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BANKING CONSOLIDATION. CHALLENGES AND PROSPECTS

Summary: The recent financial turmoil has prompted to review the current financial regulatory framework mechanism. The present financial system reform could be a cause of the integration and consolidation processes in banking. This article examines the European Union's financial system changes, regulatory rules, and the extending potential of the financial sector. This paper attempts to evaluate the European Union structural changes in the banking sector and identify the determinants of these changes.The banking sector having to vary among the three major activities – profitability, liquidity, and safety – should ensure an adequate return for its shareholders and contribute to a stable financial system.

Keywords: M&A, consolidation, financial stability, banking regulation.

1. Introduction

Recent changes in the global environment (market globalization, liberalization in finance and investment, as well as technological changes) have created a situation that facilitates the consolidation process in the banking sector. The common European market and strict banking deregulationin the EU encouraged M&A in the banking sector. This is confirmed by the EU, which noted the downward trend in credit institutions – during the period between 1985 and March 2011, the number of credit institution declined from 12 256 to 8167 (or by 33.4%). The recent financial turmoil has prompted researchers, politicians, and other public representatives from different countries to review the current financial regulatory framework mechanism and their impact on the prospects of the financial sector. In the present decision to regulate the financial sector, it is clear that this will affect the future of the sector's development prospects.

There are a number of research studies [Fiordelisi 2009; Sood, Ahluwalia 2009; Walter 2004] that analyzed M&As in the banking. Some researches [Coeurdacier *et al*. 2009; Novickyté 2009; Martynova, Renneboog 2006] are focused on the analysis of M&As in the Europe context. There are several studies [Walkner, Raes 2005; Ayadi, Pujals, 2004; Ludwig-Vogler, Giernalcyk 2010] that examined the consolidation and integration process in the EU and the resolution for European banking system. Also some researchers [Mishkin 1999; Boot 1999; Uhde, Heimeshoff 2009] analyzed

financial consolidation dangers and opportunities, and the impact on financial stability.

The purpose of the paper is to analyze the European Union's financial system changes and overview the process of financial system regulation in Europe and its impact on future integration or consolidation process in banking. In particular, the authors focus on how the international financial crisis, which started in 2007, has affected banking consolidation and supervision financial system.

The authors of this article conceptually overview the recent financial downturn decisions regulating financial institutions as well as evaluate the potential prospects in the European banking sector.

The following research methods are used: scientific literature analysis and synthesis, statistic data analysis, analytical and statistical information organization, comparison and aggregation methods.

2. Banking consolidation and integration

Banks as the main part of financial intermediaries play the core role in the economy because they help to distribute funds from those willing to invest/lend to those who want to borrow. Whereas EU credit institutions assets are more than 1/3 of EU-27 GDP (see Figure 1), this article examines only banks as a fundamental part of credit institutions, important to financial system stability.

According to ECB's report on EU banking structure [*EU Banking*… 2010], the financial crisis and its structural consequences have started to change the EU banking sector significantly. The global overhaul of banking regulation and supervision that has been brought about by the crisis is identified as the main factor shaping the banking industry. In addition, the impaired macroeconomic environment and the ongoing deleveraging process will impact the profitability of the sector and investors as well ascustomers will have to adjust their behaviour to the new economic situation.

Globalization and the desire for efficiency composed facilities for the consolidation and integration processes in the financial sector. Financial consolidation creates some dangers because it leads to large institutions that might expose the financial system to increased systemic risk [Mishkin 1999]. Also a large financial institution increases the potential for more severe moral hazard problems created by too-big--to-fail. Hartmann *et al*. [2007] assume that integration and development are distinct, but interrelated notions. Integration generates competitive pressures on financial intermediaries, creates economies of scale, increases market liquidity, and improves the scope for diversification and risk sharing. The development of financial system reduces asymmetric information, increases the competition and the completeness of markets. The recent financial crisis showed that integrated and developed financial system with ability to diversity assets does not improve the performance in efficiency and stability. Uhde and Heimeshoff's [2009] empirical analysis showed a negative

relationship between banking market concentration and financial stability is driven by a higher return volatility of larger banks in concentrated markets.

