate, as shown recently in Italy, because it does not only involve the causes of supervisory interference to block specific transactions. It also involves the legitimacy of this intervention in relation with competing transactions and even the supervisory procedures. Therefore, due to the ambiguity of the current supervisory provisions, coherent and consistent approaches to M&A transactions are highly desirable.

The supervisory provisions should be based on competition principles rather than domestic and entrepreneurial considerations linked to government activity. To illustrate this, Philip Lowe provided the example of Unicredito in Poland. The Polish government tried to block Unicredito's merger in Poland on competition grounds even though it already had the EU approval. Since Poland joined the European Union, the assessment of competition aspects on a particular merger becomes an EU responsibility to clear, so the Commission unblocked this transaction in spite of the Polish government's opposition. The Polish government came to an agreement with Unicredito to divest a number of branches and presented this result as a remedy for competition reasons on that particular transaction. The European Commission does not share this view and makes clear that competition issues do not involve the responsibility of national authorities if they are under the EU jurisdiction.

Aiming at tackling all these obstacles, the Commission is taking the relevant policy actions to improve the supervision of cross-border financial institutions (improving the EU supervisory structures, to enhance convergence of supervisory practices and to streamline reporting requirements provisions). It is also in the process of reviewing Article 16 of Banking Directive, which provisions has previously impeded cross-border corporate expansion. And finally, its Green Paper on Financial Services Policy 2005-2010 is targeting to achieve more integration in the retail financial markets to allow selling the same products across European countries.

To conclude, Philip Lowe emphasized that market developments and policy actions contribute to the dynamic process of cross-border consolidation. In particular the latter should contribute to create an adequate framework for further expansion. These policies should be complementary to allow the exploitation of efficiency and risk diversification gains derived from financial integration. To achieve this, the Commission is working to remove any policy obstacle and improve the synergies of consolidating financial institutions in Europe. The role of the Commission as a referee is essential to guarantee some degree of legal predictability and ensure the level playing field. It is up to the Commission - in collaboration with Member States - to create the right, transparent and neutral environment for financial services sector consolidation.

*Issues addressed by the conference participants*

Participants wondered about **the desirability of a "Group of Wisemen" to explore further ways of cross-border supervision in Europe with an emphasis on competition policy**. Philip Lowe believes that competition decisions taken on the basis of cooperation and consensus among national jurisdictions can deliver progress. They can facilitate cross-border activities to achieve sectorial competitiveness and benefits for business and consumers.

Even though cross-border activity has happened in spite of the predominant national legislation, supervisory institutions and existing regulation at national level may create disadvantages and obstruct the gains of cross-border activities.

In addition to a better understanding of the market by existing and potential market participants, further progress in the financial sector will come through a reconsideration of the application of national and EU regulation.

As far as the competition regulatory framework is concerned, there are already 26 competition authorities in the EU, so another organization is not an attractive idea to facilitate further gains in cross-border activities. The existing competition authorities and the business community can strengthen cooperation among supervisors to give impetus to regulation harmonization and achieve further improvements in the area of national regulation to favour benefits of cross-border activities.

### *Nick Page*
*Partner, PricewaterhouseCoopers LLP*

Nick Page's presentation focused on an overview of the banking consolidation process. The findings are contained in two recent PricewaterhouseCoopers publications on European banking consolidation[3]. Firstly, the recent M&A activity's trends were displayed and commented upon and then the developments in the banking sector in Western and Eastern Europe were portrayed over the last ten years. Finally, the conclusions remarked the possible scenarios over the coming years.

The studies on cross-border consolidation provided some interesting facts concerning cross-border activity in the last couple of years. Nick Page highlighted the following as the most relevant developments in European cross-border consolidation:

[3] The aforementioned PricewaterhouseCoopers publications are the following: "European banking consolidation", April 2006 and "Financial services M&A. Review of and outlook for mergers and acquisitions in the European financial services market", April 2006.

- There is clear evidence that cross-border consolidation in European financial services is underway (67% in value terms in 2005 as compared to 32% in 2003).
- From a geographical perspective, the UK has been very active in M&A activity among industrialized countries in recent years through large scale transactions, such as the acquisition of Britannic Group by Resolution Life Group. This market was mostly active in terms of number of deals. In addition, other important deals took place in Italy, e.g. ABN AMRO acquisition of Antonveneta and Capitalia acquisition of Fineco.
- The emerging markets displayed a strong growth rate in M&A activity in total value (16% in 2005, compared to 9% in 2004).
- The average M&A deal size in 2005 was around 400 million Euros, 140 millions more than the average M&A deal size in 2004.
- The number of deals over half a billion Euros has increased from 14 in 2004 to 27 in 2005.
- Banking clearly dominated M&A activity scene with 61% in value terms in 2005 (as compared to insurance with 25% and asset management with 9%). Banks have become larger, as a reflection of their profitability and their desire to enter other markets through acquisitions.

It is also important to remark that M&A activity in the financial services grew significantly from 2003 to 2005. However, cross-border deals gained great importance only from 2005. In that period, five elements of the financial services consolidation deserve to be mentioned as highlights:

- **The "second home market"**. Empirical evidence shows that the institutions potentially exhausted the easier opportunities domestically and have looked for new markets abroad, which become key parts of their organization.
- **The search for growth in emerging markets**. Emerging markets have come back into fashion as suitable locations for achieving faster growth. Financial institutions are looking for markets with larger populations and rapid GDP growth, although some high prices were paid. Examples are the acquisitions of BCR (Romania) by Erste Bank and of Bank Aval (Ukraine) by Raiffeisen. Since then, Ukraine has become one of the hottest banking markets in Europe.
- **Restructuring and economic recovery expectations in Germany**. Germany is an important market due to the size of its economy. The profitability in the German banking has suffered in the past for various reasons including its exposure to the property sector. The removal of state guarantees created expectation of possible consolidation, which is occurring at a slow pace.

  Some examples of the restructuring activity are the acquisitions of Eurohypo by Commerzbank and the acquisition of Berliner Bank by Deutsche Bank.
- **The search for scale**. The financial services are largely dependent on scale.
- **The importance of US bidders, particularly private equity firms**. There is a general question as to whether American financial institutions such as CitiBank or Bank of America will acquire key financial institutions in Europe. US bidders have been increasingly prominent in the recent years. Some examples are GE acquisition of Garanti Bank in Turkey, Morgan Stanley acquisition of Goldfish Credit Card and JC Flowers acquisition of NIB Capital in the Netherlands.

Taking a look at **a ten-year time span**, Nick Page highlighted the following facts in banking M&A activity in Western and Eastern Europe between 1996 and 2005:

- From a general perspective, a total of 274 transactions accounting for 682 billion Euros in deals took place between European banks. 390 billion euros were domestic transactions, 158 billion Euros within Europe; and 134 billion euros were cross-border transactions involving European institutions as bidder and non-European targets.
- There has been a significant drop in domestic M&A after the peak in 98–99. Specific examples are Royal Bank of Scotland acquisition of NatWest and Barclays' acquisition of Woolwich. Since then, it has been harder for directors of large institutions to raise capital so easily due to competition authority concerns, concentration, and also to the dynamics of the equity markets.

- After a significant drop until 2003, European cross-border deals resumed an upwards trend in number and value in 2004 and it is likely to continue. For instance, the number of deals rose up to 18 in 2004 and 29 in 2005. The value has been raising particularly over the last two years and generally involved Western European banks -83% of the total. The value of cross-border operations increased from 6 billion euros in 2003 to 20 billion euros in 2004 and reached 38 billion euros in 2005.
- Breaking down the operations by deal size, there has been a relatively small number of very large cross-border transactions[4] until 2003. However, there was a recovery in 2004 and 2005 -14 and 21 very large cross-border deals, respectively-, which certainly stimulate discussions and speculations in the press about more potential cross-border transactions. However, the number of complete majority or control transactions is insignificantly moving upwards.
- Concerning the geographical features of these developments, there is evidence of a significant pickup in cross-border M&A activity in emerging Europe by value, due to macroeconomic, political and other factors. Turkey is an interesting market owing to the large amount of investment attracted and having in mind the size, the population, the EU aspirations and the expected macroeconomic stability. This market is considered to allow rapid entries and to secure quick pay-back. Currently, amongst the most active markets in emerging Europe are Ukraine, Russia and other CIS countries[5].
- In addition, some of the **banks in emerging Europe are deploying in other emerging markets** and are expected to become important cross-border investors. In particular, ATP has been looking in Southern Europe and other emerging markets In Russia, consolidation activity has been active in the banking sector. More recently, Greek banks were seeking to acquire financial institutions in Turkey. Finally, the Bank of Cyprus was making a move in Greece.
- Categorizing **investors according to the target market**, Unicredit, Fortis and ING are institutions who invested mainly in Europe, while Royal Bank of Scotland and Standard Chartered mainly invested outside Europe.Three institutions moved into a slightly different geographic area due to individual transactions. HSBC, a very international institution; Santander Central Hispano, which created greater balance between its investments in Europe and outside Europe after the Abbey National acquisition; and ABN Amro, as a result of its acquisition of Antonveneta.

To conclude the presentation, Nick Page addressed the prospects of cross-border consolidation in European banking:

- European banking sector's M&A activity is expected to remain high.
- Domestic consolidation will take place in Italy, since there is still an opportunity and need for it, after overcoming previous political interference.
- There will be more prominence of private equity in order to take advantages of the consolidation process in Europe.
- Increasing investment in European emerging markets is expected. There will be more institutions seeking for more safety and more exposure to higher growth, bringing along improvements in earnings.
- Greater M&A deals involving the infrastructure of European financial services as a result of mergers between clearing houses and stock exchanges.
- The regulation, e.g. Basel II, MiFID, Solvency II and the internal market put pressure on financial institutions to reevaluate their strategies and their markets. These could provide some impetus but unlikely to be a driver alone.
- Potential need for third parties (private equity firms from the US or elsewhere) to promote further consolidation
- Consolidation poses significant strains and pressure on financial institutions in terms of management stretch, capability and challenge. It is increasingly difficult to manage diverse and complex operations. The markets are extremely focused on delivering synergy benefits, but research shows that most of the growth usually results from existing operations. There are prospects to create value through M&A transactions,

[4] Transactions over 5 billion euros.
[5] Commonwealth of Independent States.

but the cost of entering some of these markets and making these acquisitions get even higher.

