II. Special topics on the euro-area economy

The financial crisis has had a strong impact on the euro-area banking sector. In particular, the restructuring process that was initiated by the crisis and is still ongoing has slightly changed the trends in bank mergers and acquisitions (M&A). The cross-border dimension of these M&A operations is a key indicator of the integration process of the euro-area banking sector, which is fundamental to the integration and deepening of the EU internal market. The analysis presented in the first section of this chapter shows that the process of market integration is still ongoing, although at a slower pace as a consequence of the crisis and of the ensuing restructuring of the banking sector. Furthermore, the process of market integration is not uniform across countries and types of banks. In particular, some large banks appear to have continued to expand across borders.

The second section in this chapter looks into the effect of the sovereign debt crisis on the recovery process in the euro-area financial sector. The deterioration of investors' perception of sovereign risk has contributed to a negative feedback loop between public finances and financial market developments. It has also raised funding costs for banks in a number of Member States and has complicated the process of banks' balance sheet repair. The emergence of some sovereign bonds as risky assets has segmented the investor base and led to higher funding costs for some Member States, while at the same time benchmark interest rates have fallen in the euro area. Lower benchmark rates may stimulate economic activity, but they may also reduce profit margins in the financial industry and encourage risk-taking. Overall, the sovereign debt crisis has led to the recovery in the financial system becoming even more dependent on the strength of economic recovery than before.

External financing of non-financial corporations has traditionally been more bank-based in the euro area than in the US. Nevertheless, the last section argues that this may be changing. The surge in bond issuance by non-financial corporations in 2009 and the persistently high share of bonds in corporations' external funding in 2010 suggest that the euro-area corporate sector may have responded to the financial crisis and the tightening of bank credit conditions by diversifying its sources of external funding. If persistent, this diversification process would make part of the euro-area corporate sector — mostly large companies — less reliant on banks. It would also entail a shift of bank lending towards small and medium-sized enterprises.

II.1. The impact of the financial crisis on the integration of the euro-area banking sector

Introduction

Prior to the financial crisis, many banks expanded their balance sheets by increasing the use of wholesale funding, ([17]) allowing them to develop cross-border activities or even to acquire and integrate foreign banks within their groups. This integration process improved efficiency and profitability in the banking sector through increased competition, price transparency, interoperability among the participants and transfers of technology and managerial skills. Empirical evidence points to lower loan rates or higher deposit rates resulting from this process of integration. ([18])

Although critics of banking sector consolidation point to the risk of job losses and failed business strategies, the empirical evidence shows that cross-border activity provides a greater competitive impulse to national banking markets than purely domestic integration and that foreign bank entry tends to enhance consumer welfare. ([19])

([17]) As opposed to a more stable source of funding such as customer deposits.

([18]) European Commission (2007), 'Report of the Retail Banking Inquiry', *Commission Staff Working Document*; European Commission (2008), 'EMU@10 — Successes and challenges after ten years of EMU', European Economy Vol. 2 2008; SEC(2007) 106; Jimenez, G., J.A. Lopez, and J. Saurina (2007), 'How does competition impact bank risk-taking?', *Federal Reserve Board of San Francisco*, Working Paper No 2007-23; Humphrey, D.B. (2009), 'Payment scale economies, competition and pricing', ECB Working Paper Series No 1136.

([19]) In view of these potential economic benefits arising from cross-border activity between banks, the European Commission has been working since 2004 to examine the barriers to cross-border consolidation in the financial sector and how to address existing inefficiencies. Walkner, C. and J.P. Raes (2005), 'Integration and consolidation in EU banking — an unfinished business', *DG ECFIN Economic Paper* No 226.

The global financial crisis has acted as a shock to the ongoing transformation of the banking sector. As in other advanced economies, the majority of euro-area banks have been strongly affected by the sharp retrenchment on the interbank market, the balance sheet deterioration due to toxic and otherwise illiquid assets, and the collapse of global demand that followed Lehman's bankruptcy, although with varying degrees of intensity and some differences in timing of the distress.

The severe loss of liquidity in the asset-backed securities markets coupled with higher levels of non-performing loans hampered banks in performing one of their core functions, namely financing the real economy. At the same time, these circumstances forced banks to stop or delay their integration plans.

Integration of the euro-area banking sector can be assessed through different indicators, for instance the amount of foreign branches and subsidiaries; cross-border M&A; and the provision of services on a cross-border basis. This section focuses on cross-border M&A activity in order to shed some light on the challenges that cross-border banking integration is currently facing. ([20]) It shows that the process of market integration is still ongoing, although at a slower pace as a consequence of the crisis and the ensuing restructuring of the banking sector.

