

# CONSOLIDATION AND DIVERSIFICATION IN THE EURO AREA BANKING SECTOR

*This article examines the extent of consolidation in the euro area banking sector over the last ten years and explains some of the reasons for this. It also looks at the ways in which consolidation has affected banks' performance and geographical, product and sectoral diversification strategies. It then examines the trend towards a transformation of banks into large and diversified financial conglomerates, particularly in the form of bancassurance groups. Finally, it discusses some of the financial stability implications related to the conglomeration process.*

## I THE CONSOLIDATION PROCESS AFFECTING EURO AREA BANKS

This section gives an overview of the consolidation that has taken place in the euro area banking sector since the early 1990s. It focuses in particular on aspects related to increased sectoral diversification and internationalisation of the ownership of credit institutions and then goes on to describe the main driving forces behind these developments, namely changes in the external environment and in banks' strategies.

### I.1 CONSOLIDATION AND DIVERSIFICATION PATTERNS

The number of credit institutions in the euro area declined from around 9,500 in 1995 to 6,400 in 2004 (see Chart 1). In other words, almost one-third of credit institutions active ten years ago have since disappeared. This general pattern has, however, been uneven across countries: those with a larger number

of credit institutions have witnessed more widespread consolidation (see Table 1).

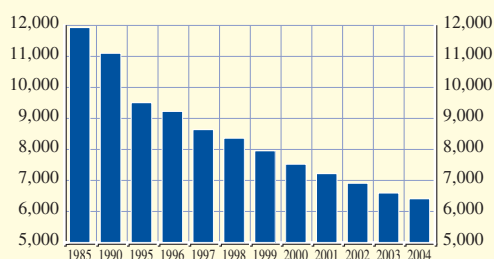
Despite the decline in the number of banks, the number of branches has remained fairly stable – or even risen – in most euro area countries (see Table 1). A restructuring of the banking sector is only evident or likely where consolidation in the branch network has taken place. The pattern observed so far supports the view that consolidation has by and large been driven by mergers and acquisitions (M&A) activity and not by (branch) restructuring.<sup>1</sup>

Figures for M&A activity further support this view.<sup>2</sup> In 1991 there was a marked increase in M&A activity – coinciding with the signing of the Treaty on European Union – and activity remained high until 2004 (see Chart 2). Most M&A activity had a local character, with 80% of the deals involving domestic institutions only. This is one reason why, initially, M&A deals generally involved smaller institutions. It was not until the period 1998-2000 that very large deals were struck between large banks and between banks and insurance companies (see below). After 2000 relatively unfavourable stock market developments and continued market uncertainty led to a general decline in M&A activity and transaction volumes, although volumes remained above those of the early 1990s.

Despite their smaller number, cross-border M&A deals have been increasing and have

Chart 1 Consolidation in the euro area banking sector

(1985-2004)



Source: ECB.

Notes: The chart shows the absolute number of credit institutions (CIs) in the euro area as a whole, based on MFI statistics. Figures for 1985 and 1990 are only indicative.

1 There is only anecdotal evidence of bank closures due to operational failures. A major shake-out took place in the wake of a banking crisis in the Nordic countries in the early 1990s.  
2 Another source of consolidation, although without direct consequences for the number of institutions in the market, has occurred through cross-shareholdings, i.e. the acquisition of a minority share in another credit institution.

