

# **Strengths and Weaknesses of European Banks: What Lessons for Future Restructuring?**

*Draft version (please do not quote)*

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Abstract: Until 1999, M&A operations in Europe occurred mainly on a national basis. Since then, a second phase, more open to cross-border acquisitions, seems to have begun. If this does happen, the first question that arises is where will these operations take place? Why do cross-border mergers and acquisitions occur in some countries and not in others? In the first part of this paper we shall examine some theoretical aspects of the internationalization of banking in order to better understand the underlying logic. In the second section we shall analyze the strengths and weaknesses of the main European banking industries in order to describe how they position themselves in relation to their competitors. On the basis of these studies we then seek to isolate the aggressive aspects (factors of internationalization) or, on the contrary, the “porous” aspects (factors encouraging the aggressiveness of others) of the main European banking systems. The goal is to determine which countries are the most likely to be at the origin of moves that recompose European banking.

## **Strengths and Weaknesses of European Banks: What Lessons for Future Restructuring?**

On an international level the financial services industry remained fragmented until the beginning of the nineties, when it experienced a period of frenetic restructuring, during which the number of mergers and acquisitions grew spectacularly, both in Europe and in the United States. This wave culminated at the end of the nineties, and then declined significantly, giving the impression that the sector had completed its consolidation. But was that really the case?

No, first of all because the banking sector remains clearly less concentrated than other industries, and at the same time both regional integration and financial globalization favor a different type of evolution. Secondly, because numerous signs both in the United States and in Europe have since demonstrated that this was not the case. If we look at what happened in the United States, the number of banks there dropped over ten years from 14,000 to less than 7,000 after the repeal first of the McFadden Act, and then of the Glass Steagall Act (1999). Today the 37 largest U.S. banks are consolidated into seven financial poles, giving them significant power on a world scale. Other signs in Europe, such as the bid of SCH for Abbey in July, 2004, prove that the movement is not over.

Until 1999, M&A operations in Europe were primarily domestic. Since then a second phase, more open to cross-border acquisitions, seems to have begun. Thus, if one estimates that such a development will be extended, particularly in Europe, then the first question that arises is: where will such operations occur? The level of consolidation is far from being the same from country to country and activity to activity. Why do mergers and cross-border acquisitions occur in certain countries and not in others? Why are certain activities largely dominated on an international level by a few big groups? Are there necessary preconditions for international expansion? Must "national champions" first be consolidated, that are only then capable of facing off with the other "national champions"?

In the first section of this paper we shall explore certain theoretical aspects of the internationalization of banking in order to better comprehend the underlying logical processes. In the second section we shall analyze the strengths and weaknesses of the main European banking industries in order to describe how they are positioned in relation to the competition. On the basis of these studies, we then characterize the main European banking systems as either aggressive (a factor of internationalization) or, on the contrary, as "porous"

(a factor accepting the aggressiveness of others). The goal here is to determine which countries are the most likely to be at the origin of moves that recompose the European banking landscape. Starting with the definition of homogenous macro and micro measurements and internationalization, and with an analysis based on banking activities, we have attempted to estimate the ability of the main banking groups in Europe to "Europeanize" their operations. In this way we have sought to highlight the strategy of the European banks most likely in our view to be motor forces in the new configuration of European banking.

## **I. What the literature teaches us**

Although the studies examining the obstacles and factors favoring banking consolidation on a national level are legion, it is a fact that few of them deal with the international dimension of this phenomenon. Between the "first generation" explanations (1980-1990) and those of today, what a difference (even if the latter may seem still insufficient)! Perhaps this was due to the fact that the initial studies considered the internationalization of banking to be a subsidiary question, essentially part of foreign direct investment (FDI) and international trade, whereas today internationalization has acquired a certain autonomy and its own logic. Doubtlessly also, the reasons behind it have changed over time. The context has changed and banking activities are no longer exactly the same. Today each bank is a "market mix" of business units with distinct characteristics. And this combination of activities varies from one country to another, just as the constraints concerning internationalization are not the same for each banking activity. Thus, it is hardly surprising that some of the explanations used today seem to us a bit outdated (the markets of the home countries), others more interesting (the difference between small and large operations, between creation and acquisition), and finally still others (microeconomic dimension and internationalization) indispensable, because they were totally absent from the studies of the seventies and the eighties!

The factors traditionally referred to in the literature to explain banking internationalization may be placed into three broad categories:

1. The first studies **the degree of integration between the home country and the host country**. Here it is primarily a question of international trade and FDI, the idea being that banks follow their clients to foreign markets.

- Thus, Grubel (1977) attempts to explain what advantage the banks may enjoy by locating to a foreign country. He estimates that the reason cannot be the differentiation of the products offered, because banking products can be copied. However, being familiar with the needs of clients from the home country is a comparative advantage, and banks follow their

clients abroad in order that banks of the host countries don't have the opportunity to acquire such knowledge.

- Goldberg and Saunders (1980) study the factors affecting the expansion of U.S. banks in the United Kingdom and conclude that U.S. trade is highly correlated to the growth of U.S. banks in the U.K., whereas exchange and interest rates do not significantly help to explain such growth.

- Gray and Gray (1981) note in their study that multinational banks enjoy a comparative advantage by utilizing the imperfections of the market. Thus, when their clients expand abroad, banks want to follow them in order to provide them with the services they need.

- Brealey and Kaplanis (1996) interpret the spectacular growth of international banking activity 1960-1985 as linked to the growth of trade and FDI.

2. The second category of arguments concerns the factors linked to **institutional and regulatory obstacles**. There is a large consensus in the literature to date that they play an important role in the form taken by cross-border activities.

- Goldberg and Johnson (1990) study the factors determining U.S. banking activity abroad. They conclude that the factors explaining which countries are chosen for expansion are a less regulated environment, a relatively large amount of international trade, and a relatively low level of domestic deposits.

- Berger, DeYoung, Genay, and Udell (2000) show that, when cross-border M&A transactions have taken place, deregulation seems to have played an important role.

- Buch (2003) finds that regulation, the cost of information, as well as a common language and legal system encourage banks to go ahead and make international investments. The importance of each one of these factors varies according to the home country, and the model of internationalization differs from one country to the next. Thus, the banks of some countries, such as Spain, may prefer markets similar to their domestic market, while others may seek markets with fewer obstacles to entry.