*Ingo Walter*
*Seymour Milstein Professor of Finance, Corporate Governance and Ethics; NYU Stern School of Business*

Professor Ingo Walter illustrated the academic point of view on financial services sector consolidation. He first presented the interest of the academic community in M&A from micro and macro perspectives. Stylized facts about M&A activity in the financial services sector were then described. He next detailed the relevant academic findings concerning size desirability according to statistical analysis, CAP (client-arena-product) matrix, cost functions and X-efficiency. , he explained the benefits related to economies of scope and the effects of conglomerate discount on performance. The conclusions made brief remarks on the effects of diversification on results and the impacts of institutions that are too big to fail.

The academic community has been interested in M&As from micro and macro points of view for many years. From a micro-economic perspective, M&As are an effective tool and benchmark to assess corporate development (following the structure-conduct-performance paradigm). From a macro or public policy perspectives,, M&As impact the efficiency of the financial system, which would impact economic growth,

These are **some stylized facts with respect to M&A activity in the financial sector**:

- The global M&A activity involves for a huge part financial services sector.. There was almost $25 trillion worth of M&A transactions in excess of $100 million from 1985 till 2005. Out of that about $10.1 trillion -around 40%- involved financial services, mostly in banking.
- Europe plays a very important role in M&A activity in the financial sector. The US went through a major consolidation wave some years ago and it is possible that much of the consolidation is now behind it. The largest transactions were American and Japanese.
- All of the large banks today have gone through a merger or acquisition in the previous decade. This also holds true for the previous ten years. The institutions were highly unstable at that time, so they performed corporate action through a merger in the best interest of their shareholders.
- Inner-market transactions in banking, securities and insurance sectors dominated the M&A data between 1985 and 2005. By value, these deals represented almost 80% of the total.

Ingo Walter then discussed **the importance of the size of a financial institution in terms of value**, which is an important issue from the shareholder perspective.

- If larger is better, the largest institutions, measured by total assets, should have the largest institutional values, measured by the Price-to -earnings ratio. The findings show that the correlation is random between these measures of size and value . For the top 400 banks, a rank correlation and a straight correlation are statistically insignificant. As a result, **size does not matter in terms of value**. This result holds even if other indicators have been used as alternatives than size to create a valuable franchise.
- However, **the results for insurance companies show more relevance of size in terms of value**. Hence, it is not necessarily true that size is not important or could not be important. The fact is that **only for the banking sector there is no much evidence of it**.
- The **importance of size** can also be **assessed with a CAP (**clients, arenas and products) **matrix**. Every matrix cell has a value coefficient, which depends on the size of that market, its growth rate, the incumbents and the possibilities of entry. This cell is called strategic positioning and determines the opportunity to maximize the value of a firm. The link between cells stresses whether or not economies of scale can be achieved. There are various activities in the financial sector which are highly scale intensive or scale extensive. Economies of scope can be assessed through the choice between particular clients and cross-selling of multiple products. Finally, the

third issue is the decision to offer in cross-multiple environments. That is where the cross-border dimension comes in.

The importance of **size could also be examined in terms of cost functions**. If an institution is small, it has sizeable economies of scale for the whole institution, but these are progressively exhausted as the size of the institution increases. Therefore, the **optimum size of a firm and the point from which economies of scale are exhausted are interesting research questions for economists**. For US banks, several studies showed that economies of scale are exhausted at $7 billion in assets, which is very small. Recently, there has been a study suggesting that economies of scale are depleted at $25 billion in assets, still small.

When looking at large banks, at their average size levels, **economies of scale turn to be depleted relatively early** regarding the size spectrum and they do not account for very much. If average cost levels between the smallest and the largest quintiles of the banks are compared, the difference is only 6% of unit cost. That result points out that **there are other reasons for mergers and gaining size than economies of scale**. This result does not hold for the whole institution, but it may be for a particular function, which raises the question whether economies of scale could arise for particular functions. For example, evidence shows strong economies of scale in custody, asset management and transaction processing, whereas, diseconomies of scale in M&A advisory.

In spite of these findings, economies of scale are used as the reason for M&A deals by managers. Sometimes there are significant economies of scale at the business lines but these results also suggest the existence of diseconomies elsewhere.

**X-efficiency or operating efficiency** is a more important reason for M&A transactions because it allows the merging institutions to eliminate redundant resources through integration of IT systems, elimination of redundant branches etc. These are not economies of scale but efficiency gains.

Evidence shows that the cost difference between the most efficient and the least efficient institution is 20%. Acquiring the least efficient bank by a more efficient one would bring the new entity to a higher efficiency level. Hence, **how a bank is managed comes out to be at least three times as important as pure size**. This shows that a mid-sized institution can operate efficiently and competitively thanks to higher degree of freedom in operating efficiency. Sometimes managers find it hard to disentangle the two.

Another important issue from the shareholder perspective is **whether broader functions and more geographical presence are desirable for earnings**.

- **The academic results showed a positive effect of broader institutions on safety and soundness**. The formal check consisted in testing various combinations of activities for synthetically merged institutions. The findings were consistent with relatively low correlations across these activities. Hence broader institutions are likely to be more stable in terms of earnings. It is an important result from regulatory and rating points of view since it could lead to potential gains in share prices.
- **However, broader institutions have higher costs**, everything else being equal. This is a cost of complexity although the cost function is not particularly steep. If a bank decides that there are some good reasons to become broader, it can take out the cost penalty. The empirical research on cost functions shows strong evidence on diseconomies of scope among large US banks, whereas no available tests on economies of scope yet among insurance companies, securities firms and financial conglomerates. This raises the issue of revenue function, where cross-selling comes in.
- **It is very hard to perform good empirical research on potential benefits of cross-selling**, because it depends heavily on the type of client and product line and could be strongly influenced by the characteristics of distribution infrastructures and technologies etc.

  **A matrix can be put up with all the activities** to determine a potential cross-selling opportunities. One firm has to check whether there is value in that cross selling and whether the provision of the service is viable. Cross selling is complex and it is

difficult to identify potential cross links and to engineer incentive compatible contracts to make both sides of the cross do best for the shareholder. In addition, there is a need to extract maximum possible economies of scope when cross-selling.
- When banks, security firms and other financial institutions want to broaden into other activities, major problems arise with respect to exploitation of conflicts of interests. Potential conflicts are cross-subsidization, stuffing fiduciary accounts, misuse of private information or abuse of fiduciary duty. The big scandals with US banks are a clear example of this risk, since they broaden into insurance and securities within three years and came close to criminal indictments. In addition, all domain transition conflicts may appear and are the most difficult ones because an institution is trying to serve both a wholesale and a retail client.

The last issue addressed in the presentation is **conglomerate discount effect on performance**.

- Conglomerate discounts could exist in non financial and financial projects. Financial conglomerate has to convince the market that its internal synergies can compensate for different businesses acquired for the same amount of stock. When the investor buys a conglomerate stock, he is actually getting a mutual fund that is run by different managers. Thus, **conglomerates have a negative demand impact**.
- On the supply side, the conglomerate can waste money because low net present value projects in a particular business that would not entail immediate punishment by the market for failure owing to the possibilities of cross subsidies within the organisation. An independent company cannot afford that and has to go back to the market too raise capital. The academic literature found conglomerate discount for industrial companies while the results for financial institutions show that functionally diversified firms have both medium and mean market valuations which are substantially smaller than focused firms. Another result is that functionally diversified financial firms sell at a discount of 21% on average. Hence, the experience in industrial firms also applies to financial conglomerates.

To conclude, Ingo Walter addressed the causality relationship of diversification and results, the issue of firms that are to big to fail and summarized his results.

Diversification can be the response to poor performance and at the same time may lead to poor performance. The empirical results show that diversification causes poor performance and not the other way around. However, there is no discount associated with breadth from a geographic as opposed to a functional perspective.

If a firm is too big to fail (TBTF), it creates benefits not only for depositors but also for the shareholders because there is **a safety net**. The empirical results show that the "TBTF" effects are positive and highly statistically significant.

Finally, Ingo Walter warned that research results provide both positive and negative evidence, and one has to look through these issues, since there is no magic answer but there should be strategic integrity.

*Rym Ayadi*

*Research Fellow and Head of Financial Institutions Research Programme, Centre for European Policy Studies*

Rym Ayadi presented the results of an ongoing research report on mergers and acquisitions in European banking[6]. The research report aims at assessing the performance of banking M&A in the EU, while using a geography/activity matrix to help understanding banking performance. She first explained the methodology of the study, and then presented the conclusions and some recommendations.

The methodological aspects of the study are the following:

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[6] Forthcoming in Research Report in Banking and Finance, CEPS publications expected in October 2006.