**Table 1 Consolidation in euro area countries**

(ranked on number of credit institutions (CIs) in 2004)

Country	Number of CIs 1995	Number of CIs 2004	Number of branches 1995	Number of branches 2003	Number of M&As 1995-2004	of which cross-border M&As (%)
DE	3,785	2,148	48,180	47,351	170	17.8
FR	1,469	897	25,581	25,789	157	21.3
AT	1,041	796	4,667	4,395	41	29.6
IT	970	787	23,493	30,502	275	12.2
NL	648	461	6,802	3,671	23	57.7
ES	506	346	36,465	39,762	95	31.6
FI	381	363	1,941	1,252	16	25.0
PT	233	197	3,446	5,440	38	40.0
LU	220	165	348	269	10	92.9
BE	145	104	7,704	4,989	34	30.1
IE	56	80	1,043	924	8	62.5
GR	53	62	2,404	3,300	34	25.7
<b>Euro area</b>	<b>9,507</b>	<b>6,406</b>	<b>162,074</b>	<b>167,644</b>	<b>901</b>	<b>23.2</b>

Sources: ECB and Thomson Financial Securities Data Company.

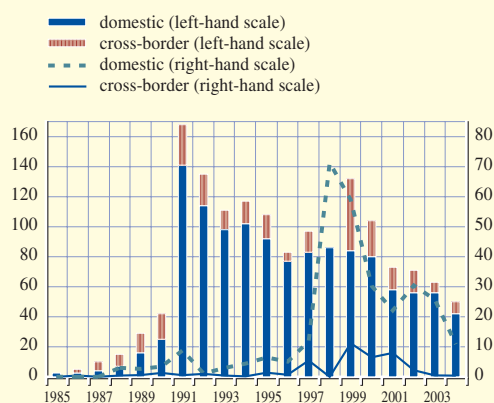
Note: The estimated number of M&As in the banking sector over the period 1995-2004 may exclude a number of smaller deals that were not reported. M&A data include both minority and majority acquisitions, cross-border M&As cover both acquirers from the euro area and third countries.

given euro area banks a greater cross-border presence – allowing them to diversify country and region-specific risks and increase their revenues. On average, foreign branches and subsidiaries account for about 15% of the euro area banking market (see Chart 3). However, this share varies substantially across markets and has tended to increase slightly.

This development is also supported by growing direct cross-border banking activity (lending and deposits), which enables banks to take advantage of diversification opportunities without incurring the high fixed costs of establishing a local presence. The cross-border provision of banking services within the euro area has been clearly supported by the

**Chart 2 M&As in the euro area banking sector**

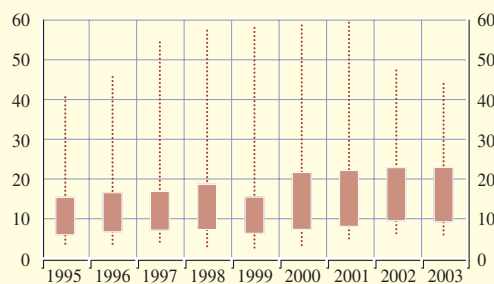
(number of M&As; EUR billions)



Source: Thomson Financial SDC.  
Notes: A number of deals are without reported value. Cross-border refers to intra-euro area M&As.

**Chart 3 Market share of foreign banks in the euro area member countries**

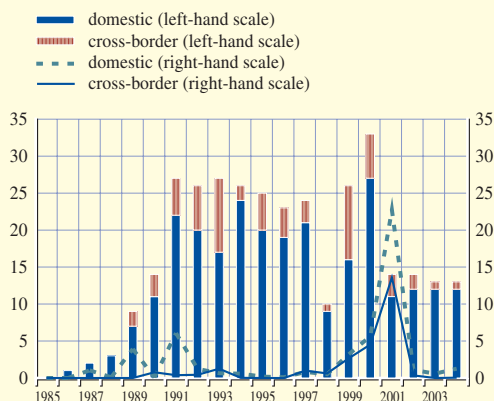
(percentage of total assets)



Source: ECB.  
Notes: The chart shows the minimum, maximum and interquartile distribution of market shares of foreign banks (branches and subsidiaries) in euro area countries. Luxembourg was excluded for reasons of scaling (foreign ownership represents almost 100%).

**Chart 4 M&A deals between euro area banks and insurance companies**

(number of M&amp;As; EUR billions)



Source: Thomson Financial SDC.