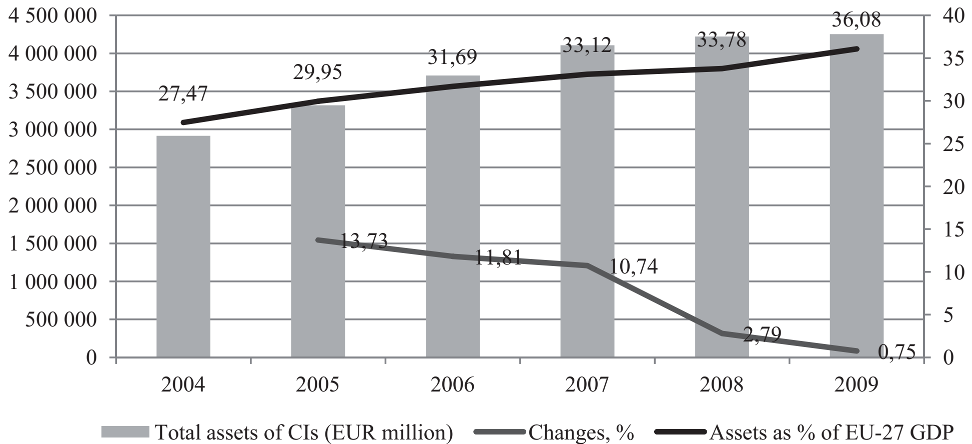

Fig. 1. Total assets of credit institutions in EU-27

Source: authors' own study based on ECB data.

Mergers and acquisition in EU banking has been observed with remarkable acceleration in consolidation activities in recent years. During 2000-H1 2010 M&As were more than 1100 transaction. However, the maximum number of transactions dropped in 2008 (see Figure 2), bringing the total number to the lowest point in the analyzed period. M&A activity started to pick up in 2009, with the clearest increase taking place in the sub-category of domestic deals. Important deals in 2009 and early 2010 include the acquisitions of Dresdner Bank by Commerzbank and HBOS by Lloyds TSB as domestic deals, but also Fortis by BNP Paribas as an example of a cross-border deal, and Mellon United National Bank by Banco Sabadell as an example of an outward deal [*EU Banking*… 2010]. Most of these deals were accelerated or induced by the financial crisis.

The drop in transactions is mainly due to the losses in banks and willingness to restructure their assets as well as strengthen their capital base. However, in 2009 the number of transactions increased and this is due to the possibility of acquiring a bank to generate, in the future profit, from the purchased bank (in crisis, the purchase price is usually smaller), for example as a acquisitions of Fortis by BNP Paribas and of UK banks by Santander. Consolidation is also occurring as economically strong banks take the opportunity to acquire those that were seriously impaired in the crisis. The limited duration of government recapitalisation measures is another reason which may offer M&A opportunities in the banking sector.

