BANKING CONSOLIDATION IN THE EU
OVERVIEW AND PROSPECTS

RYM AYADI & GEORGES PUJALS

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ABSTRACT

The European banking industry experienced an era of profound restructuring in the 1990s, manifested by an unprecedented wave of mergers and acquisitions (M&As). The creation of banking giants on the domestic scale, the development of cross-border and cross-sectoral transactions and thus the emergence of a few large pan-European financial groups have been the principal features of this latest consolidation wave in banking. Financial globalisation, deregulation and market integration, the adoption of a single currency, technological and financial advances and shareholder value have been the main driving forces behind the wave of M&As over the past few years. Yet, despite the slowdown of the M&A activity since 2001 due to the world economic downturn and the collapse of financial markets, banking consolidation in the European Union will continue. Indeed, the progress made in the Financial Services Action Plan (FSAP) towards the integration of European financial markets including the new rules-setting envisaged by the new capital adequacy directive 3 will be a real impetus to further banking restructuring.

Against this background and after providing an economic explanation of the recent banking consolidation wave, this report raises two fundamental questions: If the race to a larger scale leads to the homogenisation of banking behaviour and to the emergence of a European banking model, what prospects remain for small- and medium-sized banks? And if large pan-European financial groups dominate the financial scene, what will be the response of the supervisory authorities to ensure the stability of the European financial system?

Keywords: Banking consolidation, mergers and acquisitions, shareholder value, efficiency, collective welfare, financial stability, market structure, banking model, e-banking, Basel II, banking supervision.

JEL Classification: G21 G34 G28

Banking Consolidation in the EU
Overview and Prospects

Rym Ayadi & Georges Pujals

EXECUTIVE SUMMARY

The European banking sector experienced a rapid process of consolidation during the 1990s. The main characteristics of this process were the emergence of 'mega-banks' at the national level, the increase of cross-border and cross-sectoral transactions and the constitution of broad European financial conglomerates. The deregulation of banking activities, the progress made towards the completion of an integrated European financial market, financial globalisation, technological and financial innovations, the imperative of value creation and the introduction of the euro are some of the principal forces that fuelled the process of banking consolidation in Europe.

Nevertheless, the worldwide economic downturn experienced since 2001 has brought merger and acquisition (M&A) activity to its lowest level compared to the level in the mid-1990s. As we argue, this break in the trend is rather cyclical and we expect that worldwide M&A activity will continue as soon as the economy picks up. Indeed, faced with increased risks, uncertainty and enhanced competition, banking institutions will adopt the most economic strategic means to cut their costs and enhance their revenues. Moreover, the progress made in the Financial Services Action Plan (FSAP) towards complete integration of European financial markets and the new rules-setting envisaged by the new Capital Adequacy Directive 3 will act as a real impetus to accelerate banking consolidation in the coming years. Amongst others, M&As would be a preferred response to preserve a stable equilibrium for banking institutions. Alliances and partnerships could be a temporary means whereby a bank could establish itself in a new market or activity and prepare for a likely acquisition.

Many studies of the M&A wave of the 1990s, however, found that M&As are far from having proved their economic effectiveness. Consequently, one can question the real motives behind these operations for managers and shareholders and the effects on the collective welfare and financial stability. Finally, as big financial groups emerge, this might raise competition concerns when the concentration threshold in a relevant market is reached.

By accelerating the pace of strategic responses, the recent consolidation wave within the European banking industry might lead to the homogenisation of banking behaviour. This raises the possible emergence of a dominant banking business model in Europe on which the majority of the banking and financial groups might have to converge. One could question the drivers of success of such a model. The evidence shows that customer satisfaction and value creation will remain the objectives of any strategic action to come.

Moreover, in the medium term, the acceleration of cross-border and cross-sectoral transactions is inevitable, envisioning a more integrated European banking market. A priority is to target a more effective and efficient way to perceive the role of European supervisory authorities in the years to come. In order to ensure a sound and safe financial system in Europe, there is a pressing need to go beyond the 'shared subsidiarity' and the multilateral cooperation alternatives that characterise the current situation. The combination of geographical centralisation and institutional opening up could be an appropriate response to a future increased integration in the financial services sector in Europe.

Banking Consolidation in the EU
Overview and Prospects

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Introduction

During the last decade, the financial services sector has been subject to an unprecedented wave of restructuring operations.[1] In particular, the banking sector has recorded a certain delay in restructuring in comparison with other sectors due to restrictive national regulations and to competition reasons. In 2001, the banking sector accounted for almost 23% of the total value of M&A transactions in Europe, making it one of the most active in M&A activity worldwide.

After a period of intense domestic concentration since the mid-1990s aiming to create strong domestic players, many banks are seeking to expand across border and sectors announcing the beginning of a second phase, characterised by the acceleration of pan-European and cross-sectoral transactions (involving banking, insurance, securities firms and/or financial groups within the European Union), which will certainly lead to the emergence of leading cross-border banking groups at EU level.

Despite a collapse in worldwide M&A activity following the global economic and financial downturn in 2001, banking consolidation in Europe should continue. Indeed, besides deregulation, technological and financial innovation, value creation and the imperative to increase market share and to reduce over-capacity will continue to give impetus to the consolidation process in the coming years.

Moreover, two other factors will also play an important role in the process. Indeed, cross-border transactions have been constrained for a long time by a number of cultural, regulatory, fiscal and political obstacles. The introduction of the euro and the progress achieved towards the completion of an integrated European financial market[2] will trigger pan-European consolidation as soon as market conditions allow for it.

Finally, the new Basel Capital Accord seems to be beneficial for large institutions, which will now be able to adopt the most sophisticated credit risk models to efficiently assess their portfolios and allocate capital. As a consequence, the drive to reach a larger size will be a comparative advantage in the post-Basel era, which will probably accelerate the consolidation wave.

The banking sector in Europe is at a turning point in its history. This report aims to provide a complete and up-to-date picture of the banking consolidation process in Europe during the last decade. It offers a structural, economic and strategic analysis of the European banking sector and identifies the new challenges facing supervisory authorities and their likely responses to ensure financial stability. The report is structured as follows:

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[1] Restructuring operations in the banking sector can take various forms. The most common are mergers and acquisitions (M&As), but there are also different possible strategic options, such as forming a strategic alliance, a joint venture or cross-shareholding. In this research report, we are particularly concerned with contemporary M&As.

[2] See Annex 1 on the Financial Services Action Plan (FSAP), a series of policy objectives and specific measures adopted by the European Commission in 1999 to improve the Single Market for financial services.

The first chapter shows briefly the main trends and characteristics of the banking consolidation wave in Europe during the 1990s. Chapter 2 reviews the principal 'drivers' of the current process, with a particular focus on value creation. A third chapter highlights the economic, social and structural effects of the recent banking consolidation wave. Finally, the fourth and the fifth chapters examine the prospects for the future of the European banking sector and the supervisory responses to the challenges created by a more integrated European financial market.

Undoubtedly, the consolidation process has contributed to a more integrated financial market thanks to the blurring of the traditional frontiers between financial activities, and even more, to an increased interest in cross-sectoral and cross-border transactions, leading to the emergence of multi-specialised financial groups operating across borders. One could wonder if these developments imply a more uniform banking practice and growth strategies across Europe. And if this is the case, how will the European supervisory authorities respond to ensure a safe and sound banking system in Europe?

Chapter 1

The Main Characteristics of the Recent Wave of Banking Consolidation in the EU

1.1 Mergers and acquisitions: A worldwide and multi-sectoral phenomenon

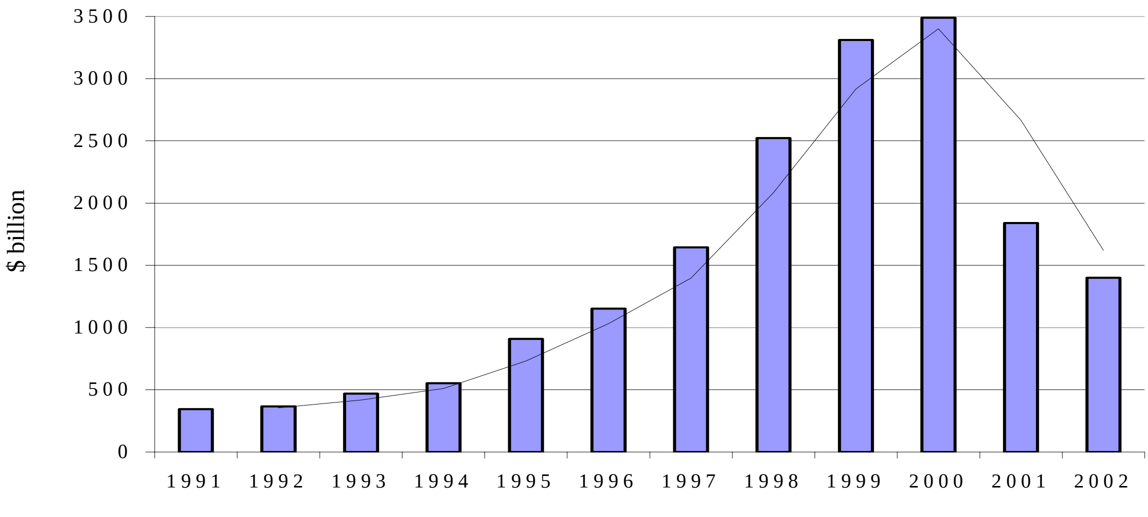
Mergers and acquisitions (M&As) are considered as consolidation strategies where a change of control takes place through a transfer of ownership. For the purposes of this study, M&A activity is defined as the transfer of ownership by one firm to another from less than 50% to more than 50%. Such a change generally results in an unambiguous transfer of corporate control.

1.1.1 A recurring phenomenon having specific characteristics...

The pace of M&A activity has been heating up internationally, not only in developed countries but also in the majority of the emerging economies (Levasseur, 2002). Although the current phenomenon may seem to be new, it should be borne in mind that important waves of consolidation have already occurred in the past. Since the beginning of industrialisation, the world experienced four periods of consolidation: 1) 1897-1904, 2) 1916-29, 3) 1965-69 and 4) 1984-89. Consequently, the current wave would only constitute the fifth one during the 20th century. Unlike the M&A wave of the 1980s, however, the recent wave focused on strategic growth options based on the imperative of strengthening the competitiveness of the companies in their core business, rather than simply registering quick financial gains. Its main characteristic has been an overall increase in the number and the total value of transactions.

Precisely, the latest wave seems to have experienced two considerable accelerations since the beginning of the 1990s: the first between 1994 and 1995 and the second and more pronounced, since 1997 (see Figure 1). Between 1998 and 2000, however, it appears that the total value of the transactions recorded a tremendous increase never observed in the past.

Figure 1. Global M&A activity in value (1991-2002)



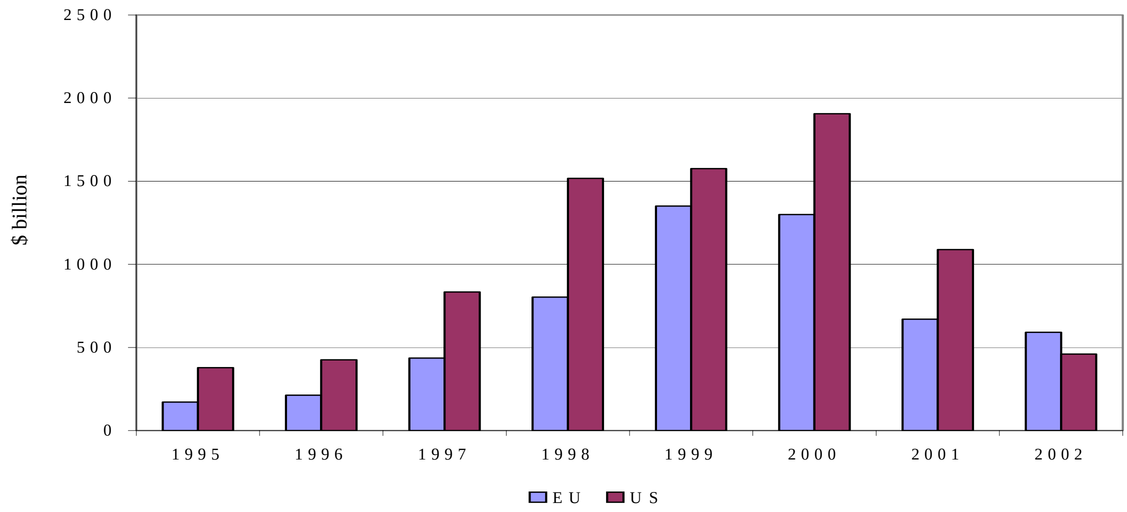
Sources: SDC Platinum database on M&As and Dealogic (2003).

According to Thomson financial data, the total transaction value of M&As reached almost $3,500 billion in 2000 (distributed among 37,000 transactions), compared to less than $500 billion recorded at the beginning of the 1990s. Hence, the total value of the M&A operations multiplied seven-fold during a decade, in nominal terms. Since 2001, however, the volume of worldwide M&A operations seems to have slowed down sharply.

A survey by Dialogic in 2003 showed that the total value of worldwide M&A deals has registered an annual decrease of 47% between 2000 and 2001, and 24% between 2001 and 2002 (see Figure 1). This is a drop in value comparable to the levels reached in 1996.

The total number of transactions registered a decrease of 12%, bringing the total to 23,611 transactions in 2002, compared to 26,359 transactions in 2001. Besides the decrease of the overall transaction number including 'mega deals', the drop in value could also be attributed to the low valuation of the acquired firms following the overall downturn in the financial markets.

Figure 2. Total value of M&A transactions in the US vs the EU (1995-2002)



Source: Dialogic (2003).

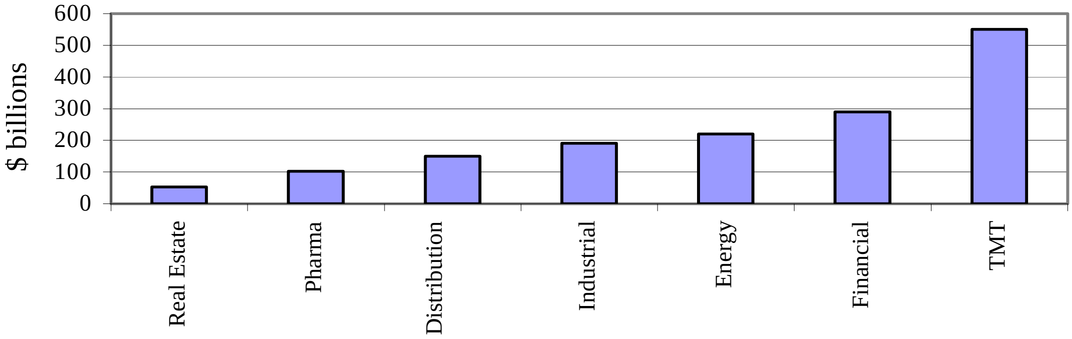
A breakdown between the EU and the US firms involved in M&A activity shows that they both displayed an upward trend between 1997 and 1999. But US firms remained significantly more active than European firms. In Europe, the M&A wave started to heat up in 1998. By 1999, the value of deals was almost comparable to the US.

The drop in transaction values between 2001 and 2002 has affected both the US and the EU, but was sharper in the US (41%) than in the EU (5%) and for the first time, the total value of European M&As exceeded that in the US (see Figure 2).

A second distinctive feature of the latest M&A wave is that it is more pronounced in some sectors of the economy than in others. In the past few years, an increasing proportion of worldwide M&A transactions concerned TMT sectors (technology, media and telecommunications) and financial services (banking, insurance and securities) (see Figure 3). Since the burst of the technological and financial bubble, the 'old economy' sectors[3] have dominated the M&A market.

[3] The energy sector has registered 23% of the total amount of the operations carried out in 2002, followed by the industrial sector with 12%. Controversially, the most affected sectors were retail trade, which saw

Figure 3. Sectoral distribution of M&A transactions in 2000

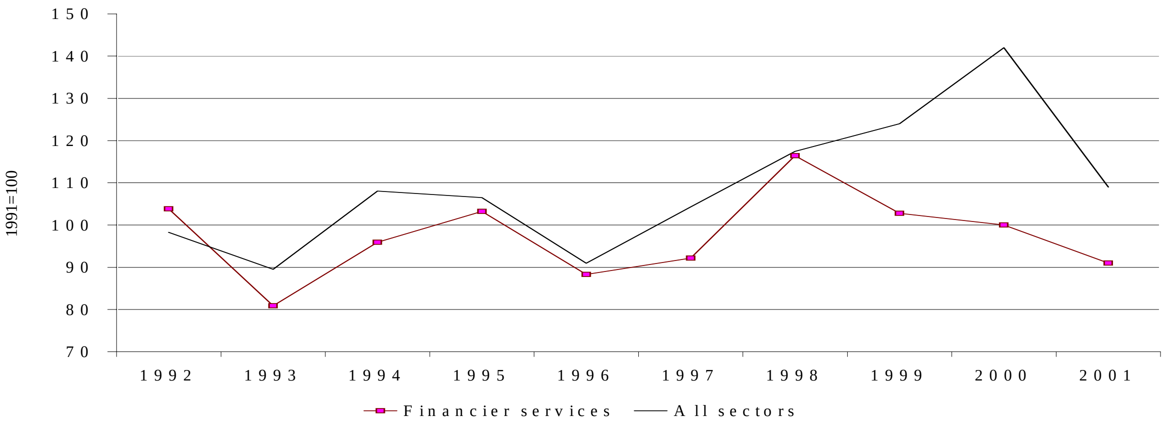


Source: SDC Platinum database on M&As (2001).

1.1.2 … and which particularly affects the European financial sector

The level of M&A activity involving European financial firms increased during the 1990s, with a strong growth in total value. The number, however, has fluctuated from one year to the next without the emergence of a real trend since 1992 (see Figure 4). After a sharp decline in 1993 due to the economic slowdown in the European Union, a slight increase was registered until a peak was reached in 1998, after which an overall downward trend was experienced.

Figure 4. Importance of the financial services sector in the M&A wave in the EU (1992-2001)



Source: SDC Platinum database on M&As (2002).

Controversially, according to the Bank for International Settlements (BIS, 2001), the total value of transactions has shown a remarkable increase reaching $147 billion in 1999, compared to $23 billion at the beginning of the decade. And roughly two-thirds of the transactions' volume was concentrated between 1997 and 1999, when the average value had increased substantially.

Despite the recent overall decline in global M&As, the financial services sector in the EU continued to be engaged in these activities up to 2001. By the following year, however, the number of M&As had declined by 43%. In Europe, financial firms have been among the most involved in the M&A wave following the energy sector (see Figure 5).

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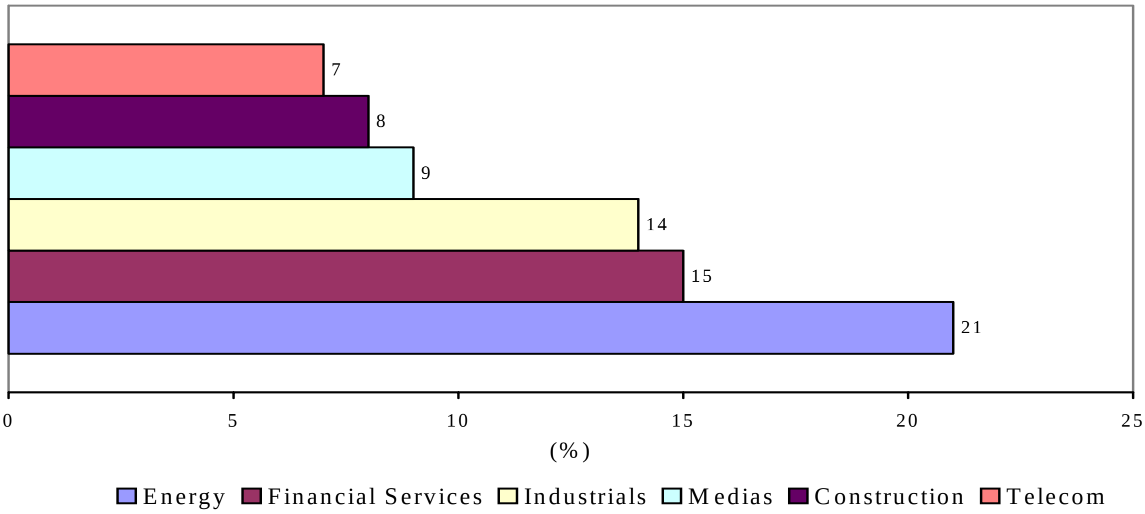
a 40% decline in the number of deals compared to the same period in 2001, and information technology with a decline of 38%.

More particularly, the banking sector has accounted for two important deals valued at more than $10 billion: the transaction in the UK between HSBC and Household International and the transaction between Crédit Agricole SA and Crédit Lyonnais in France.

Figure 5. Sectoral distribution of European M&A transactions, 2002



Source: SDC Platinum database on M&As (2002).

Even though the financial services sector has been strongly involved in the M&A wave in recent years, it is useful to recall that it recorded a certain delay in the restructuring process compared to other industries (manufacturing, energy, distribution, pharmaceutical, chemical, automobile, TMT...). This situation can be partially explained by the restrictive national regulations found in Europe, which initially aimed to protect the domestic financial sectors from foreign competition.

1.2 Banking consolidation in the EU

According to the BIS (2001), most of the worldwide M&A activity in the financial services industry during the 1990s involved banking firms (60% of transactions). Interestingly, banking transactions accounted for about 70% of the value of all the deals. In Europe, this has resulted in a substantial change in the ranking of the major banking institutions (see Table 1).

Table 1. Change in ranking (by total assets) of the major European banking institutions, 1992 and 2001

Rank in 1992	**Bank**	**Total assets (€ billion)**	**Rank in 2001**	**Bank**	**Total assets (€ billion)**
1	Crédit Lyonnais	272	1	Deutsche Bank	918
2	Deutsche Bank	235	2	UBS	829
3	Crédit Agricole	232	3	BNP Paribas	825
4	BNP	220	4	HSBC	776
5	Société Générale	200	5	BHV	728
6	HSBC	199	6	Crédit Suisse Group	677
7	ABN Amro	199	7	ABN Amro	597
8	Barclays	174	8	RBoS	593
9	Natwest	168	9	Barclays	573
10	Dresdner Bank	158	10	Crédit Agricole	563

Source: Caisse des dépôts et des consignations (CDC), 2002.

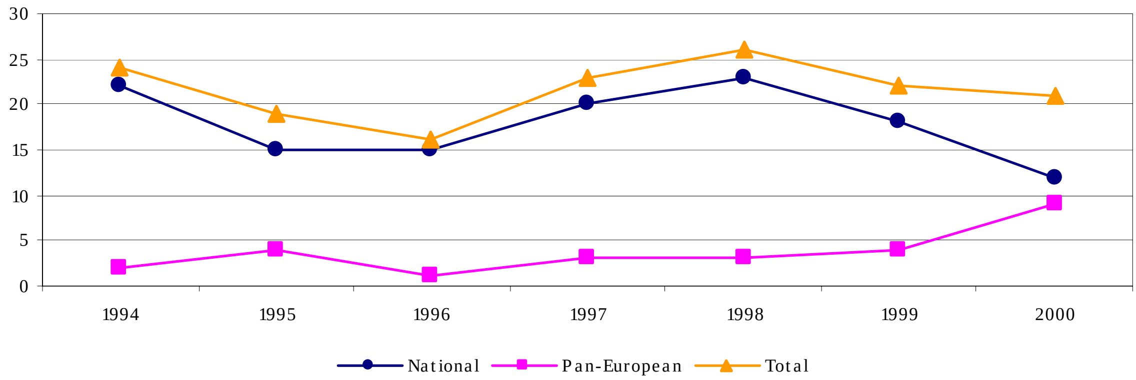
To characterise the banking consolidation wave in the EU, a targeted statistical analysis[4] was carried out on a sample of the main M&A transactions announced and completed involving exclusively banking institutions, over the period 1994-2000 (see Annex 2 for methodological details). Statistical analysis was performed on the number, total value[5] and average value of the transactions. The results show the following characteristics:

- an acceleration of M&A operations since 1996 with a sharp decline in 2001,
- the emergence of 'mega banks' at national level since 1999,
- the timid development of cross-border transactions at Community level and
- the constitution of European financial conglomerates.

1.2.1 Acceleration of M&A activity since 1996

The annual breakdown in the number of the transactions seems to confirm a significant upward trend since 1996 to reach a peak in 1998, before a slight decrease in 1999 and 2000 (see Figure 6).

Figure 6. National vs. pan-European banking M&As, by number (1994-2000)



Source: SDC Platinum database on M&As (2001).

The aggregate value of all transactions over the period amounted to €262 billion. Since 1996, the annual value has grown much more rapidly than the number, to reach its peak in 2000 (see Figure 7). Globally, the number of M&A and the annual value of the transactions have followed different trends. The average transaction value,[6] which takes into account both the number and the annual transaction value, has increased steadily over the period (see Figure 8). Consequently, these developments confirm the strong growth of M&A activity in the EU banking industry.

Nevertheless, the slowing down of global M&A activity has strongly affected the banking sector, despite several large transactions that have taken place in Europe since 2001.[7]

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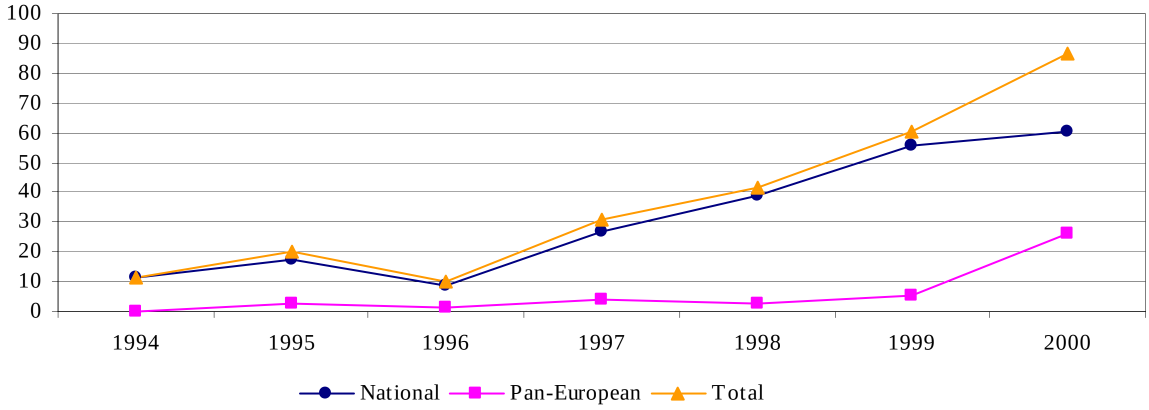
[4] The analysis was complemented by external observations as regards the evolution of M&A activity in banking since 2000.

[5] Total value is based on the acquisition value.

[6] Average transaction value = total amount/number of operations.

[7] See Annex 3, which lists the principal banking M&A operations within the European Union over the period 1995-2002.

Figure 7. National vs. pan-European banking M&As, by value (1994-2000)



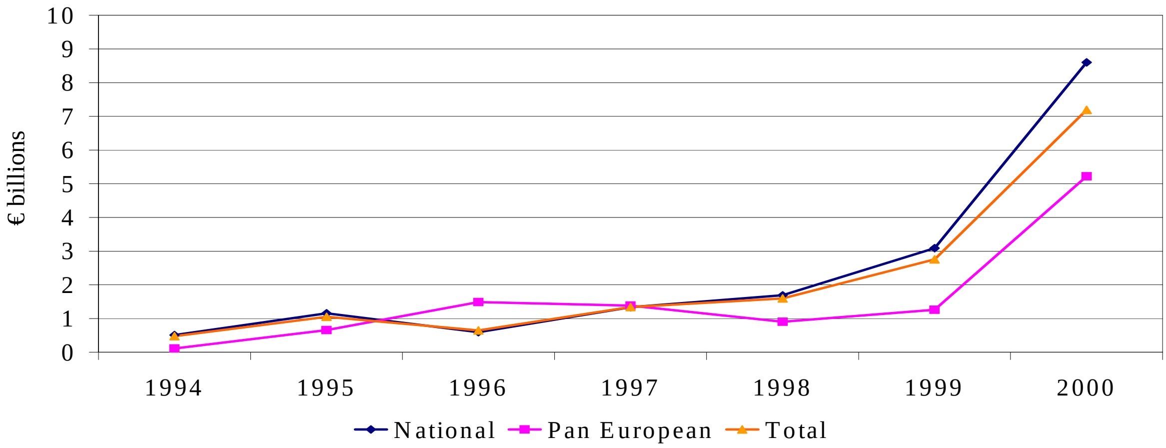
Source: SDC Platinum database on M&As (2001).

1.2.2 The emergence of 'mega-banks' at national scale since 1999

The evolution of the average transaction value is very interesting. After a steady growth between 1994-99, it jumped to reach a peak in 2000 (see Figure 8). As a consequence, the transaction value was especially large at the end of the decade.

In practice, this is reflected by the emergence of 'mega-banks' operating at a national scale in the major EU countries (BNP Paribas in France, SCH and BBVA in Spain, IntesaBCI and Unicredit in Italy, RBoS Group in UK and Bayerishe HypoVereinsbank in Germany…). These developments indicate that a growing M&A activity will lead in the medium to long term to the co-existence of a few large actors at the domestic level, which will result in more concentrated banking markets.

Figure 8. National vs. pan-European banking M&As by average value (1994-2000)



Source: SDC Platinum database on M&As (2001).

Two hypotheses can be mentioned to explain the significant increase in the average value of these transactions in 1999 and 2000: either this increase is attributable to a few large transactions within the banking industry or it is the consequence of a widespread consolidation process affecting the whole banking industry.

In the first case, it would be a specific and prompt process of reconfiguration in which only the large-sized European banking institutions would take part. In the second case, however, it would reflect a major and a lasting restructuring process, since all the European banking institutions would be involved. The latter interpretation could be favoured if the banking domestic M&A distribution in Europe over time would show an overall distortion towards the right side, implying that the majority of the transactions would involve higher transaction values.

In order to analyse the national concentration process of the European banking industry throughout the period, the distribution of M&A transactions[8] is successively represented (see Table 2) per year and then per sub-period by considering the following intervals based on the annual transaction values:

- small transactions (less than €500 million),
- medium-sized transactions (between €500 and €5,000 million) and
- large-sized transactions (€5,000 million and more).

Table 2. Distribution of domestic M&A transactions per year

	1994	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Number of M&As	22	15	15	20	23	18	7
Intervals (€ millions)			% of M&A transactions				
<100	50%	27%	40%	25%	39%	11%	0%
100-500	23%	47%	20%	20%	9%	6%	14%
500-1000	5%	7%	20%	15%	13%	28%	14%
1000-2000	14%	13%	13%	15%	9%	17%	0%
2000-5000	9%	0%	7%	20%	22%	17%	43%
5000-10000	0%	0%	0%	5%	4%	11%	14%
+10000	0%	7%	0%	0%	4%	11%	14%

Figures 9a and 9b show the results of the statistical analysis. The distribution per period indicates that the banking consolidation process within the EU has experienced two successive stages over the period 1994-2000. The first one, completed in 1998, was dominated by small- and medium-sized transactions.[9] Indeed, these transactions accounted for more than 90% of the total. Over the period 1999-2000, a major change occurred and a second stage was started. Indeed, large-sized transactions accounted for more than 50% of the operations, with the persistence of medium-sized transactions (35%).