Notes: Targets are banks or insurance companies located in the euro area and acquired by insurance companies or banks respectively. See also notes to Chart 2.

introduction of the euro in 1999 and benefited mainly wholesale banking activities, such as interbank loans, syndicated lending and asset allocation. Cross-border retail lending and deposit-taking have also continued to grow, although they remain at relatively low levels.

Many euro area banks are part of larger financial groups or financial conglomerates. A financial conglomerate is a group of entities whose primary business is financial and whose regulated entities are engaged to a significant extent in at least two of the activities of banking, insurance and securities.<sup>3</sup> The combination of banking and insurance activities in a global financial services institution has proven to be particularly successful, and the number of such institutions has experienced strong growth worldwide. In the period 1985-2004, several bancassurance groups emerged through a sequence of M&A deals in the euro area (see Chart 4). In the period 1999-2001 in particular, a number of large deals were struck. Nearly 70% of all transactions involved domestic banks and insurance companies. Most cross-border transactions were initiated by insurance companies looking for bank outlets to distribute their products and diversify their income

streams. Cross-sector M&A activity between domestic financial institutions often involves larger deal values than cross-border deals. This may suggest that the distribution of products is a stronger motive for M&A activity than the geographical diversification of income streams.

## 1.2 DETERMINANTS OF CONSOLIDATION

Changes in the external environment – including regulatory, technological and macroeconomic changes – have contributed to consolidation in the banking sector.<sup>4</sup> Since the mid-1980s the EU financial sector has experienced significant liberalisation and deregulation (see Table 2). These measures have created a more competitive environment, facilitating the consolidation of credit institutions.

Looking ahead, the new European Company Statute could foster further consolidation by enabling banks to operate under a common set of EU rules in addition to the various national regimes. It may also provide banks with a tangible channel for cross-border restructuring, such as a change of seat or a rationalisation of group structures.

Furthermore, since the mid-1980s, most EU countries have increasingly deregulated their financial markets, encouraging euro area banks to expand into related activities such as investment banking, asset management and insurance, thereby fostering cross-sector consolidation in the financial sector.

The creation of Economic and Monetary Union (EMU) has forced banks to reconsider their strategic orientation and has led to increased internationalisation and geographical diversification, making banking practices more uniform and pricing more transparent. This has also lowered costs and increased the liquidity of securities issuance in the euro area, thereby stimulating disintermediation. As a result, this

3 See Dierick, “The supervision of mixed financial services groups in Europe”, ECB Occasional Paper No 20, August 2004.

4 See also the Group of Ten’s report on “Consolidation in the financial sector”, January 2001.

**Table 2 Overview of relevant regulatory measures for the EU financial sector**

Year	Description
1977	First Banking Directive: coordination of laws on credit institutions; freedom of establishment for credit institutions
1988	Basel Capital Adequacy Regulation: solvency framework
1988	Deregulation of capital movements in EMS countries
1989	Second Banking Directive: principles of home country control, mutual recognition of prudential norms and standards
1993	Investment Services Directive
1999	Launch of the Financial Services Action Plan (FSAP)
2000	Directive on e-money institutions
2001	Directive on the reorganisation and winding up of credit institutions
2001	Regulation on the European Company Statute
2004	New EU Takeover Directive
2006-8	Basel II Capital Adequacy Regulation: new solvency framework

has also bolstered consolidation in the euro area banking sector.

Technological progress has also been one of the main driving forces behind change in the banking sector, making it possible for banks to increase their geographical reach via electronic channels.<sup>5</sup> The benefits, however, are disproportionate, as only larger banks have the minimum scale needed to justify substantial investments in technology. From a strategic perspective, this supports the move towards larger, consolidated institutions.

Finally, the macroeconomic environment has also contributed to consolidation: throughout the 1990s a favourable interest rate environment, high stock market valuations and high economic growth allowed banks to record high profits and build up significant reserves, which were subsequently used to finance their expansion and takeovers of (weaker) competitors. The converse impact was also notable, as the economic slowdown in 2001-2003 led to a reduction in M&A activity.