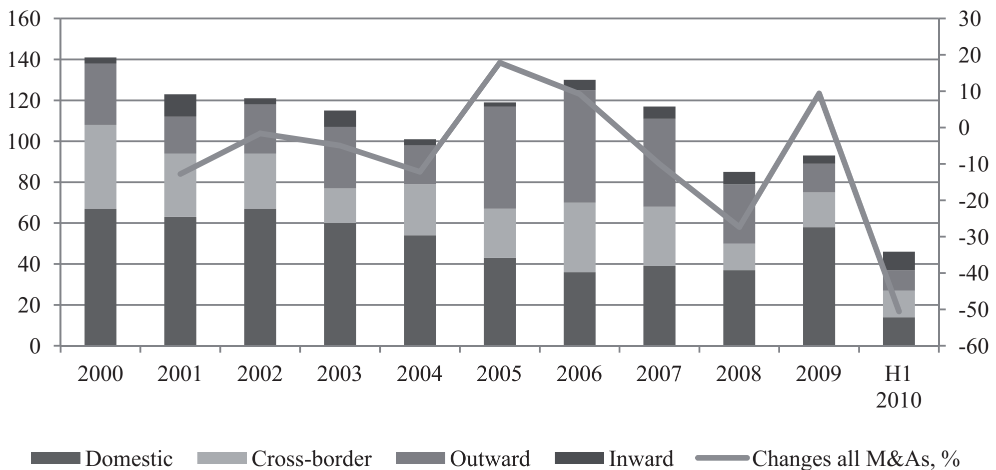

Fig. 2. Bank M&As in the EU (number of transactions)

Source: authors' own study based on [*EU Banking Structure* 2010].

Also there are some other reasons, like efficiency enhancements such as the concentration of functions at the group level, the transfer of technology and managerial skills, the diversification and the advances in the harmonization, and the integration of retail payment legislation and infrastructures, which can be the fundamental drivers of banking integration or consolidation.

Mergers are driven by three forces: the reduction of risks with the help of diversified financial structures, the economies of scale in the operation of financial services, and the increase of market power. These forces have resulted in the rising market shares of the five biggest banks in Europe: in 19 of the 27 EU Member States, these five banks have a market share of over 50% [Vogler-Ludwig *et al*. 2010].

According Ernst & Young survey [*Bank Barometer*... 2011], more than 52% of the respondents expect a wave of consolidation in the banking sector in the next 12 months. The fundamental challenges will bring about long-term changes in private banking. The transformation process is associated with costs and increasing competitive intensity. The medium-term consolidation expected by the surveyed banks is likely to be the final consequence of this development.

3. The recent changes in financial system supervision

The recent financial crisis has resulted in the excess of governmental and regulatory actions. As the financial markets begin to stabilize, governments are now seeking to develop an improved regulatory environment. The approach appears to have two main objectives: first, decreasing the likelihood of a similar financial crisis recurring and second ensuring that the costs of any future failure are not borne by taxpayers, but by the failing bank and the financial sector more generally.

In response to the financial crisis, the European Commission started consulting on and implementing changes to the Capital Requirements Directive (comprising two directives: Directive 2006/48/EC and Directive 2006/49/EC) [*Regulatory Capital*… 2011]. The main changes should be done in key areas: liquidity standards, the definition of capital, leverage ratio, counterparty credit risk, counter-cyclical measures including through-the-cycle provisioning for expected credit losses, systemically important financial institutions and single rule book in banking, etc. The new EU rules on capital requirements for credit institutions aim to establish a comprehensive and risk-sensitive framework and foster enhanced risk management amongst financial institutions. According to the EU, this would maximize the effectiveness of the capital rules in ensuring continuing financial stability, maintaining confidence in financial institutions.

According to de Larosière Group, in December 2010 European Systemic Risk Board was established, which is responsible for the macro-prudential oversight of the financial system within the EU. In January 2011 the European Banking Authority was established. The EBA main responsibilities are preventing regulatory arbitrage, guaranteeing a level playing field, strengthening international supervisory co-ordination, promoting supervisory convergence, and providing advice to EU institutions in banking.

One of the most important areas of banking supervision of the challenges ahead is the new Basel capital agreement on the rules for calculating capital adequacy. According to Bank for International Settlements [*Basel Committee*… 2011], Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision, and risk management of the banking sector. These measures aim to:

– improve the banking sector's ability to absorb shocks arising from financial and economic stress, irrespective of the source;
– improve risk management and governance;
– strengthen banks'transparency and disclosures.

Also Basel III's main goal is to enhance banking sector's resilience to unexpected shocks and thereby promote financial stability.