The distribution per year confirms these results. Whereas in 1994, the majority of the transactions were mainly motivated by the desire to reduce excess capacity and entailed less than €500 million, an apparent and progressive shift towards larger transactions has been experienced since 1997. These results confirm an overall shifting of the M&A transaction distribution towards the right side, implying higher transaction values. Hence, the small, medium and large banking institutions have successively taken part in the global consolidation process.

To conclude, the recent consolidation process has been structural, profound and dynamic. Moreover, the same tendency is likely to continue towards the creation of both national and pan-European mega-banking groups. Indeed when the possibilities for acquisition are exhausted in a domestic market and the concentration threshold is attained, banking institutions will look for

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[8] The analysis was carried out on a sample of 120 domestic transactions in which the values were made available.

[9] The size of the transaction depends on its value (market value). The transaction value could be amplified by the stock market valuation following the announcement of the M&A, but we do not consider that this would have an important effect on the analysis.

other potential external growth opportunities in other markets. Consequently, cross-border consolidation could offer adequate growth opportunities without damaging competition.

Figure 9a. Changes in domestic M&A banking distribution per year

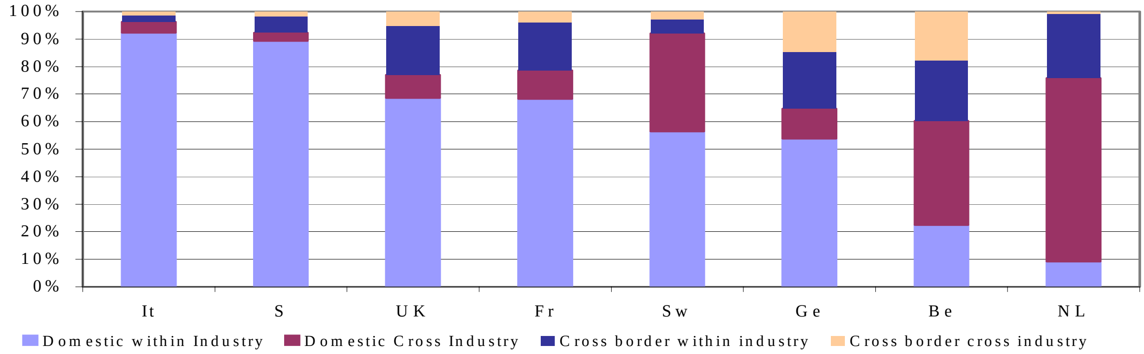
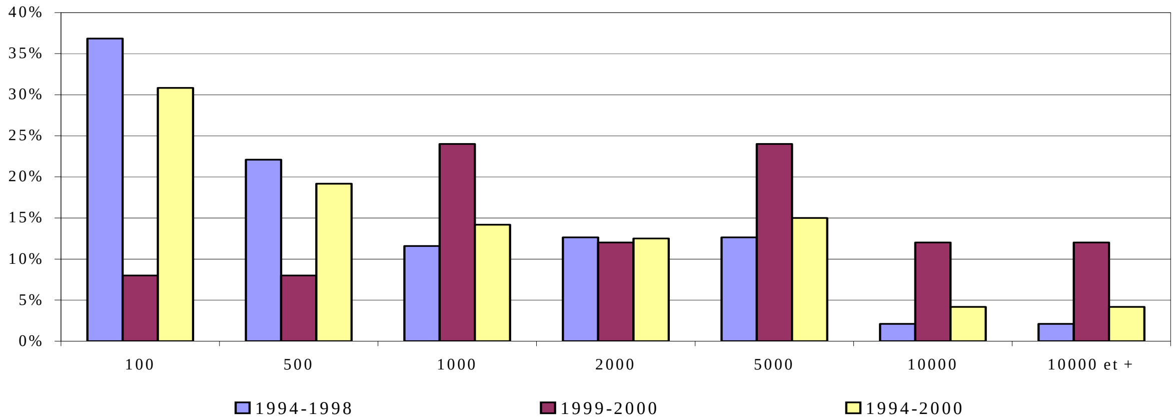


Figure 9b. Changes in domestic M&A banking distribution per period



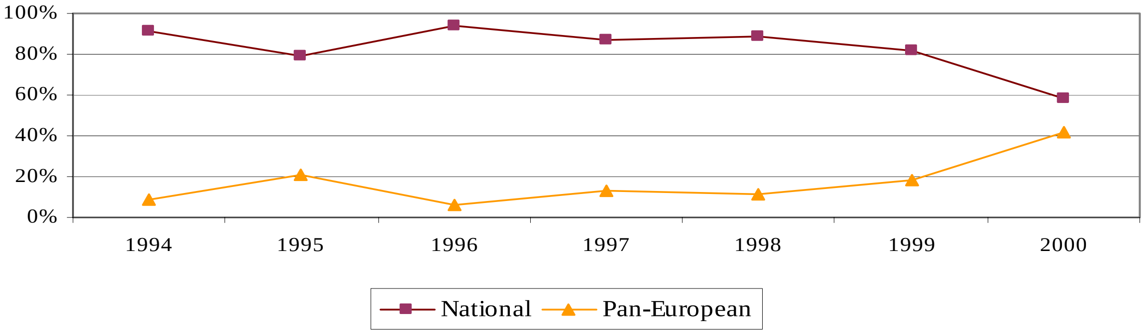
1.2.3 The timid development of cross-border transactions at EU level

Cross-border consolidation activity was fairly modest in the first half of the 1990s. Domestic deals constituted the majority of M&A activity, accounting for 87% in number, and 90% in total value over the period 1994-2000 (see Figures 10 and 11). This evolution has clearly contributed to increased levels of concentration within individual European banking markets. As shown previously, the domestic consolidation process is advancing to the point at which the domestic markets are starting to reach a saturation level, encouraging banking institutions to move beyond their national frontiers to seek new growth opportunities.

The statistical results show the predominance of domestic consolidation throughout the entire period, but a marked increase can be observed in cross-border transactions starting in 1999 to reach 42% in number and 30% in value in 2000. This modest growth of cross-border consolidation could be partly attributed to the elimination of the currency barriers stemming from the creation of the economic and monetary union (EMU) in 1999 and the introduction of the euro.

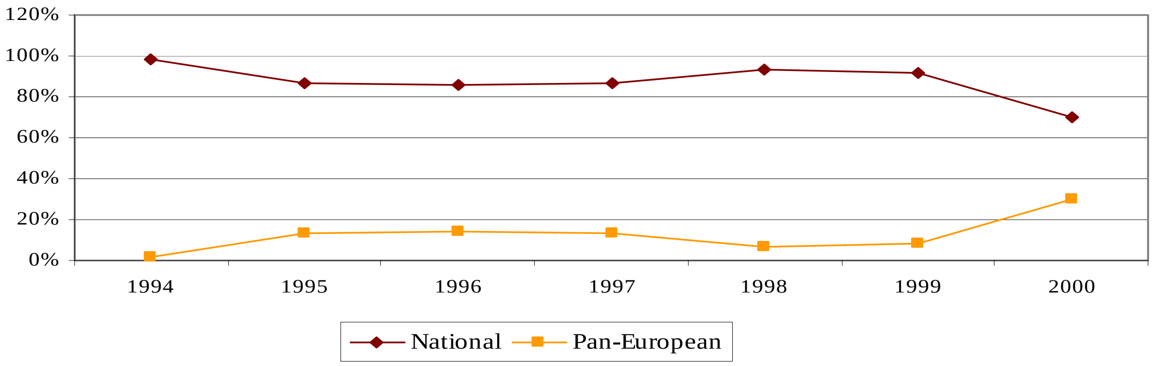
Also several country-specific factors influenced cross-border consolidation in Europe. The Scandinavian and Benelux countries were indeed very active in cross-border transactions – not only as acquirers but also as targets (see Figure 12). Due to their small and rapidly saturated domestic markets and the relatively advanced domestic consolidation process, the main banking actors have been compelled to quickly develop their activities outside of the strictly national field more than elsewhere.

Figure 10. Comparison of national vs. pan-European banking M&As, by number (1994-2000)



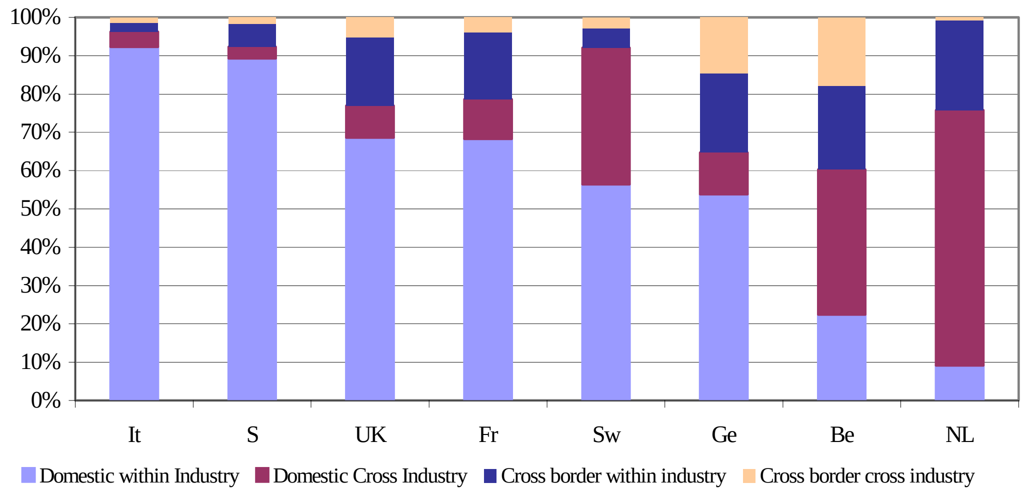
Source: SDC Platinum database on M&As (2001).

Figure 11. Comparison of national vs. pan-European banking M&As by total value (1994-2000)



Source: SDC Platinum database on M&As (2001).

Figure 12. Value of European M&A transactions within the financial industry by country (in %, 1990-99)



Source: BIS (2001).

Nevertheless, we have not yet witnessed large-scale cross-border transactions in the European Union. Indeed, in the past few years, European banking institutions have shown more interest in deploying to emerging areas offering high potential growth and new opportunities for development, such as Eastern Europe and Latin America, or to the United States in order to benefit from the know-how and the technological advances made in various activities, such as investment banking or asset management (see Table 3).

Table 3. M&A transactions completed in 2001-03 involving European banks

	Domestic	European cross-border	International cross-border
Within-sector	BoS-Halifax (UK) DG Bank-GZ Bank(Ger) Dexia-Artésia (Be) SanPaoloIMI-Cardine (It) BPVerona-BPNovara (It) Banca di Roma-Bipop Carire (It) CCF-Banque Hervet (Fr) Banco Sabadell-Banco Herrero (Sp) Banca di Roma-Bipop Carire (It) BP di Bergamo-BPCI (It) Crédit Agricole-Crédit Lyonnais (Fr) BP di Vicenza-Cassa di Risparmio di Prato (It) DnB-Nordlandsbanken (Nor) BP di Lodi-Banco di Chiavari e della riviera Ligure (It) SanPaoloIMI-BP Adriatico (It)	DeutscheBank-Scudder(Ger-Sw) SocGen-Komercni (Fr-Cze) KBC-Nova LjubljanskaBanka (Be-Slovenia) Unicredit/Allianz-ZagrebackaBanka (It-Ger-Croatia) Erste Bank-Ceska Sporitelna (Au/Croatia) Unicredit-Zivnostenska Banka (It/Cze) SanpaoloIMI-Inter europabank (It/Hung) Barclays-Zaragozano (UK/Sp)	SCH-Banespa (Sp/Mex) SCH-BancoSantiago(Sp/Chile) ING-Seguros(NL/Mex) BNPParibas-BancWest (Fr/US) BNPParibas-UnionCaliforniaBank (Fr/US) RBoS-Medford Bancorp (UK/US) Rabobank-VIBC(NL/US) HSBC-GF Bital (UK/Mex) HSBC-Household International (UK/US) RBoS-Cambridgeport Bank (UK/US) ABN AMRO-Sudameris (NL/Brazil) SocGen-SSB Bank (Fr/Ghana)
Cross-sectors	Allianz-Dresdner (Ger) CDC-Caisse d'Epargne Group (Fr) Natexis Banques Populaires-Coface (Fr) Crédit Agricole-Finaref (Fr) BNP Paribas-Facet (Fr) ABN AMRO-KBC Private Banking (NL) RBoS-Churchill Insurance (UK)	SCH-AKB (Sp/Ger) BNP Paribas-Cogent (Fr/UK) BNP Paribas-Consors (Fr/Ger) DnB-Skandia AM (Nor/Swe) ING-Entrium (NL/Ger) SocGen-HertzLease (Fr/US) Deutsche Bank-Rud Blass (Ger/Swi) Crédit Mutuel CIC-Van Moer Santerre (Fr/Lux)	Dresdner Bank-Wasserstein Perella (Ger/US) Société Générale-TCW (Fra/US) Deutsche Bank-RREEF (Ger/US) SCH-Origenes (Sp/Argentina)

1.2.4 Towards the constitution of European financial conglomerates

Traditionally, universal banking has been the prevailing reference model in Europe thanks to the provisions introduced by the second banking directive in 1989. As their name suggests, banks may engage in a full range of investment services in addition to commercial banking activities.[10] This trend is expected to continue after the implementation of the revised investment services directive (ISD) of 1996 and the new capital adequacy directive, which applies to credit institutions and investment firms.

Moreover, it is interesting to note that in some countries,[11] the universal banking principle has been extended to insurance activities owing to the historical link between both industries and the increased interest on the part of some banking institutions to expand into insurance activities. In other countries, however, restrictive rules at the national level still exist aimed at separating banking and insurance activities. The adoption of the conglomerate directive in 2002 provided a

[10] These activities should be undertaken in a direct way rather than through separately incorporated subsidiaries and banks may closely link themselves to non-banks by either equity holding or board participation (BIS, 2001).

[11] In the Netherlands, the insurance industry has historically had a close relationship with the banking industry, explaining the early emergence of the bancassurance model there as compared to other European countries.

suitable regulatory framework for financial groups operating in banking, insurance and investment services.

The regulatory reforms undertaken in recent years have been the main accomplishments of the vast programme of the FSAP which started in 1999 and aims to remove most of the regulatory barriers to a single integrated financial market and to create a level playing field. Nevertheless, it is too early to draw a full picture of the most developed form of financial integration: the financial conglomerate. Indeed, reality shows that a majority of the M&A transactions were carried out within the same sector accounting for almost 67% against 33% across sectors in 1999 (see Table 4).

Table 4. Sectoral and geographical breakdown of M&As in the European financial sector (1999)

	National	Cross-border	Total
Within banks	320	11	331 *66.60%*
Cross-sector	94	72	166 *33.40%*
Total	414	83	497 ***100%***

Source: ECB (2000b).

In the past few years, however, a distinguishing feature in Europe has been the relative importance of cross-industry transactions in the insurance field (see Table 5). Indeed, various banking institutions sought to develop new sources of income by widening the range of their supply through the development of insurance activities (life and non-life products).

Table 5. The distribution of targets and acquirers industries in 1999 ($ billion)

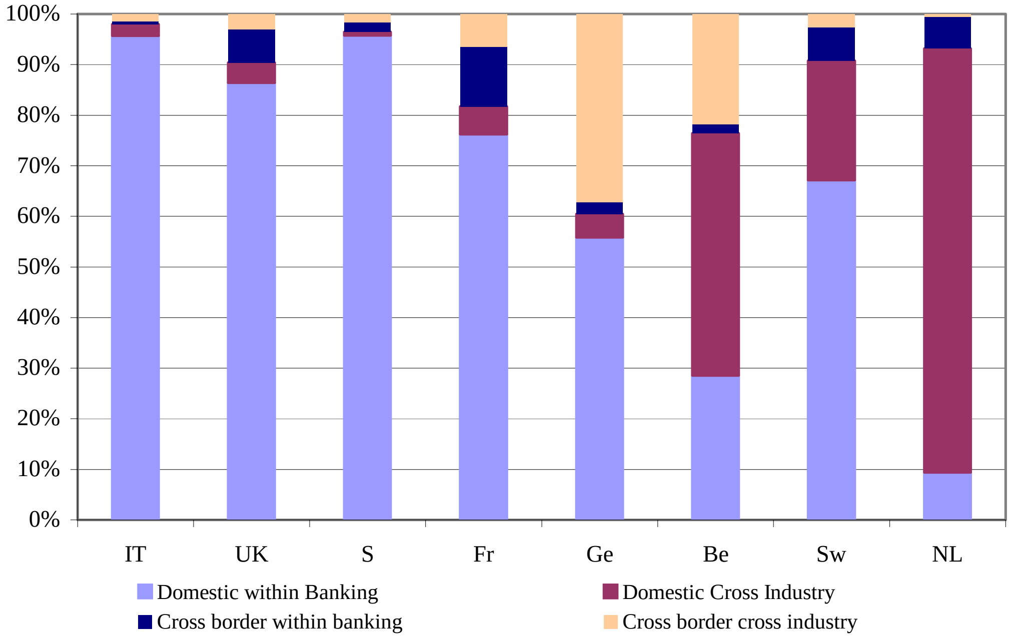
Targets / **Acquirers**	**Banks**	**Securities**	**Insurance companies**	**Total**
Banks	89 *36.03%*	9 *3.64%*	20 *8.10%*	118 *47.77%*
Securities	23 *9.31%*	19 *7.69%*	24 *9.72%*	66 *26.72%*
Insurance companies	11 *4.45%*	6 *2.43%*	46 *18.62%*	63 *25.51%*
Total	123 *49.80%*	34 *13.77%*	90 *36.44%*	247 *100%*

Source: Thomson Financial (2000).

Among European countries, Belgium and the Netherlands were home to a few but important domestic cross-industry transactions during the last decade. Indeed, in both countries, the aggregate value of domestic cross-industry transactions exceeded the value of domestic within-industry transactions (see Figure 13). These developments enabled the emergence of conglomerates that paired banking concerns with insurance companies (Fortis and KBC in Belgium and ING in the Netherlands).

Since 2000, several mergers between banking groups and insurers have come to light. Among the most significant have been the mergers of Fortis Group and ASR Verzekeringsgroep in the Benelux, Sampo with Leonia in Finland, but especially the latest acquisition of the Dresdner Bank by the German insurer Allianz. Since then, the bancassurance model has attracted considerable attention in European business circles.

Figure 13. Share of different models of banking M&A transactions, by country (1990-99)



Source: BIS (2001).

In sum, the overall picture of the recent wave of financial consolidation initially showed an intensification of domestic M&A activity within the banking industry in the EU during the last decade. The rapid growth in the total transaction value, which was accompanied by an increase in the average transaction value, contributed to a change in the overall consolidation process towards larger-scale transactions. Accordingly, it seems that the recent M&A wave aims to finalise the domestic banking consolidation and is triggering cross-border consolidation.

Furthermore, as shown, banking institutions are now searching for new opportunities in external markets to replace or supplement declining domestic growth possibilities. The removal of regulatory barriers in the European financial services industry will give an additional impetus to cross-border and cross-industry consolidation and particularly to the emergence of the bancassurance model.

Chapter 2

The Key Drivers of Banking Consolidation

The wave of M&As in European banking is not over. In order to explain and assess the extent and the pace of future consolidation in Europe, it is helpful to consider the various factors likely to further stimulate the banking consolidation process. According to the academic literature in banking and industrial economics, there are a variety of motivations driving consolidation, ranging from value maximisation (including cost reduction and revenue growth) to other external and managerial goals.

2.1 Various but convergent factors

The key factors that have driven the recent consolidation wave in the European banking sector are in general those already observed in other industries. In any given industry, more than one motive may underlie the decision to engage in a merger or an acquisition. Motives may also vary with firm characteristics, such as size, organisational structure or strategy, over business cycles, across countries and/or across industry segments.

This paper explains the recent consolidation process on the basis of two sets of basic factors: 1) maximisation of shareholder value and other managerial motives and 2) external environmental forces that currently govern the sector (deregulation, financial globalisation and new technologies) and that have forced European banking institutions to adapt in order to remain competitive.

2.1.1 The 'leading' role of the environment

Many 'external' factors have played a crucial role in fuelling the consolidation process in the EU: deregulation, privatisation, financial globalisation, the increasing integration of capital markets and the introduction of the euro. Moreover, technological innovations[12] have generated very high fixed costs which can only be profitably recuperated from large-volume activities. Hence, these factors have not only reduced the entry barriers (in a geographical and functional sense) but have also provided market opportunities to new entrants, thus intensifying competition. In response to these environmental changes, European banking institutions have been obliged to attain a critical size by increasing their sphere of activity, in order to compensate for the erosion of their margins and to restore their revenues to remain competitive in the marketplace.

Two other 'external' forces have created further pressures for change. Firstly, confronted with increasing globalisation of their activities, banking institutions have had to make greater financial commitments in order to satisfy their growing clientele of 'corporate customers'. Secondly, the economic situation in Europe at the end of the 1990s – characterised by strong growth and low interest rates – was very favourable to financial markets and generated strong acquisition capabilities.[13] As noted by Perthuis (2000): "Over a long period, it seems that the M&A activity was not developed in a linear way. The overall trend took the form of a cycle which has generally been accompanied by strong economic growth and financial markets prosperity" (authors' translation).

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[12] De Perthuis (2003).

[13] Owing to the high increase of M&A operations financed by stock-to-stock takeover bids, the stock exchange inflation has increased the 'purchasing power' of the potential purchasers. In 1998, almost two out of every three operations were financed by the exchange of shares, compared to only 10% in 1995.

2.1.2 Value-maximising motives

In addition to its contribution to reducing overcapacity,[14] banking consolidation has tended to be justified in the economic literature on the ground that it created shareholder value. Indeed, the strengthening of the shareholders' role, the increasing importance of institutional investors in banking capital (pension funds, mutual funds...), the pressures from the financial markets and the new corporate governance rules have encouraged managers to orient their business objectives towards value-maximisation.

The traditional argument that M&As increase shareholder value is based on the assumption that the anticipated value of the entity created by the merger of two groups will exceed, in terms of potential wealth creation, the sum of the respective values of the two separate groups. That is, 1+1 = 3. Two main types of synergies are achieved: operating synergies and financial synergies. The former takes the form of either revenue enhancement or cost reduction. The latter refers to the possibility that the cost of capital may be lowered by combining one or more companies.

In theory, M&A operations in the banking sector could create value by obtaining gains either in terms of market power or in terms of efficiency.

2.1.2.1 Enhanced market power

Theoretically, market power is defined as the capacity to fix market prices as a result of a dominant position in a certain market. The economic literature[15] concludes that prices are positively correlated to local market shares in general, but this position is not justified in the context of international markets (inter-banking activities, multinational companies...). Therefore, increased market power can be gained through a merger or an acquisition of two competing institutions operating in the same local market.

Thus, value creation through market power would seem more likely to explain mergers at the local level and within the same activity (especially in retail banking), which appears to be coherent with the theoretical evidence noted above, in particular in the European Union, where the majority of the operations are within sectors and national.[16]

In practice, banking institutions can influence supply (as a supplier) or demand prices (as a client). In the first case, the size obtained following a merger or an acquisition might create a dominant position which enables the bank to manipulate price levels in a certain market either by: a) decreasing prices (by pre-emption and/or predation[17]) to evict some non-competitive existing banking institutions and/or new entrants, or b) increasing prices in the absence of effective competition in the marketplace. In the second case, the size obtained will enable the new group to reduce its refinancing costs thanks to reputation, size or diversification effects.

Nevertheless, some recent studies[18] have shown that the previous correlation between concentration levels and market power diminished during the 1990s. This could be attributed to

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[14] 'Overcapacity' or 'excess capacity' is mentioned when supply exceeds demand in a given sector (Rosa, 2001). Although demand in financial services has grown significantly during the last two decades, it has not always followed the evolution of supply. Thus, overcapacity appeared in an increasing number of activity segments. By reducing the prices and the margins, overcapacity obliges banks to seek increased volumes and therefore higher market shares.

[15] Hannan (1991) and Berger & Hannan (1989, 1997).

[16] Vander Vennet (1996).

[17] *Pre-emption* implies that the price fixed by the bank is lower than the average cost while *predation* involves fixing the price at a level lower than the marginal cost.

[18] Hannan (1997) and Radecki (1998).

the opening up of markets which has encouraged the entry of new competitors and thus increased the degree of contestability of the market.[19] Moreover, the emergence of new distribution channels such as e-banking, while contributing to the disappearance of the geographical boundaries, has made the concept of 'local market' less relevant.

2.1.2.2 Greater efficiency

An M&A allows the resulting company to obtain efficiency gains through cost reductions (or cost synergies), revenue increases (or revenue synergies), the exchange of best practices and/or risk diversification.

Cost synergies result from an improved organisation of banking production, a better scale and/or a better combination of production factors. The core objective is to extract benefits from cost complementarities and economies of scale and scope. In practice, cost synergies might be derived from: a) the integration of different skilled teams or information technology infrastructures, b) the combination of different back-office and general services or c) the rationalisation of the domestic and/or international banking networks. The more flexible the labour market, the more likely it is that the company will achieve cost synergies.

Revenue synergies also derive from a better combination of production factors. Improvements in the organisation of activities, however, offer benefits from product complementarities which help to enhance revenues. In practice, revenue synergies might result from the harmonisation of product ranges, the existing complementarities between activities, cross-selling and the generalisation of a 'multi-distribution channel' approach to the various segments of customers.

It should be noted, however, that revenue synergies are much more difficult to obtain compared to cost synergies, because they depend not only on managers' decisions but also on customer behaviour. In this respect, several studies have estimated that some 5% to 10% of a bank's customers leave the bank after a merger.[20] Accordingly, M&As between banking institutions in Europe have very often targeted higher cost synergies than revenue synergies (see Table 6).

Table 6. Synergies announced in recent M&A deals in the EU

Banks	Year	Expected synergies (€ million)	Revenue synergies (%)	Cost synergies (%)
Crédit Agricole-Crédit Lyonnais	2002	760	0	100
CDC-Caisses d'Epargne	2001	500	85	15
Allianz-Dresdner	2001	1080	88	12
Halifax-Bank of Scotland	2001	1113	51	49
Dexia-Artesia	2001	200	15	85
HVB-Bank Austria	2000	500	0	100
RBoS-Natwest	2000	2335	17	83
BNP-Paribas	1999	850	18	82
BBV-Argentaria	1999	511	0	100
Intesa-COMIT	1999	1000	50	50
Banco Santander-BCH	1999	630	0	100

Sources: Annual reports and financial press.

[19] A contestable market is one with low barriers to entry and exit (Baumol et al., 1982). In such a situation, potential competitors may engage in hit-and-run behaviour to take advantage of the super normal profit situation of the market. Contestability hinges on the absence of exit costs (called 'sunk costs'), which are the costs that cannot be recovered by transferring assets to other uses or by selling them. Entry to the financial services sector requires substantial investment that tends to be sunk to a high degree.

[20] See Burger (2001).

To achieve the goal of efficiency, two types of strategies can be pointed out. Firstly, in theory, a merger or an acquisition involving two companies with homogeneous activity profiles should lead to economies of scale by reducing the unitary production costs, as a result of an increase in activity volume and a decrease in the fixed costs obtained by combining the support functions (marketing, information technology, physical infrastructures, personnel management...). The final objective is to obtain a competitive advantage in the activities involved.

In Europe, expectations ride high in the reinforcement of retail banking. The strategy consists firstly in merging domestic banking institutions, while maintaining the existing branch network and secondly in implementing upstream cost synergies, i.e. at the level of physical network management. The desire to achieve greater economies of scale can be seen in the recent operations of several retail banks: BHV in Germany, SCH and BBVA in Spain, CIC-Crédit Mutuel in France, Unicredit in Italy and Lloyds TSB or RBoS-Natwest in the United Kingdom.

The second strategy to achieve greater efficiency is adopted in circumstances where banking institutions are operating in heterogeneous but complementary markets. A merger or an acquisition not only allows the resulting company to widen its customers' portfolio but it also leads to a more diversified range of services and offers scope economies by optimising the synergies between the merged activities. Here, the main objective is to increase revenues, rather than to obtain economies of scale.

For this, two possibilities could be highlighted according to the complementarities attained through diversifying activities or geographical areas. In the first case, scope economies are generally obtained through a merger or an acquisition between either commercial banks and investment banks, or banking and insurance, as illustrated by a few recent transactions in Europe: Allianz-Dresdner in Germany, BNP-Paribas and CDC-Caisses d'Epargne in France or San Paolo-IMI in Italy. Similarly, the acquisition of Bankers Trust by Deutsche Bank was completed mainly to penetrate the American market for investment banking.[21] In the second case, the principle of geographical complementarities has increased the interest on the part of Crédit Agricole to acquire Crédit Lyonnais in France. The first is firmly anchored in the provinces and in rural areas, whereas the second has a strong presence in the Ile-de-France (urban area of Paris) and other large French cities.

In sum, efficiency gains are obtained by input and output adjustments in order to reduce costs, increase revenues and/or reduce risks so as to increase the value added. Restructuring operations can also allow efficiency gains through the reorganisation of teams (managers and employees) and/or the generalisation of 'best practices', known as 'X-efficiency'.[22] Lately, beyond greater economies of scale and scope, efficiency can also be improved by a greater diversification of risks (functional and/or geographical).[23]

In practice, efficiency gains do not appear to be the only explanation for the recent M&A wave in banking.[24] Moreover, gains obtained through increased market power seem to be a strong incentive to merge, but the relationship between market concentration and performance has only been verified partially.[25] There is thus a need to seek other explanations for the current

[21] One might also mention in this context UBS and PaineWebber or Crédit Suisse Group and DLJ in 2000, and Dresdner Bank and Wasserstein Perella in 2001.

[22] Leibenstein (1966).

[23] According to Méon & Weill (2001), a comparison of the annual growth rate of real GDP suggests that the economic cycles of many European countries are not perfectly correlated. Consequently, geographical diversification could enable European banks to significantly reduce their risks.

[24] For more details, see Chapter 4.

[25] Rhoades (1998).

phenomenon.[26] Studies carried out in the United States and in Europe tend to confirm that three other factors are likely to play an important role: 'managerial hubris', mimicry effect and/or defensive reaction.

2.1.3 The role of managers, mimicry effect and defensive reaction

When control and ownership are separated within the firm,[27] managers can pursue other objectives than maximising shareholder value or increasing profit. Instead of enhancing shareholders' wealth, a manager might prefer to serve his own interests. Therefore, it is possible that a merger or an acquisition is mainly dictated by the power, prestige and/or higher remuneration that are related to the management of a larger firm. In that case, it is the desire for power[28] that is expressed, and not the direct interest of the shareholders. This situation is more likely to arise where shareholding is dispersed and passive.

M&A operations can also be triggered by mimicry effect following the consolidation process initiated by competitors in the marketplace.[29] Indeed, within a relatively concentrated sector, the actions of the major 'player(s)' might have an immediate impact on the behaviour of others, inducing in turn a homogeneous behaviour. As Keynes said: "Universal wisdom teaches that it is better for one's reputation to fail with the conventions than to succeed against them".