3. The third category contains the factors linked to the banking conditions of the host country and the opportunity for **making profits**. As institutions seeking to maximize their profit, banks go where they may expect large future cash flows. Here it is the **local banking conditions** that are the factors of attraction.

- Thus, in his study of the choices of international expansion by Japanese financial institutions, Yamori (1998) obtains results that agree with the preceding research and that

confirm the hypothesis that banks follow "the international business in the process of internationalization." But he also finds in the case of Japan, and contrary to the conclusions of Nigh, Cho, and Krishnan (1986) in their work on U.S. banks, that Japanese financial institutions at least partly determine their expansion on the basis of local opportunities provided by the host country.

- Focarelli and Pozzolo (2000) study the factors determining the internationalization of banks and their choices of where they expand. They study a sample of 260 banks from OECD countries and evaluate their work in the other OECD countries. They conclude that the potential profits in the host countries are a determining factor in the banks' decisions on where to go. In particular, banks expand to countries where the economic growth forecast is stronger and where the banking system on the whole is considered to be less efficient. The regulatory environment and the level of competitiveness of the banking sector in the host country also play an important role—banks prefer penetrating less concentrated markets and those where the regulatory restrictions are less constraining. The countries' degree of economic integration seems to them to be a factor that is relatively less important in the choices made by banks.

**Table 1: Summarizing the literature concerning the internationalization of banks**

Authors	Date Published	Countries, Periods, and Banks Examined	Explications Put Forward Concerning Reasons for and Obstacles
Goldberg and Saunders	1980	U.S. banks in the U.K.	International trade
Gray and Gray	1981		Comparative advantage linked to market imperfections
Nigh, Cho, and Krishnan	1986	U.S. banks in 30 developed and developing countries	FDI
Sabi	1988	U.S. banks in developing countries	FDI
Goldberg and Johnson	1990	U.S. banks in 22 countries	FDI International trade Less regulated environment
Brealy and Kaplanis	1996	Period studied: 1960 to 1985	International trade FDI, conditions in home country
Yamori	1998	Japanese banks in 44 countries from 1965 to 1994	International trade Opportunities offered by host countries.

Authors	Date Published	Countries, Periods, and Banks Examined	Explications Put Forward Concerning Reasons for and Obstacles
Focarelli and Pozzolo	2000	260 banks from OECD countries	Potential profits in host countries Regulatory environment
Berger, DeYoung, Genay, and Udell	2000	Banks in developed countries	Regulatory environment Managerial reasons
Focarelli and Pozzolo	2001	2500 banks in 29 OECD countries	Asymmetrical information Regulatory restrictions Difficulty of evaluating the value of international transactions Bank size is a decisive factor in decisions on cross-border growth
Buch	2001		Regulatory environment Information cost
Buch	2003	Period studied: 1983-1999, particularly the EU and the impact of the second directive	Cost of information and regulation are important factors, but other factors come to play, such as geographical distance, cultural proximity, similar legal system, as well as the level of entry obstacles
Boot	2003	Strategical considerations for the consolidation of the banking industry and its implications for European banks	Strong position on the domestic market is a crucial factor to succeed in expanding to foreign markets. European banks must be present abroad in certain activities, especially investment banking, in order to not abandon these activities on their domestic market
De Félice and Revoltella	2003	Period: 1995 à 2000 External growth strategies of European banks	High degree of national concentration, competition and narrowness of domestic market. Existence of strategies of "following the client" at the beginning of the period studied, whereas the narrowness of the national base and the potential for growth in other European markets become more important in 2000
Buch and Delong	2004	144 countries, differentiating developed and developing countries	Information costs Regulation Significant differences between developed and developing countries

From this "survey" of the literature it may be seen that, for a long time, the factors cited to explain the internationalization of banks were essentially tied to international trade,

FDI, regulation, and the size of capital markets in the home countries. It should be noted that in the more recent studies these arguments have been relegated in favor of explanations more linked to the opportunities provided by banking conditions in the host country. Above all, some of these studies, although still few in number, seek to draw the lessons from the M&A banking operations that have taken place in the last 15 years and to combine both macro- and microeconomic approaches. Do the processes of domestic and international consolidation occur in function of the same necessities? Are the big national establishments looking to attain a critical size on an international level? Does international financial globalization make this goal of critical size obligatory in order to be competitive and successful? Are domestic merger-acquisitions effective, but not cross-border operations, which would explain and justify both the breadth of the movement of national consolidation and the dearth of cross-border transactions?

Traditionally, concentration in the banking industry is justified by the virtuous character of economies of scale. Generally, these economies of scale flow from the ability to combine similar units in order to benefit from reduced costs, by spreading the fixed costs out over a larger level of production. Notions of critical size and economies of scale are directly linked to the hypothesis of increasing returns. A key function of banks, as intermediaries, is both to reduce the asymmetry of information between lenders and borrowers and to manage the means of payment. The result is two possible economies of scale—one linked to collecting information and reducing asymmetry, and the other to risk management. Are these arguments, which have been put forward to explain mergers and acquisitions on a national scale, pertinent in the case of international transactions? And shouldn't we be looking at this according to the activity involved? Is size just as important in business activities such as asset management and specialized financing, which require visibility on a world scale, as in other banking activities? Why, from this point of view, has investment banking, along with asset management, been the sector in which transatlantic operations have been the most numerous?

Studies dealing with the international dimension per se are scarce compared with the literature on mergers and acquisitions in a national framework, doubtlessly because the mechanisms justifying M&A on the domestic level cited above are more difficult to apply and evaluate on an international basis. Structural reorganization is more difficult to accomplish due to geographical dispersion. Disparities in the conditions in which banking activities take place further complicate the problem. How activities are linked together varies from one country to another, as well as the constraints, as these are not the same for all banking activities.

It would thus seem that cross-border mergers bring with them more risks when being executed and may lead to fewer cost reductions than national mergers. On the other hand, economies of scope can probably be expected thanks to "cross-selling" and the use of different trade names and distribution circuits.

