

EPFSF Briefing: Cross-border banking consolidation

1. Introduction

In its White Paper on Financial Services Policy 2005-2010, the European Commission highlighted the significant potential for increased efficiency and growth of the EU economy which as a result of freeing competition in EU financial markets and achieving a truly single market in financial services. EU financial services firms should have a wider market for their goods and services, which should help to improve productivity, customer service and choice. Larger and more diversified financial institutions should be better able to mitigate risks associated with their business and possible financial market shocks, enjoy greater economies of scale, and should be better able to compete globally. Finally, the realisation of a truly single market for financial services in the EU is a crucial cornerstone of the Lisbon Strategy to promote growth and employment in the EU economy.

The Commission's stance on promoting cross-border consolidation has helped contribute to an increase in the number of European deals completed, for example ABN-AMRO-Banca Antonveneta, Santander-Abbey National, Unicredito-Hypovereinsbank and BNP Paribas-BNL. However, consolidation in financial services remains well below levels experienced in other economic sectors.

It is important to bear in mind the commercial factors driving consolidation, and to frame these in a global context:

- a) **Size and scale matter more than ever before in financial services.** Scale building has accelerated dramatically, and will most likely accelerate further. This trend is truly becoming a global phenomenon within consolidation taking place literally everywhere, both in the more developed and less developed countries, from Europe to the Americas to Asia. The search for growth and scale has added a new, global dimension even to retail banking, traditionally seen as the ultimate local business. Discussions in Europe about cross-border bank M&A have focused on the competitiveness issue for European banks, their need to scale up in light of other regional-banks' rapid and comprehensive consolidation into a number of giants in market capitalization terms, so that they can compete effectively with them for banking assets in emerging markets.
- b) **Changing demographics (both population shifts and ageing) will alter the revenue outlook for banks around the world.** European banking revenues should continue to see a positive revenue growth rate from demographics through to about 2025, but this growth rate will almost certainly be substantially lower than most parts of the world. Many firms will therefore look to invest in new markets where demographic factors and growth rates which drive their business are more favorable.
- c) **Big does not automatically equal good.** Some activities are very scale sensitive. However, there will be opportunities for smaller domestic players to become ever more focused, and compete more in service than in price, leveraging their distribution reach, local management talent, superior knowledge of local markets and companies, and commitment to the local economy.

Between September 2004 and April 2006, the European Commission, at the invitation of ECOFIN, consulted stakeholders to better understand why there was relatively little cross-border consolidation in the financial sector. The results from the consultation revealed a number of barriers to cross-border M&A in the financial sector.

Top priorities for action included issues of banking supervision, VAT treatment, and the integration of the retail market, particularly in terms of benefits to consumers¹.

¹ European Commission, Cross-border consolidation in the EU financial sector, SEC (2005) 1398, part III.

2. Banking Supervision

The lack of transparency, clarity, and harmonisation in the supervisory approval process under Article 19 of Directive 2006/48/EC² has been the first area which the European Commission has attempted to address. Started in late 2004, the review of the current rules on the supervisory approval process of M&A was extended in 2005 to cover similar corresponding legislation in the securities and insurance fields. The Commission's stance on revising the supervisory review process over the last year has already started enhanced market confidence in the process and helped stimulate an increase in cross-border mergers in financial services.

On 12 September 2006, the Commission published a proposal for a Directive amending various Directives in the banking, securities and insurance sectors³. The proposed Directive aims at ensuring that supervisory approval process is clear, consistently applied across Europe and as transparent as possible in order to minimize the scope for political interference in cross border mergers and acquisitions. Importantly the Proposal also introduces a closed list of criteria on which supervisors can assess potential mergers and reduces the timeframe for the assessment procedure.

Within the co-decision procedure, the Proposal has, to date, been examined both by the Council and the European Parliament. Both institutions aim at adopting the amending Directive in one reading. In light of the progress made in their work, this objective seems achievable and the final text could be adopted during the spring 2007.

Fragmented European supervisory structures were also highlighted as being a significant burden on those firms operating on a cross border basis, resulting in duplication of supervision, disclosure requirements and inconsistency in approaches across jurisdictions. The framework for more efficient home/host cooperation is provided for in the Capital Requirements Directive and the Level-3 Committees (CEBS, CESR, and CEIOPS) have been tasked with fostering convergence of supervisory practices and streamlining reporting requirements. In that respect, CEBS has orientated its work from design to delivery of a more convergent supervisory framework.

3. Taxation

Among the barriers to cross-border M&A activity, taxation was identified as another important difficulty. Under the current VAT system, most charges made to customers by banks are not subject to VAT. Consequently, banks are only able to recover a percentage of the VAT that they incur on their own expenses, unlike other economic actors such as manufacturing and retailing businesses where VAT incurred is fully recoverable. For banks, VAT is therefore a pure cost, which affects profit margins and prices. This VAT cost particularly penalizes intra-group cross-border supplies as the cost of any function not performed in-house, whether by integration into a specialist centre of excellence, or by outsourcing to a third party, comes back with an irrecoverable VAT cost of approximately 20%.

Financial services groups operating in more than one Member State face considerable paperwork as a result of having to calculate their tax liabilities according to different sets of rules. For instance, different Member States have different rules on transfer pricings, and losses in one Member State cannot be offset against profits in another. EU financial groups will only be able to maintain a competitive position internationally if they are given the opportunity to rationalise, centralise and integrate their functions in a VAT-neutral way.

In the past, the Commission has attempted to address the provisions of the 6th VAT Directive (77/388/EEC) dealing with financial services, and in particular Articles 5(8) and 6(5). However, the application of these provisions is often described as uncertain and inconsistent on an EU level. The Commission has now launched a review of the present system, but it is uncertain whether sufficient political support exists in Member States for a comprehensive.

² Former Art. 16 of Directive 2000/12/EC (the so-called Banking Directive)

³ European Commission's proposal for a Directive amending Council Directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of shareholdings in the financial sector.

4. Retail market legislation

Consumer protection legislation varies across Member States affecting in particular retail markets different consumer protection regimes prevent cross-border consolidation. and require financial institutions to tailor domestic products in order to comply with varying national legislations, instead of developing pan-European products. This in turns reduces the synergies and cost savings, which are necessary to undertake and justify an M&A transaction.

The tendency so far has been to adopt minimum harmonisation legislation to approximate more closely the variety of retail banking systems across EU Member States. This has not overcome the fragmentation of consumer protection regimes across the EU. The Commission has recognized this and now suggests fully harmonising the key elements of retail banking products, which is essential to foster cross-border offerings and increase competition⁴. “Targeted full harmonisation” seems to be the most effective means of creating a genuine European market for retail banking , but it is yet to be put into practice and should be combined with a degree of mutual recognition for those product or service elements that are not considered “key”. This would permit the European retail market for financial services to open up and deliver the promise it holds for customers as well as providers.

5. Conclusion

The trend towards cross-border consolidation in financial services has increased, yet barriers remain limiting both the potential for improved efficiency of the internal market and the ability of European firms to compete globally. What is most important is to remove obstacles and let the market decide. In this regard the work of the European Commission to define common, appropriate, and transparent prudential considerations for mergers in financial services, and the Commission’s study on obstacles to cross-border financial M&A are extremely welcome.

⁴ White Paper on Financial Services Policy 2005-2010, part 4.4.2.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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