During the last two decades, indeed, the development strategies in the banking industry were very often induced by common strategic standards, which have led to a rather homogeneous behaviour. As shown in the 1980s, the commercial strategies of banking institutions were marked by a race to achieve a larger size. Similarly, in the 1990s, enhancing the profitability of shareholders' equity became the new development standard. Today, value creation represents the major strategic issue in modern banking management circles.

Moreover, the acceleration of M&A operations could also result from a defensive reaction on the part of a few actors against competitors' initiatives. Indeed, as the wave of mergers spreads, banking institutions that have remained outside the process are likely to become themselves a potential target in a hostile takeover transaction. To protect themselves from possible predators, managers can pursue an active acquisition policy in order to maintain or preserve their position.

Numerous M&As carried out recently in fact seem to have been dictated by the desire to modify the existing equilibrium and to be proactive to others' actions. Sometimes disguised as a hypothetical value creation move, a number of these operations are simply the reflection of the single market impetus, where mergers have simply become the objective rather than the result of careful strategic thinking. Most European banking institutions, reacting to the increased contestability of their national banking market, have sought to strengthen their national position, in order to improve their profitability and to protect their position from new competitive entrants.

Therefore, it seems more likely that the explanation of the recent banking consolidation process must be sought in the new rules of corporate governance. Committed to ensuring the growth of their companies while maintaining their competitiveness and forced to provide equity capital to which pressing remuneration requirements are attached, bank managers have pursued external growth through M&As as a strategic means to expand their activities.

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[26] Deutsche Bank (2001a).

[27] 'Agency relation' of Jensen & Meckling (1976).

[28] 'Managerial' theory (Berle & Means, 1932; Williamson, 1964).

[29] "Follow the leader" strategy.

2.2 Classification[30] of the industrial strategies pursued by the European banking sector through M&A operations

In order to identify the type of merger or acquisition according to its *ex ante* motives, we use both geographical (regional, domestic and cross-border – both EU and international) and activity (to distinguish between within-sectors or businesses and cross-sectors or businesses) criteria.

We are able to define the main characteristics of a typology of the underlying *ex ante* industrial strategies through M&A operations observed in recent years in the European banking sector. These strategies will have different economic effects, depending on the motives behind the transaction. We suppose that the majority of M&As in the European banking sector were at least dictated by one of these strategies. Some examples are given at the end of the table (see Table 7).

[30] The analysis and results are extracted from a chapter in the draft thesis of Ayadi (2004). This typology was validated by the use of the ACP method (factorial analysis of principal components) on a sample of 250 European banks involved in a completed merger or acquisition over the period 1994-2000. This statistical analysis permits the creation of homogeneous subgroups of mergers and acquisitions according to their ex-ante strategies before the M&As were actually announced.

Table 7. Main characteristics of a typology of industrial strategies through M&As in EU banking

	National M&As			**Cross-border M&As**			
Geographical dimension	National consolidation			Pan-European diversification		International diversification	
	National M&As			Pan-European M&As		International M&As	
	National consolidation		National diversification	Cross-border diversification			
Activity segment or business	Same activity, same business	Same activity, different businesses	Different activities	Same activity, same business	Same activity, different businesses	Same activity	Different activities
	Types of industrial strategy						
Industrial strategies	National consolidation (business)	National diversification (business)	National and conglomerate diversification	Business consolidation and cross-border diversification	Business diversification and cross-border diversification	Activity consolidation and international diversification	Conglomerate and international diversification
	Motivations related to the strategies adopted						
Motivations resulting from M&A operations	Increase of the market power in a given market	Reduced risk due to the diversification of activities (of the income), and the extension of the activity into another geographical area	Scope economies through diversification of the held portfolio	Attaining an important size in a cross-border market	Diversification of risks and incomes	Attaining a larger size in a cross-border market	Scope economies and diversification of risks
	Possible economic effects						
Economic effects resulting from the new strategy	Cost savings due to the increase of the volume of the production, rationalisation of the infrastructure and of the administrative office	Increased revenues due to larger size and the diversification of activities	Increase in revenues due to diversification of the portfolio. Possibilities of rationalisation in the administrative office that would involve economies of scale (costs savings)	Developing in new markets in other segments of customers	Increased revenues due to complementarity in businesses	Increased revenues due to international development	Increased revenues to complete diversification
Other Effects	Reduction of banking over capacity (M&A of small banking institutions)	Cost savings due to product diversification	Optimal use of the infrastructures due to complementary activities				
Examples	Crédit Agricole-Crédit Lyonnais (France)	Bank of Scotland-Halifax (UK)	Allianz-Dresdner (Germany)	HVB-Bank Austria (Germany/Austria)	SCH-AKB (Spain / Germany)	ABN Amro-Sudameris (NL / Brazil)	Deutsche Bank-Banker Trust (Germany / USA)

Chapter 3

An Attempt to Assess Banking Consolidation in the EU

Several studies have tried to assess the effects of the banking consolidation wave that occurred in the 1990s. The majority have concentrated on the impact on shareholder value and efficiency on the one hand, and on the consequences for customers – households and SMEs – on the other. Empirical studies have been more useful to policy-makers in terms of their findings related to financial stability and competition, but none to date has established a clear and direct relationship. To assess banking consolidation effects in the EU, it is also crucial to carry out a structural analysis given the strong particularities of European banking markets.

3.1 What economic effectiveness?

Concerning the impact of M&As on shareholder value and efficiency, the results were mixed. Several academic studies have been carried out mainly in the United States, using a wide range of methodologies, from the most basic (event studies or balance-sheet-based indicators) to the most sophisticated (efficiency frontier[31]), but their findings have not been conclusive.

The studies on the impact of mergers on consumer welfare focused primarily on the possible market power effect without verifying that under certain conditions, mergers might improve the customers' surplus.

3.1.1 Value creation: Still not very conclusive results…

It is very difficult to make a final and exhaustive assessment of the effects of European banking M&As on performance for several reasons. Firstly, this phenomenon is still far too new in Europe to have produced sufficient empirical results worthy of serious academic study. As a result, the majority of the studies have mainly focused on the US, but the lessons cannot automatically be applied to the European environment since the regulation and structure of European banking markets are quite different.[32]

Moreover, it is quite difficult to come up with general rules to assess M&As because each one depends on the particular context in which it was carried out (such as the flexibility of the labour market, the applicable takeover regulations including the broader spectrum of anti-take-over mechanisms,[33] the liquidity of the capital market, …), the different sizes of the institutions involved, the corporate structure (private, hybrid or public) and especially the intrinsic characteristics of the operation (friendly or hostile, cash or equity financed …).

3.1.1.1 Banking M&As and value creation

A large number of event studies have been carried out to assess the effects of M&As on stock market values. They all tend to evaluate the change in total market value of the acquiring company plus target institutions – adjusted for changes in overall stock market values – associated with an M&A announcement. This embodies the present value of expected future changes in terms of efficiency and market power. Although these effects cannot be disentangled, the change in market value may be viewed as an understatement of the expected

[31] For more details about efficiency frontier methodologies, see the first chapter of Pujals' thesis (2004).

[32] Dietsch & Oung (2001).

[33] The compromise reached by the Council to accelerate the adoption of the takeover directive in November 2003 has given a maximum flexibility to member states to implement its provisions. This will certainly create different applications from one country to another one.

efficiency improvement, since it is unlikely that an M&A would reduce the market power of the participants.

In the US, the empirical results were mixed.[34] On average, the combined shareholder value (i.e. the bidder and the target) is not affected by the announcement of the deal since the bidder suffers a loss that offsets the gains of the target.[35] Therefore, an M&A only implies a transfer of wealth from the shareholders of the bidder to those of the target. Compared to the 1980s, however, the evidence from the 1990s was more favourable where average abnormal returns have been higher for both bidders and targets.[36]

One problem with event studies is that the announcement of a deal mixes information concerning the proposed merger with information on its financing. Because investors consider the announcement of a stock issuance as ‘bad news’, the negative returns to the bidding bank could reflect the fact that mergers tend to be financed with stocks. Consistent with this notion, one study finds that returns to bidders are significantly higher when mergers are financed with cash relative to mergers financed with new equity.[37]

Other studies have examined the stock market reaction to different types of deals. Houston & Ryngaert (1994) found that the combined gains tend to be greater when the bidding firm is unusually profitable or when there is significant overlap between institutions. The first result is consistent with a market for corporate control favouring competent over incompetent managers. The second result is consistent with the market power hypothesis, according to which a higher market share leads to higher profits. DeLong (2001) found that mergers that concentrate banks geographically or in product create value while those that diversify them don’t create value.

On the other hand, Zhang (1995) found results consistent with the diversification hypothesis, according to which geographical diversification leads to a lower variability of income; and that out-of-market transactions create value for shareholders. Higher market concentration is likely to lead to an increase in prices for retail financial services, leading in turn to an increase in profits. It is also true, however, that firms operating in more concentrated markets are generally found to be less efficient.[38] This effect might offset the gains from an increase in market power and thus leave unchanged the market value of the bank.

In Europe, the few studies carried out to assess the value creation through M&As in banking found positive abnormal combined returns. In the study conducted by Van Beek & Rad (1997),

[34] Rhoades (1994) and Pilloff & Santomero (1997) provide a survey of event studies. Some studies of US banking M&As found increases in the combined value around the time of the M&As’ announcement (Cornett & Tehranian, 1992 and Zhang, 1995); others found no improvement in combined value (Hannan & Wolken, 1989; Houston & Ryngaert, 1994; Pilloff, 1996 and Kwan & Eisenbeis, 1999); while still others found that the measured effects depended upon the characteristics of the M&A (Houston & Ryngaert, 1997). A study of domestic and cross-border M&A involving US banks found more value created by the cross-border M&A (DeLong, 1999).

[35] Stock market event studies of bank mergers have shown that merger announcements typically result in a fall in the equity value of the acquiring firm and no significant gain in the combined value of the two firms together. This result suggests that the market believes that, on average, there are unlikely to be substantial gains realised from bank mergers. And since the value of the acquiring firm typically falls, the market also believes that acquiring firms tend to overpay for acquisitions in anticipation of merger benefits that are not likely to be realised. This is a common finding and is not limited to bank mergers, which points in the direction of a more general problem associated with the corporate governance of M&As.

[36] Houston et al. (2001).

[37] Houston & Ryngaert (1997).

[38] Berger & Hannan (1998).

these returns were not statistically significant. In a more recent study undertaken by Cybo-Ottone & Murgia (2000), shareholder value gains were positive and significant, mostly driven by domestic bank-to-bank deals and diversification of banks into insurance. However, these positive abnormal returns do not necessarily mean that mergers improve efficiency; in fact, one possible explanation for the difference between the European and American markets is that weaker antitrust enforcement in some European countries allows gains in monopoly power from in-market mergers.

Globally, it seems that the large majority of M&As carried out recently, in Europe or in the United States, are far from having proved their effectiveness in terms of value creation in the short run.[39]

3.1.1.2 Banking M&As and Efficiency

Efficiency may be improved following a merger or an acquisition, if the acquiring institution is more efficient *ex ante* and brings the efficiency of the target up to its own level by spreading its superior managerial expertise, policies and procedures.[40] Simulation evidence suggests that large efficiency gains are possible if the best practices of the acquirers reform the practices of inefficient targets.[41]

The M&A event itself may also improve efficiency by awakening management to the need for improvement or to implement substantial restructuring. Alternatively, efficiency may worsen because of the costs of consummating the M&A (legal expenses, consultancy fees, severance pay…) or disruptions from downsizing, difficulties in integrating corporate cultures... Efficiency may also decline because of organisational diseconomies in operating or monitoring a more complex institution.

The studies carried out on a sample of US banks showed, on average, very little or no *cost efficiency* improvement from M&As in the 1980s.[42] However, more recent studies using data from the 1990s were mixed. On the one hand, some found that mergers produce no improvement in banks' cost efficiency,[43] especially when the deals involve very large banks.[44] This may be due to the organisational diseconomies of operating larger firms in relation to

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[39] According to AT Kearney (1999): "58% of the M&As announced and completed are unfortunately a failure. Indeed, the stock market value of the merged entity two years after the operation is lower than the sum of both separated partners three months before". Similarly, Arthur D. Little's study (1999) has shown that: "Two years following the announcement of the operation, the stock market performance of 60% of the companies having merged has been lower than the average of their sector". Finally, according to a KPMG survey (2001): "30% of the M&As have increased the shareholders' value, 39% haven't brought any considerable change and almost 31% have destroyed value". In other words, 70% of mergers were unsuccessful in producing any business benefit as regards shareholder value.

[40] Generally, the acquiring bank in a merger is more cost efficient and more profitable than the institution being acquired. As noted in a recent survey (Berger et al., 1999), this holds for the US (Berger & Humphrey, 1992; Pilloff & Santomero, 1997; Peristiani, 1997; Cummins et al., 1999 and Fried et al., 1999) as well as for Europe (Vander Vennet, 1996 and Focarelli et al., 2002). The expectation is that the more efficient and profitable acquiring bank will restructure the target institution and implement policies and procedures to improve its performance.

[41] Shaffer (1993).

[42] Berger & Humphrey (1992), Srinivasan (1992) and Pilloff (1996).

[43] Peristiani (1997), Berger (1998) and Rhoades (1998).

[44] Akhavein et al. (1997) and Berger (2000).

disruptions from the M&A process, which may offset most potential efficiency gains. And on the other hand, other studies found cost reductions also for very large US banks.[45]

The evidence for European banks is broadly consistent with these results. Domestic mergers among banks of equal size seem to improve cost efficiency, but these results do not hold for all countries and all banks.[46] More recent studies on Italian banks[47] or UK building societies[48] found significant cost efficiency gains following an M&A. Moreover, simulation evidence suggests that a cross-border acquisition may be associated with a reduction in the costs of the target, while little effect is found for domestic M&As.[49] The difficulties in improving cost efficiency may be related to the obstacles often encountered, especially in continental Europe, in reducing a bank's labour force. In fact, personnel reduction, one of the main sources of savings, is hardly an option in countries with rigid labour markets.[50]

Studies on *profit efficiency* of US banks more often found gains from M&As. The fact that cost efficiency is, on average, little improved as a result of a bank merger, does not necessarily mean that there is no improvement in profits. Profit efficiency incorporates both cost as well as revenue efficiency. Revenue efficiency can be improved by simply raising prices as market power[51] is expanded through the merger process itself. Or revenues may rise because the merged institution restructures its assets mix.

Two studies in particular have attempted to determine the profit effects of mergers. Akhavein et al. (1997) found little change in cost efficiency but an improvement in profit efficiency of large US banks from 1980-90 following M&As, especially when both merger participants were relatively inefficient prior to the merger.[52] Also, after merging, banks tended to shift their portfolios to take on more loans and fewer securities. They attribute gains in profit efficiency to the benefits of risk diversification: larger banks have more diversified loan portfolios and lower equity-asset ratios. But their measure of profit efficiency does not account for changes in risk likely to result from such a portfolio switch. Berger (1998) found similar results in a study that includes all US bank mergers, both large and small, from 1990 to 1995.

In Europe, Vander Vennet (1996) found that domestic mergers of equals in European countries have a positive impact on profitability, mainly driven by improvements in operational efficiency. Focarelli et al. (2002) found that Italian deals that consist of the purchase of a majority (but not all) of the voting shares of the target appear to result in significant improvements, mainly due to a decrease in bad loans. For full mergers, they observe that Italian

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[45] Houston et al. (2001).

[46] Vander Vennet (1996).

[47] Resti (1998).

[48] Haynes & Thompson (1999).

[49] Altunbas et al. (1997).

[50] Focarelli et al. (2002).

[51] Many studies of market structure, price conduct and profit performance have found that higher bank concentration is significantly associated with lower prices for deposits, but the relationship between higher concentration and higher profits is often mixed, being sometimes significant and sometimes not. A recent study has found that cost efficiency tends to be lower in markets where concentration is higher (Berger & Hannan, 1998). Indeed, higher concentration (market power) may lead to higher prices and revenues but, with less competition, the incentive to reduce costs to their minimum levels is blunted. So, the higher revenues are largely absorbed in higher costs rather than contributing fully to expanded profits. From this perspective, market concentration seems to have a greater negative effect on cost efficiency than it does on prices.

[52] Other relevant studies include Berger (1993 and 1996), Berger & Mester (1997), Clark & Siems (1997), Cummins et al. (1999) and Berger (2000).

banks aim to change their business focus towards providing financial services and thus increase their non-interest income, rather than to obtain efficiency gains. After the merger, they observe an increase in profitability in the long run that is also related to a more efficient use of capital.

3.1.1.3 What are the reasons of failure and the drivers of success of M&As?

According to a KPMG survey (2001), several factors could explain the incapacity of banking institutions to fully benefit from the pre-assumed synergies to enhance shareholder value through M&A operations:

- poor strategic rationale or a poor understanding of the strategic levers of the whole transaction process
- overpayment of target firm
- overestimation of the potential synergies
- inadequate strategy or planning
- too slow an integration process
- a void in executive leadership and strategic communication
- high integration costs of the information systems and/or risk management
- cultural mismatch
- bureaucratic complexities
- loss of customers
- team defection, particularly in investment banking, where the main know-how resides in human capital.

In this context, the same survey identified the main drivers of success of M&A transactions, along the whole process from strategic planning to the measurement of the outcome:

1) The entire process should be robust, thoughtful and well-managed. Indeed, mergers should not only mean growing in scale. Rather, success requires gaining scale in specific activities or sources of revenues and then using them to become more competitive overall.
2) As a merger or an acquisition is considered as a strategic deployment, it is crucial to redefine the business model by re-organising and prioritising what should be carried out, and take decisions about how and by whom the activities should be handled.
3) A strategic rationale for a merger or an acquisition allows a rigorous assessment of the target company and the deal, understanding the drivers of value and the price range that will enable the purchaser to create value.

Moreover, it appears that banks that have had prior experience with mergers are more successful at lowering costs and creating shareholder value.[53] That is, it is likely that a 'learning curve' is involved in making the merger a success. This finding is supported by consultancy analysis that concluded that firms with prior merger experience were the ones that added the most equity value (relative to peers) after a merger.

According to these findings, it is essential to complement the economic and financial assessment of a merger or an acquisition by a strategic dimension. This not only gives a new horizon to any growth operation, but also enables a more thoughtful and robust process.

3.1.1.4 Conclusions

The empirical evidence suggests that banking M&As do not significantly improve cost and profit efficiency and, on average, do not generate significant shareholder value. These results seem to contradict the motivations cited by practitioners for consolidation strategies, which are

[53] Peristiani (1997).

largely related to economies of scale and scope and to improvements in management quality. However, there are a few possible explanations for the divergence between the econometric evidence and bankers' beliefs:[54]

1) The lack of clear-cut results on the effects of M&A could reflect difficulties in measuring efficiency improvements.

2) Studies restricted to short post-merger periods might fail to detect value gains that can only emerge slowly, after some years. For example, studies restricted to a short post-merger period might fail to account for the efficiency gains of consolidation.[55] Long lags in the improvement of performance may reflect difficulties in refocusing lending policies, rationalising branches, integrating data processing systems and operations, and training the personnel of the target to market the new owner's products.[56] Moreover, culture clashes may be especially harmful in banking,[57] as the relationship with customers depends heavily on soft information, which is more difficult to transfer than such objective information as balance sheet data. The resignation of key executives or the emergence of morale problems due to reassignments or employee turnover may cause a loss of information, especially when the new management has little time to develop customer information.

3) Deals done in the past might have suffered from stricter regulation that prevented firms involved in an M&A from reaping all the benefits of the deal. For example, the limitations imposed by the Glass-Steagall Act on the range of US banks' financial activities could have impeded the realisation of gains from cross-selling. Similarly, restrictions on bank branching or on geographical expansion could have hampered the exploitation of scale economies. This view suggests that the deregulation of banking underway in all major countries (e.g. the Riegle-Neal Act or the Gramm-Leach-Billey Act in the US) might increase the potential for scale and scope economies. The evidence available for the 1990s in the US is consistent with this view.

4) The fact that mergers often occur in waves makes it hard to separate the effect of a single deal from transformations experienced by the industry as a whole.

Another possibility is that – in the presence of agency problems between managers and shareholders – M&As could be mainly driven by non-value maximising motives (such as 'managerial hubris'). Non-value maximising motivations for M&As have been analysed in recent papers that examine the relationship between executive compensation and M&A activity. According to these studies, the motivations of M&As could be traced back to managers' desire to increase their compensation (CEOs of larger institutions earn higher compensation).

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[54] Amel et al. (2002).

[55] In an analysis of the effects of M&A in the market for bank deposits, Focarelli & Panetta (2002) find that in the short run the costs of restructuring the consolidated bank cancel out the gains, which cannot fully emerge for years. In the long run, however, the efficiency gains dominate over the market power effect, leading to more favourable prices for consumers.

[56] Berger et al. (1998) and Calomiris & Karceski (1998) mention three years as the gestation period needed to restructure the merged bank. This was consistent with the results of the interviews conducted by the Federal Reserve Board staff with officials of banks involved in mergers (Rhoades, 1998). In a study of US bank mergers, Houston et al. (2001) find that cost savings and revenue gains take two to four years.

[57] Practitioners indicate that "differences in corporate cultures" is one of the main obstacles to the completion of bank mergers in all the major industrial countries (see BIS, 2001).

There is some evidence that CEOs with higher levels of stock-based compensation relative to cash-based compensation are less inclined to lead their institutions to make acquisitions.[58] Moreover, managers without a large stake in their banks are more likely to get involved in non-value maximising mergers.[59] Thus, managerial hubris may be an important reason for the lack of conclusive evidence on the benefits of M&As among banks during the past decades.[60]

3.1.2 Towards an improvement of the collective welfare?

Based on the hypothesis of the increase of market power, it appears that the creation of mega-banks, by altering the effective competition, does not allow for any immediate profit for consumers because of dominant position abuses[61] and consumers' surplus capture. The effects of an M&A on the collective welfare, however – mainly via prices – will depend on numerous factors.

Firstly, it is necessary to distinguish between national and cross-border M&A operations. Prior studies of the pricing effects of M&As[62] found that national consolidation, by strengthening the degree of concentration, could generate substantial market power, which is likely to be harmful for households and small and medium-sized enterprises (SMEs).

However, the few existing studies on European bank mergers seem to conclude that there are often significant efficiency gains which result in better conditions for consumers. Huizinga et al. (2001) analysed 52 major mergers between European banks between 1994 and 1998, which were found to be largely socially beneficial. Some other studies found strong evidence of positive effects of M&As at a country level, leading to more favourable prices for consumers.[63]

Conversely, cross-border M&A operations would intensify competition in the domestic market but do not change the banks' local market shares. Consequently, the national authorities, after having encouraged the constitution of 'national champions', should promote cross-border and particularly pan-European operations.

Secondly, it is also essential to distinguish M&A operations according to the 'means' used – market power or efficiency gains – to create shareholder value. If the value creation occurs primarily through increased *market power*, the transaction would only constitute a simple profit redistribution in favour of shareholders, but to the detriment of the customers, employees and public authorities, without a net gain in terms of collective welfare. In this case, the transaction involves a simple redistribution between the various stakeholders of the banking institution,

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[58] See Bliss & Rosen (2001). Similar results on the existence of agency problems in the banking industry can be found in Gorton & Rosen (1995) and Ryan (1999).

[59] Palia (1993).

[60] Pilloff & Santomero (1997).

[61] The possibility of a cartel in banking is not purely theoretical and can be prejudicial for effective competition, as shown by the "Cruickshank" report (2000) in the UK and in the Canoy & Onderstal (2003) in the Netherlands.

[62] Berger et al. (1999).

[63] A number of further studies exist at the country level. For example, Focarelli & Panetta (2002), by distinguishing between short-run and long-run effects of M&As, have found strong evidence that these effects are different. Precisely, they showed that national mergers leading to deposit rate changes are unfavourable to consumers in the short-run, but in the long run, if banks succeed in reducing costs, efficiency gains from mergers prevail over the market power effects, so that consumers benefit. Hence, the adverse price changes generated through consolidation are by all means temporary. Thus, studies restricted to a short post-merger period might fail to register the efficiency gains and as a consequence overestimate the adverse price changes.

which does not create wealth for the economy because the increase of banking profits is much lower than the welfare loss suffered by the other economic agents.

On the other hand, value creation obtained through the improvement of *efficiency* (through scale and/or scope economies, risk diversification...), will benefit not only the shareholders, but also the customers (price drop and/or improvement in the quality of the services) and the public authorities (higher solvency of credit institutions). For the employees, the results remain unclear. The overall impact of the consolidation process remains ambiguous, according to whether market power or efficiency effects would prevail.

Many authors have also focused their analysis on banking exclusion and unequal treatment. In this context, Immergluck (2000) explained that the concentration of financial power between a small number of banks – the consequence of the consolidation process – may contradict the principle of universal banking service, whose objective is to ensure equal access to financial products for all people and all communities.

Over the past few years, these developments have encouraged the emergence of specialised financial institutions, taking the form of 'interdependent finance associations' aiming to reduce the harmful effects of banking exclusion on the poorest households, even if the cost of access to these financial services is higher than in traditional banking. Consequently, the establishment of a universal banking service – offering minimum banking services[64] for all the European citizens regardless of their social situation – could be addressed. This could notably permit competitive banking activities that achieve a general interest mission including the social cohesion pillar.

3.1.3 Impact on the quality of banking services: The major role of the new technologies

From a functional standpoint, banking consolidation might improve the quality of banking service under certain conditions, which might improve the customers' surplus. According to the existing literature, the quality of banking service is measured by geographical availability,[65] financial access and the technology integrated in the service.

Banking consolidation is likely to affect access to banking services through branch rationalisation and/or price increases, and also their quality through the reduction of services and/or the loss of customer relationships. In this respect, retail activities appear to be particularly exposed. Indeed, recent empirical studies[66] show that the quality of banking services would be inversely correlated to the size of the institutions restructured. In other words, a merger between large credit institutions would tend to reduce the quality of banking services offered to retail customers, while operations between small- or medium-sized banks might increase it.

If these results are verified in some observed restructuring operations in the US or in Europe, they should be carefully manipulated. Indeed, the study carried out by Morgan Stanley Dean Witter (2000) shows that on the contrary, the incorporation of new information technology, such as the internet, would reduce the price of banking service and strengthen its geographical availability through new distribution channels (e.g. e-banking, call centres, internet services...), leading to the improvement of consumers' surplus.

The customer would benefit from an improvement in the quality of the banking service for two reasons. Firstly, the creation of new distribution channels supplementing the service offered by

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[64] Called '*service bancaire de base'* in France.

[65] Such as the availability of banking services from the branches.

[66] Berger et al. (1999).

the branches would improve the financial services access and the overall geographical availability. Secondly, by integrating new technologies, banking institutions would provide services at higher value-added.

However, this situation could encounter some resistance from the customers, related to the acceptance of new distribution channels. Moreover, access to these new distribution channels requires a substantial financial cost, such as internet access or computer tools, that could be the source of socio-economic discrimination towards some less-favoured population categories.

3.2 Banking consolidation and growth: An ambiguous relationship

For the time being, there are very few analytical models or empirical studies illustrating the impact of banking consolidation on the long-term growth path. Nevertheless, it appears that the possible transmission channels are numerous.[67] It is particularly important to focus on the stability of the banking sector, due to the major role it plays in financing the economy. Indeed, the existence of a sound and safe banking sector depends on the effectiveness of the monetary policy. Currently, the case of Japan illustrates the extent to which this structural element can have a negative influence on the growth path of the economy.

One could think that M&As are likely to strengthen the soundness and the financial stability of the sector for three reasons. Firstly, the persistent threat of a possible repurchase by a competitor urges banking institutions to constantly attempt to be more competitive. Moreover, M&As constitute a kind of natural selection mechanism to permit the increase of the long-term efficiency in the sector, through the rationalisation of the banking supply structure. Consequently, only the 'best' banking institutions will remain in the long term, with the least efficient being repurchased by the most efficient ones. Finally, banking consolidation can also contribute effectively to the elimination of over-capacity and thus strengthen the profitability, competitiveness and therefore the soundness of banking sectors.

The relationship between banking consolidation and stability, however, is not as simple and uniform as it might appear at first sight. In a highly competitive environment, where there is a constant battle to keep the margins and profitability levels high, consolidation could constitute a response to counter the fragility of the system resulting from competitive pressures. Nevertheless, it might also be perceived as a new source of fragility.

More precisely, the current wave of banking consolidation, while leading to the creation of mega-banks, could involve an extension of the application of the 'too big to fail' rule[68] (TBTF), which is likely to exacerbate the consequences of the 'moral hazard' phenomenon.[69] Beyond a certain size, which varies from one country to another, a banking institution cannot declare bankruptcy without generating, by a contagion effect, an enlarged systemic risk,[70] creating instability for the whole banking sector. Consequently, the supervisory authorities are forced to

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[67] De Boissieu (2001).

[68] This rule, which is de facto applied everywhere in the world, has forced the supervisory authorities to act as a 'lender of last resort', in order to contain any possible systemic-risk crisis as a result of the failure of one or more banking institutions (in particular the large ones).

[69] Deutsche Bank (2001b).

[70] Within the banking system, a systemic risk appears when the failure of an important banking institution, or even of several institutions, can contagiously cause the bankruptcy of other institutions and induce situations of serious ruptures within the banking and financial system. The mechanisms of contagion can be in particular psychological (panic behaviour of the participants and/or of the depositors) or technical (through the payment systems and the inter-banking markets, for example).

prevent such a scenario by rescuing large and insolvent banks under the rule of ‘lender of last resort’.

This supervisory behaviour not only causes competitive distortions between large and small-sized banking institutions, but it might also produce a moral hazard effect. Indeed, benefiting from a public guarantee de facto, these mega-banks would feel less compunction to monitor the quality of their assets, and therefore could be exposed to riskier and more volatile activities, thought to be supported over time by competent authorities in the event of serious difficulties. In order to counter this moral hazard problem, and therefore to protect their role as ‘lender of last resort’, the central banks have a) cultivated the principle of ‘constructive ambiguity’, which maintains the uncertainty in their policy and b) implemented two lines of defence: the guarantee mechanisms (of a curative nature) and supervision (of a preventive nature). The latter consists of two complementary aspects: prudential rules and monitoring. Intervention as ‘lender of last resort’ is reserved only for the most extreme cases.

In sum, the banking consolidation process in Europe could generate more efficient banks and a healthier banking system that is less exposed to banking failures. Conversely, it could be a source of greater instability/vulnerability,[71] leading to a chain of bankruptcies and unprecedented financial crises.[72]

Finally, the observation of the recent M&A wave leads to strong contradictions. On one hand, the marketplace has been hit hard by this phenomenon which, since the beginning of the 1990s, has been progressively more pronounced. On the other hand, the rare attempts to assess the real effects of the consolidation process in terms of economic (micro and macro) effectiveness have revealed frequent failures and ambiguous results based on the various performance indicators. Consequently, banking institutions should base their acquisition strategies on a genuine framework mainly oriented to the interests of shareholders, stakeholders and consumers.

3.3 What impact on market structure?

Amongst others, the latest M&A wave contributed substantially to changing the market structure in European banking. These changes might have important effects on the market concentration and capacity utilisation (branches and employment).