However, economic factors tied to the narrowness of national bases for actors of a certain size are speeding up the reconfiguration of banking, particularly European banking, and are helping to push some actors beyond their national framework. For example, such is the case with the large British banks, as it is with their Spanish colleagues, who know that the time for national mergers is now past for them. To these banks, cross-border mergers appear to be the next logical stage of development. The question is all the more urgent in that the mega-mergers in the United States (Bank of America - FleetBoston or JP Morgan Chase - Bank One) will give birth to giants who will necessarily reach out, one day or another, to the European market. In addition, diversification can be seen as another motor force behind the process of cross-border mergers and acquisitions. Thus a good national base and highly profitable domestic activities may authorize and even incite a bank to explore how to geographically diversify, seek new revenues, and to a lesser degree, become less dependent on the domestic market.

Berger et al (2001) suggests that the efficiency obstacles particular to international mergers, such as geographical distances, cultural and linguistic differences, as well as hierarchical and regulatory structure differences cancel out part of the gains coming from cross-border consolidation.

Vennet (2002) evaluates the capacity of European cross-border mergers and acquisitions between 1990 and 2001 to reduce inefficiency. He calculates the efficiency cost and efficiency profit coming from these operations. He establishes that there was no improvement in efficiency cost in the sample of target banks. There may be various explanations for this—difficulties encountered by executives to adequately link up differing structures, difficulties in reducing salary costs in continental Europe, or geographical dispersion which, contrary to domestic mergers and acquisitions, limits the possibility of improving efficiency cost through restructuring and eliminating redundant units. However, results are quite different concerning the efficiency profit of the target, which often increases because of economies of scope.

As for De Félice and Revoltella (2003), they identify several variables upon which international growth strategies are founded. They distinguish between intra- and extra-European Union investments. They establish that investments outside the European Union

essentially concern countries that are closest culturally and that have well developed commercial relations with the home country of the bank that is buying. The latter may also obtain gains in efficiency through the transfer of technology and competence.

Buch and Delong (2004) seek to better understand where and why cross-border mergers take place. Their study is centered on the importance of information costs ("cultural proximity") and regulation costs. Their results suggest that information costs are significant obstacles to cross-border banking mergers. Another important aspect of their study is their investigation into the effects of regulatory initiatives in Europe (the Common Market) and in North American (NAFTA) on banking mergers. Deregulation measures seem to have had little effect on cross-border banking activities.

We may thus establish that the studies on the cross-border aspect of banking activity have evolved considerably, both in the dimensions envisioned and in the variables utilized. Today we can no longer be satisfied with simple criteria linked to international trade and the specific characteristics of the firm. The intense M&A activity in Europe through 2000 and the striking absence of any Pan-European operation, as well as the pursuit of a primarily national logic of consolidation, seem to indicate the emergence of a new geography of banking. Whereas since 2000 European banks have essentially endeavored to digest previous acquisitions, to re-orient towards domestic retail banking, and to clean up their balance sheets rather than strike out with international growth strategies, U.S. banks seem, on the contrary, to be experiencing a period of intense restructuring, with numerous acquisitions of medium-sized banks, as well as large-scale operations, such as the acquisition of FleetBoston by Bank of America, and Bank One by JP Morgan Chase.

In order to better grasp this new banking geography, it is necessary to conceive new instruments of measure, or at least attempt to do that. The point is to find indicators that make it possible to better describe reality and the various possible scenarios.

## **II. Indicator and data problems**

Comparing and interpreting banking operations on an international scale turns out to be an extremely difficult task, because it is hard to compare the data and the indicators are unsatisfactory. The first difficulty that arises is to define what a bank is—to take just one example, is Salomon Brothers a bank in Frankfurt but not in London? A second difficulty concerns the nationality and the home country—is CCF now an English or a French bank? Finally, a third difficulty arises with indicators. How can banking activity abroad be

measured? Should we count the number of offices or agencies open? Should it be done independently of the number of employees in these agencies (data concerning personnel is rare and subject to interpretation)? Should we then study the volume of banking assets abroad? Or rather the product of banking activities abroad?

To measure the profit opportunities on a foreign market, often total GNP and per capita GNP are used as indicators. This leads to problems, because these indicators are higher on the average in the more developed countries, precisely where competition in the banking sector is more intense and where opportunities for external growth are scarcer. By the same token, in recent empirical literature countries with a low rate of inflation, a high rate of children in school, and developed financial markets are supposed to have a higher rate of economic growth in the years to come. Can we be satisfied with such an indicator?

Clearly it is urgent to invent new indicators, which, to be sure, do not yet exist, but which force us to think on three levels—micro, meso, and macroeconomic—and makes it possible to distinguish the trends in a given banking industry that turn one country's banks into a potential predators, and others into targets.

### **Indicators selected**

We have chosen three categories of indicators:

1. **On a microeconomic level** we have defined indicators of financial health, where we also find those demonstrating the greater or lesser capacity of a given bank to resist an offensive. Capitalization, profitability, the degree of internationalization, as well as equity capital seem to us to be key indicators. They are calculated in relative values in order to reflect the disparities between the different banks studied and to make comparisons possible on a national as well as on a European level. Capitalization is certainly not a criterion in itself; it does, however, indicate the "league" in which the "game" is played. It may be completed by the PER (price/earnings ratio), which may indicate how relatively "expensive" a bank is. The profitability of a credit institution demonstrates its capacity to derive profits from its operations sufficient to allow it to pursue and develop its activity on a long-term basis. According to what goal is being pursued, the indicator used to measure profitability will not be the same. The return on equity (ROE) shows the investment return for shareholders. In order to complete this indicator and to make up for its limitations (it uses a total, net earnings, that can include non-recurring or heterogeneous profits or charges, which can mask the actual structure of bank profitability), we use the cost to income ratio, calculated by comparing operating costs to net income. This ratio makes it possible to evaluate the impact costs of

functioning have on the level of profitability. Poor cost control goes hand in hand with a low level of profitability (example of the German banks). The cost to income ratio constitutes an indicator of the level of bank efficiency and productivity. Finally, the equity capital indicator measures, in relative terms, the solidity or fragility of the bank's financial base. It thus completes the financial health indicators.

**The degree of internationalization**, as well as the international portion of net income, must also be included as indicators. It should be noted that the market clearly separates out global and local activities. On a world level, the consolidation of so-called "global" activities is fairly important (fewer than 15 investment banks share two thirds of the world market), whereas distribution remains fragmented and local. Thus, in the United States, the market share of Citigroup does not measure more than three or four percent, and that of Crédit Agricole in the European Union is less than five percent. The position of "leader" in global activities is expensive, and banks the market feels to be fragile, marginal, or ordinary often lead to lower valuations. This represents an incentive to merge or grow in order to attain a critical mass. For local activities, banks use more structural valuations and the gap between two competing banks is generally slight.

