



Scope Insights – In this back-to-school edition of their Point and Counterpoint dialogues, Sam Theodore and Keith Mullin consider the likelihood of cross-border bank M&A in Europe, notably within the euro area (EA). And, more importantly, whether it is a good idea at all.

- **Can cross-border M&A improve bank efficiency and profitability?**
- **Is there a contradiction between policy rhetoric and regulation?**

SAM THEODORE

Transformational cross-border bank M&A in Europe is not a bright idea. Not before the pandemic; even less so in the post-pandemic age. Especially not for the reasons usually put forward by market participants and regulators. Chief among them being

- improving efficiency and profitability in a banking sector where both are sub-optimal,
- (ii) offering a wider and deeper choice to businesses and households across the EA.

The very significant senior management and board time and resources spent on cross-border M&A of questionable value could be

better spent on an accelerated digital refocus and ESG retrofitting. Because, these are key challenges of the banking industry in the post-pandemic years, in addition to taking up the enhanced role of helping the economic rebuild. The main competition for a large bank will come not from another large bank, but from open-banking digital platforms, fintechs and other disruptive structures.

On balance, the outcome of many pre-crisis cross-border bank M&A has not been so positive. Not in terms of economic or social added value as cross-border groups were not growth engines for the economies in which they operated any more than well-run domestic counterparts. And not in terms of shareholder-value creation either, even

when we abstract the horror of the ABN AMRO saga of 2007. During and after the global financial crisis (GFC), some of these M&A transactions had to be reversed – think UniCredit, Credit Agricole, Societe Generale, RBS – as many large banks were forced to shed rotten apples abroad and re-focus on de-risking and their domestic markets.

In the aftermath of the GFC and especially after the establishment of the European Banking Union in 2013, the idea of cross-border M&A came back; a single supervisor (ECB and the SSM) creates a natural habitat for multi-country banking groups, thus enhancing the single market.

Transformational transactions, especially across borders, tend to create a very dynamic narrative which can move prices and markets, much to the liking of traders, investment bankers, analysts and not least financial media. None of the above would get any brownie points by stating that transformational M&A, especially of the more sizzling variety, would not be helpful to most.

EA and other supervisors and policymakers have joined the bandwagon much more recently, suggesting cross-border banking consolidation within the EA as an avenue to boost the industry's lagging efficiency and profitability. Especially when comparing the large European groups with their US counterparts.

Not surprisingly, pan-EA supervisors feel that large multinational groups (the more, the better) would be less influenced by national authorities and thus their own mission would be less undermined by national politics in the event of stress.

But, equally not surprisingly, no CEOs of large banks are clamouring for their groups to merge with cross-border counterparts across Europe. At least not from a position of strength. And who wants to show weakness if not forced to? And I have no doubt that their lack of enthusiasm is because they actually know better.

KEITH MULLIN

I agree with you on many points, Sam. I think the notion of cross-border bank M&A at the current time and for the foreseeable future is just fanciful. Yet it's a perennial theme that gets everyone excited. It has certainly proved to be solid entertainment for the media, which likes nothing better than dreaming up and/or positing rumours about potential tie-ups and waxing lyrical about why they make sense.

It's also part of the narrative from euro area bank regulators, who have turned 180 degrees since the Too Big to Fail mantra of the post-GFC period and landed on the idea that cross-border mergers make sense, largely because it suits their own *raisons d'être*. And from EU policymakers, who continue to push to finalise the banking and capital markets unions as a policy bedrock.

A formidable roadblock lies in the very rules put in place after the GFC. These work directly against the economics and efficiencies of cross-border M&A as they prevent the free and unencumbered flow of capital, funding and liquidity across borders. And those rules are there for all sorts of on-paper sensible reasons; sensible, that is,

from the perspective of national supervisors whose job is to protect the interests of bank solvency and solidity in their own jurisdictions.

The last thing they want to see is the precious capital and liquidity of a banking group in their territory slipping out of the country to assist a subsidiary bank in trouble elsewhere. That's the fundamental contradiction here. Euro area policy makers say one thing but their rules say another.