An important driving force behind banking consolidation has its source within the sector itself and stems from the need for ongoing development.

While difficult to assess unambiguously, some indicators – such as the number of branches per capita – suggest that banks in some countries wanted to reduce overcapacity and increase market share. This was evident from a survey

of large banks' strategies conducted in 2004, which identified preserving market share as a major strategic concern leading to consolidation in both domestic and euro area-wide banking sectors.<sup>6</sup>

Studies of the characteristics of the firms involved in financial sector M&A activity generally support the view that the search for efficiency gains motivates consolidation, provided that the management of the acquiring firm is more effective at minimising costs than that of the target firm. Many studies have found that acquiring firms tend to be more cost-efficient than target firms.

Empirical evidence suggests that economies of scale may have been a motivating factor for consolidation among small and medium-sized financial services firms during the 1990s. This is because scale economies allow financial institutions to realise operational and cost synergies and enhance their franchise value. While in a smaller market fewer banks may be able to reach an adequate scale to support a large and diversified set of activities, in a larger market a smaller relative scale may be sufficient to operate efficiently (see Section 2.1).<sup>7</sup>

<sup>5</sup> See the ECB's report on "The effects of technology on the EU banking systems", July 2004.

<sup>6</sup> See Section 3.2 of the ECB's "Report on EU banking structure", November 2004.

<sup>7</sup> Empirical evidence on scale economies for banking yields mixed results: some studies find evidence of scale economies while others do not. Nevertheless, a consensus emerges, finding scale economies in some banking segments, particularly in wholesale and investment banking.

Economies of scope – achieved by a consolidated group that is able to offer a wider range of products and services as well as products and services that would not be feasible on a stand-alone basis (e.g. because of high sales costs that make the product uncompetitive) – may also have been conducive to consolidation.

## 2 CONSEQUENCES OF THE CONSOLIDATION PROCESS

The consolidation process increases the size of an average institution: the balance sheet total of the average euro area credit institution increased from less than €1.5 billion in 1995 to nearly €3 billion in 2003. This effect of consolidation is also particularly evident among the largest institutions: the asset share of the 25 largest euro area banks increased from 45% in 1997 to nearly 60% in 2003. This section analyses the impact of this consolidation process on the concentration and performance of euro area banks, as well as the possible implications for financial stability.

### 2.1 CONCENTRATION AND COMPETITION

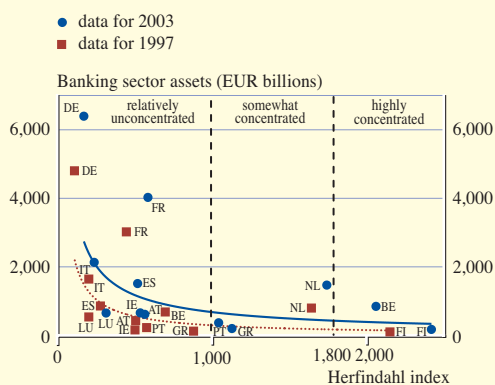
The level of market concentration provides an indication of the extent of competition within a

market, since it indicates the degree to which large banks are able to control the market. Concentration has increased in all euro area countries since the mid-1990s. In the smaller euro area countries in particular, the market share of the five largest credit institutions typically exceeds 60%. The Herfindahl index<sup>8</sup> also suggests concentrated market structures, albeit to a lesser extent (see Chart 5). However, the definition of the relevant market is changing gradually from domestic to euro area market as a result of increasing financial integration. Yet despite increased consolidation, competitive conditions in the euro area banking sector do not appear to have been adversely affected. Net interest margins have fallen significantly, even in more concentrated markets, which would suggest that banking markets have remained contestable.<sup>9</sup>

An important concern is whether increased concentration and consolidation may lead to a reduction in small business lending, given that the euro area economy relies heavily on a vibrant SME sector. Indeed, empirical evidence indicates that there are hardly any negative effects, either because alternative sources of finance are developed, because cross-industry players enter the marketplace, or because M&As improve banks' ability to assess the potential risk of borrowers.<sup>10</sup>

Perhaps more importantly, consolidation and concentration could affect the monetary policy transmission mechanism if they cause changes in the behaviour of banks or the operation of financial markets. Cross-border

Chart 5 Market size and concentration in the euro area banking sector



Source: ECB.