The differences in valuations of European banks reflect just as much discrepancies in geographical location as differences in portfolios of activities. Thus German banks, whatever their strategies, have a low level of profitability and a low valuation, whereas the contrary is true in the case of British banks.

2. **On the macroeconomic level** we have chosen indicators expressing the state of the domestic banking industry and making it possible to define an offensive or non-offensive profile for each of the national banking industries. In order to achieve this we have calculated the degree of **concentration** (the share held by the largest institutions of total assets). Elements such as the **weight of the banking sector** in the GNP (the relation between total assets of credit institutions and GNP), the degree of **saturation** of the national market (measured by the number of agencies per 100,000 inhabitants) for retail banking, for example, as well as the degree of **impermeability** (1 – the share of all assets of the subsidiaries of foreign institutions in the GNP) have been calculated.

3. Finally, an analysis of **positioning by activity** has seemed indispensable to us. The bank as an economic player, recognizable through a relatively homogenous activity of collecting deposits and granting loans, is no more. Banking today is fundamentally

heterogeneous. If a bank today is to be defined as an institution linking up various financial activities along organizational lines that are increasingly differentiated and aimed at increasingly segmented markets, then, when analyzing earnings, and particularly when it is a question of comparative analysis, we must take into account the positioning of the activities of each bank. The composition of the portfolio of activities (the share of earnings from intermediation and commissions in net income, for example), whether a range of products can be developed from those existing or not, and the strengths and weaknesses in the scope of products are all elements that must be taken into account. Banking products (interest received, commissions received, and profits made on financial operations) generated by various banking activities (including service and off balance sheet activities) constitute the primary factor determining profitability, but not all of them contribute to the same extent. The share and the evolution of the share of each of these products out of the total may explain variations in profitability. Indeed, the profitability of banks strongly oriented towards retail banking activity decreases with the lowering of interest rates, whereas the profitability of banks in which market activities dominate decreases with the decline of financial markets (the most representative example is that of the private German banks). Thus all the Euro-zone banks were affected by the lowering of interest rates but, when faced with this loss of margins, for the most part they reacted by increasing commissions on the financial services they propose to their clients.

### **III. Strengths and weaknesses of European banks**

On the basis of our empirical studies, we have analyzed the strong points of the national banking industries, as well as of European credit institutions in order to highlight a certain number of common characteristics. France has been left out of this study, being the object of separate study to come. Summaries are presented in the following tables. Although this is certainly not the only manner in which it can be done, we have structured the criteria for evaluating the banks around two poles:

1. Forces dealing primarily with the environment in which the banks function (macroeconomic criteria).
2. Advantages or particularities peculiar to banks (meso and microeconomic criteria).

## 1. Criteria tied to the banking environment

- Our first category of criteria concerns the banking environment. There do exist several factors in this domain likely to encourage new cross-border groupings—the existence of the euro as a common currency, the considerable development of new information technologies, the financialization of the economy, which broadens the scope of services requested both by companies as well as by individuals, and finally globalization and deregulation. In the latter case, this has meant fewer obstacles to entering the market of banking and financial services, thus more competition in all activities, which leads to a reduction of unit margins. Clearly many institutions seek to compensate the lowering of unit margins by increasing market share. Until now, concentration has above all concerned national markets and bank investment outside their domestic markets remain at a low level. But when domestic concentration reaches a certain level and there is a lack of growth in perspective on the national market, banks are impelled to "look beyond their borders". Thus **banking sector concentration** seems to us to be a good criterion in the sense that it gives us an idea of the base of the big banks in their national market, but also of the extent to which they are pushed to look abroad.

We have calculated that this is the case of the banking industries of several European countries—the United Kingdom, the Benelux countries, and, to a certain extent, Spain. On the other hand, banking concentration has remained at a moderate level, despite recent combinations, in both Germany and Italy, countries where regional and local banks continue to play a significant role. These two countries are behind in the process of national consolidation and this low level of concentration in their banking industries makes their banks vulnerable to takeover operations. The German case is a bit more complicated. The degree of concentration in commercial banking and financial and investment banking is rather high, but retail banking remains largely fragmented.

Deregulation in Europe has forced governments to lift regulatory barriers and has opened the road to M&A transactions, yet protectionism is clearly not dead and some governments continue to intervene heavily. The difficulty in modifying the Italian banking scene, which is largely chaperoned by government authorities, illustrates this point well. The failure of Dexia and Sanpaolo Imi to draw closer together, and the declarations of Silvio Berlusconi on the "*Italianity*" of the banks are good examples.

Thus although they have moved ahead with deregulation, some national banking industries remain strongly protected, especially retail banking, where in addition to legal and fiscal differences there are linguistic and cultural differences that help them to maintain

control of these markets. But how long will this delay the process of consolidation on an intra-European level? And doesn't this failure to create several major European banking players risk leaving the field open to takeovers by much wealthier U.S. banks?

- Our second criterion concerns **intermediation margins**, a criterion somewhat linked to the preceding criterion, but also to the regulatory environment of banking. British and Spanish banks take advantage of higher margins, whereas in Germany and Italy there has been a significant erosion of margins in recent years.

- Finally, our third criterion consists of **statutory and regulatory particularities**. We use this expression to characterize certain particularities that are linked to the status of banks and their legal environment, and that procure them an advantage in their development. We are thinking especially of cooperative banks or, more globally, of all those whose status (or for whom the composition of their capital) places them out of the reach of hostile takeovers. Practically all countries offer examples of these particularities. However, clearly the phenomenon is much more widespread in France (mutual banking sector), Germany (public and cooperative banks) and in Italy (the foundations). They are much less present in Spain -- but do exist (the *cajas*) and in the Netherlands (Rabobank). Last, we may say that in the United Kingdom, with the demise of the big building societies, that the role of protected status institutions is fairly marginal. We should nonetheless note that the statutory and regulatory particularities there are fairly ambiguous, and in some cases may also be interpreted as weaknesses.