3.3.1 Impact on concentration and contestability

The consolidation wave of the 1990s resulted in an overall increase in concentration levels in almost all EU banking markets. Nevertheless, significant differences continue to exist across countries. In some countries, this increase has reached such proportions that concern has been voiced whether it would not lead to an abuse of market position. In others, particularly in countries where small- and medium-sized banks still prevail in the savings or co-operative sector, M&A activity is expected to continue for years to come.

It is important to interpret these concentration indicators with caution. Indeed, principal drawbacks of simple concentration ratios are that they tend to be very general and static. They do not take into account the non-financial institutions, for example. Also, because the data set consists of consolidated figures, they do not distinguish between domestic and foreign operations. For these reasons, concentration index values for small countries with large international banks are overstated.

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[71] Mishkin (1998) and Lambert et al. (1997).

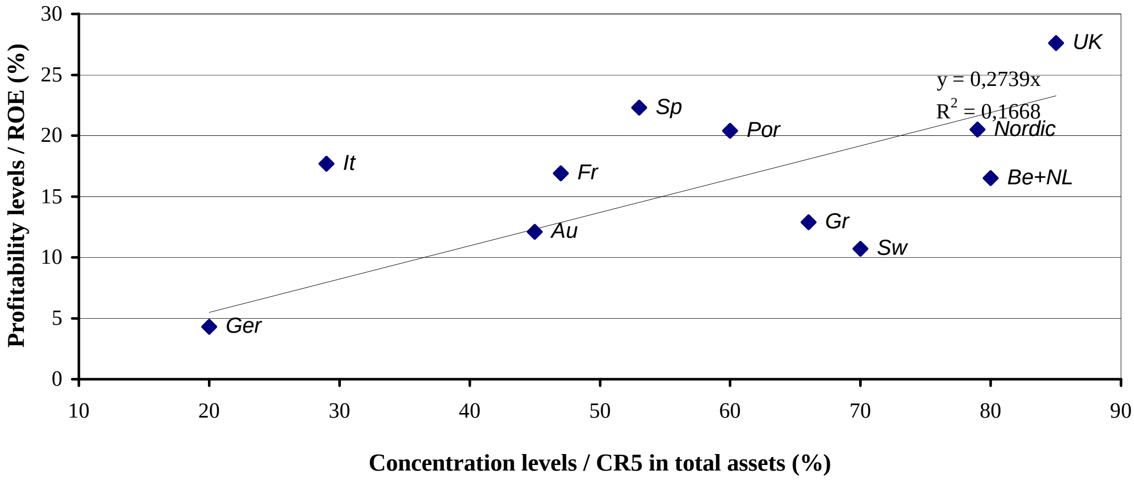
[72] Métais & Michaud (2001).

In addition, the question arises: what reference market (or relevant market) should be used to assess the degree of concentration and competition? The reference market differs depending on the type of services considered (retail or wholesale activities) and also on the geographical dimension. For retail banking, the local dimension of a market is relevant while the international dimension is relevant for investment banking. Ideally, an evaluation of the competitive conditions and the degree of concentration in the banking industry should begin with a rigorous definition of the market under consideration.

In this respect, it is important to address the issue of the degree of contestability of the market to complement the competitive analysis. Indeed, De Bandt (2000) considered that the contestability of retail banking markets is linked to the concentration of the sector because of the sunk costs associated with the bank-client relationship (based on reputation and the role of brand names) and asymmetric information. In addition, the contestability of retail banking has certainly increased as a result of technological change and the major role played by the introduction of the euro.

More applied research undertaken in the area[73] has not been conclusive as regards finding a significant relationship between concentration and profits in banking or identifying the true geographical market associated with a given measure of concentration. To verify this statement, Figure 14 below shows no sign of any systematic or significant correlation (R^2 = 0.1668) between levels of concentration measured by CR5 and profitability measured by the ROE in the main European countries.

Figure 14. Concentration and profitability in banking in the main European countries in 2001



73 The literature on the measurement of competition could be divided into two main streams: the structural and the non-structural approach. The first approach includes the Structure-Conduct-Performance (SCP) paradigm and the efficiency hypothesis. The SCP paradigm investigates whether a highly concentrated market causes collusive behaviour among larger banks resulting in higher market performance, whereas the efficiency hypothesis tests whether it is the efficiency of larger banks that entails better performance. In response to the theoretical and empirical deficiencies of the structural models, the non-structural models derived from the New Economic Industrial Organisation (NEIO) have been developed, namely the Iwata (1974), Bresnahan (1989) and Panzar & Rosse (1987) models. These models have been used to measure the form of competitiveness or the closely related concept of contestability. The Panzar and Rosse model, based on reduced form revenue functions, was very much used to assess the contestability of the EU banking market (Molyneux et al. (1994), Vesala (1995), Bikker & Groeneveld (1998) and Davis & De Bandt (1999).

Following Baumol's 1982 critique that competition depends on the contestability of the market (that is, on the absence of sunk costs), the new empirical industrial organisation (NEIO) literature has argued in favour of a set of tests based on rigorous microeconomic foundations.

In particular, the Rosse-Panzar test[74] relies on the fact that an individual bank will respond differently to the change in costs, depending on whether the bank enjoys some monopoly power or operates instead in a competitive market.[75] Many studies have used the Rosse-Panzar test on European banking markets to assess the competition levels. Vesala (1995) found consistently positive value of *H*, which implies monopolistic competition.

The results of De Bandt & Davis (1999) showed that over the period 1992-96, Germany and France tend to show monopolistic competition for large banks and monopoly for small ones, whereas in Italy there is evidence of monopolistic competition for small and large banks. A more recent study by Bikker & Haaf (2001) confirmed globally a monopolistic competition in all the EU countries. However, depending on *H* value, competition is stronger among large banks operating predominantly in international markets, and weaker among smaller banks, operating mainly in local markets, while medium-sized banks operate in an intermediate position. These results were consistent with the previous findings of Bikker & Groeneveld (1998, 2000). However, a possible drawback of this methodology is that these tests are based on reduced form equations so that they cannot cope with both the diversity of banking products and the integration of financial markets in the EU.

Finally, to assess concentration at the EU level and its impact on competition, the definition of the relevant market segments will certainly be a crucial issue in the years to come.[76] For the time being, however, the European supervisory authorities rely on simple concentration indicators such as the CR5 and the Herfindahl index (see Box 1). Hence, according to Table 8, three observations on concentration levels can be highlighted:

1. Concentration has reached relatively high levels in the Scandinavian and Benelux countries (around 70%); this might give rise to competition concerns for the national authorities in some relevant markets. Consequently, it seems that there is no further scope for domestic consolidation.
2. Despite the relatively advanced integration process of EU financial markets and the introduction of the euro, concentration indicators seems to remain highly dispersed between the EU countries, which illustrates the divergence of national banking structures.
3. With the exception of Ireland and Luxembourg, concentration levels appear to be higher in small countries. Thus, there is a direct relationship between the size of the economy and the concentration level derived from the high dependency on the size of the country or the

[74] Rosse and Panzar (1987) defined a measure of competition *H* as the sum of elasticities of the reduced form revenues with respect to factor prices (*w*) $H = \sum_{k=1}^{m} \frac{\partial R_i^*}{\partial w_{k_i}} \frac{w_{k_i}}{R^*{}_i}$. The market power is measured by the extent to which changes in factor prices are reflected in revenues. Under monopoly, an increase in input prices will increase marginal costs, reduce equilibrium output and subsequently reduce revenues; hence H will be 0 or negative. With perfect competition and when banks are operating at their long-run equilibrium, a proportional increase in factor prices induces an equi-proportional change in gross revenues, in this case H=1. Under monopolistic competition or where potential entry leads to a contestable markets equilibrium, revenues will increase less proportionally than the factor prices because the demand for banking products from individual banks is inelastic, here 0<H<1.

[75] See Schaffer (1993, 1994) for the survey.

[76] See De Bandt (2000).

banking market.[77] The speed (or the degree) of consolidation in a given market is then inversely proportional to the size of the country.

Table 8. Concentration indicators[a] in European banking (in %)

	Total assets[b]				Total credits				Total deposits			
	1990		1999		1990		1999		1990		1999	
	CR5	HHI	CR5	HHI	CR5	HHI	CR5	HHI	CR5	HHI	CR5	HHI
Austria	34.67	0.036	50.39	0.102	33.9	0.032	43.3	0.073	33.12	0.028	39.6	0.054
Belgium	48	na	77.39	0.155	58.0	na	80.38	0.167	67.00	na	74.7	0.135
Denmark	76	na	77.00	0.136	82.0	na	79	0.154	82.00	na	79	0.150
Finland	41	na	74.33	0.191	49.7	na	68.02	0.174	46.08	na	63.4	0.190
France	42.5	na	42.70	0.051	44.7	na	46.4	0.067	58.70	na	69.2	0.133
Germany	14	na	18.95	0.014	13.5	na	15.75	0.012	11.57	na	15	0.009
Greece	83.7	0.25	76.62	0.151	87.2	0.248	74.53	0.129	86.78	0.276	81.7	0.183
Ireland	44.2	na	40.79	0.048	42.9	na	48.22	0.061	43.70	na	51	0.070
Italy	19	0.014	26.00	0.060	28.9	0.015	47.57	0.059	30.64	0.013	46.1	0.058
Luxembourg	na	na	26.09	0.024	na	na	34.32	0.042	na	na	28.1	0.028
Netherlands	73.39	0.117	82.25	0.170	76.7	0.129	81.5	0.160	79.50	0.166	83.4	0.188
Portugal	58	0.096	72.60	0.123	57.0	0.101	72.9	0.130	62.00	0.119	79.6	0.164
Spain	35	0.035	51.90	0.072	31.5	0.033	47.9	0.059	36.28	0.037	45.3	0.054
Sweden	82.68	0.225	88.21	0.195	81.3	0.191	85.3	0.177	90.55	0.234	83.5	0.160
UK	na	0.019	29.07	0.026	na	0.034	30.28	0.036	na	0.024	32.4	0.028

[a] See Box 1.

[b] Calculated on a unconsolidated basis, which implies that only domestic banking assets are included.

Source: ECB (2002).

Box 1. Simple concentration measurements

Concentration has been measured by two different methodologies. The simplest is called CR5, which measures the market share of the five largest banking institutions, in terms of deposits, credits and/or total assets. A more advanced methodology is based on the Herfindahl-Hirschman Index (HHI) = $\sum_{i=1}^{n} PM_i^2$. Where PM_i represents the market share of the bank i and n the total number of banks in the market. Unlike the CR5 ratio, the HHI reflects both the distribution of the market share of the top five firms and the composition of the whole market. It also gives proportionately greater weight to the market share of the larger firms, in accordance with their relative importance in competitive interactions. If HHI reaches its maximum value (1), one bank could retain 100% of the market share, in which case the market is in a monopoly situation. In case of perfect competition, the large number of banks present in the market retains a small market share and the HHI tends to 0.

Table 9 provides a classification of the concentration levels (total assets, credits and deposits, respectively) by group of countries in 1999.

[77] Scherer & Ross (1990) and Sander & Kleimeier (2001).

Table 9. Classification of the countries by concentrations levels in 1999

Type of assets	CR5>60%	40%<CR5<60%	CR5<40%
Assets	Belgium, Denmark, Finland, Greece, the Netherlands, Portugal, Sweden	Austria, France, Ireland, Spain	Germany, Italy, Luxembourg, United Kingdom
Credits	Belgium, Denmark, Finland, Greece, the Netherlands, Portugal, Sweden	Austria, France, Ireland, Italy, Spain	Germany, Luxembourg, United Kingdom
Deposits	Belgium, Denmark, Finland, France, Greece, the Netherlands, Portugal, Sweden	Ireland, Italy, Spain	Austria, Germany, Luxembourg, United Kingdom
Concentration levels	*High*	*Intermediate*	*Low*

Belgium, Denmark, Finland, Greece, the Netherlands, Portugal and Sweden show *high* concentration ratios in assets, credits and deposits. In these countries, opportunities for domestic consolidation are rare. In this respect, competition authorities would probably object to any domestic merger between large players[78] to preserve fair competition.

Let us give the example of retail banking in the Netherlands[79] which deserves a close examination by the competition authorities given its very tight oligopolistic structure. This market is dominated by five main players (ABN Amro, Rabobank, ING, SNS and Fortis), with an estimated combined market share of 93% for payment services and also high percentages for other market segments. Besides that, reputation constitutes the most important entry barrier to new entrants. Indeed, building up a brand name requires substantial advertisement and public relations costs, which cannot be recovered in the event the company must exit the market for payment services. These sunk costs constitute an additional entry and also an exit barrier to the market, which decreases the contestability of the market and harms fair competition.

In Austria, France, Ireland, Italy and Spain, concentration ratios are *intermediate*. In these countries where savings and cooperative banks dominate the banking sector, there might be scope for further domestic consolidation. In France, the deposit market (unlike the credit market) has the distinction of being highly concentrated. This situation is partly due to *l'épargne réglementée* which forms a large part of the deposits distributed through networks such as Crédit Mutuel (Livret bleu) and Groupe Caisses d'Epargne (Livret A).

Finally, in Germany, Luxembourg and the United Kingdom, concentration ratios are *low*. In Germany, this low ratio is due to the highly fragmented character of the banking market and the dual presence of the savings banks (*Sparkassen*) and *Landesbanken* which together maintain a market share of almost 35.5%, compared to 27.3% for commercial banks.[80] At the end of 1999, the market share of the big four (Deutsche Bank, HypoVereinsbank, Dresdner Bank and Commerzbank) was only 15.3%.

[78] The planned merger in Sweden between Skandinaviska Enskilda Banken (SEB) and Foreningssparbanken (Swedbank) was not pursued because of competition concerns.

[79] Canoy & Onderstal (2003).

[80] Deutsche Bundesbank, Activity Report for 2000.

In Luxembourg and the UK, the high foreign penetration could explain their low degree of market concentration. According to the Bank of England, 306 foreign banks were established in the UK in 2000, owning 55% of the total assets. Hence, to correctly portray the British banking market, it is more appropriate to look at the total assets in sterling owned by more than 70% of British institutions, and then to differentiate between wholesale and retail markets. Foreign banks are more active in the wholesale market accounting for 40% of credits to corporate clients, and are almost absent in the retail market where the main British banking institutions share almost 60% of deposits and credits to individual customers.

Despite the ‘low’ concentration of the banking market in the UK, a Treasury-sponsored study (Cruickshank, 2000) concluded that competition problems existed in the markets for money transmission, services to personnel customers and services to SMEs. For services to personnel customers, it found that the supply of current accounts was dominated by a few large firms. For banking services to SMEs, the levels of concentration were even higher. This market structure resulted in high prices, in particular for money transmission services, and high bank profits.[81] The conclusions of the report were sufficiently alarming to cause the bid to be blocked in 2001 by Lloyds TSB for Abbey National.

To conclude, there is a general expectation that consolidation in banking will continue in the coming years, especially where the domestic concentration level is intermediate to low. In countries where competition concerns have already been raised, there will be scope for cross-border consolidation.

3.3.2 Impact on capacity

According to the economic literature and the evidence on capacity reductions, M&As can perform a disciplining function against cost inefficiency and excess capacity (see Box 2) and promote market contestability.

Box 2. Differences between over-capacity and over-branching

Over-capacity (or excess capacity) is by no means straightforward, since it is linked both to market and technological conditions. Excess capacity must not be confused with over-branching even if, under certain circumstances, over-branching could be taken as a good empirical proxy for over-capacity. Davis & Salo (2000) used two different meanings of excess capacity: 1) From the ‘engineering’ viewpoint, excess capacity means a positive gap between the maximum potential output (given labour and capital resources) and the prevailing output. 2) According to the ‘economic’ concept, excess capacity exists when at least one firm in an industry operates in the short term at an output below the optimum level (defined in terms of average cost minimisation) (Shapiro, 1989). Whatever the definition, the empirical measures of over-capacity raise difficult issues. Over-branching is considered as a simple indicator of the density of the branch network and can be used to a certain extent as a simplified measure to qualify excess capacity.

In addition to a decrease in the number of credit institutions, banking consolidation in the EU appears to have been closely associated with capacity reductions through job cuts[82] and branch closures, even though other factors have contributed to this trend, such as technological developments or the decline in the volume of business. This statement is confirmed in Table 10.

[81] An over-profit was estimated between £3 to £5 billion per year by the Cruickshank report.

[82] According to careful estimations, at least 130,000 jobs were likely to have been suppressed in the European financial services sector following the M&A wave over the last decade; the same estimations predict another 300,000 jobs lost in the years following for the same reasons (ILO, 2001).

Indeed, the number of credit institutions, branches and employment in the EU has registered an overall decline of 36%,[83] 2% and 8%, respectively.

Table 10. Branches and employment variation in European banking during the 1990s

	% of change in the number of credit institutions				% of change in branches				% of change in employment			
	90-95	*95-99*	*99-01*	*90-01*	*90-95*	*95-99*	*99-01*	*90-01*	*90-95*	*95-99*	*99-01*	*90-01*
Belgium	-8	-19	-4	**-29**	-16	-11	-12	**-33**	-5	-1	-1	**-7**
Germany	-20	-21	-16	**-46**	-6	20	-7	**5**	-16	6	-1	**-12**
Greece	36	8	7	**56**	21	13	8	**47**	10	9	2	**23**
Spain	-27	-24	-5	**-47**	12	6	-2	**17**	2	2	0	**5**
France	-28	-21	-9	**-48**	-2	-2	2	**-2**	-8	0	na	**-7**
Ireland	17	45	9	**83**	7	0	-10	**-4**	28	-4	na	**23**
Italy	-16	-8	-5	**-27**	32	15	9	**65**	5	-5	1	**1**
Luxembourg*	24	-4	-8	**10**	9	-16	-4	**-13**	7	8	11	**30**
NL	-8	na	-9	**-12**	-19	na	-15	**-39**	-9	na	2	**1**
Austria	-14	-16	-4	**-31**	0	-2	-2	**-3**	-1	-7	1	**-7**
Portugal	-10	-4	-5	**-18**	75	51	30	**245**	-2	-1	-9	**-12**
Finland	-28	-9	7	**-30**	-34	-37	-4	**-60**	-38	-26	4	**-52**
Euro Area	-19	-11	-9	**-35**	0	9	na	**9**	-8	0	na	**-8**
Denmark	-2	72	-3	**64**	-28	2	2	**-24**	-16	1	1	**-14**
Sweden	-65	-41	1	**-79**	-21	-20	na	**-37**	-8	-1	na	**-8**
UK**	-10	-12	-9	**-28**	-6	-21	-8	**-31**	-11	1	-8	**-17**
EU	-21	-11	-9	**-36**	0	6	-8	**-2**	-8	0	na	**-8**
US	-20	-15	-6	**-36**	3	1	na	**4**	-4	7	na	**3**

* Includes local and foreign branches (EU and non-EU).
** Includes major UK banking groups and building societies.
Sources: ECB, US Federal Reserve Board, OECD and authors' own calculations.

Undoubtedly, banking M&As could fully explain the reduction in the number of credit institutions as few banking closures were reported in the 1990s, but this phenomenon must be complemented with other relevant factors to explain the trend observed in employment and branches. Indeed, the development of new technologies would have strongly contributed to the closure of branches in Europe and entailed numerous job lay-offs. For example, the emergence of call centres and e-banking services have created new opportunities for banking institutions to offer their services at a lower cost than that incurred by traditional branching network. Also, in a period of economic downturn, it is inevitable to cut costs through cutting jobs or through a substantial pruning of branch networks.

Besides these factors and banking M&As, one could expect a significant rationalisation of banking branch networks as well as a substantial reduction in employees. Therefore, according to these figures, this trend has not been fully verified by the facts. Why? It seems that the overall effect of M&As on employment and branching is not straightforward. While they might

[83] The overall decrease has been divided into -21% between 1990 and 1995, -11% between 1995 and 1999 and -9% between 1999 and 2001. Likewise, over the same period, the number of credit institutions in the United States has fallen by 36%. Nevertheless, an increase has been registered exceptionally in Ireland due to the entry of foreign banks, in Greece owing to a catch-up effect in its banking infrastructure and in Luxembourg owing to the benefits of taxation. At the end of 2002, the EU banking industry, consisting of some 7,968 institutions including cooperatives and saving banks, could be considered as unusually fragmented, although it has been consolidating at the domestic level for some time.

contribute to massive job losses due to downsizing programmes,[84] they could also generate job creation through the growing banking segments such as investment/corporate banking in the decade of the 1990s, or asset management/private banking and other specialised financial services today.

Moreover, two other particularities in Europe may explain this trend. Firstly, labour market rigidities and the power of labour unions serve to protect employees of banking institutions facing restructuring. Secondly, the branch network remains the most important distribution channel for many banks[85] and customers. So, European banks seem to prefer a multi-channel strategy combining large traditional branching with new distribution channels (mainly e-banking and call centres).

At national level, cross-country differences still persist. It appears that the largest reductions in bank branches have taken place in those countries where e-banking was the most developed and the concentration ratios the highest (Belgium, Denmark, Finland, the Netherlands and Sweden). The number of bank employees has also declined significantly in these countries (except in the Netherlands). In Spain and Italy, the dual structure of their banking systems (savings banks in Spain and regional cooperative banks in Italy) could partly explain the increase in the number of branches and employees.

While the evolution in the number of branches and employees differs from one country to another, one can identify several qualitative changes. In general, European banking institutions are trying to redesign and upgrade their branch networks either by closing branches or by incorporating new technologies, which allows the reallocation of staff to more advanced tasks (back to front office for example).

It is clear that the bank-client relationship is the core strategy of Europeans banks. For that, the development of a rationalised branching network, combined with the new distribution alternatives and well-trained staff is the most effective strategy to apply in the future. With this strategy in mind, European banks will attempt to optimise geographically their branch networks, but this strategic redeployment might penalise less-favoured regions[86] and people.[87]

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[84] A report (see Rhodes, 1998) summarising nine case studies of banking mergers in the United States reported that all nine mergers resulted in significant cost-cutting in line with pre-merger projections. The largest volume of cost reduction was associated with staff reductions and data processing systems and operations.

[85] See ECB (2002).

[86] In the past, it is especially the less-favoured regions that have suffered the most from the closure of the branches (Gosling, 2000).

[87] In their study, Leyshon & Thrift (1996) have shown that financial innovations and the increasing competition in banking during the 1990s in the UK and the US have been very beneficial to higher social classes who had access to a broad range of financial products. Conversely, the poorest communities would have suffered the most from downsizing of branch networks in their areas. Geographical exclusion results from the decision by banking institutions to reduce their risks and costs, to improve their profitability and to create value for their shareholders.

Chapter 4

What prospects for the banking industry in the EU?

The diagnosis of the 1990s shows the importance of the global consolidation wave in the European banking sector, leading to an overall increase in concentration levels. In the long term, the increase in cross-sector and cross-border operations will lead to the creation of international financial conglomerates regardless of the traditional boundaries. It is likely that cross-border transactions will accelerate in countries where domestic consolidation is advanced and/or where competition concerns have been voiced in specific market segments. In countries where cross-border and cross-sector consolidation has already been triggered, the formation of conglomerates is inevitable. Therefore, one might wonder which banking model will emerge to become the dominant one in Europe.

4.1 What are the prospects for consolidation in the medium term?

The EU banking market is considered to be relatively fragmented:[88] regional leaders and national oligopolies still co-exist and very few European banking institutions operate as a global player.[89] There is no doubt that the domestic consolidation wave experienced in most EU countries has resulted in more or less concentrated domestic banking markets. In the most concentrated markets where domestic growth opportunities have become scarce, bank managers will seek new growth opportunities in different geographical areas to benefit from the effects of geographical diversification.

Accordingly, two potential future developments can be expected in the medium term: firstly, the completion of the domestic consolidation[90] taking place in EU countries where concentration levels are intermediate to low, and secondly, an acceleration of cross-border M&A operations,[91] particularly in countries where competition concerns have already been voiced from within the domestic market.

If bank mergers in the past have been hampered by significant regulatory obstacles, the 1992 Treaty on European Union, the 1998 Council directive on the liberation of capital movements, the creation of the euro in 1999 and the European Commission's progress towards the integration of EU financial markets through the Financial Services Action Plan (FSAP[92]) constitute the Union's major achievements in removing the regulatory obstacles to an integrated financial services market. In addition to the unrestrained imperative to acquire an ever-greater market share and to maximise shareholder value, these regulatory changes will sooner or later

[88] ECB (2002).

[89] In contrast to retail banking, some banking institutions operate at EU level in investment or private banking and in a few specialised financial services, such as Deutsche Bank in investment banking and Cetelem (BNP Paribas) or Sofinco (Crédit Agricole) in consumer credit.

[90] According to Fitch Ratings (2001), "The national consolidation process will continue in the main countries of the European Union (Germany, Spain, France, Italy and the United Kingdom) as long as there will remain not more than three or four major banking groups in each country".

[91] According to McKinsey (2003), "An important cross-border transaction is expected between two of the top 15 European banks in the two or three coming years. This might trigger further cross-border consolidation".

[92] See Annex 1 for an overview of the FSAP.

lead numerous banking institutions to adopt this strategic option. In the meantime, cross-shareholdings and strategic alliances might proliferate between the major banks within the EU.[93]

4.1.1 Country analyses: Different patterns of consolidation in the future

In a majority of European countries, domestic operations have been characterised by an increasing average transaction rate since 1998. This has led to the creation of banking 'giants' at the domestic scale. This observation – which seems to reinforce the idea of the maturity of the national consolidation process in numerous countries – foresees the strengthening of the cross-border consolidation phase and the emergence of a few cross-border European 'leaders' in the medium term.

As previously noted, the underlying hypotheses suggest that the swing towards cross-border operations could take place when the concentration threshold admitted by the competition authorities is reached in the national relevant market. Although none of the principal European countries has reached the threshold considered critical, in general the majority of the countries have tended to reach it, but at different degrees (see Table 11).

Indeed, in 2001, two major M&A operations were aborted due to a risk of dominant position at the national level: the failures of the bid for Abbey National by Lloyds TSB due to the veto of national competition authorities in the UK and of the proposed merger between SEB and Swedbank in Sweden due to the opposition by competition services in the European Commission.

These regulatory interventions clearly indicate that as long as domestic consolidation advances, external domestic growth opportunities will become limited due to competitive concerns. Therefore, cross-border consolidation might be the right alternative for fulfilling a targeted strategic external development via geographical diversification and enhancing competition in a domestic market.

This does not exclude the possibility that specific scaled M&A operations could take place in a majority of the European countries (notably France, Spain and the United Kingdom). In France, domestic consolidation is likely to continue but to a limited extent. The last example to date[94] is the acquisition of Crédit Lyonnais by Crédit Agricole. It is nevertheless worth mentioning the case of Société Générale, which might be a perfect target for a larger international bank.

In Spain, an important consolidation wave is expected within savings banks in order to fulfil the objective of reducing local retail excess capacity and in the private sector, where its healthy commercial banks (e.g. Banco Popular and Banco Sabadell) seem to offer an ideal target to international institutions ready to benefit from the geographical redeployment.[95]

Finally, there might be opportunities for the major British players in some specific product areas. For instance, the HSBC and the Royal Bank of Scotland Group will probably make acquisitions in the area of mortgages, since their market shares related to this segment are relatively low.[96] Amongst the principal targets in mortgage, Abbey National, Alliance &

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[93] As examples: the alliance announced in December 2001 by the French Banques Populaires Group and the German DZ Bank for the creation of a federative and powerful mutual network at a European scale and the recent one between Crédit Mutuel-CIC and Banca Popolare di Milano.

[94] In December 2002, Crédit Agricole launched a friendly takeover bid of Crédit Lyonnais. This transaction was approved by the shareholders in June 2003.

[95] The last example to date is the merger between Barclays and Banco Zaragozano (May 2003), creating the sixth largest bank in Spain.

[96] Fitch Ratings (2002).

Leicester, Bradford & Bingley or Northern Rock could be on the list. Germany and Italy, however, still seem to have a fragmented banking market leading many to predict the occurrence of national and scaled M&A operations in those countries in the near term.

Table 11. The status of national consolidation in the European banking sector (as of 2001)

Country	***Status***
Germany	Consolidation starting as obstructive tax legislation and public sector banking system are being tackled
Italy	Consolidation gaining speed thanks to reforms in the banking sector
France	Consolidation to be finalised
Spain	Consolidation of savings banks
UK	Consolidation to be completed – looking at smaller deals
Portugal	Substantially completed
Ireland/Greece	Substantially completed
Austria/Switzerland	Substantially completed
Nordic countries	Substantially completed
Benelux	Substantially completed

Source: Van Dijcke (2002).

In Germany, the banking sector is considered as one of the least concentrated, given its complex structure divided between savings, cooperative and commercial banks. Owing to this fragmented structure, a high wave of concentration is expected in the coming years. As regards the private sector, a continuing consolidation process would make Commerzbank an ideal target among major German commercial banks. The situation is more alarming for the public sector – savings and cooperative[97] banks – for two reasons.

First, the institutions that fall into this category will effectively lose the state support mechanisms by 2005,[98] following the agreement reached by the European Commission and the German authorities. Consequently, the cost of funding will increase and this will force these institutions to pay more attention to the quality of their loan books. Hence, many institutions will become more fragile than others. This situation may increase the potential targets among the German savings banks, in particular within the regional public banks (*Landesbanken*) and the local savings banks (*Sparkassen*).

Secondly, the current situation of the German banking sector seems to be worrying. Indeed, the weak profitability experienced due to excess capacity and high costs, the pressures to adapt to the new competitive environment without government guaranties and the relatively weak

[97] The cooperative banking association has accordingly undertaken to speed up the reduction of banking institutions over the next few years from 1,800 at the end of 2001 to 800 institutions.

[98] As from 19 July 2005, the Landesbank and the Sparkassen will no longer benefit from the state guarantees accorded them by the German regions and municipalities. According to the European Commission, the German system of state guarantees for public law credit institutions is incompatible with the state aid rules of the EC treaty. Indeed, the German state guarantee suggests two separate support mechanisms. The first one, called '*Anstaltslast'* or maintenance obligation, requires the founding entity (a public law entity) to make a capital injection or to provide liquidity support. In this case, the public law bank cannot be subject to insolvency. The second mechanism, called '*Gewahrtragerhaftung*' or guarantee obligation, is a formal unlimited guarantee for the banks' obligations provided by the founding entity. It is an external guarantee and therefore gives creditors a direct claim on the public sector owners of the bank. Hence, thanks to these guarantees, these banks would receive a higher credit rating which would then allow them to have access to funding on preferential conditions.

interest margins (see Figure 15a) will pressure public German banking institutions to undertake significant and necessary structural changes[99] in the coming years. Nevertheless, the particular status of the public banks – being under federal state and municipal ownership – might slow down the process of restructuring.

In Italy, the banking sector has experienced a strong consolidation wave. Some second-ranked private banking institutions seem to have been particularly exposed to the ongoing domestic consolidation movement (Capitalia, Banca Nationale del Lavoro and Banca Monte dei Paschi di Siena). Similarly, the popular banks (*banca popolare*) and the regional savings banks (*cassa di risparmio*), which hold considerable local market shares, have experienced strong consolidation activity in recent years (see Annex 3).