The financial crisis boosted State aid and bank restructuring under EU rules

Since the beginning of the crisis, significant restructuring has been carried out in the euro-area banking sector under close scrutiny of the Commission. Some degree of restructuring has typically been a condition for banks to be granted access to public support measures.

Under the Treaty on the Functioning of the European Union (TFEU), State aid that distorts competition is in principle prohibited. However, faced with the severity and systemic nature of the financial crisis, the Commission decided to urgently reassess the conditions for the application of the State aid framework, and in acknowledgement of the risk of a 'severe disturbance to the economy' thereby allowed some State aid as laid down in Article 107(3)(b) TFEU. To limit the distorting effects of such aid, the Commission produced various guidelines in the form of four Communications. ([21]) The Restructuring Communication ([22]) details the particular features that a restructuring plan (or a viability plan) has to display in the specific context of crisis-related State aid granted to financial institutions on the basis of Article 107(3)(b).

In assessing the restructuring requirements, the Commission takes into consideration the specific situation of each financial institution and in particular the degree to which such restructuring is necessary to restore viability without further State support. The main principle of restructuring is that it should lead to restoration of the viability of the undertaking in the longer term without State aid. As a general rule, the greater the reliance on government aid, the stronger the indication of a need to undergo in-depth restructuring in order to ensure long-term viability. Nevertheless, the individual assessment takes account of the individual situation and applies the restructuring framework in an appropriately flexible manner in the event of a severe shock endangering financial stability in one or more Member States.

So far, restructuring has taken two main forms: the sale of distressed banks and divestments of certain assets or activities (including through the sale to a "bad bank").

Sale of the bank. The sale of a distressed bank to another bank is considered as an appropriate element of restructuring. It can contribute to the restoration of long-term viability if the purchaser is viable and capable of absorbing the distressed bank. The sale of a bank has a consolidating effect within the sector. This consolidation can be of a domestic nature or cross-border, leading to relatively less or more cross-border banking integration respectively. ([23])

([20]) Mergers can be defined as the fusion of organisations (generally of comparable size) into one legal entity. Acquisitions are transactions where one firm purchases a controlling stake in another one, without necessarily combining the involved firm's assets.

([21]) These Communications provide detailed guidance on the criteria for the compatibility of State support to banks with the requirements of Article 107(3)(b). Three of the four documents set out the prerequisites for the compatibility of the main types of assistance granted by Member States — guarantees on liabilities, recapitalisations and asset relief measures.

([22]) European Commission (2009), 'Communication on the return to viability and the assessment of restructuring measures in the financial sector in the current crisis under the State aid rules', OJ C 195, 19.8.2009.

([23]) An interesting case is the break-up of Fortis SA/NV, which led to more cross-border banking between Belgium and

Divestment. Banks benefiting from State aid are in some cases required to divest subsidiaries, branches, and portfolios of customers or other activities. In order for such measures to increase competition and support the internal market, the Commission seeks measures favouring the entry of competitors and cross-border activity. ([24]) It therefore pays particular attention to restructuring measures being undertaken without discrimination between banks from different Member States.

Although restructuring is specific to each individual bank, a broad examination of the various restructuring plans submitted so far to the Commission allows some main trends to be identified.

The most obvious effect of all restructuring plans is the reduction in size of the financial institution concerned. This reduction in size is not only a direct consequence of the need to return to viability, but may also arise from the obligation to ensure adequate burden-sharing (the divestment of certain activities or areas allowing the restructuring to be self-financed) and to adopt compensatory measures for competition distortions created by the aid (to foster competition by giving opportunities to new entrants to acquire existing activities).

The second obvious effect of restructuring operations is a general tendency for distressed banks to refocus the activity of the institution concerned on domestic activities and core business. The need to restore viability often leads to a concentration on market segments that are deemed the safest, which are typically the ones the institution is most familiar with. This explains the abandonment of exotic segments, in terms of both activities and geographic areas. Therefore, the divestment process leads naturally to a re-concentration on national markets.