## **2. Bank specific criteria**

We distinguish four categories concerning the banks themselves:

-The first includes criteria that furnish a **financial analysis** of the bank's management. Thus we have selected **financial profitability**. Of course, insufficient profitability makes the bank in question an ideal target for a takeover. Shareholders of this institution are quick to bail out. In this type of situation, banking restructuring is the answer to certain individual weaknesses. Situations are fairly uneven concerning this criterion. On the one hand we have industries with a relatively high degree of profitability (United Kingdom, Spain, Benelux countries), and on the other hand countries suffering from chronically low profitability (Germany and Italy). The weak level of ROE characterizes all the German and Italian banks, with the exception of UniCredito. In 2003 four of the eight largest German banks even registered a negative ROE. The intensification of competition has wiped out margins on these domestic markets, which have a low degree of concentration.

In this same category we have included **cost control**. If we proceed to analyze the performance more in detail we find a situation similar to the preceding one, although not as stark. The United Kingdom and Spain are the unquestionable leaders in cost control. In general, cost to income ratios are very high for German banks (nearly 98% for HVB in 2003) and, to a lesser extent, for Italian and Dutch banks. In both Holland and Belgium the situations are slightly improving. In Italy and Germany, with one or two exceptions, all the banks are pursuing cost reduction programs.

Finally, the last criterion in this category is **management risk**. In this field the United Kingdom is the outstanding leader. Spain and the Benelux countries possess similar risk levels. In Italy, despite exposure being essentially limited to the domestic market, the quality of bank assets has declined considerably. It has been strongly affected by recent financial scandals. And, according to this criterion, Germany is dead last.

-The second category associates criteria linked to **financial solidity**. From this point of view, **equity capital** is a rare and expensive resource for banks. It is used both to respect prudential ratios (Cooke ratio and the McDonough ratio), and to finance external growth. Once again, two countries are clearly ahead—Spain and the U.K. The Benelux countries occupy an intermediary position. Finally, the weakest observed are Germany and Italy.

We also add to this category **market valuation**, which is the weakness *par excellence* of European banks. The only ones to at least partially escape this rule are the British banks.

- The third category concerns the **distribution of activities**. We attempt to join together two criteria dealing with the distribution of activities, one geographical, and the other concerning the lines of business themselves.

The **geographical** distribution of the activity portfolio is examined under two angles. The Netherlands, and to a lesser extent Belgium and the U.K., have the best profiles of geographical diversification of activities. Concerning the analysis of external growth policies, the hierarchy is basically the same, with, however, a slight advantage for the British banks, which seem to have conducted policies of external growth that are most appreciated by the market, despite being more conservative.

**How activities are linked together** may be examined under two different angles. It may be felt that the strongest profile is one that best balances various activities. In this case it is generally the Netherlands, Belgium, and Spain that lead the pack. Or it may be preferable for banks to specialize, and in this latter case we should highlight the expertise of German banks in wholesale banking, of Italian banks in asset management, and of Dutch banks in bancassurance.

- Finally, our last category concerns commercial strategy. This last criterion, of course somewhat fuzzy, tries to evaluate the effectiveness and innovative character of the commercial policy of the banks. But comparisons in this realm are difficult. With that proviso in mind, the U.K. and Spain seem to hold the inside track here.

Examining the situation of European banks reveals a certain number of current and structural weaknesses that characterize them. Schematically, we can define two broad categories of weaknesses—operational and financial weaknesses (low profitability, insufficient cost control, low quality of assets, insufficient equity capital, and low market valuation) and the strategic weaknesses (little geographical diversification, weaknesses in some activities, lack of opportunities for external growth on the domestic market, overexposure to certain markets or segments, risk of a housing bubble and delays in the process of national consolidation).

Far from being perfect, this attempt at classification has nonetheless the advantage of putting a finger on the differences between the weaknesses characterizing the European banking industries.

**Table 2: Summarizing the strengths of the main European banking industries**

<b><i>Germany</i></b>
<ul style="list-style-type: none"> <li>• Significant efforts of restructuring that are beginning to bear fruit.</li> <li>• Good expertise in corporate risk.</li> </ul>
<b><i>Benelux countries</i></b>
<ul style="list-style-type: none"> <li>• Profitability of Dutch banks has strongly improved in recent years—now sometimes reaches levels comparable to British banks.</li> <li>• Clearly dominate their domestic market</li> <li>• Narrowness of their domestic market has pushed these banks to seek growth both beyond the borders of this market (successful geographical diversification for most of them—even the cooperative groups) and through non-traditional activities (successful model of bancassurance).</li> <li>• Growing improvement of their productivity—continuing drop in cost to income ratio.</li> <li>• Financial solidity</li> </ul>
<b><i>Spain</i></b>
<ul style="list-style-type: none"> <li>• Good profitability—expressed in high return on equity ratios—higher than the European average; this holds for all the banks studied. Improvement in these indicators over the period 2001-2003.</li> <li>• Effective cost management; cost to income ratio is considerably lower than the average level observed in our sample of banks. Moreover, continuous efforts to manage costs more effectively .</li> <li>• Good level of equity capital—strong solvency ratios.</li> </ul>
<b><i>Italy</i></b>
<ul style="list-style-type: none"> <li>• Well established in the Italian market.</li> <li>• Improvement in the quality of their assets.</li> <li>• Successful establishment in Central and Eastern Europe.</li> <li>• Italian banks prefer certain low-risk activities that require little equity capital—AM, bancassurance, etc.</li> <li>• Development centered around retail banking.</li> <li>• Banking regulation in Italy as well as certain statutory particularities allow Italian banks to develop sheltered from the competition of foreign banks and the threat of hostile takeovers.</li> </ul>
<b><i>United Kingdom</i></b>
<ul style="list-style-type: none"> <li>• Good cost control—low cost to income ratios.</li> <li>• High level of financial profitability (one of the highest among European banks).</li> <li>• High level of market valuation of British credit institutions—the national leaders (HSBC, RBoS) are also first among European banks.</li> <li>• Whereas British banks face international competition on the wholesale market, they hold a strong position on the retail market in the U.K.</li> <li>• Relative financial solidity—capital ratios improving.</li> <li>• Development of competence in several sub-sections of their market—mortgages, small businesses, consumer credits, asset management.</li> </ul>

