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European lessons on consolidation in banking

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Abstract

Does Europe offer lessons for the consolidation in US banking? In this paper, it is argued that the political dimension in Europe has led to the protection of national flagships and consolidation mainly on a national scale. Lessons for the US are limited. Rather, the regional expansion observed in US banking may offer valuable lessons for imminent cross-border mergers in European banking. © 1999 Elsevier Science B.V. All rights reserved.

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Contrary to banking in most of the world, US banking has historically been quite fragmented. This is not really surprising. US banks face(d) substantial regulatory constraints on their activities concerning both the type of their activities (e.g. commercial banking or investment banking, not both) and the location (e.g. limits on interstate banking). More recently however regulatory constraints have become less binding. This undoubtedly (partially) explains the surge in mergers and acquisitions.

Between 1979 and 1994, the number of banking organizations fell from 12463 in 1979 to 7926 in 1994 (Calomiris and Karceski, 1998). In the last few years we have observed several large mergers. For example, sequences of

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mergers led to the regional powerhouses BankOne and NationsBank that subsequently announced mergers with, respectively, First Chicago-NBD and BankAmerica. Similarly, money center banks chose to consolidate, e.g. Chase Manhattan Bank and Chemical Bank. Moreover, the (anticipated) expanded powers of banks led to union of Salomon Brothers and Smith Barney (Travelers), and the announced merger of this conglomerate with Citicorp.

It is very difficult to give an interpretation and direction to this ongoing dynamic restructuring of the US financial-services industry. The European experience may give some direction. Consolidation has been observed in Europe already for some time. But is there really something to be learned from the European experience? And are experiences across continents and countries comparable? In a recent paper on corporate governance, Jon Macey and I describe one of the big fallacies in comparing models of corporate governance. We say "the rhetoric about corporate governance appears to us to be divorced from reality in that two paradigmatic governance systems – the German model and the US model – are not really models at all... The German model is not even a model for the rest of Europe" (Boot and Macey, 1998). I feel the same in the context by discussing European trends, and what US policy makers could learn from them. Of course, some obvious lessons can be learned from the European experience, e.g. the more consolidated financial sector observed in Europe gives a clear hint about what can be expected in US banking when regulatory constraints become less binding (as they have become in recent years). But what can be said more fundamentally about the *diverse* European experience?

European lessons: The political dimension

Let me first focus on the arguable superficial common European experience as it may relate to the US. Europe and the US share some common dynamics. In particular, the relaxation of constraints on interstate banking in the US is reminiscent of the European Union banking directives liberating cross-border banking. However, immediately a fundamental difference between US and Europe surfaces. The domestic banks in Europe were – and are – protected as domestic flagships. A fundamental belief that financial institutions should not be controlled by foreigners has (so far) almost prevented any cross-border merger.

I believe that this political dimension is very important. Even in countries that do not have any direct interference by governments in banking operations and where banks are considered truly commercial enterprises (and have generally been successful, e.g. ABN AMRO and ING in The Netherlands), the political dimension is important. Central banks, ministries of finance and the banks operate in close concert. This is not very surprising: a very homogeneous group of executives is in charge of the financial sector, central bank and government ministries guaranteeing a clear national identity of domestic institutions. In countries with explicit government involvement (e.g. France and Italy), foreign control over domestic institutions is even more unlikely. Unless banks become so inefficient and weak that involvement of foreigners becomes almost inevitable. To some extent this is happening. For example, in the recent bidding war for the French bank CIC, ABN AMRO was favored by some because of its excellent track record vis-à-vis competing French bidders.

The primary response to the liberating EU directives has so far been defensive: domestic mergers are generally encouraged to protect national interests. A case in point is Germany. Many have observed that banking in that country is surprisingly dispersed despite the powerful images of Deutsche Bank, Commerzbank and Dresdner Bank. Public policy definitely aims at protecting the interests of these powerful institutions, but the consolidation is played out mainly on the Länder-level (the separate states). Indeed, precisely at the level where the political dimension is at work. This is an important explanation for the regional consolidation in German banking.

So wherever we look in Europe, I dare to conclude that the national flagship dimension has been of primary importance. Cross-border expansion is rare and consolidation is primarily observed within national borders. For the US this gives little direction. Interstate expansion has been a driving force behind the consolidation in US banking. Politics does seem to interfere little with interstate expansion.

No other lessons?

Focussing only on the political dimension is inadequate. The paper by Milbourn et al. (1999) shows that there might be distinct (non-political) rationales for consolidation.