Such measures often follow directly from the actions of the banks themselves, for the following reasons. First, difficulties of the distressed banks often originated from having ventured into unfamiliar markets and/or geographic areas during previous years through a process of M&A. Second, these distressed banks (e.g. RBS, Fortis, ING) were typically large systemic banks with substantial cross-border activities. This favoured a number of specific divestments, from both a financial stability and a corporate profitability perspective. While government interventions in the restructuring negotiations have sometimes revealed a temptation to preserve national ownership of domestic financial activities, bank restructuring and divestments have made it possible for more solid non-aided banks to expand abroad. ([25])

Restructuring operations under EU rules were not evenly distributed geographically. Some Member States, including large ones, did not see any of their financial institutions undergo restructuring at all (Italy, France, ([26]) Slovenia, Slovakia, Cyprus), or have had only a very limited number so far (Portugal). On the other hand, some Member States had a large number of their financial institutions restructured, representing a significant share of the total sector. This was particularly the case in Belgium and the Netherlands (which had very concentrated financial sectors), but also in Ireland and in Germany, where Landesbanken were the sources of significant difficulties. The situation in Greece is somewhat particular, as its financial institutions did not display indications of distress at the beginning of the crisis, only coming under pressure recently due to the persistence of the crisis and the emergence of sovereign difficulties.

But banks have also restructured on their own initiative

Beyond the cases of restructuring under EU rules, some banks have chosen to restructure on their own initiative, in order to avoid government intervention or to restore market confidence. These restructuring operations were aimed at creating sounder and more cohesive entities, leading in some cases to refocusing on a smaller set of activities, which in turn has had an effect on the cross-border presence of banks. The divestments of certain activities and particular types of assets have reduced the size of these banks' balance sheets and improved their capital ratios, in a similar way to the process observed for publicly rescued banks.

Other banks have also aimed at cleaning and strengthening directly their balance sheets, by

France through the acquisition of Fortis BE by BNP Paribas, and a more domestically owned banking sector in the Netherlands.

([24]) It should be pointed out that the Commission does not as such propose or dictate the restructuring actions, but only assesses them after submission by the beneficiary of the aid in cooperation with the national government involved.

([25]) To some extent, this 'nationalism' matches the sovereign dimension of the aid provided by the Member States to their systemic domestic banks.

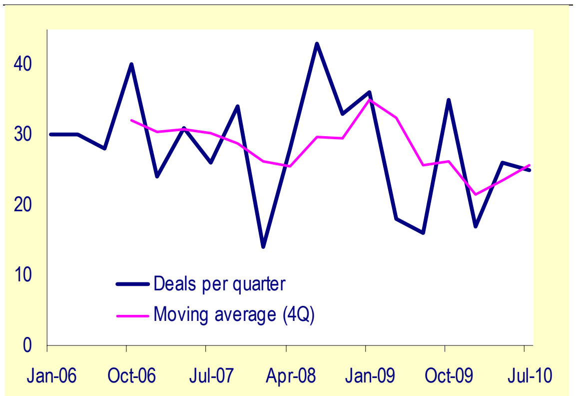
([26]) Disregarding the Belgian-French group Dexia.

writing-down or selling impaired assets and portfolios and by raising additional capital, partly also in order to meet expected higher capital requirements. ([27])

Bank M&A and divestment data point to slower international integration

In a historic perspective, two peaks for cross-border M&A deals in the banking sector are evident, one following the launch of the Single European Act in the late 1980s, and another in the late 1990s, prior to the creation of the euro. More recently, a relative decline in the number of announced M&A deals is evident following a further peak in the third quarter of 2008 (see Graph II.1.1), around the Lehman collapse. This can be seen as a consequence of the crisis in view of the deterioration in market confidence and the difficulties in finding buyers. ([28])

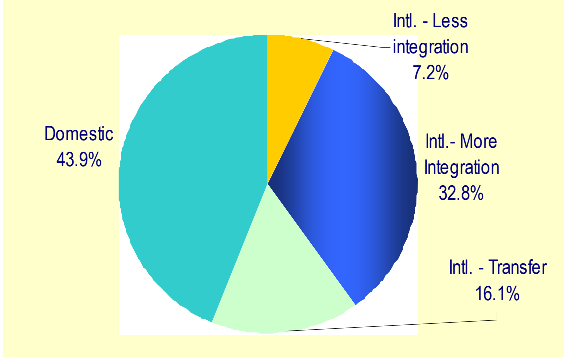
Graph II.1.1: **Evolution of M&A, euro-area banking sector (number of deals)**



(1) Based on announcements.
Source: Bloomberg and Commission services.