8 The Herfindahl index is the sum of the squares of the market shares of a country's banks. It ranges from 0 to 10,000. A market is said to be "highly concentrated" if the index is above 1,800, and "relatively unconcentrated" if the index is below 1,000.

9 Assuming that competition strengthens efficiency and reduces interest margins, the latter can be considered an additional proxy indicator of competitive conditions. It should be noted, however, that some segments are generally considered less contestable than others, in particular retail (as opposed to wholesale) banking activities, owing to the importance of branches, reputation effects, high sunk costs, etc.

10 See Bonaccorsi di Patti and Gobbi, "The effects of bank mergers on credit availability: evidence from corporate data", Banca d'Italia Working Paper No 479, June 2003.

consolidation and more integrated financial markets, in addition to other factors, could increase the speed and predictability of the transmission mechanism, which would be beneficial for both monetary policy and consumers. However, consolidation can also cause greater aggregate liquidity risk and increase aggregate liquidity needs if the interbank market dries up in favour of internally kept reserves, which could occur if refinancing is very expensive.<sup>11</sup> In addition, if larger banks were able to exercise more market power, interest rates could become more volatile. However, in reality, as EMU and the introduction of the euro have led to increasingly integrated money and capital markets, the effects of consolidation on competition are alleviated by the increase in the size of the market and the rise in the number of participants. The competitive and contestability situation of the financial industry in the euro area should nonetheless be monitored carefully.

## 2.2 PERFORMANCE

Over the past ten years, euro area banks' performance has been resilient to a number of external shocks,<sup>12</sup> even though individual banks have occasionally experienced adverse conditions. On average, the sector's return on equity (ROE) has remained fairly stable and loan loss provisions have remained well within historical limits. To some extent, consolidation has contributed to the resilience of the euro area banking sector, as weaker institutions have generally been acquired by bigger and stronger rivals. In the euro area, larger banks seem to be more cost-efficient and profitable than smaller ones. For example, in 2003, the cost-to-income ratio was 66% for large banks and 69.8% for small banks;<sup>13</sup> similarly, ROE amounted to 7.93% for large banks and only 5.83% for small banks. These differences may imply that, over time, consolidation can help to make the financial system more efficient.<sup>14</sup>

Cross-sector consolidation, especially bancassurance, would appear to improve

financial performance – as measured by ROE – in comparison with the overall euro area banking sector. While some studies found evidence of a “conglomerate discount” – i.e. a situation where financial conglomerates performed worse than stand-alone banking, insurance or securities firms – some more recent studies suggest that this may well be a statistical artefact.<sup>15</sup>

Empirical studies suggest that bancassurance may also help to diversify income risks.<sup>16</sup> The box below provides some arguments along the same lines. Furthermore, diversification of income sources is also taking place within the banking sector: in 1997 non-interest revenues accounted for 33% of total revenues; in 2003 it accounted for more than 40%.<sup>17</sup>

11 See Carletti, Hartmann and Spagnolo, “Bank mergers, competition and liquidity”, ECB Working Paper No 292, November 2003.

12 See the article entitled “Accounting for the resilience of the EU banking sector since 2000” in the July 2004 issue of the Monthly Bulletin.

13 See the ECB's “Financial Stability Review” of December 2004.

14 See Altunbas and Marqués Ibáñez, “Mergers and acquisitions and bank performance in Europe: the role of strategic similarities”, ECB Working Paper No 398, October 2004. The authors found that, on average, bank mergers in the EU resulted in an improved return on capital.