To confirm this diagnosis, the Italian Minister of Finance announced in December 2001 the adoption of a broad reform of the 'banking foundations'[100] which hold significant participation in the Italian banking sector. Its principal objective is to accelerate the disengagement of the Italian foundations from the capital of the banking institutions, which will lead to a dispersion of the ownership of a significant proportion of Italian banks. This will certainly accelerate the restructuring process.

The national consolidation process, having reached its mature phase in most of the European banking sectors, has gradually encouraged interest in cross-border operations. Therefore, until today, the majority of the cross-border M&As at the EU level have been confined to geographical areas with strong historical and cultural links.[101]

However, the merger of HSBC and CCF in 2000 and that of Barclays and Banco Zaragozano in 2003, and the permanent rumours of probable transactions between the major European banking institutions (such as HSBC and Dexia, ABN Amro and Nordea or BNP Paribas and Fortis…) seem to sustain the idea of a growing interest in pan-European operations in the banking community. This is true despite the existing disparities between countries, which not only increase the risk of failure but also limit the expected operational synergies of such operations, particularly in retail banking.[102] Besides, only a few large-scale transactions at EU level may play an important role in triggering a cross-border consolidation process[103] through a chain reaction involving the major banking institutions in Europe.

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[99] The trend has slowly begun to emerge since 1999, with the merger between SudwestLB, Landesgirokasse and Landeskreditbank Baden-Wurttemberg to create Landesbank Baden-Wurttemberg in 1999, between SGZ Bank and GZB Bank to form GZ Bank in 2000 and finally between DG Bank and GZ Bank to create DZ Bank in 2001.

[100] New stricter measures have been introduced for application to the foundations. These rules require the transformation into non-profit-making organisations within a 3-month time frame, in order to separate their mission from that of the banking sector and to compel them to sell their stakes to independent savings management companies. According to the Italian authorities, the purpose of excluding the foundations from the banking sector is "to enable banks to compete at European and international levels in the realms of privatisation and development".

[101] Scandinavian countries (Nordea = MeritaNordbanken-Unidanmark-Christiania Bank), Germany/Austria (HVB-Bank Austria), England/Scotland (Natwest-RBoS), Belgium/France (Dexia), Belgium/Netherlands (Générale de Banque-Fortis) and Spain/Portugal (SCH-Banco Totta & Acores).

[102] As observed by Michel Pebereau, CEO of BNP Paribas, in April 2003: "There will be certainly a large cross-border consolidation in the near future. Nevertheless, owing to the lack of harmonisation of European regulations particularly in the fields of savings taxation and consumer protection, it is difficult today to fulfil the objective of synergies creation, especially in retail banking in Europe".

[103] A study carried out by McKinsey (2002) concluded that the opportunities of mergers between equals seem to be rare in the European banking sector. Indeed, only 22 opportunities of cross-border mergers

Against this prospect, it is important to highlight that the major banking institutions in the UK, which are considered very efficient (see Figure 15b) and strongly valued by the markets, will occupy a prime place in the future reconfiguration of the European banking sector. This will be an impetus to the creation of cross-border group leaders at EU level.

Although there has been a certain convergence in the financial performance of the main European banks (see Figure 15c), the British banking institutions have held the lead in the global market valuation at nearly the equivalent of the combined market value of the Dutch, French, German, Spanish and Italian banks in November 2003 (see Annex 4). As a result, the high valuation of British banks constitutes an advantage for the future pan-European M&A movement.

Figure 15a. Changes in interest margins in the main EU banking sectors

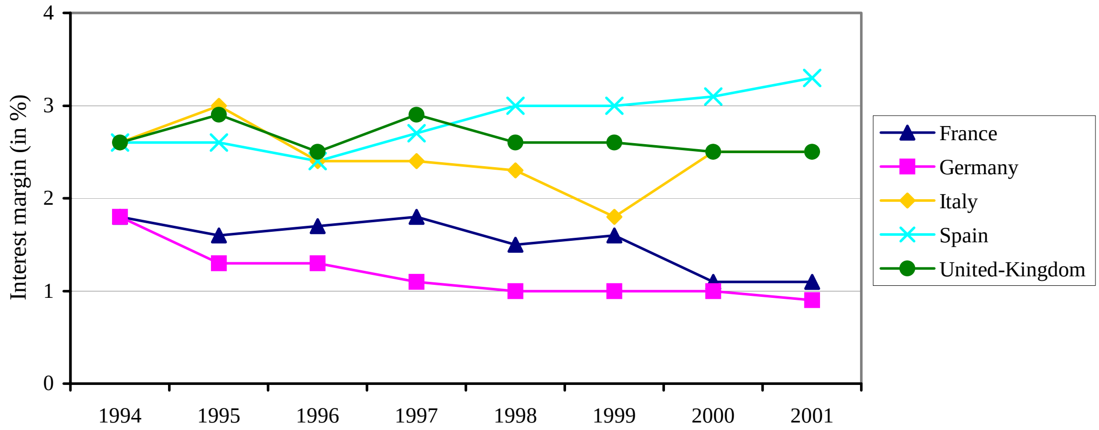
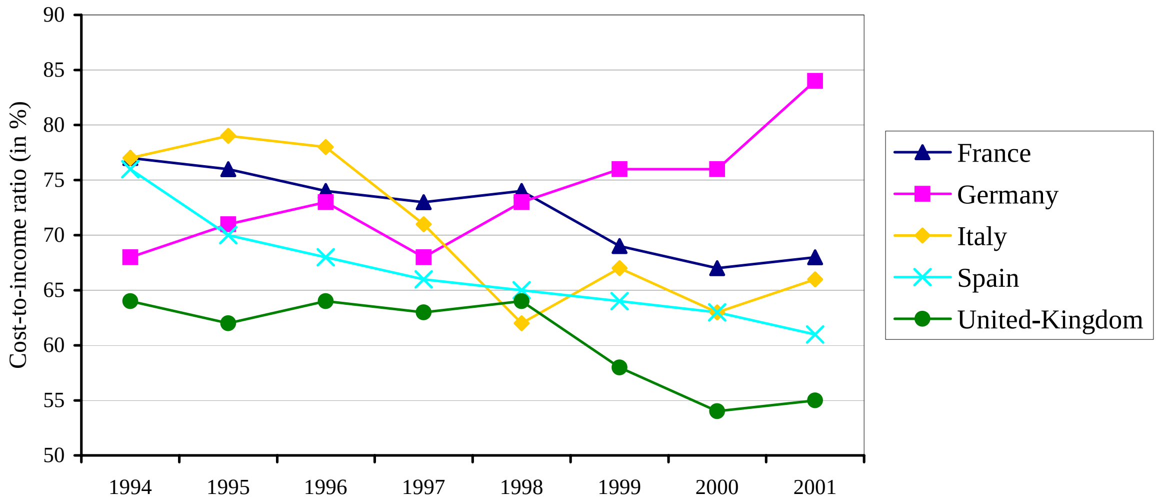


Figure 15b. Changes in the cost-to-income ratio in the main EU banking sectors



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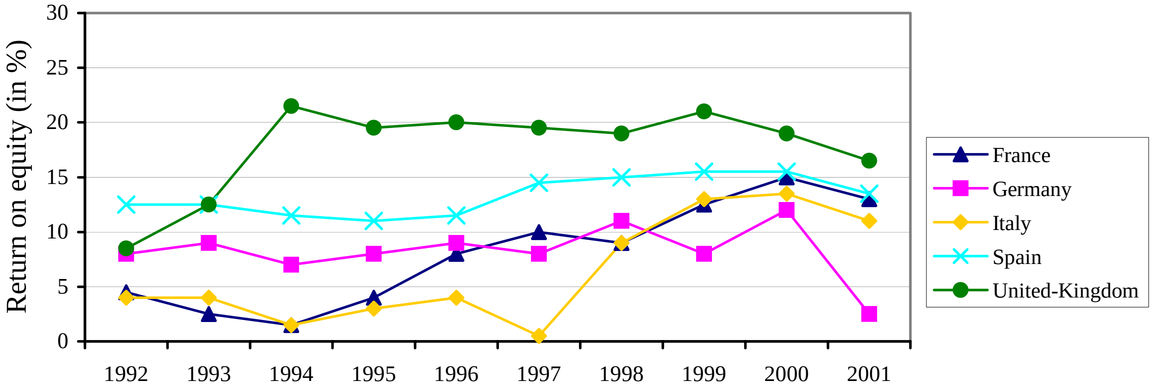
between equals are likely to happen out of a total of 60 cross-border operations. According to this report, two large operations might drop the number of opportunities from 22 to 10.

Figure 15c. Changes in financial profitability for the main EU banking sectors



Source: Bankscope (2002).

4.1.2 Regulatory changes and remaining obstacles to full European banking integration

Many actions have been undertaken since the establishment of the Treaty of Rome in 1957 to create a single European market. Almost 20 years of deregulatory measures (1957-77) have facilitated the right of establishment and the coordination of legislation for banking institutions. In 1973, the Council adopted a directive on the abolition of restrictions on freedom of establishment and freedom to provide services for self-employed activities of banks and other financial institutions.[104]

In 1977, the adoption of the first banking directive on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of credit institutions[105] was the first step to harmonise the regulations by the establishment of the principle of home country control. In 1989, further principles including a single banking licence, home country control and mutual recognition were legally incorporated in the second banking Directive,[106] under which all credit institutions authorised in an EU country would be able to establish branches or supply cross-border financial services in the other countries of the EU without further authorisation, provided that the bank was authorised to provide such services in the home state.

These regulatory developments were complemented by the creation of the single currency in 1999 and the Financial Services Action Plan (see Annex 1), which consists of a long series of initiatives taken to ensure the full integration of banking and capital markets by the year 2005. Besides that, the adoption of the Lamfalussy (2001) process in the area of capital markets is considered as the first step to increase the speed and the flexibility of the European legislative processes. This procedure has been put forward under a committee set up to design and implement common regulations in the area, possibly to be extended to other financial sectors, to enhance the reactivity of regulations to constant market developments.

The adoption of the financial conglomerate directive in November 2002, which aims to enhance the prudential soundness and effective supervision of large financial groups in Europe, and the approval of the investment services directive (ISD) were the major European regulatory achievements in the field of financial services. In addition, it is important to mention the

[104] Directive 73/183/EEC.

[105] Directive 77/780/EEC.

[106] Directive 89/646/EEC.

progress made by the European Commission services as regards the new capital adequacy directive (CAD3) which will apply to credit institutions and investment firms and is expected to enter into force in 2006. This new directive will certainly create a new competitive environment for European banks and investments firms.

As regards the European Community merger regulation, many actions have been taken and are expected to enter into force in early 2004 to better harmonise the merger control procedure,[107] to reduce the burden of the European merger review and to achieve better coordination between the EU and the US.

Besides adding flexibility to the current regulatory system, these developments will create a new regulatory and competitive environment for banks and other financial services providers. On the one hand, they will facilitate any cross-border growth opportunities without the attendant high transaction costs and less regulatory burden and on the other hand will enhance competitive pressures by encouraging new entrants and thus increasing the contestability of the market. To respond to the competitive pressures due to the relaxation of regulatory barriers, banking institutions would have to operate strategically in order to maintain or increase their profitability. Cross-border consolidation could be an adequate response to diversify revenues by acquiring new foreign market shares without incurring any regulatory burden.

Nevertheless, many of the regulatory obstacles identified in the FSAP are not yet removed and important challenges have to be addressed to fulfil the objective of a fully integrated European financial services market by the scheduled deadlines. Following a 14-year period of negotiations aiming to harmonise takeover regulations across the EU, a compromise[108] was reached by the European Council and the European Parliament on the Commission’s new proposal on takeovers bids in November 2003. Nevertheless, there are still many obstacles and controversies to resolve before a system of fair common rules for takeovers bids will have been achieved in the EU for all interested parties. Hence, the lack of minimum harmonised rules on takeovers continues to act as an obstacle to the cross-border consolidation process.

Also, according to the current national regulations on mergers, member states can act individually to protect certain domestic interests from foreign competition. National competition authorities may indeed favour domestic consolidation and discourage acquisitions by foreign banks.[109] Last but not least, divergent taxation rules for savings remain an important issue that needs to be tackled in order to achieve full integration. In addition, the process of establishing harmonisation in consumer information and procedures for solving disputes with financial services providers is still on track. The result is that it is difficult to acquire services abroad, and banks need to develop products separately for different local markets. Consequently, these remaining barriers, which are scheduled to be removed, act as a temporary brake to the current cross-border consolidation process.

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[107] The proposal for review of merger regulation was adopted by the Competitiveness Council in November 2003, and is due to enter into force on May 2004.

[108] The compromise reached by the Council in November 2003 under the Italian Presidency tabled on the introduction of optional arrangements for the application of provisions concerning defensive measures used by the target company and obligations of its board as well as the so-called breakthrough provisions: Article 9 (which aims at ensuring shareholders can vote on which defensive measures to take after a bid has been publicised) and Article 11 (which neutralises measures that could be interpreted as pre-bid defences, including voting right restrictions). The Commission was dismayed by the compromise reached, saying that it had emptied the original proposal of its substance.

[109] This situation still prevails in Italy where the Governor of Banca d’Italia, Antonio Fazio, has always discouraged foreign acquisitions in the Italian banking market aiming to support the creation of national banking leaders in Italy before opening the sector up to international competition.

Finally, the ongoing process of consolidation raises two important questions for the future of the European banking sector: Which banking model is going to prevail in Europe and what reforms to banking supervision in the EU will be necessary?

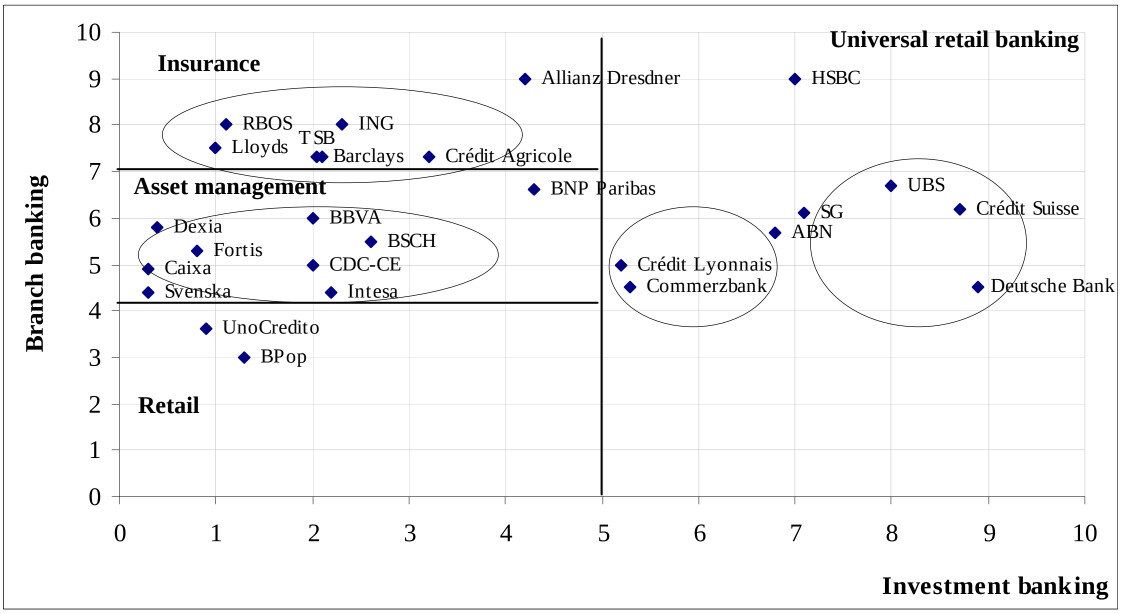
4.2 Towards which banking model in Europe?

Together with the consolidation wave of the 1990s and the regulatory developments undertaken since the mid-1970s, the boundaries between financial activities – which were clear cut in the past – began to blur. This contributed to the enlargement of the range of activities proposed by the major European banks (see diagram in Annex 5). Hence, operating under the universal banking model became more popular than operating in one specific financial activity. In Europe, the integration of the financial markets and the ongoing regulatory changes, including the new Basel Capital Accord, have intensified this trend.

4.2.1 Which banking business model will prevail in Europe?

Whereas a common integrated universal banking model in Europe has prevailed in the past few years, two big trends[110] seem to have emerged following the recent consolidation wave (see Figure 16).

Figure 16. Current business strategies in the European banking sector (end 2001)



Source: Crédit Agricole SA (2002).

[110] Contamin & Melone (2002).

On the one hand, there is *global investment banking*, which is highly concentrated on a worldwide scale and specialised in a few activities – M&A advisory, capital market activities (equities, fixed income, forex, interest rate, derivatives…), corporate or specialised financing (export, real estate…) – for international corporate clients. Deutsche Bank, Credit Suisse Group and UBS are the only European banking institutions to have reached a critical size in investment banking comparable to the American 'bulge bracket' (see Table 12).

Table 12. European ranking of investment banks (M&A advisory, deals completed in 2003)

Rank	Advisors	$ billions	Deals	Market share (%)
1	Goldman Sachs	126.5	58	29.8
2	Lazard	100.1	46	23.6
3	Citigroup	97.8	47	23.1
4	JP Morgan	96.8	60	22.8
5	Morgan Stanley	83.1	56	19.6
6	Merrill Lynch	81.6	44	19.3
7	UBS	75.5	56	17.8
8	Rothschild & Cie	74.4	69	17.5
9	Deutsche Bank	57.1	60	13.5
10	CSFB	44.8	43	10.6
	Industry total	*424.0*	*561*	

Notes: Market shares and deal totals include double counting of deals; therefore markets share totals will not add up to 100%. All transactions over $100 millions are included. Year-to-date is as of 31 December 2003.

Source: Thomson Financial (2004).

Reaching a certain size is necessary in the investment banking segment owing to the high fixed costs inherent in these activities and the importance of having distribution channels around the world. Nevertheless, the economic downturn experienced since 2001 confirmed the high cyclicality of investment banking activities. Consequently, during the past few years, many European banking institutions (such as the British Barclays and Natwest, the Dutch ING and ABN Amro and the French BNP Paribas and Société Générale) have progressively reallocated their capital into other less cyclical banking activities, i.e. essentially retail and asset management (see Table 13).

Table 13. The main characteristics of banking activities

	Customer proximity	**Risk**	**Equity utilisation**	**Economies of scale**	**Entry barriers**	**Income volatility**	**International exposures**
Retail banking	5	2	2	2	4	2	1
Corporate banking	3	4	3	3	3	3	3
Market activities	3	5	3	4	4	4	4
Asset management	3	3	2	5	2	2	4
Corporate finance	2	3	3	3	2	4	4
Bancassurance	3	2	3	3	4	3	3

Note: Ranked from 1 to 5, with very low indicated by a 1 and very high by a 5.

Source: Bellon & Pastré (2003).

On the other hand, the multi-specialised banking institutions or 'universal retail banking',[111] which are heavily involved in retail activities, are considered as the dominant model in Europe. Today, these banks are highly diversified. Their logic is not to merge networks but to associate specialised subsidiaries with a branch network oriented to retail businesses, e.g. private customers, SMEs and corporates, and to offer complementary financial services, such as insurance, asset management, private banking and corporate and investment activities.

For the past few years, the asset management business has been one of the most important activities for banking institutions in Europe owing to the favourable retirement schemes for savings and the likely synergies between the production subsidiaries and their distribution networks. Also, international retail banking, specialised financial services and private banking offered banks new growth opportunities. It is important to note that this strategic redeployment has been accompanied by asset and capital reallocation towards these new activities and probably at the expense of traditional ones.

4.2.1.1 Are specialised banks condemned to disappear?

Recent developments in national, European and American banking legislation seem to encourage a greater diversification of banking activities, with reference to the 'universal banking' model. In the US since the late 1990s, wide-ranging deregulatory measures have been introduced partly through liberalising the legislation contained in the Gramm-Leach-Bliley Act and partly through a more liberal interpretation of the Bank Holding Company Act. Similar regulatory developments in Europe have aimed at the creation of integrated financial markets. The financial conglomerates, including banking, insurance and securities, have represented the most completed form of the diversification strategies.

Beyond the purely regulatory factors, the development of universal banking is justified by economic reasons related to the advantages of diversification with respect to economies of scope, the satisfaction of specific customer demand and risk reduction. Banks might find it profitable to diversify in order to benefit from these range savings and thus to lower their production costs. If economies of scale do not always exist, scope economies resulting from diversification are more frequent.

Also a diversified supply that corresponds to the characteristics of the demand could be the right means to develop customers' trust in the context of intensified competition. Finally, diversification (functional and/or geographical) could reduce risks.[112] Theoretically, a diversified portfolio involves lower risks than its respective individual components, since bad results recorded for one activity could be compensated for by the good results obtained in another.

Nowadays, universal banking can follow a specialisation strategy through an efficiency aim. This dual requirement – diversification versus specialisation – could be satisfied through an internal reorganisation, which leads to a creation of banking groups structured in two levels. At the lower level, banks are organised into specialised productive units benefiting from

[111] See Blanqué (2002).

[112] Banks face three distinct types of risk. The first is related to interest rates and derives from the fact that asset investments have a different period of maturity than savings and consequently, different interest rates. The second type is the risk of solvency, derived from credits granted by banks. The third is liquidity risks which exist because of the possibility of immediate withdrawals which in turn would require the cancellation of asset investments. For the two fundamental theories involving the advantages of diversification, see Markowitz (1952, 1959), which was made more sophisticated by Sharpe (1963, 1964), and Lintner (1965).

management autonomy. At the higher level, the activities benefiting from range savings are gathered into broader entities.[113]

Nevertheless, universal banking is not the only possible business model in Europe. Indeed, the specialised banking model is also viable, although it is subject to certain conditions (size, activity segments...). Specialisation takes on multiple dimensions. Firstly, it can be functional while covering an individual activity and/or customer segment, for example, in private banking or custody. In this respect, it appears that the strategic segments concerned will have to offer a high-growth potential in a reasonably competitive environment. Moreover, specialisation could be geographical: the knowledge of a specific geographical area would be a decisive comparative advantage in the future.

It is difficult to choose between the alternatives of diversification and specialisation. Banking institutions will have to approach this strategic choice with flexibility and pragmatism. Universal and specialised banking institutions will continue to co-exist in Europe, each one having its specific characteristics and responding to individual needs. One of the major objectives of banking consolidation is precisely to reconcile the advantages of diversification, specific to the universal and/or multi-specialised banks, with the search for better specialisation (taking the form of a centring strategy towards the core business).

In this context, it is worth mentioning that European banking institutions are expected to seek recourse in outsourcing[114] and/or offshore[115] strategies for non-core activities to optimise the utilisation of their inputs (productive efficiency objective) and to reduce their costs (cost efficiency objective).

4.2.1.2 Optimum size: A controversial question…

The recent banking consolidation wave, characterised by relatively large-scale M&As, might give the impression that the so-called ‘optimum size’ of banking institutions is getting larger (as in the ‘big is beautiful’ principle) and thus the small and/or medium-sized banking institutions might gradually disappear as the consolidation process advances.

Theoretically, a larger size could lead to economies of scale and economies of scope. With respect to the former, a larger scale would permit better absorption of fixed costs. In fact, the importance of technology investment in the banking cost function reinforces this concept. This is particularly true when the need for software is growing. More precisely, given a certain size, a bank operates with economies of scale when the average cost per unit decreases as output grows.

Conversely, up to a certain size, diseconomies of scale occur when operating costs increase more proportionately than the production volume. Size could also be a source of scope economies when it is possible to generate cost savings from delivering multiple goods and services jointly through the same organisation rather than through different specialised providers.

[113] Plihon (2000).

[114] According to a study by McKinsey (2002), the outsourcing market of banking activities should register an annual increase of 11% up to 2005.

[115] According to a survey by Deloitte Consulting (2003), the world’s 100 largest financial services companies indicate they expect to transfer an estimated value of $356 billion of their operations and 2 million jobs offshore over the next five years in order to reduce their costs. This survey found that financial institutions expect to reduce costs by nearly $1.4 billion each by 2008 by sending work to low-cost centres such as India from developed economies.

Empirical research undertaken in the US and in Europe in the 1990s on the relationship between size and profitability in the banking sector was more conclusive than studies done in the 1980s. Whereas the evidence in the earlier studies on the existence of economies of scale was very weak and exclusively observed up to a rather modest size – only about $10 billion[116] – research in the 1990s found unexploited scale economies even for fairly large banks in both the US[117] and in Europe.[118]

With regard to scope economies, the evidence was more oriented towards diseconomies of scope.[119] Nevertheless, the variety of banking activities suggests that each business follows its own model. Thus, the concept of critical size is different depending upon the type of banking involved. Whereas retail banking could remain domestic, investment banking requires expansion to a continental and even a global level. Consequently, the analysis of size benefits should not be done crudely, but rather at the level of each type of banking activity.

Besides scale and scope economies, banks might want to get larger in order to gain market power. This situation is more prevalent in very concentrated industries with high entry barriers, such as reputation. Also a larger scale could be justified by the benefits of diversification. The significant regulatory progress made towards the integration of the financial markets in Europe has made it easier for banks to operate in other activities, such as asset management and/or insurance.

Finally, thanks to financial globalisation and technological innovation, the recent reconfiguration of the banking environment strengthened the competitive advantage of scale. Size could also be an essential factor in enhancing a bank's image and reputation. Given the necessity to take risks in any banking activity, the customers need to be reassured of the soundness of their bank. Hence, credibility can help to attract or maintain customers.

Despite the advantages of 'big is beautiful', it is far from certain that attaining a larger size is a synonym of higher profitability. Indeed, the race to a larger scale might increase the risks of bureaucratisation, customer remoteness and therefore, inefficiency. Also, it is not certain that small and medium-sized banking institutions are condemned to disappear.[120] Under some conditions, small-sized banking institutions can constitute a genuine comparative advantage. Today, the existence of niche activities, including the majority of services involving a high consulting dimension, such as private banking, could offer an important source of growth well adapted to provide product differentiation and service personalisation demanded by customers.

In the future, although many banking activities will be increasingly dependent on a larger size, it seems that institutions with variable dimensions will co-exist. It is more the product mix and finally, the targeted customer that will determine the optimum bank size.

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[116] Mester (1987a & b) and Vander Vennet (1994).

[117] Berger & Mester (1997) and Berger & Humphrey (1997).

[118] Allen & Rai (1996), Molyneux et al. (1996) and Vander Vennet (2001).

[119] Mitchell & Onvural (1996).

[120] According to Olivier Pastré (2001), "The principles to the survival and the development of small-sized banking institutions are the following: 1) not to work in strong economies of scale businesses, 2) to be specialised, 3) to be flexible, 4) not to take too many risks, 5) to develop cooperation and 6) never sacrifice margins."

4.2.2 Is there any 'best' banking development strategy?

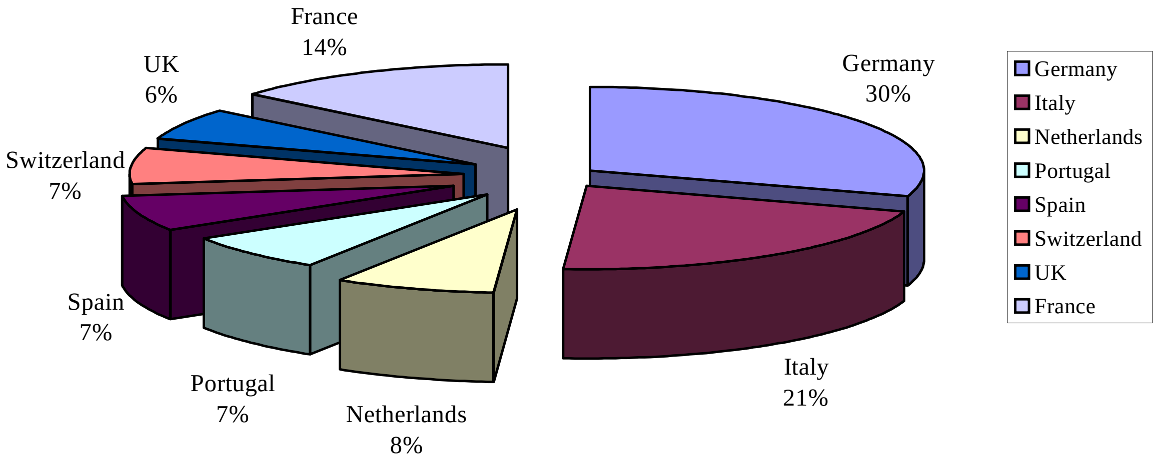
4.2.2.1 Mergers or partnerships?

Integration through mergers or acquisitions is not the only external growth strategy available in the European banking sector. Indeed, trade agreements, joint ventures, strategic alliances, cross-shareholdings... could *a priori* be considered as alternative vehicles for consolidation in Europe. Therefore none of these alternatives is considered to be as an ultimate reference. Many concerns have been raised particularly on the possible definition of an optimum threshold of cooperation. But the only consensus reached is that the smaller the bank, the greater is the need for cooperation.

According to the Group of Ten (BIS, 2001), alliances and cross-shareholdings have had relatively comparable experiences to those of M&As over the past few years. Unlike mergers, however, the alliances in the financial services sector have been mostly established at a European scale rather than at a national scale (see Annex 6). As a result, the emergence of pan-European networks involving the major banking institutions might be a first step towards pan-European mergers or acquisitions.

In practice, cross-shareholdings are very popular in continental Europe (see Figure 17). German and Italian banks have been the most active in recent years in building a finely spun network of cross participation. German financial groups represented 30% of the cross-shareholdings, followed by Italy with 21% and France with 14%. Conversely, such arrangements seem to be unpopular with financial groups in the UK, Benelux and Nordic countries, where very few agreements have been reached. It is important to note that the more fragmented the banking sector; the more the cross-shareholdings strategy is developed.

Figure 17. Distribution of cross-shareholdings in the European financial sector (% of the number of total agreements)



Source: UBS (2003).

The rationale for such a strategy is mainly to establish oneself in new markets without acquiring a banking license and/or board representation, which can be a useful way to influence a partner's behaviour and to prepare for a future strategic acquisition or consolidation scenario.

According to UBS Warburg (2003), cross-shareholdings can be divided into four broad categories on the basis of the rationale on which they were first set up:

- *Offensive market entry.* The typical pattern is for large European financial institutions to seek entry in European markets that remained fragmented, both large and small. The most typical example is Italy where the two largest Spanish banks as well as some of large Dutch and French banks have built minority stakes in local banks, as a future expansion option.
- *Defensiveness.* These transactions have been driven to protect a company from a hostile takeover or to establish an alliance with another institution aiming to position itself ahead of a future consolidation. These considerations emerged during the 1990s, partly as a proactive strategy following the introduction of the euro.
- *Operational focus*. Most cross-shareholdings have been established in the early 1990s at domestic or cross-border levels, partly as a response to the bank-insurance model. Usually, the large European insurance companies buy stakes in banks either in their own home markets or in other European markets aiming to expand their distribution networks. These agreements prevail in countries where bank distribution networks are very strong or where banks have adopted a less aggressive 'bancassurance' model (such as Italy and France) and, thus, they are willing to distribute a third party's products.
- *Tax and accounting-financial considerations*. Tax or financial considerations have been key drivers in both the Benelux countries and in Germany.

In the short term, being more flexible, partnerships are supposed to guarantee the advantages of a merger,[121] i.e. access to new markets or diversifying services offered to customers, without having to support the normal costs (such as financial or human costs...) and risks associated with cultural integration.