**Table 3: Summarizing the strengths of the main European banks**

	Germany	Belgium	Spain	Italy	Nether-lands	United Kingdom
Concentration of banking sector	+	+++	++		+++	+++
Intermediation margins			+++			+++
Statutory particularities (mutual, public banks, etc.)	+++	+	+	++		
Financial profitability		+++	+++	+	+++	+++
Cost control		+	+++	+	+	+++
Risk management		++	++	+	++	+++
Equity capital ratios	+	++	+++	+	++	++
Market valuation		+	++		+	+++
Geographical diversification of activities		++	+	+	+++	++
Assessment of external growth policy		++	+	+	++	+++
Industrial diversification		++	++		+++	++
Competence in target activities	+++			+	+++	++
Commercial strategy			+++			++

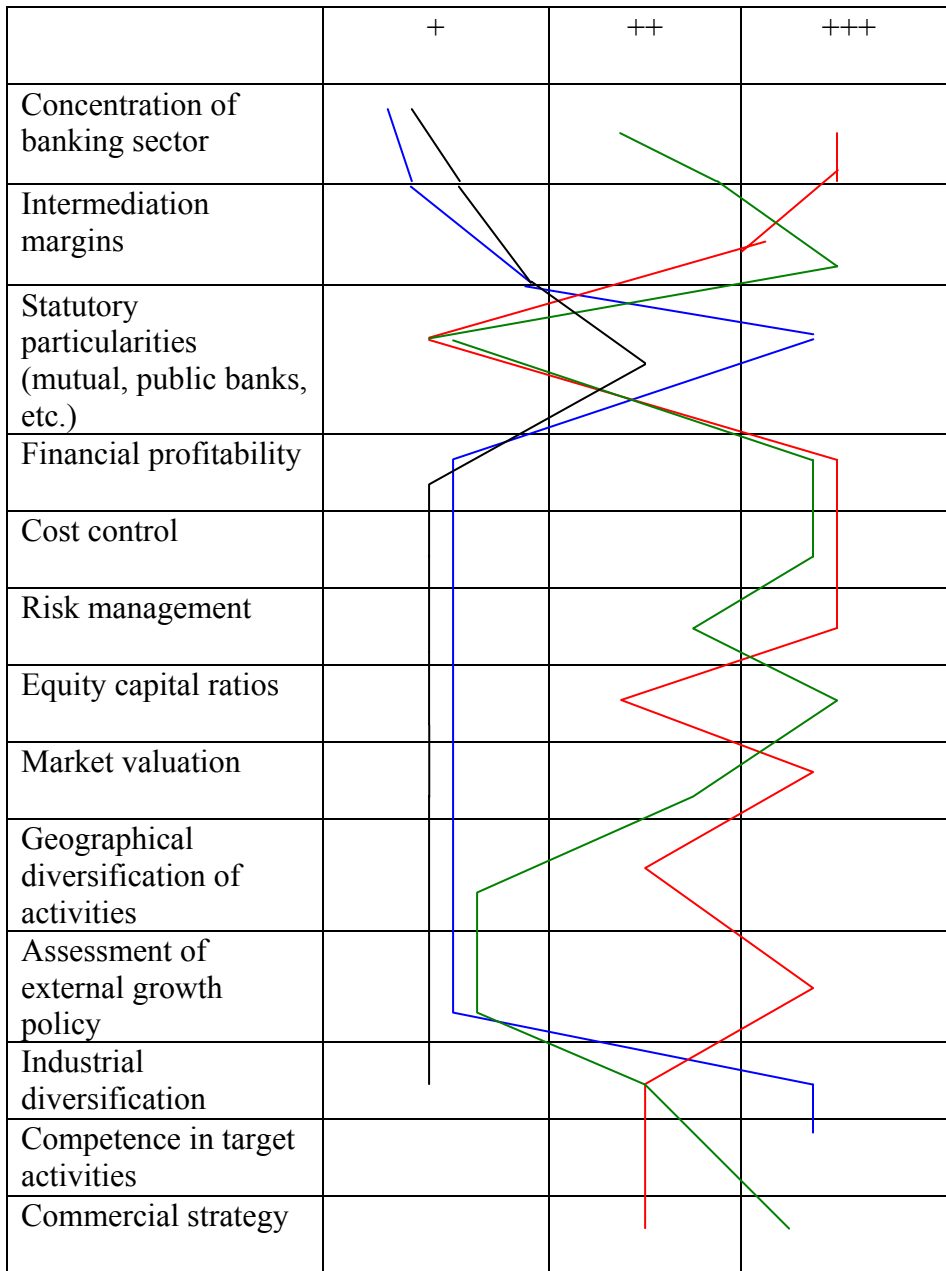
**Table 4: Positioning of the main European banks**

	Germany	Belgium	Spain	Italy	Nether-lands	United Kingdom
Financial profitability		(Fortis)	Santander Banco Popular	San Paolo IMI	ABN Amro ING	RBoS HBS Barclays Lloyds
Cost control		KBC	Bankinter BBVA Caja madrid Banko popolar	Mediobanca		HSBC HBS Barclays Lloyds
Risk management		Fortis	BBVA La Caixa	SPIMI MPS		HSBC Barclays Abeyes
Solidity of equity capital	Deutsche Bank, DZ bank	Fortis, BC		MPS Unicredito	Rabobank	HSBC RBoS HBS Lloyds
Market valuation						HSBC RBoS HBS
Geographical diversification of activities	Deutsche Bank, HVB	Fortis		Unicredito Intesa	ING	
Industrial diversification	HVB, West LB	Fortis, KBC		Intesa	ING	HSBC RBoS Barclays
Competence in target activities	Deutsche Bank, Commerzbank Dresdner, HVB	Fortis, KBC	BBVA, Banco Sabadell La Caixa	MPS Capitalia BNL SPIMI Mediobanca	ING, Rabobank	HSBC RBoS HBS Barclays Lloyds Abbeys
Assessment of external growth policy	DZ bank					
Commercial strategy		KBC	Banc Inter	BNL	ING	HBS
Statutory particularities	DZ bank, West LB		La Caixa, Caja Madrid	MPS		