According the new capital requirements (see Table 1), the minimum requirement for common equity will be raised from the current 2% level, before the application of regulatory adjustments, to 4.5% after the application of stricter adjustments. This will be phased in by 1 January 2015. The Tier 1 capital requirement, which includes common equity and other qualifying financial instruments based on stricter criteria, will increase from 4% to 6% over the same period. Also it is agreed that the capital conservation buffer above the regulatory minimum requirement is calibrated at 2.5% and met with common equity, after the application of deductions. The purpose of this buffer is to ensure that banks maintain a buffer of capital that can be used to absorb losses during the periods of financial and economic stress. The second proposal is a countercyclical buffer within a range of 0-2.5% of common equity or other fully

loss absorbing capital will be implemented according to national circumstances. The purpose of the countercyclical buffer is to achieve the broader macro prudential goal of protecting the banking sector from the periods of excess aggregate credit growth.

Table 1. The calibration of the capital framework
(capital requirements and buffers, in %)

	Common equity	All Tier 1 capital	Total capital
Minimum	4.5%	6.0%	8.0%
Conservation buffer	2.5%		
Minimum plus conservation buffer	7.0%	8.5%	10.5%
Countercyclical buffer *	0-2.5%		

* Common equity or other fully loss-absorbing capital

Source: BIS.

Started on 1 January 2019, minimum common equity capital ratio should be 4.5%, capital conservation buffer must seek 2.5%, minimum tier 1 capital – 6%, minimum total capital – 8%, and minimum total capital plus conservation buffer should be 10.5%.

The new regulation requires banks to lift their reserves substantially and increase the proportion of the capital that banks need to hold in reserve. This situation will lead banks to re-assess and adjust their business lines towards diversified, safer, and more rational models and risk practices.

New banking regulation rules may be a driver of M&A activity. Some authors [Ludwig-Vogler, Giernalczyk 2010; Ayadi, Pujals, 2004] assume that internal ratings-based capital adequacy calculation could release capital. Smaller banks that cannot adopt IRB model 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. Also larger banks have more opportunities to diversify their assets and hold relatively less capital in reserves. Consolidation may be also the considerable convergence of financial institutions to a new universal model of retail banking, operating in different activities and countries.

Ernst & Young survey [*Bank Barometer* 2011] showed that the economic benefit of increasing regulation is quite controversial. Around 50% of the surveyed banks recognize the economic benefits, whereas the other 50% do not. Contrary to smaller banks, large banks, which usually have to comply with several national regulations, are more skeptical about these benefits. 85% of the surveyed banks expect that shareholders will have to generally anticipate lower returns in the future.

One of the main challenges is for banking regulators and supervisors. Ingves [2007] describes major problems in cross-border banking supervision. He claimes that a regulating institution should share relevant information about banks activity and risk to have the complete view of all banks-group risk. Also there should be an arrangement how to co-ordinate decisions by the authorities. And the most important challenge is to assume responsibility for an institution which facese financial problems. For systematic problems, the government would have to intervene. There is a problem if countries governments –the country of origin or the country of residence – should contribute to the bank rescue and/or a taxpayer in one country is willing to support the depositors in another country. This is the too-big-to-supervise problem.

The last part of this section is about banking sector challenges and the policy solution presenting by IMF [*Global Financial*… 2011]. Incomplete policy actions and inadequate reforms of the banking sector have left segments of the global banking system vulnerable to further shocks. Many institutions – particularly weaker European banks – are caught in a maelstrom of interlinked pressures that are intensifying risks for the system as a whole (see Figure 3).