15 For a summary of recent studies see the “Financial Conglomerates” section of the National Bank of Belgium's Financial Stability Review 2002.

16 See Genetay and Molyneux, “Bancassurance”, Macmillan Press, London, 1998, for an overview of the studies carried out in this area. Oliver, Wyman and Company, “Study on the risk profile and capital adequacy of financial conglomerates”, February 2001, provides an estimate of incremental diversification benefits between banks and insurance companies, ranging from a 5% to 10% reduction in capital requirements, depending on the business mix.

17 Diversification also tends to enhance revenues. This is supported by the positive and significant correlation (0.60) between non-interest revenues as a percentage of total revenues and ROE over the period 1997-2003 for the euro area banking sector.

## Box

## RISK DIVERSIFICATION IN THE BANKING AND INSURANCE SECTORS

An analysis of the correlations between euro area banking and insurance indices suggests that there may be some diversification benefits from conglomeration: time-varying correlations of sectoral stock indices reveal substantial idiosyncratic factors across sectors (see Chart A). Chart A depicts the correlation between returns on euro area bank and insurance stock indices, over a rolling three-month window, called full correlation. It also shows an adjusted correlation, which filters out the impact of market-wide movements. While the unadjusted correlation is very high, the market-adjusted correlation tends to be much lower and is often close to zero. Thus, both sectors appear to be heavily influenced by market-wide movements but not so much by developments in the other sector.

In addition, time-varying betas are estimated. They gauge the sensitivity of bank and insurance sector returns to changes in the market-wide return (see Chart B). A high degree of commonality in the sectors' reaction to market-wide changes is evident. However, the sensitivities are not of exactly the same magnitude, suggesting a slightly different reaction to market-wide movements.<sup>1</sup>

Chart A Correlation between euro area bank and insurance stock price indices

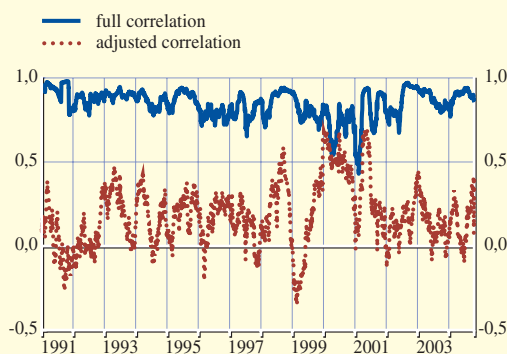
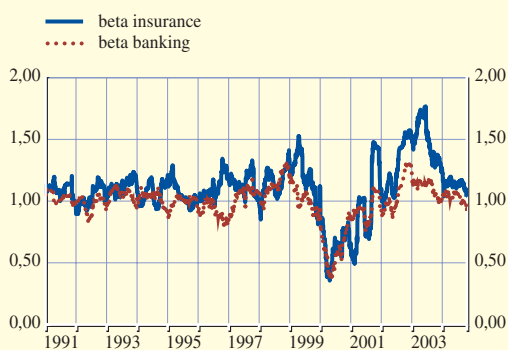


Chart B Betas of euro area bank and insurance sector stock price indices



Sources: Datastream (January 1990 to August 2004) and ECB calculations.

Another way to assess possible benefits of diversification is through the Sharpe ratio – a yardstick of the risk-return trade-off. Simulations with different weightings of banking and insurance sector stock price indices show more favourable Sharpe ratios for combined business lines than for the stand-alone sectors. The highest return per unit of risk over the period 1990-2004 is achieved when banking and non-life insurance activities are combined. Despite this, banking seems to have been better able to withstand the equity value deterioration than any simulated combination between 2000 and 2002, a period of sluggish equity market performance. However, shareholder value creation should be evaluated over the longer run, allowing for short, temporary setbacks in performance.