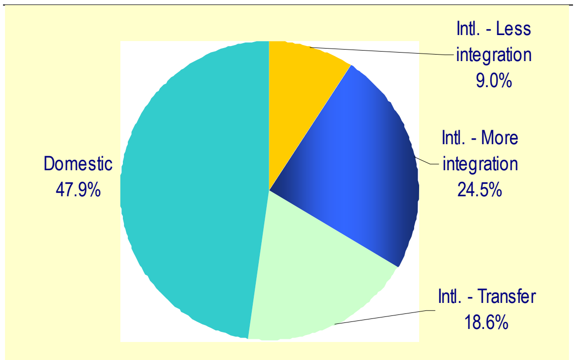
While direct cross-border retail activity of banks is usually limited, the ownership of banks is much more internationalised. ([29]) Since 2006, more than 50% of the M&A deals involved actors coming from at least two different countries.

Graph II.1.2: **M&A in the euro-area banking sector before the crisis (number of operations - 2006 to Sept 2008) (1)**



(1) "Domestic" deals: all parties are resident in the same country. "Intl.": international deal, i.e. transaction involving at least one non-domestic entity. "More integration": ownership of the target moves away from its country of origin. "Less integration": ownership of the target moves back to its country of origin. "Transfer" (neutral): both acquirer and seller come from a country other than the one of the target. Based on announcement dates. Date of collapse of Lehman Brothers taken as the cutting point.
Source: Bloomberg and Commission services.

Graph II.1.3: **M&A in the euro-area banking sector after the crisis (number of operations - Oct 2008 to Oct 2010) (1)**



(1) See footnote of previous graph.
Source: Bloomberg and Commission services.

Graphs II.1.2 and II.1.3 describe the effect of M&A transactions on market integration within the euro area. The indicator 'Intl. — More integration' shows the share of transactions where the ownership of a domestic target in the euro area was transferred to a non-domestic bank. In most cases the acquiring entity is also located in the euro area, although the sample includes all

([27]) Bloomberg estimates that €210bn of capital (both public and market capital) was raised by euro-area banks between 2008 and June 2010.

([28]) The analysis hereafter is based on the Bloomberg M&A database. It includes all deals announced between 2006 and October 2010 where the target is a bank with residence in the euro area (537 deals), irrespective of the residence of the buyer and seller. The analysis focuses on the number of deals rather than on volumes for two reasons: (1) large transactions would bias the picture and (2) data availability. Terminated deals were ignored. Three actors may play a role in each deal: a seller, an acquirer and the target; however, for an acquisition of a full entity or in joint ventures, there are only two actors: acquirer and target. The database only includes divestments of parts of the banks, so that it gives no indication of the activities or departments that are terminated.

([29]) See, for instance, European Commission (2009), 'European financial integration report 2009', Commission Staff Working Paper, SEC(2009) 1702 or ECB (2010), 'EU banking structures', September.

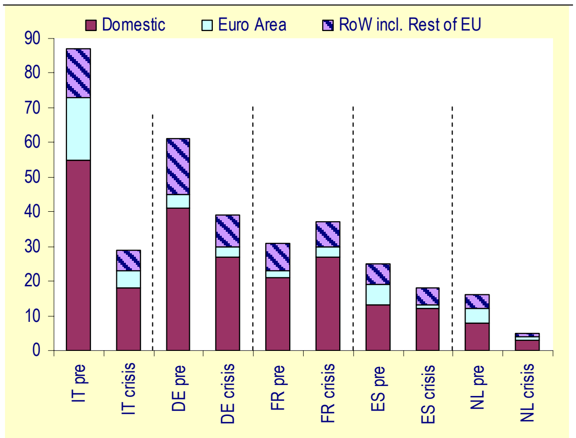
transactions, i.e. also involving non-EU entities (buyers or sellers). The indicator recording more integration registered 32.8% before the crisis (Graph II.1.2) and 24.5% during and after the crisis (Graph II.1.3), indicating a slowdown in integration within the euro area. At the same time, the share of domestic transactions ([30]) and transactions leading to less integration have both increased, to 47.9% from 43.9% and to 9% from 7.2% respectively. These three indicators point to a shift in the cross-border dimension of M&A towards a relatively slower pace of integration.