However, in the long term, the constitution of a broad network of partners in Europe may not guarantee the synergistic advantages (rationalisation of the productive chain and the unity of the decisions) of a merger or an acquisition.[122] Moreover, partnerships are complex to manage and constitute an unstable equilibrium which can be modified constantly. Thus, pan-European partnership strategies that have succeeded[123] are rare. Indeed, according to a study by Bearing Point (2003), it seems that only few partnership projects are successful, such as that between SCH and RBoS in retail banking and between ABN Amro and Rothschild in investment banking.

To conclude, partnerships or alliances between European banking institutions should be seen more as a temporary solution with the aim of achieving external growth, but they should not be considered as a permanent situation.

4.2.2.2 Do pure e-banks live?

In contrast to earlier studies performed by consulting companies following the internet wave, which forecast an e-banking 'boom' and an erosion of traditional banking institutions, the latest studies have found that the traditional banking actors are more than ever strongly positioned in the e-banking market.

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[121] See Bailly & David (1999).

[122] In October 2002, BNP Paribas signed a 'friendly' accord with Dresdner Bank to put an end to their cooperation agreement, which had existed since 1996, as a result of profound differences in their respective development strategies.

[123] In October 2001, the Spanish banking group SCH decided to reorganise its participation portfolio, keeping only the partnership concluded with the British Royal Bank of Scotland (RBoS), which had positive economic repercussions.

A study done by Accenture (2001), for example, reported that:

- The seven principal French banking groups hold 99% of the on-line accounts.
- Three internet users out of four are likely to open an on-line account with a traditional banking institution.
- Only 6% of them are thinking of closing their accounts in banking branches.

The observations made recently in the United States have strengthened this diagnosis. Thus, according to a study of Gomez Advisors (2001), only 4% of account holders are customers of a pure on-line bank. These results would suggest an uncertain future of the e-banking business model (‘click’ only). To illustrate this statement, two of the major European e-banking players found themselves unable to efficiently pursue their activities and were acquired by banks in 2002.[124]

Traditional banks can see in these results the confirmation that traditional brands are preserved on the internet, and that only a multi-channel distribution strategy combined with a large branch network and e-banking services (‘click and mortar’) is successful today.

Moreover, traditional European banks have perfectly integrated this strategic opportunity by considering that e-banking is not only a fashionable phenomenon with favourable prospects[125] but that it also has strong economic justification. Indeed, e-banking could be an efficient means to reduce banking costs (the transaction costs are ten times lower than those of traditional networks[126]), to enhance productivity and to improve the quality of banking services (see Box 3 and Annex 7).

Under certain conditions,[127] the e-players could probably overcome their initial disabilities, including the lack of recognition, the absence of a customer base, the high costs of acquiring new customers and the absence of a physical network. In addition to the implementation of a minimum agency network, the survival of on-line banking institutions passes through their backing to an already established financial group, which would enable them not only to have access to the broad existing customer base, but also to diversify the range of products and services offered. The experiences of the British Egg, which belongs to the insurer Prudential, and the Dutch ING direct are worth mentioning in this context.

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[124] Boursorama (Société Générale) acquired Self Trade in France and Cortal (BNP Paribas), the German Consors.

[125] In January 2003, *Jupiter* forecasted that the number of online banking users in Europe would increase from 54 million in 2002 to 103 million in 2007. It is expected that the number of online banking users will grow at a Compound Annual Growth Rate (CAGR) of 14%. In the near future, the personal computer will remain the most popular online channel for banking services, followed by wireless devices and interactive digital television. Despite the saturation of many European markets and the negative outlook for internet investment, banks are having success in persuading their customers to migrate onto the internet, giving them plenty of reasons to continue investing strongly in e-banking services in order to support this growth. In April 2003, *Forrester* projected that the number of Europeans using online banking would double to almost 130 million users in five years, representing a CAGR of 21%.

[126] The figures quoted by the British Ministry of Trade and Industry revealed that a financial transaction carried out by a banking agency costs in general $1.07. This cost can be reduced to 52¢ thanks to the use of telephone call centres and to 10¢ by using the internet.

[127] See Taufflieb (2002).

Box 3. Economic advantages of e-banking as a new distribution channel for European banks

Several features of internet banking make it an attractive distribution channel.

- Firstly, there is a decisive *cost advantage*. The costs of internet banking are estimated to be as low one-tenth of those associated with traditional distribution channels. These savings arise from: 1) the lower overall cost of electronic transactions, 2) greater cost economies arising from centralised information collection and transaction processing, 3) rationalisation of financial services production and standardisation of banking processes and 4) the cross-selling of non-banking products.
- Secondly, e-banking offers *enhanced revenue opportunities*. New lines of business are possible from capitalising on existing customer bases, which can be used to match individuals with business customers for e-commerce opportunities or selling advertisement space.
- Finally, there are several *customer benefits*, including: 1) improved price transparency as a large amount of financial services suppliers become accessible on the internet, 2) round-the-clock access to banking services, 3) faster transactions where time is valuable, such as stock market operations or transfers between accounts and 4) easily customised banking services.

Internet banking thus represents a potential strategy for large banking groups to compete in areas where the high initial cost of traditional 'brick and mortar' branches and the dominant position of local players have traditionally acted as barriers to entry.

4.2.3 Prospects for banks after the new Basel Capital Accord (Basel II)

4.2.3.1 An overview of the new capital adequacy regime

The new capital adequacy regime (Basel II) was initiated in response to the perceived drawbacks of the current regulatory regime. Hence, in 1999, the Committee considered that the 1988 Accord was no longer containing the true risks faced by the banking industry and proposed a new framework built on three mutually reinforcing pillars:

- Pillar 1, minimum capital requirements
- Pillar 2**,** supervisory review
- Pillar 3, increased disclosure and market discipline (see Table 14).

Table 14. Framework of the Basel II Accord

Minimum capital requirements	**Supervisory review**	**Market discipline**
• Sets minimum acceptable capital level • Enhanced approach for credit risk (external ratings, internal ratings, mitigation) • Explicit treatment of operational risk • Market risk framework	• Banks must assess solvency versus risk profile • Supervisory review of banks' calculations and capital strategies • Banks should hold in excess of a minimum level of capital • Regulators will intervene at an early stage if capital levels deteriorate	• Improved disclosure of capital structure • Improved disclosure of risk measurement practices • Improved disclosure of risk profile • Improved disclosure of capital adequacy

Source: Mercer Oliver Wyman (2003).

The three main goals of the new Accord are to introduce a framework that is more risk-sensitive and compatible with current market practices; to provide incentives for banks to improve their risk measurements and management procedures; and to better align regulatory capital with economic capital.

With regards to the first pillar, the new Accord offers alternative approaches to credit risk measurements, ranging from the standardised approach to a more sophisticated one called the internal rating-based approach (IRB). While the standardised approach is the simplest, it represents a significant change and improvement with respect to the 1988 capital adequacy guidelines. It incorporates a finer gradation of risks based on the external ratings assessment of the different weighting categories of claims.

The IRB approach ranging from the foundation to the advanced approach allows banks to adopt their internal rating systems after a proper validation by the relevant national supervisory authorities. These approaches are considered to be quite challenging for banks, taking into account the entire body of credit portfolio assessment criteria. As such, the IRB approach represents a considerable amount of complexity but permits a fine and efficient internal risk assessment.

As far as the second pillar is concerned, it requires banks to demonstrate their ability to justify to their supervisors the use of their internal systems to assess their risk profile and the allocation of economic capital, as well as to improve their risk management. Finally, the third pillar focuses on efficient market disclosure.

4.2.3.2 What strategic impacts for European banks?

At the European level, the new capital Accord will be implemented as a European capital adequacy directive 3 (CAD3), taking into account the main characteristics of the European banking industry. This directive along with its annexes will be applied to credit institutions and investment firms by the end of 2006. Undoubtedly, these new regulatory rules will strongly impact the structure of the European banking industry. This is true for at least three reasons.

Firstly, the new rules-setting will entail capital reallocation in banking portfolios (or ‘strategic reorientation’) by introducing significantly different capital requirements across most activities/segments depending upon the approach adopted (standardised, IRB foundation or IRB advanced). More precisely, banks would have to hold higher capital charges for higher-risk segments, such as low-rated SMEs, low-rated sovereigns, and also investment, asset management or custody activities, which had had no capital charges assigned to them under the current Accord. On the other hand, capital charges for retail, consumer credit, mortgage or leasing activities might decrease depending on the approach used. Hence, to enhance their solvency, many banks would be confronted with the choice either of re-capitalisation or withdrawal from riskier activities. Not being able to match the requirement of the universal banking model, these banks might trigger a trend towards a specialisation or re-specialisation strategy.[128]

Secondly, the new Accord may be a driver of M&A activity (see Table 15). Indeed, banking M&As have traditionally been motivated by ‘synergies’, typically opportunities to reduce costs or increase cross-sales of products. The new Accord raises the prospect of capital synergies as a

[128] According to Christian de Boissieu (2001), “We should assist in the coming years to ‘re-specialisation’ of certain European banking institutions which will not be able to match, in the long run, the requirements of the ‘universal banking’ model. This phenomenon could be designated under the ‘overshooting’ terminology”.

driving factor. Banks that use the most sophisticated and costly[129] IRB approaches can potentially liberate capital to acquire less sophisticated banks.

Table 15. Summary of Basel II impacts on M&As

M&A factors	Basel II impacts
Capital release	Acquirers release capital through IRB compliance to help fund purchase
	Unsophisticated banks facing increase in capital requirements under standardised approach could be acquired
Portfolio mixes	Business line profitability shifts prompt shake-outs. Retail banks benefit from increased balance sheet flexibility
Targets identification	Enhanced disclosure via Pillar 3 on risk and capital position aids screening of targets and due diligence
Regional focus for expansion	Regulatory capital changes will differ by country/region, yielding a concentration of possible targets
National barriers	Basel II and IAS reduce international regulatory and accounting differences

Source: Mercer Oliver Wyman (2003).

Indeed, according to the Quantitative Impact Study 3 (QIS 3) results,[130] European banks are expected to release capital if they use the IRB approaches (see Table 16).

Table 16. The global impact of the Basel II proposals on minimum capital requirements

	Standardised approach			IRB foundation approach			IRB advanced approach		
	Average	*Max*	*Min*	*Average*	*Max*	*Min*	*Average*	*Max*	*Min*
G10 Group 1	11%	84%	-15%	3%	55%	-32%	-2%	46%	-36%
G10 Group 2	3%	81%	-23%	-19%	41%	-58%			
EU Group 1	6%	31%	-7%	-4%	55%	-32%	-6%	26%	-31%
EU Group 2	1%	81%	-67%	-20%	41%	-58%			
Others Group 1 & 2	12%	103%	-17%	4%	75%	-33%			

Notes: Group 1: Banks are large, diversified and internationally active with tier-one capital in excess of €3 billion.
Group 2: Banks are smaller and, in many cases, more specialised.

Source: BIS (2003).

This capital could be reallocated more efficiently either internally by streamlining the portfolio to less risky activities or to acquire unsophisticated banks having a strong potential to unlock capital. Conversely, smaller banks that cannot adopt sophisticated and efficient risk models will probably face an increase in capital requirements and a decrease in the quality of their balance sheet, thereby becoming easy targets for high performers' institutions. As larger institutions will benefit from adopting credit risk models to efficiently assess their portfolios and release capital, the motivation to reach a larger size will be a comparative advantage in the future, thus in all likelihood accelerating the consolidation wave.

Finally, the new capital Accord will also foster the emergence of new competitors. Indeed, the developments of new regulatory models will encourage non-banking specialists to enter

[129] According to a report carried out by Mercer Oliver Wyman (2003), banking institutions are spending an average of 5 basis points of assets on compliance, with the largest players typically investing between $100 and $200 million over the next five years.

[130] BIS (2003).

financial services or to expand their portfolios. These firms will avoid the cost of compliance and be able to anticipate and adapt more quickly to the post-compliance world and in many cases hold less capital against the same business portfolio.

Hence, Basel II will give the banking industry one of the biggest structural shocks it has experienced in decades. In the future, advances in risk and balance sheet management will be a clear signal of potential success. Since both strategic and tactical decisions to address the post-Basel II era need to be made, the winners and losers in Europe will become increasingly identifiable as the date for Basel II implementation approaches.

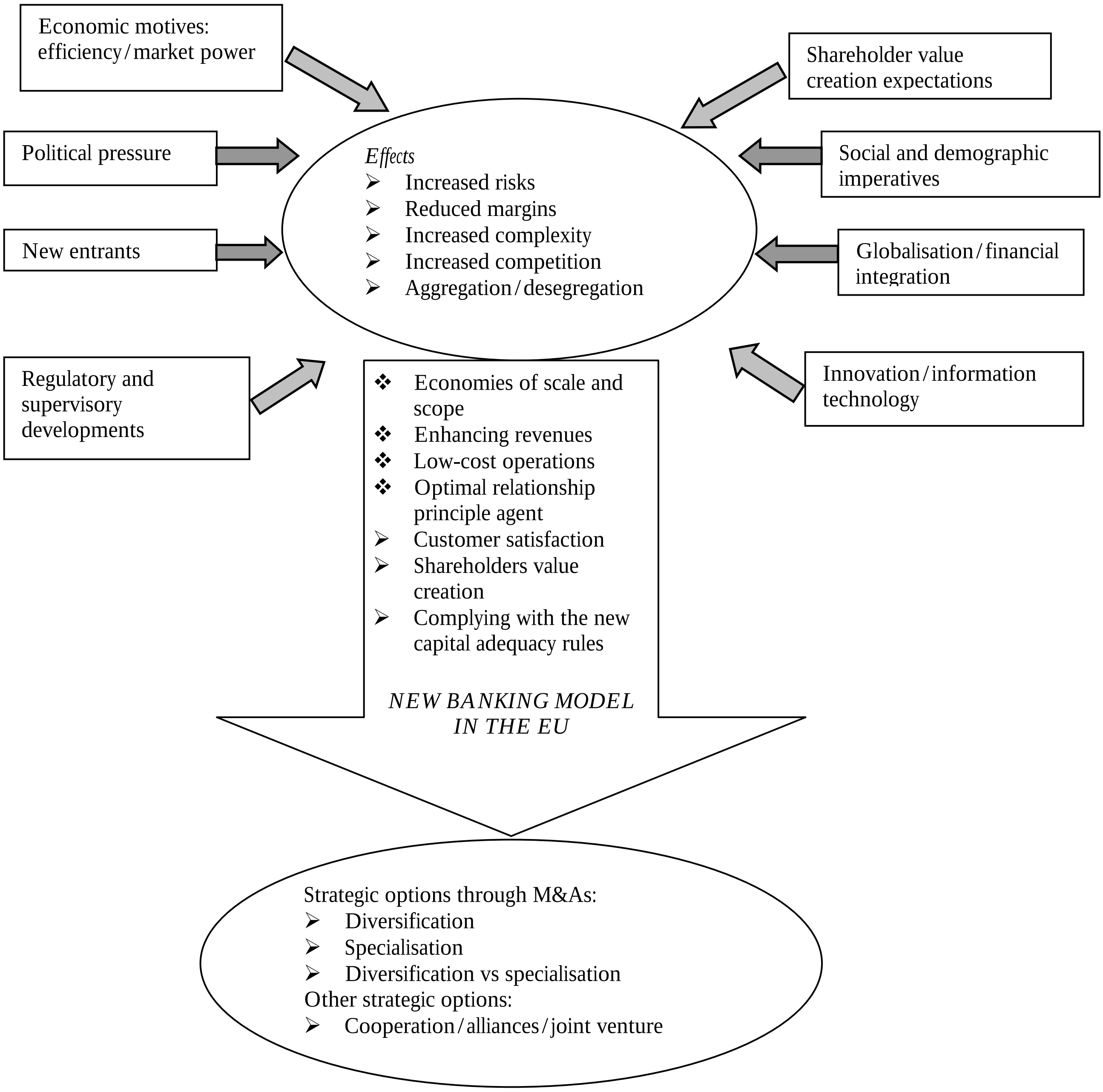
Based on previous developments, it does not seem that there is an ultimate reference model for banking institutions that will prevail in Europe in the coming years. Until today, there is no standard and/or single strategic rule to guarantee the success of one or another banking model at the beginning of the 21st century. The only certainty is that customer satisfaction, shareholder value and compliance with the new capital requirements will be the core objectives of any opportunity or strategic action to come (see Figure 18).

The prospect of growing cross-sectoral and cross-border consolidation as well as the likely convergence of a substantial number of financial institutions to the new universal retail banking model, operating in different activities or/and countries, will certainly create new challenges to supervisory authorities in Europe. Indeed, the proper monitoring of large and complex financial institutions requires effective coordination and cooperation between supervisors within one country, as well as between the national supervisors in different countries.

In that context and given the considerably fragmented and heterogeneous structure of European financial supervision, there is a growing need for cross-sectoral and cross-border financial supervision.[131]

[131] Ruding (2002).

Figure 18. The main characteristics of the new banking model in the EU



4.3 Which prospects for European supervisory authorities?

The diagnosis of the industry in the 1990s has shown that the consolidation wave has contributed to an increase of concentration levels in the domestic markets and to a constitution of banking and/or financial cross-border conglomerates operating in different activities and countries in the EU. Future trends towards more cross-border and cross-sector transactions will generate a new type of systemic fragility by widening the area of the 'too-big-to-fail' rule.[132]

[132] Berger et al. (1999).

This situation is likely to increase the difficulties in supervising financial institutions at national and cross-border levels. Consequently, the task of supervisors has become more demanding.

Besides that, the transition period between the current regulatory capital accord and the new one (Basel II) and the extension of the Lamfalussy process to banking and insurance will create new challenges for supervisors, which have to find a balance between adaptability and flexibility. To respond to these changes and to contain *moral hazard*, the supervisory authorities must not only improve the monitoring of large banks and financial conglomerates but also make sure of the reliability of the control procedures applicable to small and medium-sized banks. Undoubtedly, this would influence the organisation of prudential policy and banking supervision.

Many initiatives have already been taken to develop the practical functioning of supervision and to enhance cooperation between the competent authorities as a first step. Indeed, closer cooperation might prevent systemic crises and financial instability, and provide an answer to the deficiencies due to the geographical decentralisation of the current European supervisory mechanisms and their traditional institutional anchoring. However, in this context of strong financial market integration and increased cross-border and cross-sector consolidation activity, the European supervisory authorities are facing new challenges to effectively preserve financial stability and to contain systemic crises.

4.3.1 The institutional framework and the current state of cooperation in banking supervision

The institutional framework for banking supervision in the EU countries has been established by Community directives – notably the first banking directive in 1977 and the second in 1989 – and relies on two building blocks: national competence (based on the principles of home country control and mutual recognition) and cooperation.

Firstly, by being close to financial institutions at a national level, supervisors could exercise better control if any cause for concern over financial stability appears. This option favours timely access to information and allows detailed monitoring of banks' activities. National competencies are based on two fundamental principles for the practical functioning of the supervision:

1. *Home country control* requires that an institution remains subject to the exclusive control of the supervisory authorities of its home country. Thus, a financial institution can expand throughout the EU countries (offering cross-border services or establishing branches) without extra supervision. The host country has to recognise the home country authorities' supervision. However, the home country authorities are not responsible for the financial stability of the host countries (it is the responsibility of the host country to monitor the stability of its financial system).

   The arguments in favour of home country control are two-fold. Firstly, it promotes the effectiveness of the supervision, as the national supervisor can make a group-wide assessment of the risk profile and the required capital adequacy of financial institutions. Secondly, it promotes the efficiency of supervision, since financial institutions are not confronted with different supervisors likely to result in a duplication of efforts and a higher regulatory burden.[133]

[133] In practice, financial institutions also operate through subsidiaries (separate legal entities) in other countries. These subsidiaries are separately licensed and supervised by the host country authorities. Large financial institutions such as ABN AMRO or Deutsche Bank report to over 20 supervisors in the EU (EFC, 2002).

2. *Mutual recognition* of the authorisations granted to EU banking institutions by their national banking regulatory authorities. Hence, an institution based in one member state can use its national authorisation as a 'passport' to export its activities to other member states, either through the establishment of branches or through the cross-border provision of services.

Secondly, to avoid the possible drawbacks of a fully decentralised approach vis-à-vis an increasingly integrated financial services market, the principle of cooperation between the competent authorities is forcefully stated within the institutional framework of the EU. More precisely, the European supervisory and regulatory cooperation option consists of the adoption of transverse and cross-border information networks throughout the EU countries at the bilateral and multilateral level.

Bilateral cooperation is based on a Memorandum of Understanding (MoU), which is a form of agreement between supervisors having no legal force, but defining the tasks and obligations of both parties. It covers information exchanges between national supervisors and also aims to insure the good functioning and efficient supervision of the financial institutions.[134] On the other hand, the multilateral cooperation between regulators and supervisors (see Table 17), assured by several other committees, aims to improve the rules and the practices of the supervision and to assure an equal treatment.

Although the current institutional framework of banking supervision – based on a decentralised approach combined with ever-more cooperation – has functioned fairly well up to now, it does not seem to be appropriate in an increasingly open and competitive EU context. Indeed, in a period of strong market integration, financial market volatility and increased cross-border or cross-sector activity stimulated by EMU and EU enlargements, the highly fragmented[135] European supervisory structures could reveal their limits in three cases: the supervision of the financial conglomerates, the supervision of cross-border groups and the management of systemic crises[136] within the eurozone.

Being aware of the inadequate regulatory and supervisory structures, national and European authorities undertook a number of institutional and structural reforms in order to improve the efficiency of the current system. As a consequence, many actions have recently been initiated to address the deficiencies of the current system.

In October 2002, the European Commission launched an open consultation on improving the way the EU institutions draw up, adopt and put into effect legislation on financial services (banking, insurance and financial conglomerates). The objective is to strengthen supervisory practices and boost regulatory convergence between the member states, as well to shorten the time necessary for adapting financial regulation to new market developments and practices.

[134] In banking, some 90 bilateral MoUs had been signed by the end of 1999.

[135] Presently, supervision in the EU is dispersed over an extremely complex network of some 39 different institutions and authorities at national or European level.

[136] In the EFC report (2001), the Economic and Financial Committee deplored the fact that the level of coordination between prudential supervisors was still inadequate, especially with regard to devising procedures to cope with financial crises.

The consultation is based on a report[137] from the EU’s Economic and Financial Committee (EFC), endorsed on 8 October 2002 by the Ecofin Council meeting in Luxembourg and approved by the Council in December 2002. In particular, under the new approach based on extending the Lamfalussy framework to the banking and the insurance sectors, the EFC report recommends that arrangements should adhere to those already implemented in the securities sector based on existing inter-institutional agreements, whilst also recognising sectoral characteristics.[138]

Then, in November 2002, the European Parliament adopted the financial conglomerates directive[139] as provided in the strategic objective 3 (namely “prudential rules and supervision”) of the Commission's Financial Services Action Plan (FSAP). This directive will enhance the prudential soundness and effective supervision of financial conglomerates, defined as large financial groups active in different financial sectors and often across borders, which are important for the overall stability of the financial system. It will also promote convergence in national supervisory approaches and will make a much-needed contribution to the stability of the financial sector.

More recently, in March 2003, the banking supervisory authorities and the central banks in the EU have agreed on a Memorandum of Understanding on high-level principles of cooperation in crisis management situations.[140] The cooperation envisaged in the MoU aims to pursue the

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[137] In April 2002, the informal Ecofin Council in Oviedo, having agreed on the need to ensure that the EU has appropriate structures in place for financial supervision to deal with a rapidly changing financial environment, invited the Economic and Financial Committee (EFC) to assess and report on possible arrangements for improving financial regulation and supervision in the EU. A preliminary report on financial regulation, supervision and stability assessing possible options was presented to the Ecofin Council meeting in July 2002, and a final report was completed in October 2002.

[138] EFC (2002).

[139] The directive on financial conglomerates stipulates that a single supervisory authority should be appointed to coordinate the overall supervision of a conglomerate – which may involve many different authorities dealing with different parts of the conglomerate’s activities – and sets out the scope of the responsibilities of that coordinating supervisor. Then, while granting that current MoUs between banking and insurance supervisors are an adequate way to treat financial conglomerates whose activity spreads across a limited number of countries, this directive implicitly acknowledges that this form of cooperation may be insufficient when facing future conglomerates operating all over Europe. Furthermore, the directive amends some existing rules for homogeneous financial groups (banking groups, insurance groups and investment firm groups) in order to achieve more coherence and ensure a minimum of equivalence between the supervisory regimes for such groups and financial conglomerates. This directive must be implemented by member states within 18 months of its publication in the Official Journal.

[140] This MoU, which is not a public document, consists of a set of principles and procedures for cross-border cooperation between banking supervisors and central banks in crisis situations. These principles and procedures deal specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at the cross-border level. The MoU also provides for the setting-up of a logistical infrastructure to support enhanced cross-border cooperation between authorities. The framework defined in the MoU will apply in crisis situations with a possible cross-border impact involving individual credit institutions or banking groups, or relating to disturbances in money and financial markets and/or market infrastructures (including payments infrastructures) with potential common implications for member states. Cooperation will take the form required by the specific features of the crisis and with regard to all the relevant supervisory and central banking tasks and functions, and will be consistent with the necessary flexibility of action of each of the authorities involved. Crisis management procedures will in practice involve a wider range of authorities and respective functions than those within the scope of this MoU. They include ministries of finance and deposit insurance funds, securities and insurance supervisors in the case of crises involving these financial sectors, as well as non-

common objective of banking supervisors and central banks to ensure the stability of the financial system. The progress made in the integration of financial markets and market infrastructures in the EU, the growing number of large and complex financial institutions and the diversification of financial activities have increased the liquidity and efficiency of the relevant markets. At the same time, such developments may also increase the likelihood of systemic disturbances affecting more than one member state, and possibly increase the scope for cross-border contagion.

In this context, the MoU aims to enhance the practical arrangements for handling crises at the EU level, since smooth interaction between supervisory and central banking functions will facilitate an early assessment of the systemic scope of a crisis and contribute to effective crisis management. The MoU also represents a contribution by banking supervisors and central banks towards meeting the recommendations made by the Economic and Financial Committee in its report on financial crisis management (EFC, 2001), as endorsed by the Ecofin Council. In order to follow up on the recommendations of this report, the Banking Supervision Committee of the European System of Central Banks worked on the definition of cooperation principles and procedures, and these have now been formalised in the MoU.

Finally, in November 2003, the European Commission launched a package of seven measures consisting of one directive and six Commission decisions aiming to create a modern and streamlined decision-making structure for financial services designed to improve regulatory and supervisory cooperation. The package aims to extend the committee structure and approach that has been used in the securities sector since 2002 to banking, insurance and investment funds (UCITS). Once agreed and implemented, the measures will produce real benefits by allowing greater and more detailed cooperation between supervisors and much greater convergence in day-to-day regulation and supervision.[141]

In banking, two committees are set up (see Table 17). The European Banking Committee (EBC), which is a regulatory committee, serves to advise and assist the European Commission in adopting implementing measures in banking legislation, as well as adapting the EU directives. The Committee of European Banking Supervisors (CEBS), which is a supervisory committee, aims to improve the practical implementation of EU law in their respective fields in the member states.

EU authorities in the case of crises originating or having an impact outside the EU. The MoU can therefore be regarded as a contribution to other cooperation arrangements that might be implemented or may be developed in the future involving other relevant authorities. The banking supervisory authorities and central banks of acceding countries will be invited to become parties to the MoU once these countries have joined the EU. The MoU entered into effect on 1 March 2003.

[141] To avoid duplication of committees and to avoid pre-empting the views of both the European Parliament and the EU Council of Ministers, the Commission's decisions to establish the EBC and EIOPC and to transfer responsibility for UCITS to the ESC and CESR would be suspended until the proposed directive replacing references to existing committees in current financial services legislation was adopted by the European Parliament and the Council. In addition, the package establishes two committees bringing together national supervisors, the CEBS and the CEIOPS, with effect from 1 January 2004 and 24 November 2003, respectively.

Table 17. The new structure of European supervisory and regulatory cooperation

	Banking	**Insurance and occupational pensions**	**Securities (including UCITS)**	**Cross-sector and horizontal matters**
Regulatory	European Banking Committee (EBC)	European Insurance and Occupational Pensions Committee (EIOPC)	European Securities Committee (ESC)	European Financial Conglomerates Committee (EFCC)
Supervisory	Committee of European Banking Supervisors (CEBS)	Committee of European Insurance and Occupational Pension Supervisors (CEIOPS)	Committee of European Securities Regulators (CESR)	Financial Services Committee (FSC)
Financial stability	ECB's Banking Supervision Committee (ESCB and EU non-central bank supervisors)			Economic and Financial Committee (EFC)

Source: European Commission.

4.3.2 The main scenarios to a more effective supervision in the EU

The choice of an appropriate model for Europe's supervision – regarding in particular the organisational structure – has not yet received much attention. On a conceptual level, the range of possible models for the institutional structure of financial supervision at a national and a European level is identified by Kremers et al. (2001). The main scenarios are summarised in Table 18.

Horizontally, the table shows a classification of the national models. In the *sectoral* model, there are separate supervisors for banking, insurance and securities. In the *functional* model, there are separate supervisors for each of the supervisory objectives: prudential supervision and conduct-of-business (protection of consumers and investors).[142] Finally, in the *integrated* model, there is a single supervisor for banking, insurance and securities combined (or, put alternatively, one supervisor for prudential supervision and conduct of business combined). At the time being, all three national models can be observed at a domestic scale in Europe, but the organisational structure of national supervision is changing in most European countries (see Annex 8).

Vertically, the table shows various forms of European models. The first level depicts *decentralised* supervision with some form of cooperation between national supervisors. Cooperation means decision-making by consensus. The second level is *coordination* between national supervisors. Coordination means international decision-making by autonomous national decision-makers according to some sort of rule (e.g. majority voting). The third level is the *two-tier* model; the largest banking or insurance institutions that operate increasingly at cross-border and cross-sector levels would be supervised at the European level whereas the local institutions could still be supervised at the national level. The two-tier system may constitute the right balance between efficiency and proximity.

[142] The functional model is also known as the 'twin peaks' model (Taylor, 1995).

Finally, the fourth level is a *centralised* structure of supervision. A centralised solution means that supervision is organised on a European basis instead of a national basis. Decision-making on supervisory policy in that case is shifted from the national to the European level. The European structure is currently moving from cooperation to coordination with the extension of the Lamfalussy approach to the whole financial market.