<sup>1</sup> In statistical terms, the two sectors' betas are significantly different at the 1% level.

## 2.3 POSSIBLE IMPLICATIONS FOR FINANCIAL STABILITY

In assessing the possible effects of the consolidation process and of the development of financial conglomerates on the overall stability of the financial system, two main aspects need to be considered:

- the impact on the risk profile of the institutions themselves, and
- the impact on the risk profile of the financial sector as a whole.

The risk profile of individual institutions is affected both positively and negatively by within-sector and cross-sector consolidation. For the reasons outlined above with regard to performance, large and diversified entities appear to be able to absorb non-systemic shocks more easily. Risks or losses in one business area tend to be offset by gains in other unrelated business areas. Therefore, higher concentration – possibly, but not necessarily, reflecting a less competitive environment – can go hand in hand with lower risk for individual banks.<sup>18</sup> However, conglomeration can pose specific problems of its own: in particular, complex group structures can be more difficult to manage, less transparent, and more easily subject to conflicts of interest and regulatory arbitrage. The overall net effect is difficult to gauge because aggregating these risks is a difficult task, although in theory, combining different financial activities in one institution may allow for economies of scope in risk management.

The effect of consolidation on the risk profile of the financial system as a whole, or systemic risk, is, in essence, a question of whether risk diversification is more effective through large banks and conglomerates than through smaller banks. It is evident that a bank or conglomerate's systemic importance increases with its size and reach across markets and geographical boundaries, and also that large banks or conglomerates grow more resilient to sector or activity-specific (idiosyncratic) shocks as their

size or scope increases. This is due to the realisation of diversification benefits within the firm resulting from growth. However, if a large financial institution were to fail, the impact could be larger, geographically wider and affect more business lines. Therefore, the financial sector as a whole may become less diversified as individual financial conglomerates become more diversified across business lines and more similar in their risk exposures.<sup>19</sup>

An extreme example serves to illustrate this point. If a single firm provides financial services across different sectors, its risk management effectively becomes that of the industry as a whole – with all its faults and virtues. If a sufficiently large shock affects this major financial group and causes a failure, it effectively translates into a systemic problem. It remains unclear, however, whether the same shock would have been diffused in a system with smaller and more diverse institutions. To some extent, these systemic problems may be offset if the smaller number of large institutions facilitates the monitoring of risks by supervisors or counterparty institutions.<sup>20</sup>

There is therefore no clear answer as to what prevailing effects large financial groups have on financial stability.<sup>21</sup> An important role in this respect is played by the existence of sound internal risk management and control systems and by effective public supervision.

18 See Bikker and Wesseling, "Intermediation, integration and internationalisation: a survey on banking in Europe", De Nederlandsche Bank Occasional Paper No 3, 2003.

19 See Section VII of the Bank for International Settlements' 73rd Annual Report, Basel, 30 June 2003.

20 See Berger, Demsetz and Strahan, "The consolidation of the financial services industry: Causes, consequences, and implications for the future", *Journal of Banking and Finance*, Volume 23, 1999.

21 Consolidation may also raise the question of whether some institutions have become "too large to fail" and, hence, of whether a failure might disrupt the whole financial system.



### 3 CONCLUSION

Consolidation in the financial sector – by fostering M&A activity and reducing the number of credit institutions – has been a major force driving structural change in the euro area banking sector over the past decade. Consolidation seems set to continue, especially as financial integration may lead to more cross-border M&A activity on the part of major banks wishing to establish a pan-European distribution network.

To some extent, consolidation has also taken the form of financial conglomeration. The main driving force for conglomeration has been the realisation of income synergies and similarities in competitive strategies. Bancassurance has been one of the most common types of conglomeration involving the euro area banking sector.

Both consolidation and cross-sector diversification are powerful drivers of change in the euro area financial landscape. Although this process is likely to improve the overall efficiency of the financial system, possible implications for financial stability still need to be closely monitored.