- The performance to be assessed is defined as the economic performance based on cost efficiency and profit efficiency indicatorsand is complemented with financial indicators.
- The results were tested at least one year before and at least three years after the transaction; in order to have a sufficient time span to assess profit or cost efficiency improvement/deterioration following the M&A transaction.
- This approach is different from what has been done by the literature so far since it **introduces a new approach based on a geography/activity matrix to assess performance of banking M&As**. The matrix comprises the crossing of two criteria that define the M&A transaction: 1) The geographic dimension of the merger or acquisition; and 2) The activity profile of the two banks involved in the transaction. **The first criterion** is based on the location of the headquarters of the banking institutions and allows the assessment of the extent to which partners are pursuing an in/out market geographical expansion strategy. The **second criterion** is based on the activities of the banks before the announcement of the M&A. To assess the focus versus diversification of banking activities, the banks' revenue was broken down into interest and non-interest revenues. Interest revenue is an indication of the traditional banking activities (deposit and loans) and non interest revenue is an indication of other banking activities including market, advisory etc. This breaking down is allowed by looking at the balance sheet of banks involved in the transactions.
- After crossing both criteria, six different strategies based on homogeneous versus heterogeneous activities and domestic versus pan-European M&A were displayed.
- The analyses were performed on a sample of 71 transactions of mergers & majority acquisitions in the banking industry over the period 1996–2000. The selection criteria of the sample were very strict, only looking at mergers and majority acquisitions exceeding the threshold of 49% of voting rights, so that a transfer of control is granted. This study is focused mainly on the banking industry (targets and acquirers are banking institutions as defined in the Second Banking Directive), no insurance or securities firms were involved.
- The cost and profit scores were constructed based on a cost and profit frontiers computed through a non-parametric approach using the data envelopment analysis method (DEA). The construction of the cost and profit frontiers was based on a sample of some 600 non-merging European banks (control group) respecting the same selection criteria as the M&A sample. This allows the identification of an industry benchmark to make possible the positioning of banks involved in an M&A deal.

The **results** on cross-border transactions and performance were displayed as follows:

- There is **no evidence of improvement in cost efficiency for the acquiring bank**, although there is a **very slight improvement for the target**. The targets involved in cross-border transactions are much more cost efficient than those involved in domestic deals.
- The application of the strategy/country matrix shows that **it is much harder to improve cost efficiency when M&As involve different activity profiles**.
- **The results show found no improvements in profit efficiency for the acquirers and for the targets**. Unknown product prices for the industry restrict the robustness of the tests.
- When applying the matrix, **the study shows that it is much harder to improve profit efficiency when the transactions are focusing on the same activity**, which is consistent with the revenue synergies hypothesis.
- These results are consistent when looking at financial ratios, confirming the economic analysis.

In conclusion, Rym Ayadi argued that the M&A diversifying geographies intra-EU15 failed to improve economic and financial performance so far. The sample was limited to M&As announced up to 2000 to ensure sufficient time for the efficiencies versus inefficiencies to materialize. The recent cross-borders M&A over the last five years could show completely different M&As performance patterns. Therefore, the scenario might not be as gloomy as it seems with the results of this study.

The weak effects on cost and profit efficiency might be explained by all obstacles that render obsolete any potential for cost-profit synergies. Unless these obstacles are not tackled, the real motivations of cross-border M&A till 2000-2001 could be seen in relation with motivations such as managerial hubris, defense reaction or herding behavior. Moreover, in the next years, capital synergy motivations should be taken into account and Basel II/Solvency II will deepen these effects.

*Issues addressed by the conference participants*

The participants questioned about **the role of regulatory frameworks in obstructing M&A.** Nick Page believes that regulatory matters do not necessarily obstruct consolidation. Regulation influences the activity at the initial stage and contributes to a momentum. There are many discussions and reports being written on the implications of Basel II and other regulatory measures. The regulation leads to favor certain types of organizations over others since it puts pressure on financial institutions to reevaluate their strategies and their markets.

Professor Ingo Walter stated that, in the academic world, the relevant term for the impact of regulation on institutions is **the net regulatory burden**. Regulation provides a subsidy to the market by setting rules and ensuring a more equitable and trusted market. At the same time, regulators impose a cost of regulation. The net cost of regulation is a balance between the two. When creating a regulatory basis, it is important to **compete for optimal regulation rather than for minimum/maximum regulation**. Sometimes regulation provides opportunities, sometimes costs, but these are not debilitating issues.

The Chairman, Onno Ruding, made some comments on Ingo Walter's presentation. He added that successful diversification is possible but depends on correct selection of products and markets. Additionally, cross-selling works also very well from the risk diversification point of view. Ingo Walter believed that the situation is more complex with respect to risk matters. With the six different types of risks, there are 30 linkages possible. Something that a company does is to prevent that one type of risk can harm another. There is not enough experience with all types of risks, which can cause a problem.

## CROSS-BORDER FINANCIAL SERVICES' SECTOR CONSOLIDATION: OBSTACLES AND ALTERNATIVES

This session consisted in five presentations by Arnaud Pecker (DG Internal Market), Arthur Kerrigan (DG Taxation and Customs Union), Freddy Van den Spiegel (Fortis Bank), Ulrich von Kenne (Association of German Banks) and Michaela Koller (European Savings Banks Group). The presentations' objective was manifold. It addressed the advantages and drawbacks of the consolidation process in financial services in Europe; it identified the main obstacles to cross-border consolidation and the means to overcome these obstacles; and provided specific alternatives to integration in addition to consolidation. The highlights included an in-depth assessment of VAT legislation as an obstacle to consolidation and introduced a new issue to the debate: the ownership structure of savings banks in some EU countries -e.g. Germany.

### *Arnaud Pecker*

*Financial Services Policies, DG Internal Market, European Commission*

Arnaud Pecker, from DG Markt, identified the obstacles to cross-border consolidation based on the main results of the Commission Staff Working Document entitled "Cross-border consolidation in the EU financial sector"[7].

He first introduced the motivation of the Commission's review and put in view some stylized facts concerning the consolidation process in the EU. Then he explained the main obstacles

[7] Available at http://europa.eu.int/comm/internal_market/finances/docs/cross-sector/mergers/cross-border-consolidation_en.pdf

to cross-border consolidation in banking and finally concluded with an overview of the ongoing policy actions.

The Commission’s report was motivated by the Ecofin Council in September 2004. It aimed at analyzing the possible obstacles and reviewing the regulatory weaknesses that can explain the lagging of cross-border consolidation in the EU.

Arnaud Pecker emphasized that **the Commission is neutral with regard to the desirability of more consolidation and ownership regimes**, as long as they are in conformity with the European legal system. Its role is limited to properly reinforce existing EU laws and create conditions for an efficient banking sector.

Accordingly, the Commission’s report only identified the unjustified obstacles that hinder the consolidation process. It also compared domestic and cross-border consolidation within the EU from the internal market perspective, since consolidation has been more intensive domestically than cross-border and this gap deserves attention.

Arnaud Pecker provided the following stylized facts with regard to the cross-border M&A in the financial sector:

- Only 20% of the deals in financial sector were cross-border as compared to 45% in the non-financial sector between 1999 and 2004, in spite of freedom to capital movements and right of establishment.
- Strong structural differences between domestic and cross-border deals arise in terms of targets and bidders. There are smaller targets and more minority undertakings in cross-border deals rather than deals between firms of similar size.
- Cross-border activity differs also across market segments. A larger proportion takes place in the markets area –almost 60% in securities trading and post-trade activities segment– than in the institutions area –20% for banking and 15% for insurance companies.

The results of the public survey on the main obstacles to cross-border consolidation in the EU financial sector addressed all types of obstacles –legal, supervisory, economic and other “soft obstacles”. It also looked at all possible consequences –execution risks, one-off costs and ongoing costs. The survey results are highly representative of the industry due to the large number of replies, 363 (of which 326 individual institutions).

The most relevant impediment identified in the study is **the inadequate cross-border cost synergies** relative to domestic cost synergies. Synergies are insufficient to offset the M&A costs and fail to generate a sufficient return on investment. They are also smaller than those in domestic deals. This lack of synergies is explained by the following drivers:

- Fragmentation of retail markets, related to the difficulties of selling similar products in different domestic markets;
- Divergent supervisory rules and practices, e.g. multiple reporting requirements, divergence of supervisory practices and complex supervisory approval processes;
- Legal impediments to corporate expansion and reorganisation, e.g. taxation on dividends, VAT and other forms of double taxation, employment legislation and legal structures of the companies;
- A discouraging environment, which may dissuade or impede two institutions from undertaking cross-border M&A in spite of their will or agreement; and
- Potential reluctance of consumers or employees to takeovers and acquisitions from foreigner, especially from smaller savings or cooperative institutions.

To conclude his presentation, Arnaud Pecker stated that policy action has been already taken to tackle the unjustified obstacles to cross-border consolidation. The Commission’s initiatives range from the White Paper on Financial Services Policy (2005-2010) and some other initiatives such as the review of Article 15 in the Banking Directive. These policies are much in line with the view of the industry, consumers’ organizations and the national authorities; and provide a good common basis for further policies.

*Arthur Kerrigan*

*VAT and Other Turnover Taxes, DG Taxation and Customs Union, European Commission*

Arthur Kerrigan, from DG Taxation and Customs Union, stressed **the role of the Value Added Tax (VAT) as an obstacle to cross-border consolidation in the financial services industry**. The VAT legislation may discourage cross-border deals through reduction of potential cost synergies. Although the reform of the VAT legislation is extremely complex, first steps have been recently taken by the Commission.

He first described briefly the current VAT legislation (the sixth VAT directive) in financial services and insurance in the EU. The effects of the outdated provisions were then pointed out. To conclude, the potential reforms of the VAT legislation were introduced and the difficulties of their implementation were discussed.

Arthur Kerrigan stated that the VAT application to financial services and insurance is a complex issue and the existing legislation that governs VAT dates from 1977. Its most important features are the following:

- It reflects the state of the industry at that moment, dealing only with operations that existed at that time and were used mainly on a local basis;
- It reflects the knowledge that the government had of the industry;
- It comprises differences in application across Member States; and
- It has never been revisited for many reasons.

The most significant negative effect on cross-border M&A is the reduction or removal of the potential cost savings of centralization. Indeed, when cross-border consolidation occurs, incentives arise to centralize production of some internally consumed services in shared-cost centers of the group in order to profit from cost saving synergies. VAT taxation may reduce and even eliminate these incentives.

In addition, other effects arise in the absence of modernization of the existing VAT provisions:

- Differences in application across Member States create no level playing field and legal uncertainty as regards the scope of the tax and the recovery rates;
- Financial and insurance companies cannot recover VAT on expenditure, which reduces competitiveness;
- Business structure changes to mitigate the costs that VAT accidentally created;
- Increasing need to seek clarification through judicial means rather than through legislation; and
- VAT has become an important revenue source and compensates in many cases the decline in other revenue sources.