Table 18. The main scenarios leading to an appropriate model for European banking supervision

National models / **European models**	**Sectoral** **(Separation between banking, insurance and securities)**	**Cross-sector: Functional** **(Separation between prudential supervision and conduct-of-business)**	**Cross-sector: integrated** **(all sectors, all practices)**
Decentralised with cooperation	Cooperation in sectoral committees	Cooperation in functional committees	Cooperation between national single agencies (FSAs)
Coordination (or enhanced cooperation)	Coordination between national sectoral supervisors: *Harmonisation in sectoral regulation* **Convergence in supervisory practices in banking, insurance and securities respectively**	Coordination between functional supervisors: *Functional EU-wide legislation* *Convergence in supervisory practices in prudential supervision and conduct-of-business supervision*	Coordination between national single agencies: *Tendency toward single financial services market act within the EU* *Convergence in supervisory practices between national single agencies*
Two-tier	Separate European banking and insurance supervisors for large cross-border institutions and national supervisors for local entities *Coordination between the two level of supervision + European financial market agency*	European prudential or conduct-of- business supervisors for large internationally operating institutions (financial conglomerates) and national prudential or conduct-of-business supervisors for local entities **Coordination between the two level of supervision + European financial market agency**	European single agency for large cross-border institutions and financial markets + national single agencies for local entities *Coordination between the two level of supervision*
Centralised	Separate European banking, insurance and securities supervisors	European prudential supervisor and European conduct-of-business supervisors (broad SEC) **+ European financial market agency**	European Single Agency (European FSA)

Sources: Kremers et al. (2001) and authors.

There are two important questions in this crucial debate on the future design of the structure for financial supervision in the EU: a) Would it be desirable to move from the current national structure to a European structure? b) If so, which model should be chosen for financial supervision at the European level? Both questions are controversial.

The basic argument in favour of moving to a European structure is that it might be difficult to achieve simultaneously a single financial market and stability in the financial system, while preserving a high degree of nationally-based supervision with only decentralised efforts at harmonisation.[143] Arguments against moving to a European solution for the time being could be that the degree of integration in financial markets[144] does not yet justify such a move and that other preconditions have not yet been fulfilled, e.g. harmonisation of financial regulation. The pros and cons of moving supervision to the European level have been extensively debated in the literature.[145]

Nevertheless, we believe that the present stage of enhanced and strengthened cooperation/coordination[146] constitutes only a transitional period in a general trend, which will ultimately lead to the creation of one or several European integrated supervisors. Hence, it appears inevitable that the control of financial institutions and the decision-making process in Europe will have to be done through federal mechanisms even if the information remains decentralised. Although such developments are not currently feasible, given the still relatively fragmented financial services industry and the lack of psychological readiness on the part of national supervisors, the need for ever-closer union will become so urgent in the medium term that the choice of unified supervisor at European level will gradually come to appear preferable. Besides, a major crisis could force national authorities to hasten this inevitable conclusion.

Further financial integration within the enlarged Europe may hence require a move to a more centralised system, as argued previously, but it is too early to provide a definitive answer regarding the optimal institutional structure of the supervision in the EU.[147] It might be entirely speculative to attempt to predict what would be the dominant model for European financial supervision, given the unpredictable structural changes within the financial services industry, and also due to the fact that no prospective scheme (integrated or single-sector specialised supervisors) is currently dominant. Indeed, the evidence is still mixed.

Although an integrated financial supervisor approach may look attractive[148] from an organisational point of view and with respect to the future challenges of financial supervision, it also makes sense to have specialised supervisors for banking, insurance and securities (see Box 4). Indeed, in term of objectives, the independence between a securities market supervisor and a banking supervisor, for instance, is relevant, as the former's priority is to protect retail investors, whereas the latter may have overriding priorities in relation to preserving profitability and the soundness of financial institutions.

Secondly, no empirical research has yet found which organisational model would perform better in terms of achieving the objectives of supervision (financial stability, prudently managed financial institutions and proper treatment of consumers). Furthermore, some authors argue that

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[143] Thygesen (2002).

[144] The process of integrating 15 national financial systems is not yet completed. While wholesale markets are generally largely integrated (with the exception of the fragmented clearing and settlement infrastructure), retail markets are still highly fragmented within the EU. However, the introduction of euro notes and coins in 2002 as well as the removal of remaining legal and regulatory obstacles as envisaged in the Financial Services Action Plan (FSAP) of the European Commission (to be completed by 2005) may give new impetus to the integration of retail markets.

[145] Prati & Schinasi (1999), Lannoo (2000) and Vives (2001).

[146] The European structure is currently moving from cooperation to coordination with the implementation of the Lamfalussy approach to speed-up the regulatory process and to foster supervisory convergence in the EU.

[147] Kremers et al. (2001).

[148] Recently, the increasing conglomeration trend leading to more complex financial services groups has been an important argument in favour of an integrated financial supervisor, but its advantages, compared to specialist supervisors, are not clear-cut. See Lannoo (2002) for more details.

a certain competition may be beneficial to highlight the strengths and the weaknesses of the different models.[149]

Box 4. Specialist vs. integrated financial supervisor: Comparative advantages

Advantages of a specialist supervisor

- Lower profile
- Clearly defined mandate
- Easier to manage
- Better adapted to the differences in risk profiles and nature of the respective financial businesses (e.g. retail vs. wholesale), clear focus on objectives and rationale of regulation
- Closer to the business (but not necessarily)
- Better knowledge of the business, more specialisation
- Stimulates inter-agency competition

Advantages of an integrated financial supervisor

- One-stop shopping for authorisations, and (possibly) a single rule book
- Adapted to evolution in financial sector towards more complex financial products (as credit-derivatives) and financial conglomerates
- Eases cooperation between sectoral supervisor; one lead supervisor or a single supervisory team for conglomerates
- Can reduce regulatory arbitrage and deliver regulatory neutrality
- Pooling of expertise and economies of scale (certain units could be merged; e.g. authorisations, support services)
- Lower supervisory fees
- More transparent to consumers

Source: Lannoo (2002).

However, all possible models should provide a close link between the prudential supervisor and the central bank, which is always responsible for safeguarding financial stability[150] (see Box 5 and Annex 8). This link with the European System of Central Banks (ESCB) is especially important in EMU, since the integration of payment systems and the interbank market could lead to an increase in systemic risk across borders. Central banks are the first to detect this kind of problem and the access by central banks to supervisory information is crucial in these circumstances.[151]

[149] Fender & Von Hagen (1998).

[150] According to Padoa-Schioppa (2002): "Central banks do play and should play an important role in maintaining financial stability, regardless of the institutional structure of supervision". He defined central banks' financial stability functions as occupying a *land in between* monetary policy and supervision, somewhat independent of both functions. Smooth interplay on both borders is, however, crucial. He didn't see a fundamental conflict of interest between preserving price stability and being concerned with financial stability. A successful monetary policy (in keeping prices stable) will not always be sufficient to prevent financial instability. Hence, central banks cannot be indifferent to financial stability. While central bank involvement in financial stability is distinct from, and complementary to, supervisory functions, the role of the central bank needs to be embedded in an appropriate overall supervisory regime, whether or not it is due to the Central bank. Successful conduct of supervisory and central bank functions requires close cooperation and information exchange, and central banks should continue to provide advice on supervisory rules and policies. Moreover, according to Duisenberg (2002): "Central banks have a genuine interest to prevent any financial instability from arising, which clearly has its origins in the Treaty on European Union. Indeed, the Treaty states that the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".

[151] Goodhart & Schoenmaker (1995).

Box 5. The central bank and supervision: Pros and cons

Arguments in favour of assigning supervisory capacity to the central bank. A central bank is best placed:

- To distinguish between problems of liquidity and solvency in order to minimise the losses associated with loans granted and making possible a role as crisis manager;
- To determine the best kind of intervention (open-market or discount operations);
- To profit from economies of scope in the acquisition of information between the function of providing liquidity and that of supervising; and
- To exploit synergies between the conduct of monetary policy and information collected with supervisory purposes. Indeed, banking supervisory information (early warning of problems with non-performing loans or changes in the lending pattern of banks) may improve the accuracy of macro-economic forecasts.

Arguments against the central bank having supervisory capacity:

- The combination of control of monetary policy and the role of lender of last resort (LLR) at the dentral bank raises an inflationary concern. However, a central bank committed to price stability will sterilise the injections of liquidity necessary for the stability of the system in the event of crisis (as the Federal Reserve did in 1987) so that there is no undesired increase in the money supply. In practice, matters may not be so simple, however, and intervention as LLR may give rise to confusion in the expectations of the private sector regarding the central bank's monetary policy stance.
- There may be a conflict of interest between the reputation of the central banks as guarantor of currency and financial stability. For example, concern for the reputation of the central bank as supervisor may encourage an excessive use of the LLR facility so that bank crises will not put its supervisory capacity in question. Underlying the conflict of interest concern are incentive problems among regulators related to their career concerns, accountability and monitoring of their multiple tasks, allocation of control, incentives to produce information and potential capture (see Vives, 2000).
- Some preliminary evidence indicates that central bank involvement in supervision may increase inflation (see Bini Smaghi, 2000 and Di Noia & Di Giorgio, 1999).

The case for an independent FSA. Arguments for the separation of supervision from the central bank:

- Separation facilitates the optimal provision of incentives to self-interested bureaucrats so as to minimise conflicts of interest.
- The convergence between the activities of financial institutions and markets points to the need for the combined regulation of banking, insurance and securities. It is becoming increasingly difficult to separate market-derived risk from credit risk. Banking crises that involve operations with financial derivatives (such as Barings or LTCM) seem to require specialised knowledge of the market regulator. At the same time, banking and insurance tend to converge.
- There are also EU-related political economy considerations. In a system in which the ECB is already perceived as having too much power and faces accountability questions, the creation of an independent regulatory agency may help lessen both concerns. It is easier to hold an agency accountable that has a well-defined mission.

Source: Vives (2003).

Also, the introduction of more risk-sensitive capital requirements (as envisaged by Basel II in banking and Solvency II in insurance) may require stronger interaction of the macro-approach of the central bank and the micro-approach of the prudential supervisor. While risk-sensitive capital requirements foster good risk management (micro), they may also increase pro-cyclicality (macro) as these requirements are sensitive to business cycle effects (increasing capital charges and limiting credit supply, right when the economy is slowing). To dampen these pro-cyclical effects, supervisors may need to require higher capital buffers in 'good' periods, which can in turn be drawn down in 'bad' periods.[152] Consequently, it seems evident that the central bank should be properly involved in the various forms of future EU-wide prudential supervision.

[152] Schoenmaker & Wierts (2002).

4.3.3 Concluding remarks

Historically, different models of regulation and supervision for the financial sector have been developed in the member states. The different solutions currently seen are the result of local developments and market situations, inevitably leading to diverging perceptions and priorities. Therefore, unfortunately, total harmonisation of modes of regulation, in the short run, even if it would be warmly welcomed, is probably not within reach.

However, the lack of harmonisation of supervision and regulation is an important obstacle to the development of cross-border financial services, which is one of the major ways of creating an integrated and more efficient European financial sector. Moreover, a harmonised framework for supervision will contribute to improving the stability of the European financial system.

Given this situation, it is of vital importance in the short run that the goals and functioning of supervisors should be totally compatible between all member states and that a process of continuous convergence is encouraged by the political authorities. The initiative taken in November 2003 by the European Commission to extend the Lamfalussy approach for securities to the banking and insurance sectors is a first step not only to improve the organisation, cooperation and coordination between regulators and supervisors in Europe, but also to ensure more convergence in supervisory practices. But clearly this is not sufficient as was recently stated by the EFR, a group of leading European bank and insurers formed in 2001, to provide a strong industry voice on European policy issues relating to financial services.[153]

In the meantime, an open debate in Europe about the future institutional structure of financial services supervision is also necessary. Several solutions can be envisaged. One possibility is a structure similar to the ESCB, with a centralised organisation, e.g. a European FSA. Another possibility is a specific organisation, operating in all member states, exclusively for cross-border financial institutions (two-tier model). For each of these possible solutions, a choice has to be made between a single supervisor or specialised supervisors for each sector (banking, insurance and securities).

Consequently, it is clear that reform of the future organisation of supervision is a complex process which raises many questions requiring thoughtful and carefully researched answers. Moreover, a complete overhaul of the regulatory and institutional framework, in the short run, might provoke institutional battles and bring more confusion instead of improving the quality of supervision. Hence, we recommend a pragmatic step-by-step approach, both at the national and at the European level, which joins all forces to ensure efficient and effective supervision of financial services in Europe.

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[153] In October 2003, the European Financial Services Round Table (EFR) presented an appeal for harmonised supervision and regulation in the European financial sector. In its main recommendations, the EFR strongly appealed for an increased harmonisation on a European level, promoted convergence of supervisory practices (e.g. changing supervisory organisation only after consultation) and asked for an urgent debate on the future institutional structure of supervision in Europe. According to EFR: “The extension of the Lamfalussy approach to the banking and insurance financial sectors offers an opportunity to improve the organisation and functioning of regulation and supervision in Europe. Nevertheless, there is a risk that the process will not produce the expected results because timing and goals are not precisely defined. In addition it is not clear who will be in the driving seat to point the process in the direction in which it should be heading. The idea that discussion between local supervisors will lead to convergence and best practices is an optimistic view of a complicated and time-consuming process. Furthermore, there is no clear incentive to organise efficient coordination between the different sectors. Finally, the responsibility and mission of each of the committees within the framework of the global European legislative process should be clearly set out.”

Nevertheless, in the medium to long-term, it seems generally accepted that an integrated European financial sector – initiatives such as the FSAP aim precisely to remove the remaining obstacles – implies de facto an integrated European structure for regulation and supervision. Major discussions about the future institutional model of financial supervision for Europe should start as soon as possible in order to move towards a gradual convergence of local systems or at least to avoid further divergence.

Chapter 5

General Conclusions

The diagnosis of the banking industry of Europe in the 1990s showed an intensification of M&A activity. This has led not only to the emergence of large banking groups at the domestic level, ready to deploy out of their national market if competition concerns were to be raised by the national authorities, but has also contributed to the consolidation process in countries where a fragmented banking market still prevails. This trend has been accelerating owing to the continuously changing regulatory and competitive environment which creates pressures for change in order to remain competitive and to benefit fully from the dynamic character of the financial market.

The diversity of European banking markets was illustrated by the difference in consolidation patterns across countries, showing that consolidation is more advanced in the north, with the exception of Germany, as compared to the countries in the south of Europe. This diversity will certainly lead to different evolutions in the medium term. In markets where the concentration threshold is reached, managers will look to cross-border opportunities, especially those offering the greatest growth given the strategic priorities. In markets where the priority is to reduce over-capacity at domestic scale, further consolidation is required.

Nevertheless, one can observe a strong contradiction in the recent M&A wave in banking. On the one hand, banking markets have been hit hard by this phenomenon, which has been steadily growing for over a decade. On the other, economic, strategic and financial studies aimed at assessing the real effects of banking consolidation on efficiency, shareholder value, customer welfare and financial stability were usually inconclusive. Is this a product of a strong divergence between the econometric evidence and the bankers' beliefs or it is simply the shortage of pre-merger analysis and the brevity of the post-merger period on which most economists and strategists have based their post-merger analysis? The reality is that M&As provide an appropriate means to grow externally and to expand into one or more different markets to increase revenues and sometimes to reduce operating costs if the activities imply redundant fixed costs.

In the European context, the previous regulatory developments and the ongoing ones have facilitated the emergence of the universal banking model, which combine retail and investment activities, and in some cases insurance activities. Wisdom suggests that this model is more likely to achieve the theoretical underlying diversification benefits of M&As. This might raise questions in the future, however, as regards the co-existence of multi-specialised banking and specialised banking institutions and their optimal size.

As was stated earlier in this paper, it is difficult to set a general rule between diversification and specialisation alternatives. It is essential for all institutions to approach this strategic interrogation with flexibility and pragmatism. Universal and specialised banking institutions will continue to co-exist in Europe, each one having its specific characteristics and responding to individual needs. And although many banking activities will be increasingly dependent on a larger size, it is fundamental to note that 'big is beautiful' is not an absolute criterion of efficiency and profitability, for it may entail the extension of the application of the 'too-big-to-fail principle'. It is more the product mix and finally, the selected consumer target that will determine the optimum size of a bank.

Accordingly, it is necessary to preserve market competition forces to ensure an efficient and secure financial market that delivers full benefits to consumers and investors. Competition is either preserved by structural changes provided by the market itself, e.g. technological advances that permit the enhancement of the quality of the service – the emergence of financial services providers in competition with the traditional providers, or regulatory intervention. Regulatory and supervisory authorities intervene to ensure financial stability and to contain financial crises.

In Europe the objective of integrating 15 financial markets, which is reaching 25 with the enlargement, poses a strong challenge to competent authorities. Many achievements have already been recorded, at the same time that the financial industry has been reshaped thanks to the consolidation process, including cross-border and cross-sectoral consolidation. The emergence of complex cross-border and cross-sectoral groups in the financial services sector will increase the difficulty for supervisors to ensure day-to-day supervision.

Moreover, the transition from the current capital accord to the new one and the implementation of the growing number of directives in the context of the FSAP will create new challenges for supervisors, which have to find a balance between flexibility and adaptability to respond to these prominent changes. The main issue to be addressed is the future institutional organisation of prudential policy and banking supervision.

It is true that the recent initiative taken by the European Commission aiming to extend the Lamfalussy approach to banking and insurance is an important step to enhance cooperation and coordination between national supervisors to ensure more harmonisation and more convergence in the procedures in the supervisory procedures. But is this a permanent situation or simply a transitional structure aiming to achieve a complete integrated financial supervisor in the long term?

Although several institutional structures can be envisaged for the financial supervision in Europe, it is clear that, in the medium- to long-term, the prospects for an integrated European financial sector implies de facto an integrated European structure for regulation and supervision. But in the short run, a complete overhaul of the regulatory and institutional framework might provoke institutional battles and bring more confusion instead of improving the quality of supervision. Hence, we recommend a pragmatic step-by-step approach, at both the national and the European level, which joins all forces to ensure efficient and effective supervision of financial services in Europe.

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Databases

SDC Platinum M&As and Thomson financial

http://www.tfsd.com

Mergers & Acquisitions

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http://scope.bvdep.com/

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Annexes

Annex 1. The Financial Services Action Plan (FSAP)

Adopted by the European Commission on 11 May 1999, the Financial Services Action Plan (FSAP) outlines a series of policy objectives and specific measures to improve the Single Market for financial services over the next five years. This initiative stems notably from the introduction of the euro, the gathering pace of restructuring in the financial services sector and greater understanding of the need to take account of consumers' concerns. The FSAP suggests indicative priorities and time-scales for legislative and other measures to tackle three main strategic objectives, namely completing a single wholesale financial services market, developing open and secure markets for retail financial services and ensuring the continued stability (prudential rules and supervision) of EU financial markets.

1) Completing a single wholesale market

Market-driven modernisation of EU securities and derivatives markets (such as closer relationships between different exchanges and improved payment and securities settlement systems), spurred by the introduction of the euro, are already making it easier to issue and trade securities across the EU. This brings the potential to generate significant benefits in terms of liquidity, risk-spreading and the emergence of viable risk-capital markets (as an attractive alternative to debt-financing for SMEs). Carefully targeted EU regulatory measures can encourage and facilitate these market-driven improvements. The envisaged EU action would focus on:

- the removal of outstanding barriers to raising capital on an EU-wide basis (updating the directives on reporting requirements and prospectuses);
- a common legal framework for integrated securities and derivatives markets (inter alia clarification and possible amendment of the investment services directive, the proposal for a directive on market manipulation and the communication on the clarification of protection rules for sophisticated and retail investors);
- moving towards a single set of financial statements for listed companies (inter alia amendments to 4th and 7th company law directives);
- providing legal security to underpin cross-border securities trading (inter alia a proposal for a directive on cross-border use of collateral);
- creating a secure and transparent environment for cross-border restructuring (agreement on proposals for a European Company Statute and the takeover bids directive; proposals for Directives on cross-border mergers and transfers of company headquarters; requirement for disclosure of objective and stable criteria for authorisation of restructuring in the banking sector); and
- creating a sound framework in which asset managers can optimise the performance of their portfolios in the interest of the fund-holders (proposals for directives on prudential supervision of and tax arrangements for supplementary pensions and on closed-end collective investment funds).

2) Developing open and secure markets for retail financial services

Consumers wishing to shop around for basic financial services, particularly with the spread of electronic commerce and other methods of distance selling, are likely to be frustrated by an array of legal, administrative and private law obstacles which hamper the cross-border purchase or provision of these services (e.g. single bank account, mortgage credit). The Communication identifies a number of pragmatic steps that could be undertaken to realise this objective. These steps would focus on:

- promoting enhanced information, transparency and security for cross-border provision of retail financial services (inter alia the proposed directive on distance selling of financial services), recommendation on mortgage credit information, proposed directive on insurance intermediaries and action plan to prevent counterfeiting and fraud in payment systems);
- expediting speedy resolution of consumer disputes through effective extra-judicial procedures (communication on out-of-court settlements); and
- balanced application of local consumer protection rules (inter alia communication on waiver from application of local consumer protection rules to business-to-business/sophisticated investor transactions, interpretative communication on 'general good' in the insurance sector).

3) Ensuring the continued stability (prudential rules and supervision) of EU financial markets

EU regulatory safeguards need to keep pace with new sources of financial risk and state-of the-art supervisory practice in order to contain systemic or institutional risk (e.g. capital adequacy, solvency margins for insurance) and take account of changing market realities (where institutions are organised on a pan-European, cross-sectoral basis). Suggested measures include:

- moves to bring banking, insurance and securities prudential legislation up to the highest standards, taking account of the work of existing bodies such as the Basel Committee and the Forum of European Securities Commissions (adoption of proposed directives on winding-up and liquidation of banks and insurance companies and on electronic money, amendment to the money laundering directive, proposals to amend the capital framework for banks and investment firms and amend solvency margins for insurance companies);
- work on prudential supervision of financial conglomerates (proposal for a directive); and
- arrangements to increase cross-sectoral discussion and cooperation between authorities on issues of common concern (creation of a Securities Advisory Committee).

4) Eliminating tax obstacles to financial market integration

The FSAP also addresses broader issues concerning an optimal single financial market, including the elimination of tax obstacles and distortions. The Commission considers that it would be technically unbalanced and politically difficult to boost the full realisation of a Single Market for financial services unless the parallel process of tax coordination currently underway delivers the expected results. The Action Plan therefore underlines the need for adoption of the proposed directive on minimum effective taxation of cross-border income from savings and implementation of the December 1997 Code of Conduct on business taxation. The Commission will also present a proposal for a directive to coordinate tax arrangements governing supplementary pensions and will further examine with the member states (within the Taxation Policy Group) ways to eliminate tax distortions on cross-border financial products (insurance and pension funds).

Source: European Commission.

Annex 2. A Note on the Study's Methodology

The sample contained 151 completed mergers and acquisitions (120 domestic and 31 cross-border deals) executed by banks headquartered in the EU. The announcement dates ranged between 01/01/1994 and 01/01/2001. The deals were obtained essentially from the Thompson Financial Securities, M&A SDC database and from press coverage. The period under scrutiny is of a particular interest because it immediately follows the regulatory changes associated with the completion of the single market programme in the EU, and it also covers the period before and after the introduction of the euro. As a breakdown is made between the domestic and the cross-border deals, both the single market programme and EMU are expected to be catalysts for cross-border M&A activity in banking.

The analysis on the number, value and average value was carried out for the year of the announcement. Only the principal operations (based on the amount of the transaction) announced and carried out are taken into account.

All the deals included in our study are horizontal takeovers that can either be classified as complete mergers (involving the combination of the consolidating partners) or majority acquisitions exceeding the threshold of 49% of voting rights (in which the acquiring bank buys a controlling equity stake in the target bank, and both banks remain legally separate entities), in order to take into account all the operations having generated a transfer of capital control.

The targets and the acquirers are banking institutions as defined in the second banking directive. Insurance and 'securities' are excluded.

Since the legal differences between the various types of institutional banks have been abolished, the sample contains commercial banks, savings institutions, cooperatives banks and public credit institutions.

Annex 3. The Major M&A Deals in the EU Banking Sector, 1995-2002

Year announced	Acquirer	Origin	Target	Origin	Transaction amount (€ million)	Type
1995	Abbey National	**UK**	National And Provincial Building Society	**UK**	1,628.5	Merger
1995	Dresdner Bank	**GER**	Kleinwort Benson Group	**UK**	1,168.3	Merger
1995	Lloyds Bank	**UK**	Tsb Group	**UK**	11,667.1	Merger
1995	Ing	**NL**	Barings	**UK**	770	Merger
1996	Svenska Handelsbanken	**SW**	Stadshypotek	**SW**	2,723.5	Merger
1996	Caisse Nationale Du Credit Agricole	**FRA**	Banque Indosuez	**FRA**	970.3	Acquisition
1996	Mediocredito Centrale	**ITA**	Banco Di Napoli	**ITA**	1,401.1	Acquisition
1996	Credit Local De France	**FRA**	Credit Communal De Belgique	**BEL**	1,488	Acquisition
1997	Societe Generale	**FRA**	Credit Du Nord	**FRA**	332.8	Merger
1997	Sparbanken Severige	**SW**	Foreningsbanken	**SW**	1,153.8	Merger
1997	Bayerische Vereinsbank	**GER**	Bayerische Hypotheken-Und Wechselbank	**GER**	6,491.3	Merger
1997	Nordbanken	**SWE**	Merita	**FIN**	3,831.2	Merger
1997	Banco Ambrosiano Veneto	**ITA**	Cariplo	**ITA**	4,071.5	Merger
1997	Bank Austria	**AUS**	Creditanstalt	**AUS**	1,241.6	Acquisition
1997	Cie Financiere De Paribas	**FRA**	Cetelem	**FRA**	1,919.8	Acquisition
1997	Cie Financiere De Paribas	**FRA**	Compagnie Bancaire	**FRA**	2,406	Acquisition
1998	Almanij Kredietbank	**BEL**	Centrale Raiffeisenkasbank	**BEL**	4,664.8	Merger
1998	Almanij Kredietbank	**BEL**	Abb Verkekeringen Bank	**BEL**	2,047.7	Merger
1998	Credito Italiano	**ITA**	Unicredito	**ITA**	10,032.3	Merger
1998	Istituto Bancario San Paolo Di Torino	**ITA**	Istituto Mobiliare Italiano (Imi)	**ITA**	8,628.3	Merger
1998	Banco Santander	**SP**	Banesto	**SP**	3,544.7	Acquisition
1998	Caisse Centrale Des Banques Populaires	**FRA**	Natexis Banque	**FRA**	548	Acquisition
1998	Credit Mutuel	**FRA**	Cie Financiere Du Credit Industriel (Cic)	**FRA**	2,026.8	Acquisition
1998	Banca Intesa	**ITA**	Cassa Di Risparmio Di Parma (Cariparma)	**ITA**	2,121	Acquisition
1998	Credit Agricole	**FRA**	Sofinco	**FRA**	1,470	Acquisition
1998	Dexia	**BEL / FRA**	Banco De Credito Local	**SP**	2,600	Acquisition
1999	Banco Santander	**SP**	Banco Central Hispanoamericano (Bch)	**SP**	9,713	Merger
1999	Hsbc	**UK**	Safra Republic Holdings	**LUX**	2,413.2	Merger
1999	Skandinaviska Enskilda Banken (Seb)	**SW**	Bfg Bank	**GER**	1,589.8	Merger
1999	Bnp	**FRA**	Paribas	**FRA**	12,122.9	Acquisition
1999	Banca Intesa	**ITA**	Banca Comerciale Italiana (Comit)	**ITA**	7,760.8	Acquisition

1999	Efg Eurobank	**GRE**	Ergo Bank	**GRE**	2,051.2	Acquisition
1999	Caisse Centrale Des Caisses D'epargne	**FRA**	Credit Foncier De France	**FRA**	709.2	Acquisition
1999	Dexia	**BEL / FRA**	Banque Internationale De Luxembourg	**LUX**	1,003.2	Acquisition
1999	Banco Bilbao Vizcaya (Bbv)	**SP**	Argentaria	**SP**	10,460	Merger
2000	San Paolo Imi	**ITA**	Banco Di Napoli	**ITA**	2,224	Acquisition
2000	Royal Bank Of Scotland (Rbos)	**UK**	National Westminster (Natwest)	**UK**	42,150	Merger
2000	Dexia	**BEL / FRA**	Labouchere	**NL**	896	Acquisition
2000	Banco Comercial Portugues	**POR**	Banco Pinto E Sotto Mayor	**POR**	3,000	Acquisition
2000	Merita Nordbanken	**FIN / SW**	Unidanmark	**DAN**	4,780	Merger
2000	Hypovereinsbank	**GER**	Bank Austria	**AUS**	7,800	Acquisition
2000	Banco Santander Central Hispano (Bsch)	**SP**	Banco Totta & Acores	**POR**	1,610	Merger
2000	Hsbc	**UK**	Credit Commercial De France (Ccf)	**FRA**	11,000	Acquisition
2000	Barclays	**UK**	Woolwich	**UK**	9,100	Merger
2000	Den Danske Bank	**DAN**	Real Danmark	**DAN**	3,500	Merger
2000	Merita Nordbanken	**FIN / SW**	Christiania Bank	**NOR**	na	Merger
2001	Bank Of Scotland	**UK**	Halifax Group	**UK**	14,500	Merger
2001	Ccf	**FRA**	Banque Hervet	**FRA**	529	Acquisition
2001	Dg Bank	**GER**	Gz Bank	**GER**	12,270	Merger
2001	Dexia	**BEL / FRA**	Artesia Banking Corp.	**BEL**	3,300	Acquisition
2001	Caisse Des Depots Et Consignations (Cdc)	**FRA**	Groupe Caisses D'epargne	**FRA**	na	Merger
2001	Sanpaolo Imi	**ITA**	Cardine	**ITA**	6,200	Merger
2001	Banco Sabadell	**SP**	Banco Herrero	**SP**	na	Acquisition
2001	Banca Popolare Di Verona	**ITA**	Banca Popolare Di Novara	**ITA**	na	Merger
2002	Banca Di Roma	**ITA**	Bipop-Carire	**ITA**		Merger
2002	Banca Popolare Di Lodi	**ITA**	Banco Di Chiavari E Della Riviera Ligure	**ITA**	405	Acquisition
2002	Banca Popolare Di Bergamo	**ITA**	Banca Popolare Commercio E Industria (Bpci)	**ITA**	na	Merger
2002	Credit Agricole	**FRA**	Credit Lyonnais	**FRA**	16,900	Acquisition
2002	Banca Popolare Di Vicenza	**ITA**	Cassa Di Risparmio Di Prato	**ITA**	411	Acquisition
2002	Den Norske Bank	**NOR**	Nordlandsbanken	**NOR**	130	Acquisition
2002	Credit Agricole	**FRA**	Finaref	**FRA**	2,500	Acquisition
2002	Natexis Banques Populaires	**FRA**	Coface	**FRA**	290	Acquisition

Sources: Thomson Financial and financial press.