Pan-regional rhetoric tends not to translate well into someone else's adversity, when national interests take over. That makes the logistics of running a pan-EA banking group pretty problematic. But if cross-border M&A isn't the answer, Sam, how else can the European banking sector right-size itself and improve profitability and efficiency?

SAM THEODORE

Talking about regulators changing their views, I remember vividly how during the GFC they were saying a big part of the problem was that there had been too much bank consolidation leading to runaway large groups. Not so much these days.

But to your question, imagine for a minute that, following a cross-border M&A, a bank proceeds to cut excess capacity, branches and back-office, to make the group more efficient. Such a step is likely to have ominous side effects, as in the 'foreigners are slicing us' up. I'm afraid that in the real world, including inside the world of banking, Europe is far less harmonious than the views within EU and EA institutional bodies.

In-market consolidation is one of the key avenues to reducing excess capacity. Not so much among the already diversified national champions as among the second and third-tier institutions: savings banks, co-operative banks, small retail and commercial banks in Germany, Italy, or Austria.

Domestic M&A could occur even in Spain, which went through a massive consolidation process after the GFC. Bankia and Caixabank are reported to be in merger talks. This makes sense. Having either of these large retail institutions involved in a cross-border merger would make far less sense.

In-market consolidation is less of a plausible scenario at this time in France, which is already a relatively consolidated banking market. French banks on balance display sub-par efficiency indicators even by European standards, which suggests that systemic consolidation in and of itself does not automatically generate higher efficiency.

In general, as the industry moves into the digital age, having a multitude of sub-dimensional legacy banks providing pre-digital commoditised products and services serves no purpose. Many will have to disappear, especially after the pandemic. Ideally through consolidation into stronger groups. They can always preserve brand if it adds value locally, but not much more.

But, again, the main challenge for large European banks is not so much to boost profitability in the short term to satisfy shareholders who complain that banks are not investable. They said the same thing during the GFC yet they kept investing. The main challenge is to adapt to the new world

by going successfully through the digital and open-banking challenge, by retrofitting their activities and balance sheets to ESG criteria e.g. by gradually pulling out of brown-asset financing or addressing climate-change and social-equity considerations.

And, for the short to medium term, making sure they focus their efforts on financing the rebuilding of the economies they operate in after the pandemic. There is nothing more important than that. Which, by the way, you could not guess from analysts' questions during the Q2 results announcements.

Increasingly, a central question for banks should not be "how much money are you going to make", but "how are you going to make your money".

KEITH MULLIN

I agree that domestic consolidation is the way to go to reduce costs, increase efficiency and raise profitability (to the extent possible given the monetary policy environment we're in). This is absolutely the focus at the moment. Cross-border pipe dreams which are overloaded with rules that undermine efficiencies and economics and which are beset by political minefields should be laid to rest for now.

Even if the economics can be made to work and operational and logistical difficulties overcome, let's not forget cultural factors – or more to the point cultural mis-alignments that often lead mergers to fail, especially cross-border. I never cease to be amazed by how much this element is overlooked in merger situations, where internal corporate cultures

as well as business and national cultures can be very different.

But on the basis that Europe is overbanked, Sam, I agree with you: it's absolutely at home that work to right-size the sector needs to start. But even there it's not easy. You mention the difficulties of cost-cutting in a cross-border context; I'm not sure the story is fundamentally different domestically, where some countries have robust employment rules that makes cutting jobs difficult. And banks cutting back on staff and branches too aggressively face similar reputational issues.

As an exercise, I looked at Europe's national champions and reviewed their M&A activity since the end of the 1980s. While there has been some notionally successful cross-border activity, they have almost exclusively grown through domestic M&A.

It's those domestic footprints that gave European banking groups the wherewithal to finance expansion in growth markets or in selected products lines overseas. Just look at the sheer amount of takeovers the Spanish banks undertook in Latin America to diversify their revenues streams and build market share in retail, consumer, business and corporate banking.

Same for Western and Northern European banks buying across Central and Eastern Europe and the Baltics. And that's the aspect I'll end on. While the focus now is on dealing with inefficiencies, too many costs and lack of profitability, banks can't shrink their way to greatness. Good reasons may emerge at some point that put mergers and cross-border mergers on-side strategically.

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