Arthur Kerrigan remarked that a high number of significant shortcomings are starting to be revised by the Commission. For instance, the DG Taxation and Customs Union and the European Banking Federation held the public conference “Modernizing the VAT rules for financial services and insurances” in May 2006. This conference addressed the ways in which the EU VAT system can be modernized and simplified to achieve a level playing field.

Based on the results of a public consultation launched by the Commission, five proposals for solving the problems of the current provisions of the VAT legislation are under discussion:

- Zero-rating;
- Extension of the scope of exemptions;
- Uniform linked input credit option;
- Option to tax for B2B supplies; and
- Cross-border VAT bodies.

The latter proposal is particularly important because cross-border VAT bodies can be achieved in many ways, namely through grouping provisions. This strategy attracts investment in the area of back office facilities and eases the convergence of VAT systems.

The presentation closed with a review of the challenges that the revision of the VAT legislation will face:

- The distorting impact of the VAT has become a very useful source of revenue for Member States over the years and it is difficult to renounce;
- The options to change the legislation rely heavily on consensus among all 25 Member States and need active participation and coordination from the financial sector.
- National governments should be aware of the potential efficiency gains for the whole European economy through a VAT reform, notwithstanding the attractiveness of VAT revenues.

*Freddy Van den Spiegel*
*Chief Economist and Director Public Affairs, Fortisbank*

The presentation by Freddy Van den Spiegel highlighted the importance of promoting cross-border consolidation to achieve financial integration in the EU. Special attention was given to the importance of cross-border consolidation to obtain larger optimal size in an integrated financial sector; and the business solutions for consolidation. After an introduction on the close link between integration and cross-border consolidation, the second part of the presentation discussed the importance of the optimal size. The third section pointed out the current hurdles to cross-border consolidation and provided some suggestions on policy measures to tackle this lagging process. Before concluding, Freddy Van den Spiegel described some business solutions for cross-border consolidation. The conclusion addressed the most relevant issues to be discussed in order to promote financial integration.

Financial integration is politically a priority goal and cross-border consolidation serves as indicator of integration and as important tool to achieve it. If cross-border consolidation is slower than domestic consolidation, the normal process of integration can be sped up by tackling the barriers that prevent further cross-border consolidation.

Cross-border consolidation is stimulated by a wide range of drivers, which were broken down as follows:
- Economic ambitions: economies of scale and scope, diversification effects and, more importantly for financial institutions, need for certain size to ensure market access.
- Other ambitions, often more dangerous: CEO's personal ambitions, market power ambitions and national ambitions of governments to create national champions.
- Technology, which increases the fixed costs but reduces the marginal costs; hence, larger scale is encouraged through consolidation.
- At consumer level; converging preferences facilitate cross-border provision of more homogeneous financial services.

As concerns cross-border integration and optimal firm size, Freddy Van den Spiegel argued that the average optimal size is bigger in an integrated market than in a single market and a larger size requires cross-border consolidation. However, approaches to the optimal size are divergent and often inaccurately measured. It differs across regions -according to differences in regulation and culture-, by heterogeneity of sub-business and in time.

In addition, a dilemma for banks arises. On one hand, cross-border consolidation drives more efficiency and allows for larger sized banks to compete in an integrated market. On the other hand, profit possibilities based on inefficient markets could be threatened. However, more efficient markets via integration should be in agenda because the cost of inefficiency is entirely transferred to the consumer.

Freddy Van den Spiegel addressed the hurdles to cross border consolidation and suggested some measures to tackle them. On a general basis, the barriers are the following:
- Diverging regulation restrains and hides the potential synergies from consolidation.
- Nationality discrimination inhibits market access and constraints the optimal size. This is possible through Article 16 of the Banking Directive or national competition legislation or the takeover bid directive.

Accordingly, the political challenge to overcome these obstacles requires:

- Creating a desirable cross-border framework for regulation to get rid of the unnecessary add-on costs for financial institutions;
- Boosting integrated infrastructures for market integration, such as SEPA and clearing and settlement systems;
- Regulation and practical supervisory behaviour organized according to a top down approach (lead supervisor model);
- Allowing optimal cross-border organisation (outsourcing, transfer pricing and exit tax); and
- Eliminating tax-penalties for cross-border organization, such as the ones related to VAT.

In the next section, Freddy Van den Spiegel introduced two business solutions for consolidation: 1) Cross-border banking to customers; and 2) Provision of cross-border services to customers through local intermediaries. In fact, banks are exploring both alternatives since a policy mix for all players and even within institutions is optimal.

In particular, cross-border banks for consumers comprise:

- Cross-border acquisitions under a holding model;
- Real cross-border mergers;
- Greenfield and start-up initiatives; and
- E-Business.

Cross-border financial services provided through local bank and non bank intermediaries are designed to provide different solutions for different segments and different products. They include:

- Acquisition of product components in international markets to create local products;
- Selling of white labelled cross-border products;
- Provision of local access to global markets; and
- Creation of international joint ventures for payments.

To conclude, Freddy Van den Spiegel emphasized that removing unjustified hurdles to consolidation will lead to better competition, more choice and more diversified financial landscape for customers. The European integrated space needs a real debate on the following issues: 1) The role of the financial industry in Europe; 2) The optimal size of institutions; 3) Concentration issues; 4) Financial stability; 5) Competition in relevant markets and finally 5) How to push competition innovation within the European integrated space.

### *Ulrich von Kenne*

*Managing Director, Banking Supervision and Competition Policy, Association of German Banks*

Ulrich von Kenne started his presentation with general remarks on the current facts of the cross-border consolidation in the financial services industry in Europe. The most relevant obstacles to consolidation were mentioned in the second section. The third section emphasized the ownership structure of savings banks and state banks in Germany as a barrier. To conclude, Ulrich von Kenne asked the Commission more impetus towards consolidation in the financial sector in the EU.

The first part of the presentation remarked the following facts concerning the cross-border consolidation process in the EU:

- The EU-banking sector is still behind on M&A when compared with other sectors or the US financial industry.
- M&A should not be an end in itself but a quick and effective way for providing financial services across borders.
- M&A should allow customers to benefit from both a wide range of products and keen competition among providers.
- Removing obstacles is rightly on the Commission‘s agenda.
- The number of legal obstacles to M&A is comparatively small but their significance can be extremely serious.

- Indirect obstacles are much more numerous and are driven by certain rules and regulations which make M&A deals unprofitable. In particular, M&A may become an unattractive proposition due to the fact that much of the EU legislation is actually based on the concept of minimum harmonisation and the country of origin principle.
- There is little evidence of application of Article 16 of the Banking Directive for protectionist purposes; hence, it cannot be considered a major explanation to lagging European consolidation.

Secondly, Ulrich von Kenne addressed some specific obstacles to cross-border consolidation and provided measures to overcome them:

- **Insufficient harmonisation of the supervisory framework.** It is related to the Capital Requirements Directive and it creates is a danger of diverging interpretation by national competent authorities. The work of the Committee of European Banking Supervisors (CEBS) is therefore important to overcome this situation through harmonization or convergence. Developing the idea of "lead supervisor" and a system of mutual recognition among supervisors are desirable initiatives.
- **Consumer protection rules.** They are generally excessive civil-law formalities designed to protect consumers and place an excessive burden, as they vary from one Member State to the other and prevent standardization of business processes company- or group-wide.
- **Current taxation laws of earnings**. It poses a permanent obstacle to cross-border groups and should therefore be amended so that loss offsetting for tax purposes between parent companies and subsidiaries is also possible across borders in the future.

As strongest point of the presentation, Ulrich von Kenne claimed that public ownership of large parts of the German banking industry is an extremely serious obstacle to consolidation in the European banking sector, given the large size of the German market.

Section 40 of the German Banking Act contains the following restrictive provisions:

- Since the savings banks law stipulates that Landesbanken and Sparkassen must be state-owned, the largest sector of the German banking industry is completely excluded from mergers or acquisitions by foreign banks. The only exceptions are the Freie Sparkassen.
- Selling Landesbanken or Sparkassen (state banks or savings banks) is not allowed due to national law, even if the owner agrees on selling. Cross-border consolidation is ruled out from the outset, so there can be no question of any misapplication of Article 16 by supervisors.
- It reserves the name Sparkasse for state-owned banks, so it prevents privatisation efforts in the savings banks sector and necessary modernisation of the German banking market.
- It contravenes freedom of establishment and freedom of capital movements since it allows only state-owned institutions to continue to use the name Sparkasse.
- It effectively walls off the state-owned banking sector from competition from other EU-Member States.

Ulrich von Kenne closed his presentation calling the Commission to give more impetus to this process in addition to its role as referee, since cross-border consolidation is very necessary for the European industry and economic growth.

### *Michaela Koller*

*European Savings Banks Group – World Savings Banks Institute*

Michaela Koller presented a provocative response to the approach of other participants in the industry to cross-border consolidation based on the results of the study on consolidation undertaken by the European Savings Banks Group. The first part of her presentation criticized the idea of cross-border consolidation as the only valid strategy to achieve financial integration. The potential negative side effects of cross-border consolidation were detailed in the second part. The third section provided specific alternatives for integration. The conclusion emphasized the desirability of a pluralistic market, where different business models coexist and not only cross-border banking prevails. Finally, a short remark on the discussion on ownership structure of savings banks and state banks in Germany was made, in response to a previous presentation.

Michaela Koller argued that cross-border consolidation is no panacea for achieving higher levels of integration in Europe's banking markets. It is an indicator of integration, but not the only one. Additionally, there is no guarantee that more banking consolidation will necessarily lead to a more efficient or a more competitive banking sector with larger benefits for the European economy or its citizens.