But developments in cross-border deals vary depending on countries considered

M&A transactions in the euro area were dominated by larger countries, in terms of the residency of targets, sellers and acquirers. Given the absolute size of the banking sectors of Germany, France, Italy, and Spain, it is not surprising that they account for the majority of transactions in all these categories. The total size of the banking system in Germany and France alone accounts for more than half of euro-area banking assets. This being said, it is also important to take into account the initial levels of integration and concentration when interpreting such figures, as a more highly concentrated banking sector is arguably less likely to offer as many potential target entities for M&A deals than a more fragmented one. ([31])

When looking at the origin of acquirers (Graph II.1.4) further differences between the euro-area countries are noteworthy. Firstly, most of the larger countries show a clear fall in the number of deals concluded between the pre-crisis period of 2006/2007 and the following three crisis years. Secondly, the reduction in M&A activity appears to have affected domestic and international transactions to a similar extent. One notable exception to this observation is the case of Spain and (to a lesser extent) the Netherlands, which saw a relative shift towards domestic acquisitions at the expense of deals featuring a foreign buyer from another euro-area country. Thirdly, looking at an extended sample that includes smaller euro-area countries (not depicted) further shows that M&A activity in smaller economies' banking sectors is typically more international, with euro-area countries accounting for around a quarter of acquisitions. Cross-border banking integration in the euro area thus appears not to be uniform, as significant differences are apparent between larger and smaller countries' banking sectors. However, this analysis does not afford any conclusions as to the extent to which this is due to the financial crisis and ensuing restructuring/divestment operations.

Graph II.1.4: **M&A in the euro-area banking sector, breakdown of origin by acquirers (number of deals pre-crisis [2006-07] and crisis period [2008 to Oct 2010])**



Source: Bloomberg and Commission sources.

Some major euro-area banks have seized the opportunity to expand across borders

Depending on the type of restructuring carried out, banks have either divested activities, raised capital (through shares or hybrid instruments), or used a combination of both measures to strengthen their financial position. Banks under restructuring following EU rules are in most cases prevented from any M&A activity that would lead to further expansion. Banks that were not directly supported by government interventions and that remained in comparatively good financial health have been in a better position to take advantage of M&A opportunities, given the comparatively low level of effective competition for an acquisition target and crisis-induced declines in the valuation of potential targets. As a result, some banks have acted mainly as acquirers, while other have mostly divested and reduced their activities. The analysis presented hereafter reveals that there are important geographical differences between sellers and acquirers, as most of the larger players' acquisitions are international, whereas divestments tend to be domestic.

([30]) Domestic deals are those where the three actors (seller, acquirer and target) are resident in the same country.
([31]) For instance, Belgium, the Netherlands and Finland have highly concentrated banking sectors, while those in Germany and Italy are relatively fragmented according to the Herfindahl index.

Table II.1.1: **Top 10 acquirers and sellers by number of deals, euro-area banking sector (2006-2010) (1)**

Top 10 Acquirers

Company	Country	Number of acquisitions	Total value (in million €) (2)	Government Support	Capital Increase (in billion €)	Total Assets (in trillion €)
BNP Paribas SA	FR	17 (10)	18253	Y	9,4 (5,1)	2.1
Credit Agricole SA	FR	17 (12)	24192	Y	8,9 (3,0)	1.6
Deutsche Bank AG	DE	15 (3)	11940	N	20.5	1.9
Societe Generale SA	FR	9 (2)	2329	Y	12,3 (3,4)	1.1
Intesa Sanpaolo SpA	IT	7 (0)	29935	N	4.0	0.7
Deutsche Postbank AG	DE	7 (0)	342	N	1.0	0.2
Natixis SA	FR	7 (2)	14807	N	5.8	0.5
Banco Santander SA	ES	6 (5)	1398	N	20.4	1.2
Marfin Popular Bank Public Co Ltd	CY	6 (4)	1160	N	0.0	0.0
Banco Popular Espanol SA	ES	6 (1)	627	N	1.2	0.1

Top 10 Sellers

Company	Country	Number of divestments	Total value (in million €) (3)	Government Support	Capital Increase (in billion €)	Total Assets (in trillion €)
Intesa Sanpaolo SpA	IT	21 (2)	12202	N	4.0	0.7
Commerzbank AG	DE	11 (5)	1112	Y	18,2 (18,2)	0.9
UniCredit SpA	IT	16 (5)	4823	N	11.0	1.0
RBS Holdings NV	NL	7 (2)	589	N	0.0	0.5
Banco Popolare SC	IT	7 (0)	1225	Y	1,5 (1,5)	0.1
HSBC Holdings PLC	GB	6 (6)	2391	N	21.3	1.7
Deutsche Bank AG	DE	6 (1)	352	N	20.5	1.9
BNP Paribas	FR	6 (2)	0	Y	9,4 (5,1)	2.1
Citigroup Inc	US	6 (4)	4900	Y	N/A	1.6
Banca Monte dei Paschi di Siena SpA	IT	6 (0)	822	Y	1,9 (1,9)	0.2

(1) 'Capital increases' include both public injections (in brackets) and capital raised on the market. For 'Number of acquisitions' and 'Number of divestments', numbers in brackets refer to euro-area transactions other than domestic.
(2) Total value includes only the value of acquisitions for which the sum was disclosed at the time of acquisition.
(3) Total assets at the end of December 2009.