**Table 5: Summarizing the weaknesses of the main European banking industries**

<i><b>Germany</b></i>
<ul style="list-style-type: none"> <li>• Very low, even negative profitability</li> <li>• Very high cost to income ratios</li> <li>• Fragile financial basis with solvency ratios lower than the European average</li> <li>• Low market valuation (Deutsche Bank is the fourth European bank by total results, but only the eighth by valuation)</li> <li>• Low degree of concentration, particularly within the saving and loan sector and among regional banks</li> <li>• Margins wiped out by intense competition from categories of institutions that benefit from government guarantees</li> </ul>
<i><b>Benelux countries</b></i>
<ul style="list-style-type: none"> <li>• Lack of opportunities for external growth on the domestic market</li> <li>• A corporate governance model (foundations and structure) that limits non-friendly combinations</li> <li>• Weaknesses in activities other than retail banking</li> <li>• Market valuation relatively moderate compared with the big European groups (ABN AMRO is only the 14th European bank by valuation, according to the 2004 rankings of <i>The Banker</i>)</li> <li>• Significantly higher cost to income ratios than those of British banks</li> </ul>
<i><b>Spain</b></i>
<ul style="list-style-type: none"> <li>• Risk of housing bubble</li> <li>• Persistence of the risk linked to the volatility of Latin America currently for Santander and BBVA</li> <li>• Saturation of the domestic retail market</li> <li>• Insufficient presence in Europe</li> <li>• Revenue structure dominated by the importance of intermediation revenues</li> <li>• Little expertise in wholesale, private, and asset management banking (except for Santander, and, to a lesser extent, BBVA)</li> </ul>
<i><b>Italy</b></i>
<ul style="list-style-type: none"> <li>• Low market valuation</li> <li>• Too little presence abroad</li> <li>• Low level of solvency ratios (with the exception of Mediobanca)</li> <li>• Delay in the process of national consolidation, which makes Italian banks vulnerable</li> <li>• Insufficient expertise in activities other than retail</li> </ul>
<i><b>United Kingdom</b></i>
<ul style="list-style-type: none"> <li>• Relatively low level of presence abroad (with the exception of HSBC)</li> <li>• Lack of opportunities for external growth on the domestic market and for domestic M&amp;A transactions</li> </ul>

**Figure 1: Profile of banking industries**



Germany

United Kingdom

Spain

Italy

We find two types of globally opposite profiles—the United Kingdom and Spain on one side and Italy and Germany on the other.

## Principal Components Analysis (PCA)

We proceed next to a Principal Components Analysis (PCA), which is a factorial based method. It's a way of identifying patterns in data, and expressing the data in such a way as to highlight their similarities and differences.

We take  $n$  individuals (in our case, 37 banks) and their values taken from  $a$  quantitative statistical variables (here there are four variables: valuation, equity capital, ROE, and internationalization). We obtain a cloud of points (the banks),  $N(I)$  of  $\mathbb{R}^4$  (each bank is located by four numbers, the values of four variables).

The PCA consists in projecting a cloud of points  $N(I)$  on the planes. Of course, with this projection there is a loss of information, but the process makes it possible to better exploit the data. PCA optimizes the projection, because it calculates the planes on which the least amount of information possible is lost. Thus according to the histogram of the following values, on a plane determined by axes 1 and 2 (each axis is a linear combination of variables, and the axes are orthogonal two by two, that is, non correlated), we obtain 84.23% of the information.

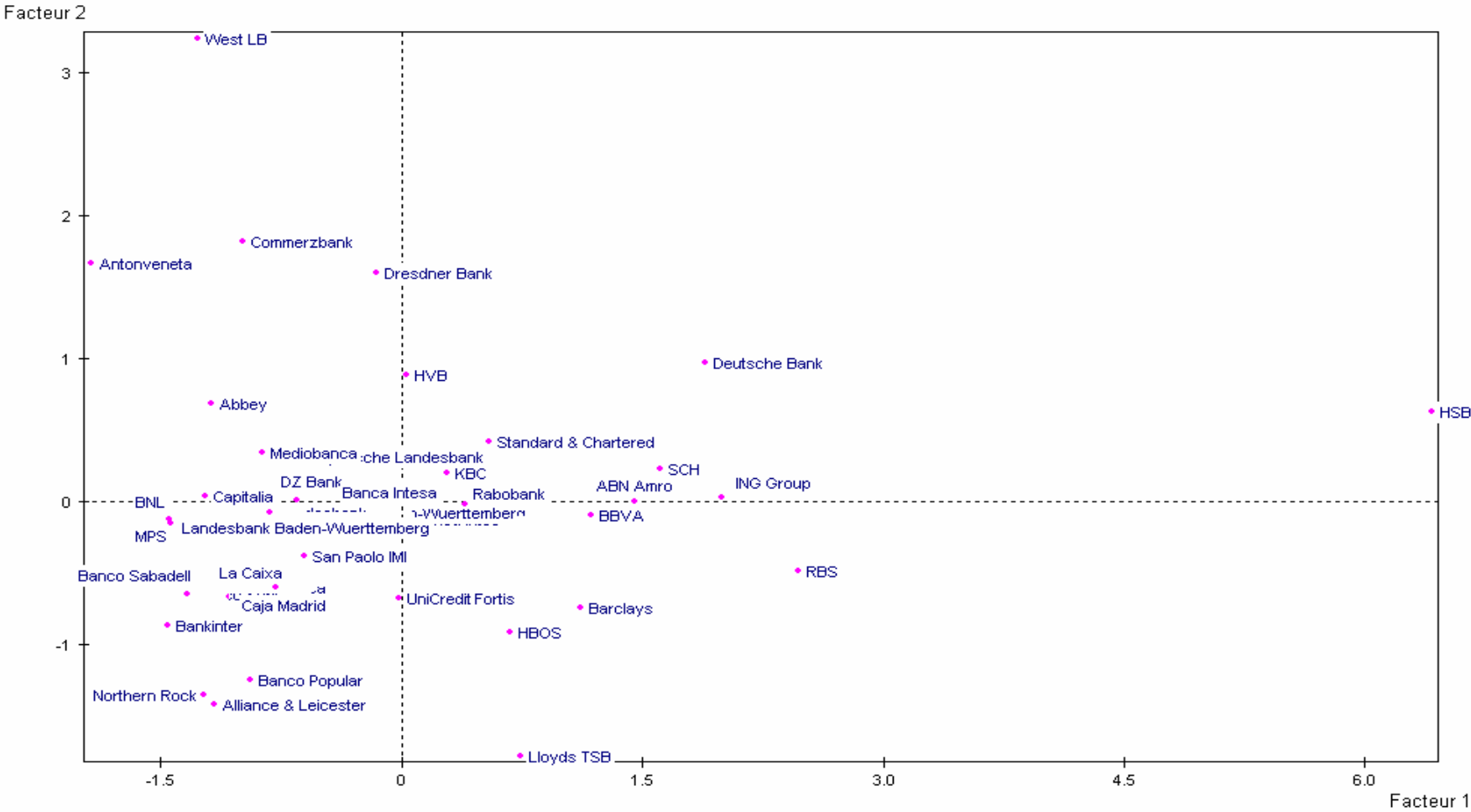
From the correlation table with factors (that is, the axes), we conclude that the C4 and C5 variables are indeed correlated positively with axis 1 and the C6 variable is indeed negatively correlated with axis 2.