The second section of the presentation addressed various several **potentially negative side effects that could materialize with increased cross-border consolidation**, such as:

- **Increased risk of market power concentration** in the hands of a few large multi-national institutions.
- **Risk of price increases.** It is more likely because cost efficiency in cross-border deals is less likely due to a wide range of reasons.
- **Increased risk to the stability of the banking sector**. The authorities and the tax payers bear the ultimate responsibility in a crisis due to the formation of large cross-border mega-banks via M&A. These banks imply a challenge for banking supervisors at the national, European and global level because they include the specific challenge of increased centralization of functions of big cross-border banks or large banks that become "too big to fail". This issue should be sufficiently discussed in the public debate.
- **Increased risk for access to finance to SME.** There is evidence of a decrease in funding to SME due to M&A. In addition, large and centralised banks are in general reluctant to finance SME in both EU and US. This issue is only tackled by the ECB, some US institutions and DG Enterprise at the European Commission.
- **Increased risk for access to finance to households**. Business strategies of cross-border mega banks may lead to closure of branches and other measures, which exclude financially lower-income consumers or consumers living in rural areas.

Before concluding, Michaela Koller sketched out the following **alternative strategies to consolidation**:

- Organic growth;
- Commercial alliances between institutions;
- Outsourcing or in-sourcing of back-office operations;
- Use of distribution channels to resell products and services sourced from competitors;
- Creation of infrastructures (e.g. payment clearing and settlement systems) with competitors; and
- Development and implementation of standards at national and/or international industry level.

In conclusion, Michaela Koller remarked that the overall policy objective should be a pluralistic market where large, consolidating, cross-border mega-banks exist alongside other players, such as proximity banks.

Regulators should consider that there is a complementary place in the market for non cross-border consolidators and should also acknowledge the risks of cross-border consolidation. Finally, regulators should not favour unilaterally one and only business model.

The last remark of this presentation was related to the issue of savings banks in Germany. Michaela Koller claimed that other banks, like ING Direct or Citibank, managed to enter the German market notwithstanding the German commercial banks complains about the barriers to access. In addition, she claimed that the German "three-pillar structure" achieved important benefits for German consumers and therefore no intervention in this structure is considered at European level.

Finally, Michaela Killer argued that the German government, as owner of the savings banks, simply does not have the intention to sell. However, since this issue is highly relevant in European circles, an in depth debate may be desirable.

## IS CROSS-BORDER BANKING A REALITY? ISSUES ADDRESSED BY INDUSTRY EXPERIENCES

The opening afternoon session displayed first a comprehensive outlook of the general restructuring process in the European banking industry through the presentation of Olivier Pastré, from Université de Paris VIII and IM Bank. Then, the presentation by Peter Tils, from Deutsche Bank, clarified successful alternative ways of expansion and adjustment in new markets, besides cross-border consolidation. From a different perspective, evidence of successful consolidation process was provided by Luc Popelier through the experience of KBC also in Central and Eastern Europe. For the final presentation, Dominique Graber, from BNP Paribas, remarked the role of cross-border consolidation to achieve further integration, specifically in retail banking, and emphasized its relevance for the future competition scenario with US banks in Europe.

### *Olivier Pastré*

*Université de Paris VIII and IM Bank*

Olivier Pastré presented his impressions on the restructuring in the European banking industry based on his recent publication[8]. The first part of the presentation showed some stylized facts of the restructuring process of the world and European banking sector. A rigorous analysis of the key theoretical debates in banking was developed in the second section. The possible scenarios in the forthcoming years for the European banking industry concluded the presentation.

Olivier Pastré believes that the analysis of the restructuring of the European banking industry must be carried out on a world-wide level and should be based on an in-depth understanding of the general developments in the world banking industry. Accordingly, Olivier Pastré characterized its most relevant features as follows:

- The ranking of world banks is changing every ten years.
- In the nineties, Japanese banks led the ground by their asset size, but they handed over the lead to American banks due to the Asian crises. It is expected that Japanese banks will come back to lead in the next ten years.
- After being archaic and uncompetitive a few years ago, American banking sector is leading the industry and would dominate the European market in next few years.
- The European banking industry is moving according to three forces. In two countries, England and Spain, banks are concentrated and have good stock market valuation. In Germany and Italy, banking sectors are poorly concentrated and hold low levels of profitability and market value. Finally, the rest of the countries are resting in between.

In addition to a thorough understanding of the banking sector developments, further progress in the debate of restructuring in banking industry needs the analysis of the relevant theoretical debates. According to Olivier Pastré, the following theoretical issues deserve special attention:

- The recent **regulatory changes** should deserve more attention. Indeed, the International Accounting Standards (IAS) and Basel II are expected to modify deeply the product mix of European banks in the coming years. Additionally, they will lead to a deepening of the heterogeneity of banking activities.
- **Markets' led issues**: European wholesale markets need to develop financial innovation. In retail banking, the margins are persistently decreasing which would jeopardise future profitability. Additionally, there is a concern of financial exclusion in terms of means of payments and deposits.

  These problems must be tackled with the relevant market and policy actions.
- **Products**: There is a concern of the mounting importance of operational risk and risks related to credit derivatives in Europe. Moreover the latter activities will be increasingly dislocated in Europe, although the process is not as intensive as in the US.
- **Protectionism**: it can determine the most convenient pace of restructuring in European banking.

[8] La Très Grande Bagarre Bancaire Européenne E. Jeffers et O. Pastré, (2005).

- **Mutualism**: the process of mutualisation in Europe makes banks behave like traditional banks.
- **Corporate governance**: recent crises have shown that banks, and especially universal banks, are in a difficult situation.

Oliver Pastré argued that European banking restructuring started with a domestic based consolidation process, which becomes cross-border recently. However, some cross-border deals were simply designed to diversify the range of activities of the institutions involved, as it is the case for Banco Santander and Abbey National. For that reason, the real European banking battle is only beginning and will intensify in the next years. Regulators should be well aware of that.

Accordingly, Olivier Pastré outlined the potential forthcoming scenarios of consolidation in the world and European banking industry.

- **The American "razzia"** refers to the possibility of EU banks being absorbed by large US banks. This would change completely the European banking industry and the financing of national economies. This has not occurred before since the US market was under restructuring and also because US banks were focusing on other markets for M&A.
- **The selective market opportunities for HSBC**. HSBC is the only institution with both local and global presence. In Europe, there are many opportunities for this bank.
- **English banks** can be both bidders for European banks and targets for US and European banks.
- **The "mutualist Europe"**. The continental Europe banking industry is mostly mutualist. Mutual banks do not behave like other institutions and they operate by successful partnerships with other banks. However, mutual banking creates alternative ways to M&A in order to create Europe's banking.
- **The world wide leader in asset management**, led probably by Swiss financial institutions.

To conclude, Olivier Pastré stated that the future in the banking industry is likely to be a mix of these five scenarios described above. Many cross-border operations are expected and they will affect competition and financing of the economy, given that continental Europe banking is still an intermediated sector. The European Commission should put more emphasis on economic aspects because the financing of the economies is a crucial issue, in which banks play an important role.

*Issues addressed by the conference participants*

Participants addressed **the role of size in managing big banks**. Olivier Pastré remarked that banking is a diverse business nowadays; its activities differ in terms of economies of scale, barriers of entry, revenue, risk, possibilities of industrialization, etc. Hence, product mix and the organization determine bank managing, rather than size. For instance, decentralization has proved to be an important organizational strategy in many large institutions and contribute to their success, such as the French mutual banks.

The Chairman remarked that growth strategies to gain size have an impact on managing large banks. In addition, big banks are in general institutions with great experience in the market, which eases their managing.

Participants also addressed the issue whether **brands affect banking strategies**. For Olivier Pastré, the decision on branding is a marketing task. In addition it varies enormously across firms, so there is no only scenario.

### *Peter Tils*

*CEO Central and Eastern Europe, Deutsche Bank AG*

The presentation of Peter Tils focused on the internationalization process of Central and Eastern Europe (CEE) through the experience of Deutsche Bank. The presentation clarified successful alternative ways of expansion and adjustment in new markets, besides cross-border consolidation.

He first displayed the drivers of internationalization in the CEE countries, which differ from those in cross-border consolidation; then the strategies used in these markets were briefly depicted. Secondly, he gave a picture of the prospective acquisitions in the CEE market and finally illustrated some measures to streamline the presence of institutions, such as Deutsche Bank, in these markets.

It is important to acknowledge that the restructuring in CEE banking sectors has led to high levels of international presence in their domestic markets. This internationalization process was triggered by different drivers, such as the lack of capital, products and knowledge in terms of IT, credit, etc. These grounds may significantly differ to those which rule cross-border consolidation.

Once the internationalization process starts, new institutions' strategies in those markets require adjustments in terms of product provision and legal entity according to the market needs. As for, products' strategies Deutsche Bank relied on investment banking products, e.g. structured products for the local banks, asset management, structural financing for highways, etc. With respect to legal entities, they had to differ according to the structure and the size of each entry country.

Since CEE markets still show growth potential, there are several potential acquisitions in the forthcoming years. Peter Tils gave a picture of them according to sectors and markets:

- **Sectors**: Expansion of retail branches is boosted by the market profitability and size. The example is the acquisition of Romanian BCR by Austrian Erste Bank at a high price-to-book multiple.
- **Markets**: Russia is the biggest market by far, since 90% of the banking assets are owned by public banks and local investors. There is no lack of capital; therefore the restructuring is likely to be different to that in other CEE countries.

To conclude, Peter Tils remarked some worthwhile measures to enhance profitability in the region in the Deutsche Bank´s case. These measures include:

- Streamlining the legal entities in every country;
- Achieving certain structure to enlarge business opportunities;
- Mitigation of legal and regulatory exposure;
- Reduction of government bodies;
- Establishment of new branches; and
- Consolidating different corporate cash entities rather than buying big banks.

*Luc Popelier*
*General Manager, KBC Group*

Luc Popelier described how KBC, a purely domestic financial group, turned into one of the largest franchises in Central Europe through successful cross-border deals in CEE countries. He first detailed drivers for expansion through M&A; then addressed the criteria for location choice and the tactics used to enter those markets. Finally, he concluded with a description of the current situation of KBC in CEE countries and an overview of the transformations KBC.