Annex 4. Market Capitalisation,* Profitability and Market Valuation of the Major European Banks

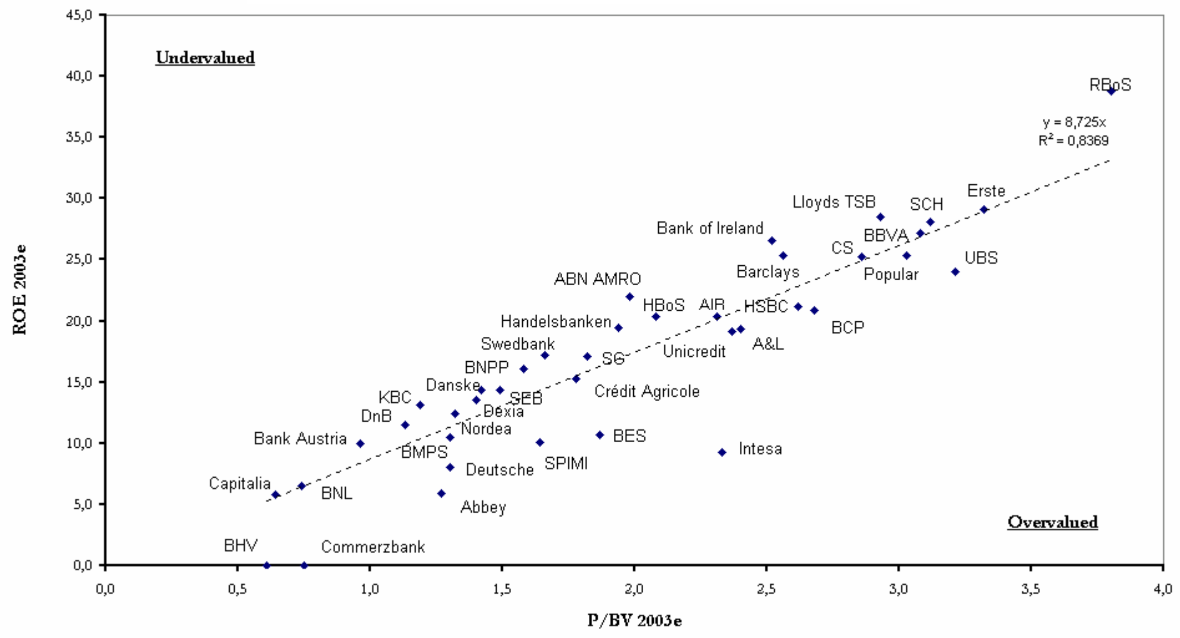
Rank Nov 2003	Rank end 2002	Bank (country)	Market capitalisation November 2003 (€ billion)	Market capitalisation end 2002 (€ billion)	Price variation from 1/01/2002 to 31/12/2002 (%)	Rank end 2001
1	1	HSBC (UK)	114.81	99.6	- 14.83	1
2	2	RBoS Group (UK)	68.24	66.1	- 11.00	2
3	3	UBS (Switzerland)	62.39	55.0	- 19.81	3
4	4	Barclays (UK)	47.67	38.9	- 32.31	5
5	7	BNP Paribas (France)	42.21	34.8	- 22.73	4
6	9	SCH (Spain)	39.91	31.2	- 30.50	9
7	6	HBoS (UK)	38.92	38.1	- 17.71	10
8	8	ING (NL)	37.91	31.4	- 43.65	6
9	13	Crédit Suisse Group (Switzerland)	35.01	24.6	- 57.63	12
10	11	Deutsche Bank (Germany)	33.69	26.3	- 44.71	11
11	5	Lloyds TSB Group (UK)	33.49	38.7	- 40.22	8
12	10	BBVA (Spain)	31.96	29.1	- 34.39	14
13	12	ABN Amro (NL)	29.83	24.7	- 13.88	7
14	15	Société Générale (France)	28.60	23.8	- 11.69	18
15	14	Unicredit (Italy)	26.42	23.9	- 15.18	15
16	18	Crédit Agricole SA (France)	24.80**	14.0	- 19.17	13
17	16	Fortis (Belgium/NL)	20.07	21.8	- 42.37	na
18	20	Banca Intesa (Italy)	17.42	13.2	- 28.55	23
19		Standard Chartered (UK)	16.56			20
20		Nordea (Scandinavia)	15.90			19

Source: Bloomberg (2003).

Notes: * Calculated as the number of outstanding shares x share price.
** Including Crédit Lyonnais.

In 2003, the British institutions have ensured their top ranking position with four banks (HSBC, RBoS Group, Barclays and HBoS + Lloyds TSB, 11th) in the European top ten of market capitalisation. The French institution, BNP Paribas, retains its position at the top of the euro zone.

Figure A4.1 Profitability and market valuation of the major European banks



Source: Deutsche Bank (2003).

Notes:
ROE (Return on equity) = Net income/equity.
P/BV (Price-to-book value) = Market capitalisation/equity.

The banking institutions situated above the dashed line are less valued than the average of the market and vice versa. According to this figure, we can establish a diagnosis of undervalued vs. overvalued institutions among the major EU banks and thereby identify potential value anomalies.

Figure A4.2 Profitability and the importance of retail activities

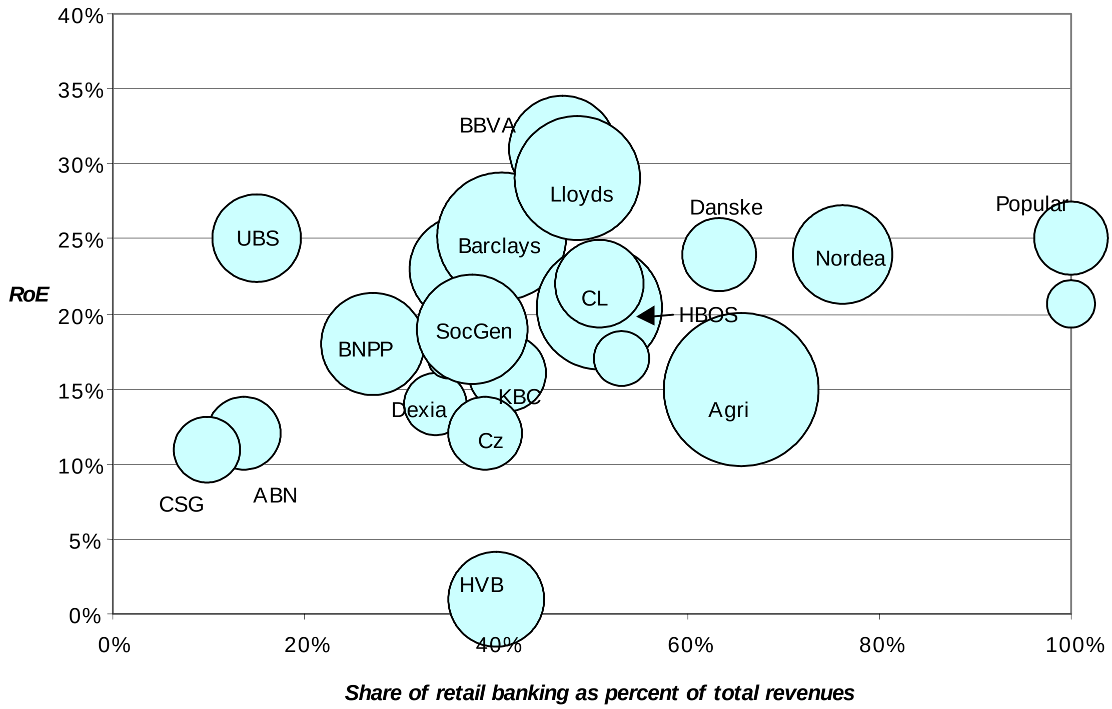
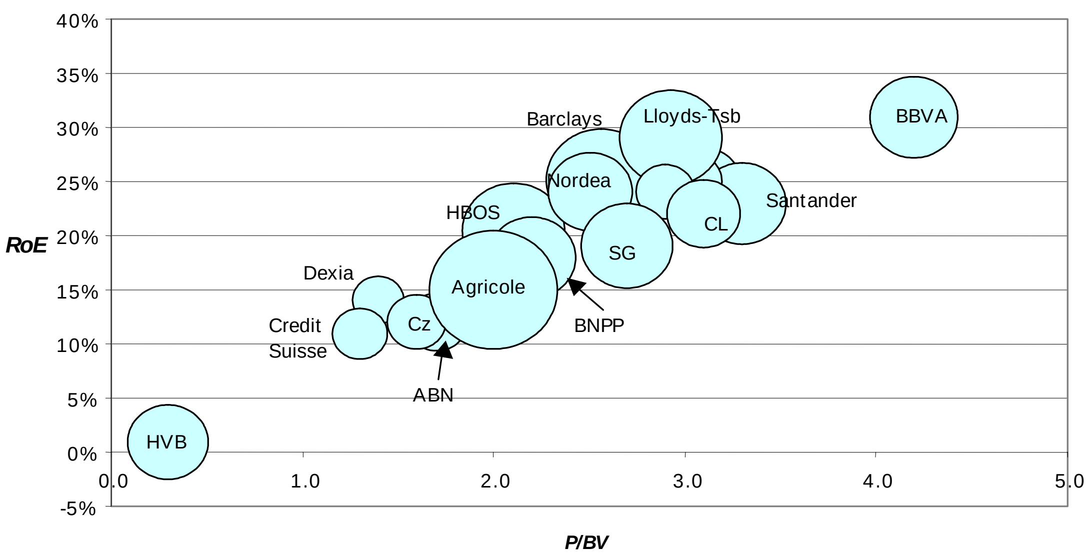
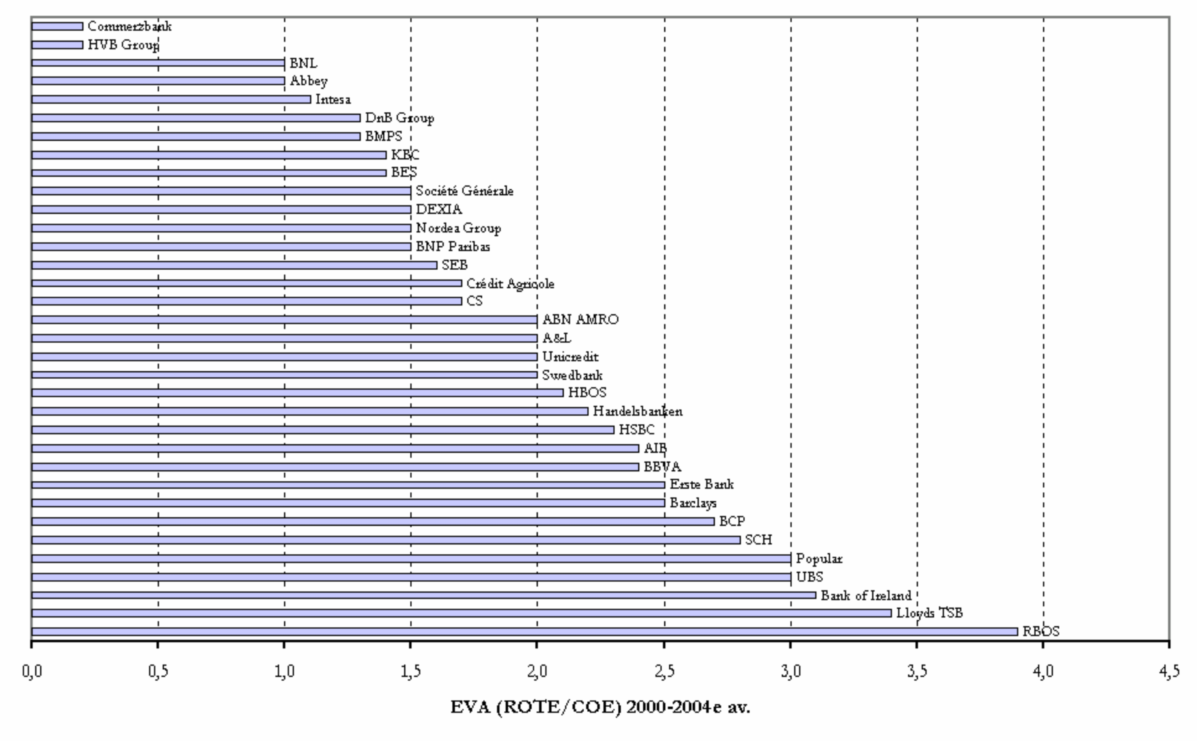


Figure A4.3 Market valuation of retail banking activities



Source: Bellon & Pastré (2003).

Figure A4.4 Identifying the value creators/destroyers in the European banking sector

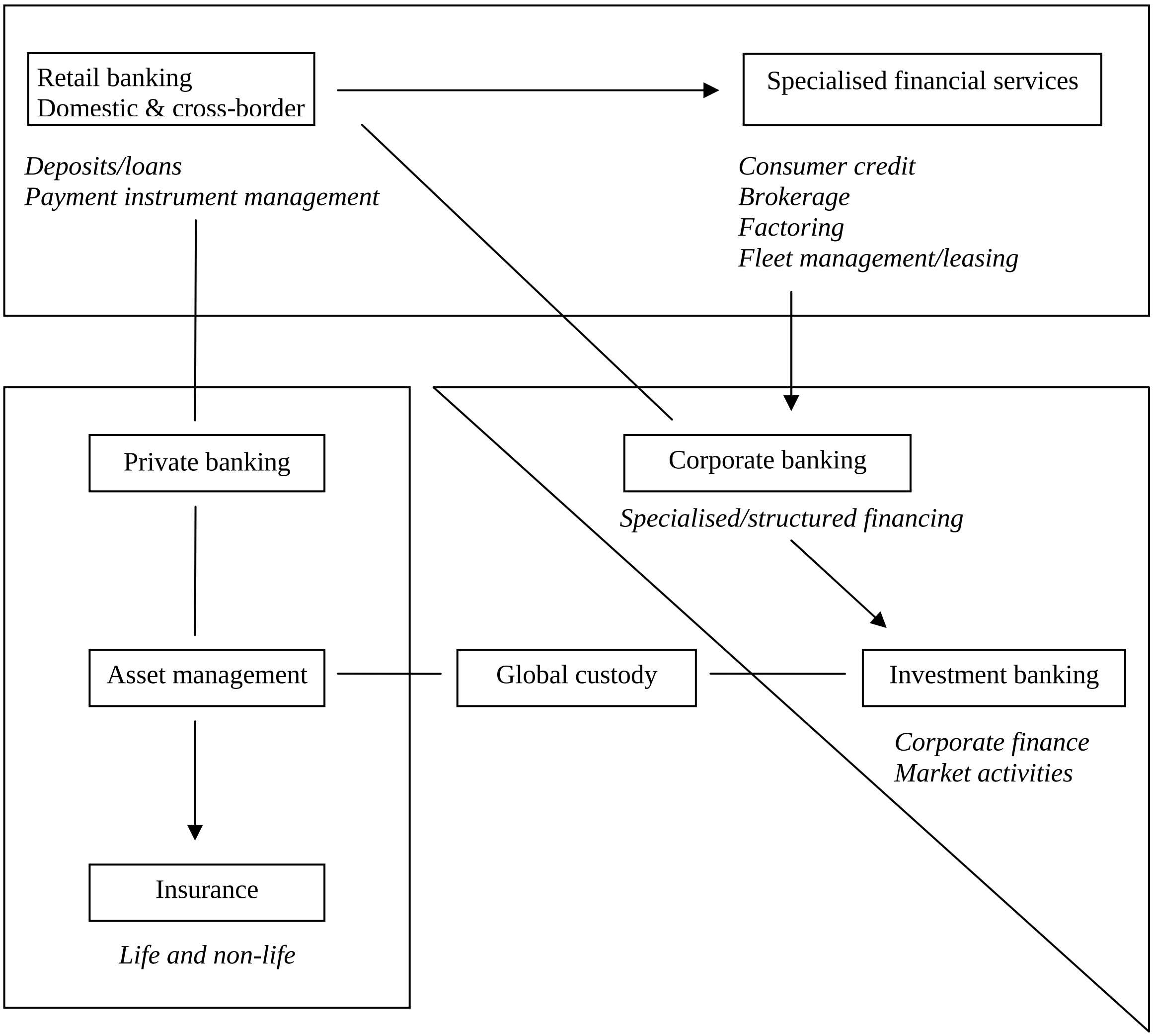


Source: Deutsche Bank (2003).

Notes: Deutsche Bank's analysts measure EVA (Economic Value Added) by comparing ROTE against COE. A bank is EVA positive if it earns returns (ROTE) above its cost of capital (COE); hence ROTE/COE > 1. The higher the ROTE/COE ratio, the more the bank is a value creator under the five-year period 2000-2004e. Because they are eliminating goodwill (i.e. they use tangible equity), most banking institutions in the Deutsche Bank universe are EVA positive.

In the Deutsche Bank universe, retail-oriented banks operating in strong economies are the greatest value creators (RBoS, Lloyds TSB, Bank of Ireland, Popular and SCH). The two German banks considered (Commerzbank and HVB) are unable to meet their cost of equity. This highlights the amount of work these banks must perform in order to restore their core profitability.

Annex 5. Main Financial Activities in the EU Banking Sector



Annex 6. Cross-Shareholding Structures of Major European Financial Companies, end 2002 (in %)

Who owns them						Who do they own					
		Aegon 6.25	Fortis 6.15	ABN AMRO 5.1	**ING**	ABN AMRO 11.6	Piraeus Bank 5.0				
				Swiss Re 1.1	**Fortis**	ING 6.2					
				ING 11.6	**ABN AMRO**	Capitalia 6.6	ING 5.1	Banco Comercial Portugues (BCP) 5.0			
				BNP Paribas 3.9	**AXA**	Crédit Lyonnais 5.3	Société Générale 1.0	BNP Paribas 5.3			
				AXA 5.3	**BNP Paribas**	AXA 3.9	Crédit Lyonnais 16.3				
			Aviva 5.0	Allianz 1.6	**Société Générale**	SCH 2.9	Crédit Lyonnais 3.9				
					Crédit Agricole	IntesaBCI 15.0	Banco Espirito Santo 24.0	Crédit Lyonnais 17.4	Commercial Bank of Greece 9.0		
	Allianz 10.5 Société Générale 3.9	AXA 5.3 BBVA 3.6	BNP Paribas 16.3 IntesaBCI 3.7	Crédit Agricole 17.4 Commerzbank 3.9	**Crédit Lyonnais**						
				Munich Re 25.7	**HVB Group**	Allianz 4.6	Munich Re 13.3				
		Munich Re 1.8	Allianz 4.2	La Caixa 4.0	**Deutsche Bank**	Allianz 3.2	EFG Eurobank Ergasias 9.3				
		Deutsche Bank 3.2	HVB Group 4.6	Munich Re 20.0	**Allianz**	AMB 9.5 Banco Popular 9.5	AGF 65.3 Crédit Lyonnais 10.5	BPI-SGPS 8.6 Munich Re 24.5	RAS 55.4 Deutsche Bank 4.2		
			Allianz 24.5	HVB Group 13.3	**Munich Ré**	Allianz 20.0	HVB Group 25.7	Commerzbank 10.4	Deutsche Bank 1.8		
Generali 9.9	IntesaBCI 2.0	Mediobanca 1.6	SCH 3.7	Munich Re 10.4	**Commerzbank**	Crédit Lyonnais 3.9	SCH 1.9	Erste Bank 1.0	IntesaBCI 4.2	Generali 1.4	Mediobanca 1.7
			SCH 6.4	KBC 0.9	**San Paolo-IMI**	SCH 2.9					
			Aviva	Generali	**Unicredit**	Mediobanca					

			< 2.0	*< 2.0*		*10.4*			
			Commerzbank *1.4*	Mediobanca *13.8*	**Generali**	Commerzbank *9.9*	Unicredit *< 2.0*	BNL *7.1*	IntesaBCI *5.0*
						Mediobanca *2.0*	SCH *1.0*	AMB *64.0*	
	BCP *2.0*	Commerzbank *4.2*	Crédit Agricole *15.0*	Generali *5.0*	**IntesaBCI**	Commerzbank *2.0*	Crédit Lyonnais *3.7*	BCP *7.4*	
				ABN AMRO *6.6*	**Capitalia**	Mediobanca *8.6*			
			Generali *7.1*	BBVA *14.8*	**BNL**				
	RAS *2.0*	Generali *2.0*	Unicredit *2.0*	Capitalia *8.5*	**Mediobanca**	Generali *13.8*	Commerzbank *1.6*		
RBoS Group *2.9*	Commerzbank *1.9*	Generali *1.0*	San Paolo IMI *6.4*	Société Générale *2.9*	**SCH**	RBoS Group *5.1*	Commerzbank *3.7*	San Paolo IMI *5.2*	
					BBVA	BNL *14.8*	Crédit Lyonnais *3.6*		
Caixa General de Depositos *8.4*	Banco Sabadell *3.4*	Eureko *8.4*	IntesaBCI *7.4*	ABN AMRO *5.0*	**BCP**	IntesaBCI *2.0*	Banco Sabadell *8.5*	Eureko *4.0*	
				Swiss Re *5.0*	**Crédit Suisse Group**	Swiss Life *6.0*			
				Crédit Suisse Group *6.0*	**Swiss Life**				
				SCH *5.1*	**RBoS Group**	SCH *2.9*			
					Aviva	Société Générale *5.0*	Unicredit *< 2.0*	Munich Re *3.6*	RBoS Group *3.2*

Source: UBS Warburg (2003).

Note: Non-financial stakes and stakes outside Europe are not included.

Annex 7. Internet Banking in Europe

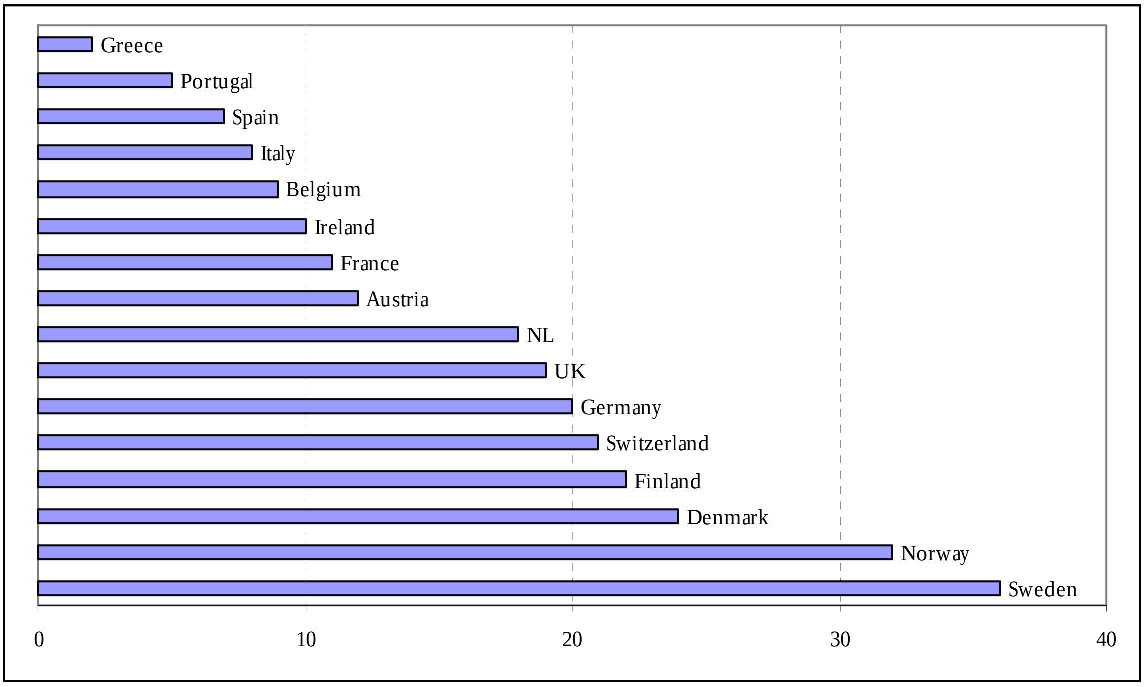
By the end of 2002, 39% of Internet users in Europe were conducting banking transactions on line, compared to 38% in the US. Their number has more than doubled in the past two years as banks have improved their sites and promoted e-banking.

Among the major European markets, Germany leads the pack in online banking users with a total of 16 million at the end of 2002. The UK follows with 10.4 million users, while France has 6.2 million users. However, in terms of penetration, the Nordic countries – Denmark, Finland, Norway and Sweden – continue to be the leaders, which is not surprising given that these are the regions where Personal Computer penetration is the highest and e-banking services the most advanced. Considerable national divergences remain at least for the time being (see Figure A7.1).

Even though Southern Europe comes from a lower starting point, these countries saw the highest increase in internet banking in 2002. In Italy, online banking jumped by 88% (the fastest-growing market in Europe), as leading banks launch aggressive e-banking strategies to attack this relatively underdeveloped market.

Penetration also increased in the Netherlands by more than 60% (as Dutch banks like ABN AMRO closed branches and heavily promoted online banking), however, growth in the Nordic countries, the UK, and Germany started to flatten out in 2002, pulling the average European banking growth rate down from 60% in 2001 to 40% in 2002.

Figure A7.1 Online banking user penetration in European countries (in %)



Source: Jupiter (2002).

Annex 8. Current Structure of National Supervision in the EU Countries

Until the late 1990s, three banking supervision models co-existed within the EU countries: the Central bank model, the separate banking supervisory model and the ministry of finance model. Today, all the member states are characterised by one of the first two models since the ministry of finance model has disappeared. However, this classification would not dissimulate the fragmentation and the wide heterogeneity of the supervisory authorities in the EU (see Table A8.1).

Table A8.1 Supervisors of banking, securities and insurance (beginning 2004)

Country	Banking	Securities markets	Insurance
Austria	FSA	FSA	FSA
Belgium	FSA	FSA	FSA
Denmark	FSA	FSA	FSA
Finland	BS	BS	I
France	B/CB	S	I
Germany	FSA	FSA	FSA
Greece	CB	S	I
Ireland	FSA	FSA	FSA
Italy	CB	S	I
Luxembourg	BS	BS	I
The Netherlands*	CB	S	I
Portugal	CB	S	I
Spain	CB	S	I
Sweden	FSA	FSA	FSA
United Kingdom	FSA	FSA	FSA
US	*B/CB*	*S*	*I*
Japan	*FSA*	*FSA*	*FSA*

* In the Netherlands, the national supervisory authorities are currently moving to a more integrated banking and insurance supervisor as a result of the planned integration of De Nederlansche Bank (DNB) and the Pensions and Insurance supervisory authority (PVK).

Notes: CB = Central Bank, FSA = Single financial supervisory authority, BS = Banking and securities supervisor, B = Specialised banking supervisor, S = Specialised securities supervisor, I = Specialised insurance supervisor.

In all the Southern European countries – Greece, Italy, Portugal and Spain – and the Netherlands, banking supervision and regulation are an exclusive *central bank* responsibility (see Table A8.2). In the Southern European countries, the central bank plays an essential role in supervising the banking systems; its prerogatives range from the approval to the resolution of banking crises.

However, a regular and gradual erosion of its involvement in banking supervision has recently been observed with the aim of focusing on the central goal of achieving price stability. But in all European countries, the central bank is solely responsible for maintaining financial stability (see Table A8.2).

Table A8.2 Role of the central bank in financial supervision in the EU (beginning 2004)

Country	Number of public institutions responsible for supervision	Central bank is responsible for financial stability	Central bank is involved in banking supervision[a]	Form of central bank involvement in banking supervision			
				Central bank is the banking supervisor	Central bank is not the banking supervisor		
					Central bank is involved in management of the banking supervisor[b]	Central bank is allocated specific tasks in banking supervision[c]	Central bank and banking supervisor share resources
Austria	1	yes	yes	no	yes	yes	no
Belgium	1	yes	yes	no	yes	no	no[d]
Denmark	1	yes	no	no	no	no	no
Finland	2	yes	yes	no	yes	no	yes
France	6[e]	yes	yes	no	yes	no	yes
Germany	1	yes	yes	no	no	yes	yes
Greece	3	yes	yes	yes			
Ireland	1	yes	yes	no	no	no	yes
Italy	3	yes	yes	yes			
Luxembourg	2	yes	no	no	no	no	no
Netherlands	3[f]	yes	yes	yes			
Portugal	3	yes	yes	yes			
Spain	3	yes	yes	yes			
Sweden	1	yes	yes	no	yes	no	no[g]
UK	1	yes	yes	no	yes	no	no[g]

[a] The Central bank is involved in banking supervision when it is the banking supervisor itself or, where this is not the case, involved in the management/oversight of the banking supervisor, contributes to supervisory policy-shaping, carries out tasks in line supervision, processes supervisory reporting or shares resources with the supervisory agency.

[b] The Central bank is involved in the management of the banking supervisor if the former is represented in the management (e.g. management committee, secretary-general and chairman) or in the supervisory or oversight board of the latter.

[c] The Central bank carries out off- and on-site monitoring in specific areas.

[d] The law of the 2nd August 2002 foresees a pooling of resources between the new CBFA and the Central bank.

[e] After the "*Loi de sécurité financière*" was adopted in July 2003 (see Box A8.1).

[f] In 2004, De Nederlansche Bank and the Pension and Insurance Supervisory authority are planning to merge. It is expected that the two bodies will operate as a single organisation from the 1st of April 2004.

[g] Under a specific MoU, supervisory agency and Central bank are obliged to share information in Sweden and UK. Moreover, the Bank of England and the FSA occasionally second staff to each other, which might be viewed as a form of sharing resources.

In the s*eparate banking supervisory model*, the control mechanisms are primarily based on an independent and autonomous legal decision-making entity. In Europe, it is either represented as a specialist banking supervisor or an integrated financial supervisor (FSA).

The first integrated financial supervisory authority in Europe was created at the end of the 1980s in the Scandinavian countries (Denmark, Norway and Sweden), followed by the UK.[154] It was recently adopted by Germany,[155] Austria[156] and more recently in Ireland[157] and Belgium[158]

Controversially, this model is far from being uniform in all the EU countries. Indeed, the broad field of competencies of the Scandinavian, British and German subcommittees could not be applied to the Benelux countries and still less in France. French banking supervision is considered as still fragmented albeit the "*Loi de sécurité financière*" adopted in July 2003 which proposed the merger between the COB and the CMF (see Box A8.1). Despite a growing attention paid to the FSA model, the institutional convergence within the EU has remained moderate.

Box A8.1 The new organisation of financial regulators in France

	Insurance	**Banking**	**Investment services**	**Securities markets**	**Asset management**
Regulation	Ministry of Finance	Ministry of Finance	AMF	AMF	AMF
Prudential supervision	CCAMIP	CB	CB	CB	AMF
Agreement	CEA	CECEI	CECEI	CECEI	AMF

Notes:
AMF: Autorité des marchés financiers (COB + CMF + CDGF)
CB: Commission bancaire
CCAMIP: Commission de contrôle des assurances, des mutuelles et des institutions de prévoyance (before CCA: Commission de contrôle des assurances)
CDGF: Conseil de discipline de la gestion financière
CEA: Comité des entreprises d'assurance
CECEI: Comité des entreprises de crédit et des entreprises d'investissement
CMF: Conseil des marchés financiers
COB: Commission des opérations de Bourse

[154] In 1997, the UK authorities decided to withdraw the supervisory functions from the Bank of England in order to assign them to an independent super-regulator – the Financial Services Authority (FSA) – which would exercise authority over all the financial services. To set up this institution, no less than nine regulators have merged (banking, insurance, securities…). After four years of organisation and planning, the FSA has been operational since 1 December 2001.

[155] Operational since May 2002.

[156] Operational since April 2002.

[157] The Irish Financial Services Regulatory Authority (Financial Services Regulator) was established on 1 May 2003. The Financial Services Regulator is responsible for the regulation of all financial services firms in Ireland. It also has an important role in the protection of consumers of financial services.

[158] The Commission Bancaire, Financière et des Assurances (CBFA) was established on the 1st of January 2004, after the merger between the Commission Bancaire et Financière (CBF) and the Office de Contrôle des Assurances (OCA).

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