Source: Bloomberg and Commission services.

To give an indication of the movements within the euro area, Table II.1.1 ranks the most active banks in terms of their number of sales and acquisitions. A look at the top sellers reveals that many banks have indeed strengthened their positions by both divesting and raising additional capital. As for government support and the restructuring imposed by the Commission, there is little indication that restructuring following State aid has been the dominant cause of divestment within the euro area, as the top sellers were mainly banks free of any restructuring requirements. Thus, restructuring on banks' own initiative, which in most cases has been a means to avoid government support, has been an important driver of changes in the banking sector as well. Similarly, the relationship between capital increases and divestment or acquisition activity is not straightforward as both sellers and acquirers have increased capital.

For the largest sellers, the majority of divestments are domestic. This is contrary to the hypothesis that in general, across the euro area, banks have refocused on their domestic market and divested euro-area activities outside their own domestic market. For the acquirers, the cross-border element of M&A is more sizeable, indicating that the most active banks have actually expanded throughout the euro area. The large presence of French banks ([32]) in terms of the number of transactions is notable. Other active acquirers, mainly from Spain, Italy and Germany, did not receive support at any point during the crisis. Among the active acquirers, several banks have raised considerable amounts of capital as well. This places these banks in a good position to continue their M&A activities in the future.

Taking into account the size of the more active buyers and sellers in combination with the earlier observation of an overall decrease in the cross-border dimension of M&A transactions, it may be concluded that the overall trend depicted earlier – of a refocus of banks on their domestic markets – does not hold for the most active and largest banks. Indeed, large acquiring banks have continued to expand their cross-border banking, while large sellers have divested more on their domestic markets.

([32]) French banks benefited from public capital injections, but to a lesser extent than those of other large EU countries, and repaid the funds very rapidly.

Conclusion

The financial crisis has had a tremendous impact on the euro-area banking sector. In particular, the restructuring process initiated during the crisis is still ongoing and has changed the trends in bank M&A transactions. The cross-border dimension of these M&A operations is a key indicator of the euro-area banking sector integration process, which is fundamental to the integration and deepening of the EU internal market.

The tentative evidence provided in the analysis at hand would indicate that the process of market integration is still ongoing, although at a slower pace as a consequence of the crisis and bank restructuring. Overall, M&A transactions have moved towards more domestic and 'repatriating' transactions, at the expense of transactions fostering international market integration.

However, differences across countries emerge. First of all, cross-border banking integration is not a uniform development within the euro area. A division exists between the larger countries' banking sectors and the smaller ones. Larger banking sectors' transactions are more domestically focused and the majority of acquisitions are by domestic banks. For the smaller banking sectors, the nature of transactions was predominantly international, including the euro area. But, with the exception of Spain, there do not seem to be diverging trends between the 'pre–crisis' and 'post-crisis' period in terms of geographic integration patterns, other than the clear fall in the number of M&A deals.

Secondly, data on the most active acquirers and sellers tentatively confirm that distressed banks have used both divestments and capital injections to strengthen their balance sheets, whereas stronger banks seem to have used the capital they raised during the crisis to expand. Often these large banks have divested more on their domestic markets and expanded throughout the rest of the euro area. Therefore, given their size, these banks are a crucial element in cross-border banking.

The impact on the various different banking activities, such as retail and wholesale activities, is not yet visible. Furthermore, the effect on other indicators of banking integration such as mortgage and deposit rates across countries is yet to be ascertained. Further investigation will have to reveal the impact of the financial crisis on these specific aspects.

Although a more cautious pace of expansion may have been expected in the light of the crisis, some banks have clearly seized the opportunity offered by the crisis in terms of cross-border expansion. Yet, most institutes have slowed their venturing into further cross-border integration for the moment. If this trend were continued it could herald an important change in the landscape of the euro-area's banking sector.