The table of contributions from individuals in the construction of each axis allows us to make groups of individuals among the 37 banks that are similar (in relation to the data) and that are linked to the two groups of variables that we have just defined.

On this basis we project our 37 banks into a cloud of points (figure 2).

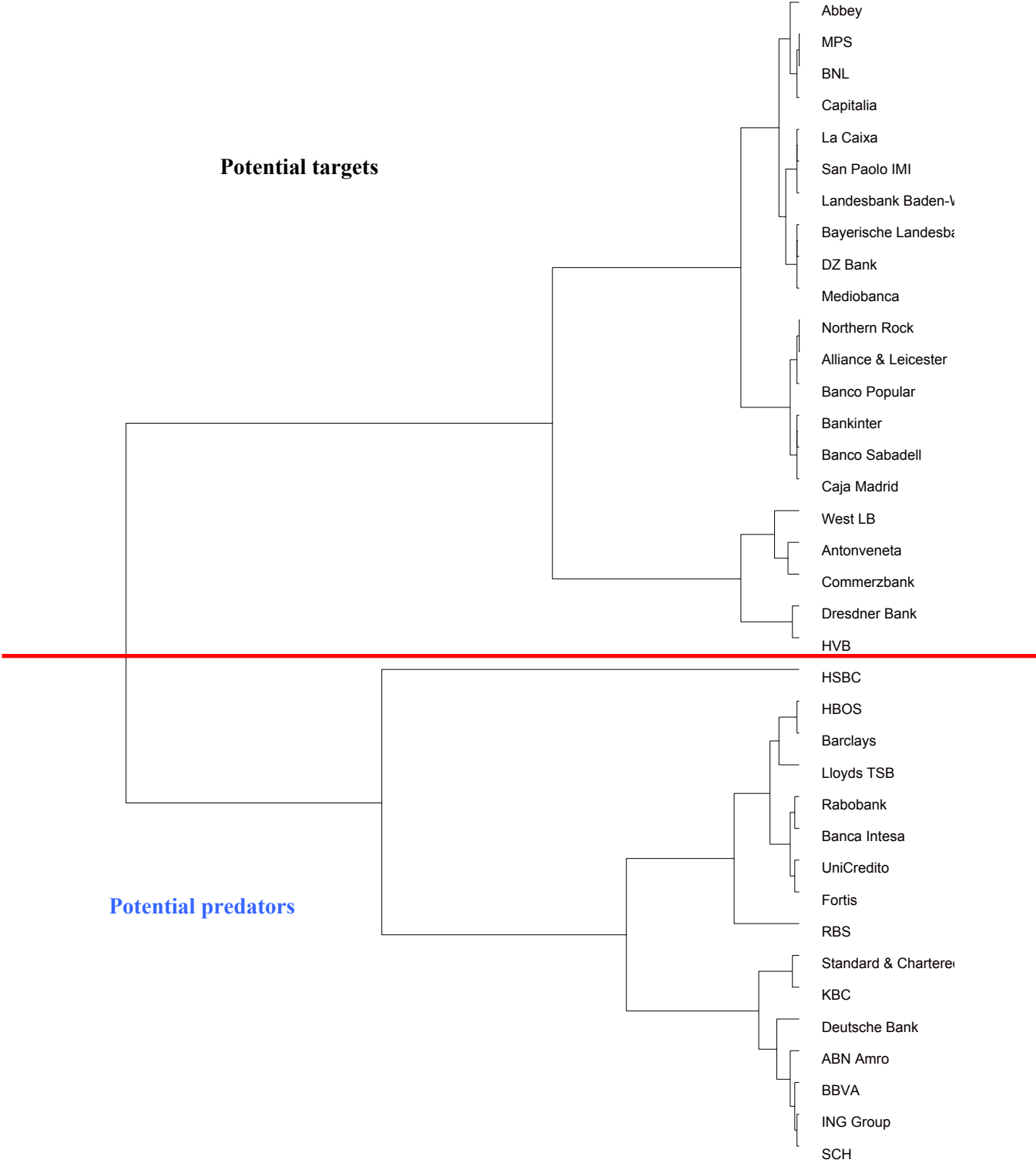
We then group the banks into potential predators and targets (figure 3).

Figure 2: The table of data by applying the PCA analysis



**Figure 3: Groups of potential predators and targets**

Classification hierarchique directe



## **Conclusions**

As we finish our study, we must observe that there is no European banking industry as such, but rather national banking industries. European banking remains fragmented and characterized by national particularities. Yet it cannot escape trends toward concentration in progress on an international scale in banking, which is relatively less concentrated than other industries. The very heterogeneous character of the industry, demonstrated by the strengths and weaknesses we have highlighted, demonstrates the complexity of the situation from the point of view of the restructuring to come.

Figures 1, 2, and 3 show that the British and Spanish banks are the strongest and therefore best placed to go outside their own borders. The banks of these two countries have the means. But will they act?

In this area, if they do not go on the offensive, then they run the risk of paying a penalty themselves. The obstacles that have, until now, delayed cross-border mergers may fall under the pressure of the movement of consolidation in the United States. The new giants born through the mega mergers in the U.S. will inevitably look at European banks. The European banking industry, appetizing because of efforts of rationalization made over the last two decades, but fragile because of its fragmentation, is attractive. For many reasons U.S. banks will prefer using the U.K. as a "beachhead" in Europe. Their deployment in the U.K. will be facilitated by the historical, cultural, and linguistic proximity of both banking systems. Since English banking is much more deregulated than any other European country, they will run up against fewer regulatory obstacles there... before perhaps crossing the Channel and the North Sea.

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