KBC is a result of a merger of three Belgian institutions focused on domestic market. KBC's expansion to CEE countries was motivated by the following drivers:

- Small size of the Belgian economy and slow growth of its financial market, due to high concentration;
- Western Europe's markets are largely saturated and the acquisition prices are high for a medium-sized player like KBC;
- CEE countries allowed for early entry at acceptable prices;
- Large market shares were easier to acquire, due to the small size of these markets; and

- Large growth opportunities in the region because of the double leverage effect triggered by the region's strong economic growth and the low penetration of financial markets.

When financial institutions embark on expansion through M&A operations, they need to choose target location and institutions. As for location, KBC chose countries characterized by a strong probability of EU accession, in order to reduce legal, market and economic risks, an attractive macroeconomic growth and a stable legal and political environment.

As concerns the target institutions' profile, KBC targeted banks which a) have a relevant market share, generally above 10%, in order to profit form economies of scale, b) are able to add value and c) enjoy a manageable restructuring process according to the experience of the bidder. When targeting insurance companies, KBC sought those which a) are able to develop a banking network, according to the bank-insurance model of KBC; and b) have a relevant market share for non-life insurance as platform, because of organic growth possibilities.

In addition, expansion involves a well-addressed tactics' selection. In view of KBC's experience in CEE countries, Luc Popelier provided an overview of the following strategies:

- **Phased expansion**. It means that growing from minority to majority stakes minimizes risks by buying small banks having potential growth at initial stage. Further growth is accomplished through branches.
- **Greenfields**. It relies on organic growth through branch openings and recruitment of agents. Since it is a slow process and it hardly obtains large market shares and large scale effects, this approach is seldom used in retail and SME banking.
- **Big bang**. It consists in buying a large domestic institution with great experience to obtain market share. It implies a risk of low returns of investment although there may be economic of scales to exploit.

To conclude, Luc Popelier provided evidence on the ranking based on total assets (second after Unicredit/HVB) of KBC in the CEE market. This evidence is a good example of the transformation through a large consolidation process into one larger cross-border institution operating mainly in the CEE. This transformation illustrates a scenario of the importance of new locations and major organizational changes through the process of expansion.

### *Dominique Graber*
*Head of European Public Affairs, BNP Paribas*

The presentation of Dominique Graber stressed the importance of overcoming the obstacles to cross-border consolidation to boost financial integration and be prepared for future competition with American banks in the retail banking area. She first provided a comparison o of the developments of EU and US baking industries in the nineties and then addressed the current state of consolidation in the EU according to business lines. The obstacles to integration of retail banking markets and potential means to overcome them were finally described.

The comparison of the developments of the US and the EU banking industries allows to identify what lacks the EU market and how can the consolidation process go further. These are the main points to characterize the banking sector evolution in the aforementioned areas.

- It is easier to make standard rules in the US than in Europe although the US is a very regulated and protectionist market.
- Although the number of credit institutions decreased about 40% in both US and Europe, major retail interstate banks emerged in the US and not in Europe.
- Concentration in Europe has been merely domestic and therefore the size gap is still huge relative to the US.
- M&A in Europe have been mainly domestic based due to many obstacles. A change is not likely in the short term, because the largest part of synergies come from large overlapped in-front and back-office operations. In cross-border deals, synergies come rather from revenues and the synergies of costs come from improvements of the processes (back-office costs, procurement costs, IT, etc.)

- Two American banks are already able to acquire important European financial institutions. American banks are looking for opportunities in retail banking in Europe and in emerging market economies, which may threaten European banks.

The European financial integration process is heterogeneous across business lines. Dominique Graber made the following overview of the current state of the integration process for each area, which creates scope for debate on the potential challenges and policy initiatives on a more precise basis:

- **Corporate and investment banking;** it is already a global market. The remaining issues are merely the dislocation of activities due to regulatory competition;
- **Asset gathering;** Europeanization is in progress, since the obstacles identified by the industry are starting to be overcome through EU policies;
- **Retail financial services;** multi-domestic players have emerged in several EU countries through branching and acquiring other local financial institutions; and
- **Retail banking**; is still a fragmented market and this discourages the provision of standardized products across countries.

Accordingly, Dominique Graber acknowledged that integration of retail banking markets through consolidation faces several obstacles in the EU, which can be potentially overcome by policy measures: There are the most relevant barriers and means to overcome them:

- **Supervisory matters**; avoid supervisory burdens, supervisor of the parent company should be fully empowered to conduct the entire prudential supervision within the EU
- **Tax issues**; heterogeneous tax treatment distorts the design of the product; and different treatment of personal income tax is a difficulty for companies to attract the best people. It is desirable to changes VAT treatment of financial services in order to facilitate tax treatment harmonization.
- **Consumer protection rules**; it drives national segmentation of markets and restricts economies of scale, competition and innovation. Harmonization across the EU is the way to go; and
- **Differentiation between equity and non-equity based banks**; it grants privileges to non-equity based banks and thus creates non level playing field. These privileges should be removed.

Dominique Graber concluded by highlighting the need to remove the obstacles because the integration of retail banking markets through cross-border consolidation is an emergency. There is no much time left until American banks start to gain presence in Europe, which is likely to change significantly the financial landscape in the continent at the expense of European banks.

*Issues addressed by the conference participants*

The first participants' question addressed **the motivations and ways for commercial banks to engage cross-border M&A even though there are still barriers and evidence of market fragmentation**. Luc Popelier claimed that undertaking cross-border activities is a process driven by the need of potential growth opportunities. Another reason is the search for products and processes to add value for consumers. KBC is an example of this model in CEE countries. For Dominique Graber, the industry only wishes for a fair retail banking market, as in the US. Additionally, M&A are a valuable tool to avoid being swallowed by foreign banks in the future.

The second question discussed **the importance of different banks and different banking models for European customers' choice**. Luc Popelier related to his first answer and claimed that banks, like KBC, add value in terms of products and constant innovation to meet the necessities of consumers. Thus, cross-border consolidation is an appropriate way to deliver them.

The final question addressed the reason **why the potential acquisition of European banks by US institutions has not happened before**. Dominique Graber argued that American banks were for years focused on domestic market issues, such as compliance issues and regulation. This stopped the external growth move, but now American and other emerging economies financial institutions are looking for market opportunities in Europe.

## EMERGING POLICY ISSUES

The last session of the conference addressed potential and ongoing policy issues in response to the recent developments in financial integration and consolidation in the EU. Arvind Wadhera, from DG Internal Market, presented the policy initiatives by the Commission to improve the supervisory framework for cross-border acquisitions. Helena Larsson-Haug, from DG Competition, illustrated the role of competition policy on cross-border transactions. The role of the European Parliament and some important policy challenges ahead were addressed by Ieke van den Burg, MEP. Panagiotis Strouzas, on behalf of the ECB, closed this afternoon session with a focus on prudential issues, policy changes and initiatives for EU policy makers, emphasising on the presence of cross-border financial groups and financial stability issues.

### *Arvind Wadhera*

*Deputy Head of Unit Banking and Financial Conglomerates, DG Internal Market and Services, European Commission*

Arvind Wadhera presented an outline of the changes that the DG Internal Market will propose to the assessment procedure of cross-border acquisitions[9]. After an introduction of the role of the DG Internal Market on this issue, he identified the limitations of the current supervisory framework, and then drew attention to some initiatives to improve the prudential assessment process for M&A.

The DG Internal Market's role is to achieve improvements in terms of legal certainty, clarity and transparency in the supervisory approval process of cross-border transactions and acquisitions in the banking, insurance and securities sectors.

Under the current supervisory framework, there is a scope for national authorities' discretion in accepting, discouraging or even rejecting economically justifiable proposals of acquisitions. Indeed, there are neither clear criteria nor detailed procedure for assessing the suitability of the acquirer.

In order to achieve more legal certainty, clarity and transparency in the criteria and procedures for the prudential assessment, the Commission launched public consultations and several competent working groups delivered various possibilities of legally binding resolutions to improve this procedure. Here are some initiatives

- Introduction of clear notification and decision making process;
- Shorter deadlines during the examination process;
- Limited use of stopping-of-the-clock under clear and specific conditions; and
- Clear and fully harmonized criteria to assess the suitability of the acquirer throughout the EU.

To conclude, Arvind Wadhera highlighted that the efficiency of these changes requires cooperation between national supervisors and should avoid ambiguity about bureaucratic and final decisions. In addition, no proposal should drive additional costs for any party concerned, because it is a crucial element to ensure the smooth functioning of the internal market.

### *Helena Larsson-Haug*

*Deputy Head of Unit Mergers, DG Competition, European Commission*

Helena Larsson-Haug focused her presentation on how DG competition is looking at cross-border transactions. Usually, cross-border mergers raise limited competition concerns.

[9] The Commission proposal was released on 12 September 2006, for more information http://ec.europa.eu/internal_market/finances/cross-sector/index_en.htm#obstacles.

Possible concerns only occur if significant overlaps arise in some national markets but the Commission has not always jurisdiction for these transactions.

These are the main issues addressed in the role of DG Competition:

- Its services deal with around 300 cases on average each year and about one third of all mergers notified to the Commission are cross-border.
- A particularly strong trend of cross-border cases is taking place in services, including telecommunications, transport, energy and banking.
- Recent cross-border mergers in the banking sector raised no significant competition issues, such as Abbey National – Santander Central Hispano, BNL - Banca Antonveneta or Unicredito – HypoVereinsbank.
- Its role is mainly to ensure undistorted competition in the internal market and benefits for consumers and to contribute fostering the integration of European market according to the principle of open market economy with free competition.
- Articles 81 and 82 of the EC Treaty and EC Merger Regulation are the tools that its services can use. In addition, national competition authorities can intervene as an instrument and second regulator.
- The EC Merger Regulation (ECMR) allows the Commission to veto mergers of Community dimension.
- ECMR establishes a threshold system and no national competition authority can intervene with a case dealt with by the Commission. It is yet possible to transfer a case under certain circumstances related to other interests than competition, to public security, plurality of the media and prudential rules and to other possible public interests.
- In retail banking market, national authorities are more involved than the Commission because it is a narrower and national scope.
- Member States showed recently interest in circumvent indirectly the Commission's clearance in merger decisions or have gone through longer supervisory processes.
- Once ECMR decisions are taken, Member States cannot adopt measure which could prohibit or prejudice de jure or de facto the transaction.
- Exceptions are interpreted narrowly, they must be necessary and proportionate to the legitimate interest pursued and they cannot be decided unilaterally by Member States without notification to the DG Competition.
- If a Member State is in breach, the Commission adopts decisions requiring the Member State to refrain from invoking the measure. This decision is directly applicable and can be invoked directly before a national court.