Let me highlight a broader interpretation of the strategic explanation in this paper. Bankers strongly believe that a strong position in the home market is crucial for a successful expansion in foreign markets. Generally, this seems to be the case. I will give a few examples. Belgian banks have weak foreign operations: the Belgian political situation (the split between the French and Dutch speaking regions) did not allow for strong domestic powerhouses. Swedish and other Scandinavian banks suffered from a financial crisis in the late eighties, early nineties inhibiting their foreign aspirations. Spanish banks started to consolidate "late". Their foreign aspirations seem limited, but some (e.g. Santander) now choose to (successfully) expand in the South American market. The Dutch, Swiss and German powerhouses have truly powerful franchises in their home markets and seem the only Continental European banks with credible foreign aspirations. [1]

[1] I deliberately leave out the UK banks whose prospects are mixed at best.

In the interpretation of the Milbourn et al. (1999) paper, strength in the home markets allows banks to invest in "strategic options". An important one is investment banking (IB). While Continental European banks traditionally dominated the *domestic* activity in investment banking, they have had a more marginal role in IB in foreign markets and now also face severe competition in their domestic IB activity. Many of them feel that a presence in IB *might* be important for their existence as powerful banks in the future. They are willing to accept – for the moment at least – relatively low returns on these activities. The potential (but uncertain) vital role of these activities in the future defines them as a strategic option.

From a shareholder value maximization point of view, investing in strategic options might be desirable (if at least *potentially* sufficiently lucrative). However, how can we distinguish the "strategic option" explanation from a simple managerial entrenchment explanation? That is, managers (and governments!) may just want powerful institutions for their own sake. This is the alternative explanation for expansion of scale and scope in Milbourn et al. (1999). Distinguishing between those explanations is difficult. As the experiences of the French bank Credit Lyonais teach us, banks that are not accountable, and even worse, operate as playground for government appointed crownies, are unlikely to follow value maximizing strategies. Growth then becomes a managerial entrenchment strategy.

Nevertheless, I do believe that scale and scope economies are present in banking. I am tempted to subscribe to Calomiris and Karceski's (Calomiris and Karceski, 1998) notion of "client based universal banking strategies" where a bank seeks to optimally service its client base by choosing the appropriate products, services and geographical presence. Simultaneously, however, I observe that much of the consolidation in European banking is defensive. Consolidation has increased scale and scope mainly in domestic markets and facilitated "local" market power. Size has reached proportions that seriously questions whether anymore benefits of scale are present. And is the wider scope truly sustainable? Will it not cause dilution and loss of focus? If so, it will clearly limit the desirability of investing in "strategic options". Instructive in this respect is that the operations of European universal banks in foreign markets (where they face more competition) are generally well focussed.

Landscape full of uncertainties

The level of uncertainty is such that I cannot prescribe – at least not with any level of confidence – a sensible regulatory and public policy vis-à-vis consolidation. The desirable scale and scope is not well defined. I also would not dare to say that the national identity of ownership of financial institutions does not matter albeit as a free-market economist, I would choose to leave it open to market forces (but take into account anti-trust concerns).

Banks themselves are *ambivalent* too. The struggle of European banks in investment banking is a perfect example: while some see it as a strategic option, others (NatWest and Barclays) have retreated, albeit not really voluntarily! We see a similar ambivalence vis-à-vis insurance activities. Some think that it is perfectly complementary to commercial banking activities and have embraced it (e.g. to economize on the distribution network) – see ING and Credit Suisse-Winterthur – others choose to stay out of it.

Finally

There are powerful forces behind consolidation. I believe that consolidation is only partially driven by value-maximizing behavior. As I have emphasized, the political dimension cannot be ignored, but is probably less important in the US.

Consolidation in Europe and the US will continue. The regional expansion that characterizes much of the US merger wave will carry over to Europe. Cross-border acquisitions are coming, particularly with the arrival of the EURO and the European Monetary Union. These will accelerate the integration of national financial markets, and induce a more pan-European view on financial services.

The surprising conclusion may therefore be that the US merger wave is more instructive for Europe than the nationally oriented European consolidation tradition is for the US. [2]

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[2] I have said little about moral hazard and regulatory concerns in light of the consolidation. For one reason there is broad agreement: certifying risk management processes is the primary task of supervision, and the EU has quite wisely allocated this task unambiguously to home country supervisors. This is something still to be addressed in the US observing the multiplicity of regulators. The consolidation, and broadening of scope now also observed in the US (e.g. Travelers and Citicorp), amplifies the importance of this issue.