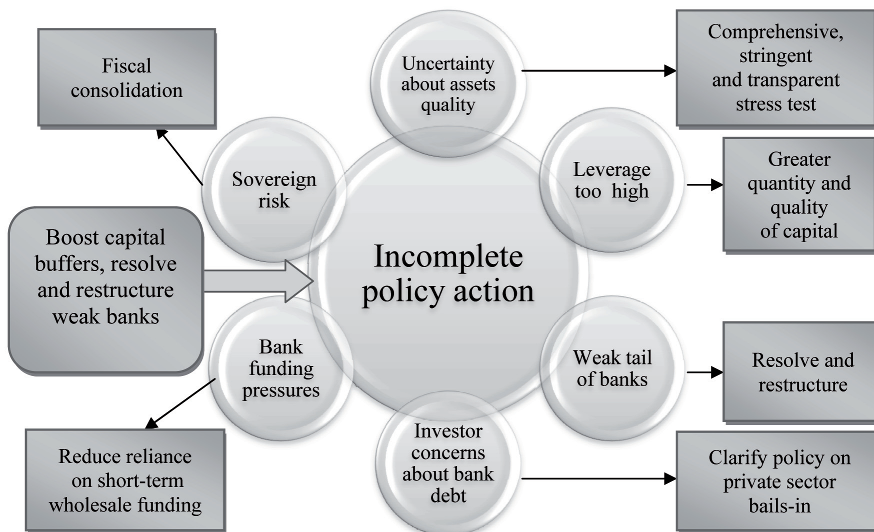

Fig. 3. Banking sector challenges and the policy solution

Source: [*Global Financial*... 2011].

The IMF, having regard for some of the EU countries governments' decisions on making considerable efforts to crystallize losses, increase capital, and implement deleveraging and divesture plans in the banking system, suggested possible solutions to every problem (see Figure 3). In order to restore confidence, banks should improve the capital quality, resolve weak banks, clarify decision by authorities' bail-in situation. These solutions need to be reinforced in each country and in each bank. This resolution can be a point of reference to ensure the stability of the banking system and the prospect of maintaining the whole financial system stability.

4. The recent changes in the Lithuanian banking sector

The Lithuanian banking sector is highly dependent on external funding, mostly provided by the Nordic parent banks to their subsidiaries, which control over 80% of all the banking assets in Lithuania. In response to the crisis and in line with wider EU anti-crisis measures, the authorities increased the deposit insurance limit from 22,000 to 100,000 EUR with the aim of preventing further deposit runs. Information sharing through the credit registry has also been broadened and the required reserve ratio was reduced from 6 to 4% in order to ease liquidity available to commercial banks. In July 2009, the parliament approved the Financial Stability Law, which allows for the swift recapitalization of troubled banks by the state. The quality of financial supervision has improved the signing of regional Memorandums of Understanding on the co-ordination of supervisory activities with Nordic and Baltic countries. The new agreement between Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden sets up a system for information sharing as well as burden sharing in the financial crisis.

Although the number of credit institutions in the EU banking sector has declined, in Lithuania a domestic bank, called Finasta, was established (in 2008; in 2009 it was acquired by Bank Snoras), also new banking licenses were granted to SEB, Handelsbanken, Pohjola Bank plc and Scania Finans Aktiebolag branches. This process indicates that there is still room for a new service provider even if concentration in the Lithuanian banking sector is still high – the three largest banks have 61% of all banking sector assets, 63.5% of all deposits, and 64.1% of all loans markets, but they continue to decline steadily [*Reviews*… 2010].

As in the EU, the Lithuanian banking sector also has opportunities in M&A, which could be caused by EU market changes and the harmonization and integration of retail payment. The Bank of Lithuania as the main supervisory institution in the Lithuanian banking sector ought to shape future prevention policies that would help maintain the stability of financial institutions.

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KONSOLIDACJA SYSTEMU BANKOWEGO. WYZWANIA I PERSPEKTYWY

Streszczenie: W artykule analizie poddane zostały zmiany w systemie finansowym Unii Europejskiej – szczególnie dotyczące zasad jego regulacji i rozszerzenia potencjału sektora. Celem pracy jest próba dokonania oceny zmian strukturalnych w sektorze bankowym Unii Europejskiej i identyfikacja determinant tych zmian z uwzględnieniem faktu, iż sektor ów musi lawirować pomiędzy trzema fundamentalnymi pryncypiami – zyskownością, płynnością i bezpieczeństwem. Sprowadza się to do konieczności dokonywania możliwie optymalnych działań biznesowych, zapewnienia udziałowcom odpowiednich przychodów i przyczyniania się do stabilizacji systemu finansowego.