As conclusion, Helena Larsson-Haug stated that competition policy plays an important role in Europe, thus the Commission will continue to use its role as referee to monitor and look at the behaviour of Member States' policies and to enforce the legal instruments, i.e. ECMR and the single market rules.

### *Ieke van den Burg*

*Member of the European Parliament, Committee on Economic and Monetary Affairs*

The speech of Ieke van den Burg put forward some conclusions of the report of the European Parliament on cross-border consolidation in the EU financial sector and addressed the challenges ahead.

- The European Parliament urged the Commission to set up a "group of wise men or women" in the short term to discuss the issues of creating European supervision and enhancing better cooperation.
- It is important to build a strong supervisory framework for this globalized sector as a worthy counterpart with the big players.
- Since anticipation and proactivity are needed to take provisions, supervisors are preparing models of crisis in cross-border banking and possible reactions to simulated events.
- At political level, measures cannot be taken on a national basis. Opportunities to get strong counterparts and to have a strong vision for the general interest should not be wasted.

- The national interests should be organized also at European level to counteract possible influences from the other side of the Atlantic, since cross-Atlantic mergers started to be an important issue to tackle from a supervision perspective.
- The European Parliament invited Commissioner Charlie McCreevy to discuss the possible scenarios and conditions that may arise under this new framework and what to do to prevent possible distortions.

*Panagiotis Strouzas*
*Head of Financial Supervision Division, European Central Bank*

Panagiotis Strouzas made an overview from the ECB's perspective of the developments and prospects of the cross-border consolidation process in the EU and focused on the prudential issues, policy changes and initiatives for EU policy makers. The main message highlighted the importance of fully exploiting the current framework and only to take on alternatives once this framework fails to address the current challenges of the industry.

A summary of the current situation of banking consolidation was first presented, then the positive and negative effects of consolidation were addressed. To conclude, policy challenges and initiatives for EU policy makers with respect to financial regulation and supervision, monitoring financial stability and crisis management arrangements were discussed.

The **current state of banking consolidation** in the EU and the euro area can be characterized by the following facts:

- Even though the number of banks fell in the EU and the euro area, consolidation continues at a decelerating pace mainly due to the decline in domestic M&A deals since 1999.
- Cross-border consolidation in financial services has been limited as a whole but increased its activities in 1999-2005.
- In 2005, M&A in European financial services increased significantly (73%) and gained a large share in the total value of deals (66%).
- By market segment, the largest proportion of deals took place in the securities trading and post-trade activities in 1999-2004, whereas the banking industry only accounts for 20% of the total value.
- There are large differences between individual Member States. Cross-border consolidation is more important in the new EU Member States whose banking sectors are characterized by high levels of foreign ownership.
- Intra EU cross-border transactions are far more intense than in any other geographical area.
- As an overall result of cross-border consolidation, there are currently more than 40 EU banking groups present in up to 17 Member States and the 14 largest groups account for almost one third of total EU banking assets.

Many internal and external factors may advocate for more intensification of cross-border consolidation. Hence, intensified cross-border banking consolidation leads to substantial positive implications for financial integration, economic growth and financial stability. In parallel, it may also render national financial systems more prone to common shocks and financial disturbances across borders.

It is essential to ensure that the EU framework for financial regulation, supervision and stability is fully prepared to respond to the greater possibility of intensified cross-border risks by taking due account of spill-over effects and contagion risks.

The ECB looks at the necessary policy responses to the challenges concerning regulation. They should focus on the removal of the obstacles to cross-border consolidation and provide effective arrangements for financial supervision and stability, for dealing with large complex cross-border groups in more integrated markets.

Policy initiatives are designed to obtain regulatory convergence, convergence of supervisory practices, streamlined supervisory interference via co-operation and reduction of reporting burden.

**The following policies to eliminate possible obstacles and to obtain regulatory convergence are under way**:

- The revision by the Commission of the Article 16 of the Banking Directive on the supervisory approval processes for cross-border M&A. It will ensure a fair, transparent and consistent way of supervisory approval process.
- The revision of the provisions in the Insurance and MiFID Directives, in order to ensure cross-sectoral regulatory consistency.
- The initiatives of the Committee of European Banking Supervisors (CEBS) to ensure convergence towards best practices in the implementation of the revised rules.
- The effective implementation of the revised capital requirements directive with particular attention to the home-host interaction, implementation of Pillar II and management of liquidity risk at group and subsidiary level.
- Effective implementation of the CEBS guidelines at operational level in a consistent way, with the collaboration of cross-border groups.
- Support for the financial regulation and financial supervision objectives and priorities for policy action until 2010, as defined in the Commission's White Paper.
- Enhanced transparency via consultations, further harmonisation and consistent and timely implementation of EU regulation.

**Supervision policies should improve the efficiency of the supervisory framework and enhance supervisory cooperation and convergence**. These are some ECB proposals and challenges on this issue:

- The current institutional set-up should be exploited to the maximum possible extent. The Lamfalussy framework should expand across all sectors to cope with challenges stemming from banking and financial integration. It should be fully exploited to show its potential before other far-reaching solution is to be implemented. In 2007, an assessment that determines whether the Lamfalussy approach and the institutional setting deliver what is expected or alternative solutions must be considered.
- Consideration to the following current initiatives: 1) The Financial Services Group report, for further developing and using existing tools of "level 3" committees to achieve supervisory convergence within a predefined timeframe; 2)The conclusions by the Council of Economic and Finance Ministers; 3) Reports by the European Commission, the Inter-Institutional Monitoring Group and the European Parliament.
- If possible alternative arrangements are required after the assessment year in 2007 one important initiative is the concept of "lead supervisor". Panagiotis Strouzas remarked that it is important that the current supervisory framework serves as a safety net and, although appealing for financial groups, it is very difficult to implement, since its introduction would go clearly beyond the present legal setting.
- One alternative to the concept of lead supervisor is the establishment of a European System of Financial Supervisors. A second alternative is the establishment of an "observatory", as independent institution of national regulators, to oversee the development of systemic risk of banks in Europe and the behaviour of national supervisors with respect to discriminatory practices, transparency etc. The third option is to extend the responsibilities of the consolidating supervisor beyond the ones provided for in the Revised Capital Requirements to encompass Pillar II and Pillar III.
- Centralized supervision could provide similar potential benefits as compared to the lead supervisor concept. However, centralized supervision is a far reaching approach because it drives both political and legal implications and implies several structural changes in the institutional framework.

Concerning **financial stability monitoring**, there are several reports published by some institutions, such as the Economic and Financial Committee/Financial Stability Table (EFC/FST), the ECB's Financial Stability Review or BSC annual report on the EU banking sector's stability.

With respect to **crisis management**, it is a priority to strengthen arrangements for cross-border co-operation and test them on a regular basis.

Finally, the **Emergency Liquidity Assistance arrangements** are a central banking function to provide support in exceptional circumstances and on a case-by-case basis to solvent and temporarily illiquid institutions and markets. They are in place within the Eurosystem to ensure an adequate flow of information, in order to manage any potential liquidity impact. It is a national competence, since it is based on the role of the national bank, and there are no specific issues that need to be addressed in the post-FSAP era.
*Issues addressed by the conference participants*

The first question addressed **the changes in the Article 16 of the Banking Directive proposed by the Commission with respect to the supervisory primacy in case of disagreement on an M&A operation**. Arvind Wadhera first highlighted that cooperation is required among supervisors in the assessment process in order to avoid confusions on decisions and to ensure decisions are taken under similar criteria. In any case the decision is to be made by the target supervisor.

The second issue tackled **the interaction between competition concerns and the inclination towards mega bank groups by the private sector and the competition authorities**. Ieke van den Burg pointed out that oligopoly is becoming dominant in many countries and the policy response is more demanding than that to usual competition issues, so this issue can be tackled in the European Parliament through the comments on the White Paper.

Panagiotis Strouzas first acknowledged that consolidation is a market-led process, where banks are continuously seeking larger size, which could influence the possible inclination towards big banking groups. The EU framework for financial supervision and stability should be prepared for that scenario. The Lamfalussy approach should be exploited before any other solution is sought. Additionally, national central banks and the ECB should continue monitoring financial stability implications. Crisis management arrangements should be strengthen and tested, in order to ensure that in case of crisis in M&A, there are tools available to use.

Finally, Helena Larsson-Haug answered from a competition perspective. She claimed that cross-border mergers are treated by the DG Competition when they create competition concerns just as other mergers are. If the work is done properly at competition level, there is no scope for market dominance. The role of national supervisors should not be discussed in these terms, because they have to look at other issues than competition. The Commission's experience shows that the transactions did not raise issues of concern in terms of competition so far.

## CONCLUSIONS OF THE CONFERENCE

The conference organized by CEPS and PricewaterhouseCoopers LLP on cross-border consolidation in the financial services industry in Europe provided the following conclusions to the debate.

***The salient facts on cross-border consolidation in the European financial services landscape:***

- Cross-border consolidation in the European financial services sector has become more important recently due to large transactions in the past five years and the fall of domestic deals.
- Public consultations carried out by the European Commission concluded that the consolidation process is still lagging and requires stimuli.
- The process is no longer dominated by the Western European countries, since the most dynamic area is located in Central and Eastern Europe and these banks are starting to take greater initiative.

***The main drivers and obstacles of cross-border consolidation:***

- The motivations of cross-border deals are generally related to size and domestic market limitations. Even though the industry considers that growth opportunities are most important and that certain company size ensures good performance, some empirical evidence contradicts this belief and favors an efficient organization.
- Regulation plays also a significant role in boosting cross-border consolidation, since its provisions affect the financial institutions' decisions on business and expansion strategies.
- To a lesser extent, cross-border transactions are encouraged by technology stimuli to gain larger scale and personal or government ambitions.

The main obstacles to cross-border consolidation were highlighted by market participants in a survey launched by the European Commission in 2004:

- The lack of cross-border cost synergies are due to: a) fragmentation of retail markets; b) diverging supervisory rules and practices; and c) impediments to corporate expansion and re-organisation.
- Other hurdles are linked to an unfavourable environment due to political interference and also due to individual reluctance from consumers or employees.
- It is important to acknowledge that the relevance of these barriers depends on the development of each business line. In particular, the retail banking sector is the most problematic sector due to high market fragmentation.

***Alternatives to cross-border consolidation:***

- Other financial institutions, such as savings banks defend alternative models of integration, in addition to cross-border consolidation, and reject favoring an only business model to drive financial integration. This position is based on the belief that benefits of cross-border consolidation are still uncertain and its negative side effects are potentially very costly for consumers and SME, particularly.
- Financial institutions may enter new markets through the provision of new products those markets lack, even in the presence of a well established financial system. This strategy relies on the potential needs that an experienced institution from a mature market can provide and requires great flexibility in terms of product design and legal entity.
- Other external growth strategies consist of organic growth, commercial alliances between institutions, outsourcing and in-sourcing of back-office operations etc…

***The way forward:***

- In spite of the barriers to cross-border consolidation, many believe that the years to come will bring more activity and the financial landscape will change dramatically.
- The American and, to a lesser extent, Japanese banking institutions will soon be able to enter the European markets through the acquisition of domestic banks, which is considered a threat by industry representatives.
- Liberalization in traditionally protected markets in some Member States –e.g. German and French savings banks and Italian banks- create new M&A opportunities, which will also reconfigure the business models of potential large financial conglomerates.

***Market and policy actions:***

- The current changes to regulatory and supervisory frameworks in financial services need coordination and cooperation among all institutions involved in the smooth functioning of the financial market.
- The European Central Bank suggested prudential measures with respect to financial stability monitoring, crisis management and emergency liquidity assistance arrangements. Since the forthcoming developments of the financial sector will pose new challenges to the European financial system; regulators, supervisors and market participants must assume a proactive attitude towards them to safeguard the well functioning of the whole system and the economy as a whole.
- Some market participants favour some alternatives to the current supervisory and regulatory framework, such as the concept of lead regulator, but the European Commission favours streamlining of the current legal frameworks and encourages the

application of the Lamfalussy[10] process at its full potential before taking any new initiative.

- The promotion of further cross-border consolidation must not be carried out at the expense of the consumers, healthy competition and the financing of the real economy.

The event was sponsored by:

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[10] For more information on the Lamfalussy process, see, http://ec.europa.eu/internal_market/securities/lamfalussy/index_en.htm.

# Cross-Border Consolidation in the Financial Services Industry in Europe

## Developments, Obstacles & Policy Initiatives

### A CEPS-PricewaterhouseCoopers Conference

**26 June 2006**

**Venue: De Warande**
**Zinnerstraat 1**
**1000 Brussels**

**Chairman: H. Onno Ruding**
**Chairman of the CEPS Board of Directors**
**and former Vice Chairman of CitiGroup**

The debate on cross-border consolidation in the financial services sector has gained momentum in Europe after the recent large acquisitions in UK, Italy and Germany and the race to acquire key banking institutions in the new member states. Almost seven years after the introduction of the euro in 1999, it seems that pan-European financial groups are beginning to emerge. According to European Central Bank data, there has been an increase in foreign ownership in the EU banking sector over the past years. At the same time, however, there are large divergences between individual EU member states: while around 70% of the domestic banking-sector assets in the new member states – which are not yet members of the Eurozone – are foreign-owned, the cross-border dimension is almost negligible in the Euroland.

It is premature to assess the economic benefits of the recent consolidation wave in the financial industry, but the recent large cross-border acquisitions have served to renew the public debate on whether this may mark the start of cross-border banking integration in the EU. However, numerous obstacles hamper the development of a smooth European financial integration process. These obstacles were surveyed by the European Commission in October 2005, and range from the multiple supervisory requirements for cross-border activity and the legal impediments to corporate expansion and reorganisation, to the difficulties of selling the same products across multiple countries and possible political interference, all of which limit the full exploitation of benefits from the Internal Market. At the same time, cross-border consolidation is not the only means to grow across borders: alliances, joint ventures and organic growth could also offer alternative strategies to managers wishing to expand. In light of these developments, EU policy-makers are facing new challenges. Not only will they need to tackle the remaining policy-related obstacles to foster the integration of the European financial market, while preserving fair competition but also to strengthen cross-border arrangements in the area of financial stability.

Organised by the Centre for European Policy Studies and sponsored by PricewaterhouseCoopers LLP, this conference seeks to bring together policy-makers, academics and high-level industry representatives to discuss the state of financial services consolidation in Europe, its economic rationale and implications, the remaining obstacles, the alternative strategies to external growth across borders and the initiatives taken – or to be taken – by the policy-makers in response to these developments.

# Conference Programme

## Monday, 26 June 2006

**9:30** **Registration & Coffee**

**10:00** **Chairman's Introductory Remarks**

**10:20** **Keynote speech**

Speaker: **Philip Lowe**, Director General, DG Competition, European Commission

**10:40** **State of play, outlook and economic rationale and implications of cross-border consolidation in the financial services' industry**

- *Recent trend and outlook in cross-border consolidation in the financial services sector in Europe*
- *Economic rational of cross-border consolidation and micro- and macro- economic implications*

Speakers: **Nick Page**, Partner, PricewaterhouseCoopers LLP, **Ingo Walter**, Seymour Milstein Professor of Finance, Corporate Governance and Ethics NYU Stern School of Business and **Rym Ayadi**, Research Fellow, CEPS

**11:40** **Cross-border financial services' sector consolidation: Obstacles & Alternatives**

- *Obstacles to cross-border consolidation in financial services in Europe*
- *How to overcome these obstacles?*
- *Alternatives to cross-border external growth*

Speakers: **Arnaud Pecker**, Financial Services Policy, DG Internal Market, European Commission, **Arthur Kerrigan,** Policy officer in VAT legislation, DG Taxation and Customs Union**, Freddy Van den Spiegel,** Chief Economist at Fortis Bank and Chairman of the FBE Working Group on Obstacles to Consolidation in Financial Services in Europe**, Ulrich von Kenne**, Managing Director, Banking Supervision and Competition Policy, Bundesverband deutscher Banken **and Michaela Koller**, Member of the Management Committee, European Savings Banks Group – World Savings Banks Institute

**12:50** **Q&A session**

**13:00** **Lunch**

**14:00** **Guest Speaker**

Olivier Pastré, Professor, University Paris VIII

**14:20** **Is cross-border banking a reality? Issues addressed by industry experiences**

Speakers: **Peter Tils,** CEO Central and Eastern Europe, Deutsche Bank AG, **Luc Popelier**, General Manager, KBC Group, **Dominique Graber**, Head of European Public Affairs, BNPParibas

**15:30** **Q&A session**

**15:40** **Coffee Break**

**16:00** **Emerging policy issues**

- *Current DG Internal Market initiatives*
- *Role of competition policy in Europe*
- *The role of the European Parliament*
- *Cross-border financial groups and financial stability*

Speakers**: Arvind Wadhera**, Deputy Head of Unit Banking and Financial Conglomerates, DG Internal Market, European Commission**; Helena Larsson Haug,** Deputy Head of Unit, DG Competition, European Commission; **Ieke Van Den Burg** , Member of European Parliament; **Panagiotis Strouzas**, Head of Financial Supervision, European Central Bank

**17:00** **Q&A session**

**17:30** **End of conference & Cocktail**

www.ceps.be

The Centre for European Policy Studies (CEPS) is an independent policy research institute founded in Brussels in 1983. CEPS research staff, numbering over 30 specialists drawn from 15 countries, produces quality research in key EU policy areas. They have consistently demonstrated significant ability to anticipate trends and to analyse policy questions well before they become topics of general public discussion. CEPS retains complete independence in terms of setting its own priorities and freedom from outside influence.

CEPS' aim is to produce sound policy research leading to constructive solutions to the challenges facing Europe. One of its key areas of expertise is the regulation of financial markets. A CEPS Task Force is currently examining the integration of retail financial markets in Europe: the findings of a research paper on the assessment of performance of banking mergers and acquisitions in Europe will be released prior to the conference. The final paper will be published in September.

www.pwc.com

PricewaterhouseCoopers provides industry-focused assurance and advisory services for public and private clients. More than 140,000 people in 148 countries connect their thinking, experience and solutions to build public trust and enhance value for clients and their stakeholders.

Through a global network of financial services specialists, PwC can help financial services organisations turn challenges into opportunities in key areas of business. It provides advisory services to assist clients in all aspects of M&A activity including deal origination, valuation, strategy advice, transaction structuring, due diligence, merger benefits analysis, integration planning and post deal assistance and support.

PricewaterhouseCoopers actively publishes on issues facing the financial services industry. In spring 2006, the firm is releasing two publications analysing M&A in the European financial services sector:

- "3rd annual European Financial Services M&A Review", providing analysis and commentary on financial services deals announced in 2005, together with views on expected activity in 2006/07; and

- a flyer entitled "European Banking Consolidation", which provides an analysis of European banking sector deals over the last 10 years to provide insight into and draw conclusions regarding the nature of consolidation in the sector to date and looking forwards.

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