OLIVER WYMAN

MOMENTUM FOR FURTHER EUROPEAN BANKING INTEGRATION

FRENCH CASE

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FOREWORD

This report was initiated by Oliver Wyman's French financial services team. It addresses the prospects for consolidation in the European banking market, as occurred in the US following the financial crisis. It looks at what banks and legislators can do to promote this goal. In preparing this report, we met with senior bank executives and with French and EU officials. We would like to thank them for their valuable insights.

By design, the report concentrates on the role that French banks might play in the consolidation of the European market. Of course, some banks from other European countries may also be well positioned to lead cross border consolidation, but they are not the concern of this report. Despite this French focus, we are also publishing in English because many of the issues raised are important for banks and policy makers across the entire European banking market.

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EXECUTIVE SUMMARY

Following the financial crisis, the American banking market has consolidated. The market share of the largest five US banks has increased from 40% ten years ago to 63% today. By contrast, the European banking market has remained domestic and fragmented, with the largest five European banks still having just 20% of the market.

A truly integrated European banking market would bring material economic benefits. The financial sector would be more stable, banking products would be cheaper, and capital would be more efficiently allocated. Large European banks operating across the whole of the Eurozone would play an important role in bringing about such an integrated market facilitating the transmission of monetary policy.

The leading French banks (and by that we mean French banking groups) are ideally positioned to play this role. Their universal banking model gives them diversified and stable revenue streams; they are already large, accounting for three of Eurozone's 9 Global Systemically Important Banks (G-SIBs); and they have considerable experience in acquiring other banks.

The prospects for pan-European banking and cross-border acquisitions have been improved by the centralization of banking regulation and supervision within the EU: the advent of the European Banking Authority in 2011, the Single Supervisory Mechanism in 2014 and the Single Resolution Board in 2015.

However, impediments still exist. Beyond differences in language and domestic market conventions, relevant laws still vary across European jurisdictions. This is particularly true for laws indirectly affecting banking products – such as bankruptcy and consumer protection. The rules that define a G-SIB and the attendant capital requirements, especially the treatment of intra-Eurozone transactions, do not encourage pan-European banking.

These impediments explain at least partly the fact that past "in market" M&A deals have delivered shareholder value for the acquiring bank more often than cross-border deals.

The emergence of large cross border European banks will require European legislators to remove the remaining regulatory impediments to cross-border expansion. This means finalizing the Banking Union by establishing a common European deposit insurance or reinsurance scheme, recalibrating the G-SIB buffer to net Eurozone flows from the calculation of cross-border claims and liabilities, removing host country capital and liquidity requirements, adapting certain scale regulations (SRF) and addressing other specific local constraints that exists in certain countries. The emergence of pan-European credit products may also require the harmonization of national laws concerning bankruptcy and consumer protection – a major legislative task.

In the meantime, cross border market integration in retail banking may be driven by market participants, both the incumbent banks and new entrants. Online "open architecture" platforms, on which customers can buy and use products from a variety of suppliers, will allow pan-European distribution brands to emerge even if "manufacturing" remains domestic. In this context, DSP2 and GDPR can be a threat but also an opportunity.

French banks are also well positioned in wholesale banking but are threatened by US banks who have captured an increasing share of business since the crisis. Brexit offers a unique opportunity for them to capture some of the capital markets business that is now conducted from London, which amounts to €16 billion a year in revenue for banks. French banks can further differentiate with European corporate clients if they develop comprehensive sectorial offerings (including M&A, ECM, DCM, hedging and transaction banking) tailored to the demands of selected client segments. If they do not, the European wholesale banking market is likely to consolidate into the US investment banks.

Disclaimer: the report has been drafted by Oliver Wyman France and reflects it views. The purpose of this report is not to comment on any specific bank or to provide firm conclusions on the future of banks. It rather aims at fostering debate on the financial integration and perspectives to strengthen it.

INTRODUCTION

A fully integrated banking market in Europe would bring material economic benefits. The financial sector would be more stable, banking products would be cheaper and capital would be more efficiently allocated. Large European banks operating across the whole of the Eurozone would play an important role in bringing about an integrated market. And European Union policy makers are keen to see the emergence of such pan-European banks.

But it isn't happening. Ten years since the financial crisis, banking in the US has consolidated. In the EU, banking remains nearly as fragmented and domestic today as it was in 2007. Although, although much banking regulation and supervision has been centralised to the EU level, many barriers to cross-border banking remain – such as differing banking conventions, differing legal frameworks around insolvency, and continued variation in banking regulation.

The best hope for promoting European banking integration comes from the removal of these barriers. If this were to occur, France's leading banks would be ideally positioned to take advantage of the opportunities created because they are among the largest and most stable in the EU.

Even without the removal of the current impediments, however, European integration may be advanced by the ongoing digital transformation of banking, especially in retail banking. Open architecture platforms may integrate the European banking market in the way that eBay has integrated retail markets around the world, with no need for legislative reform. As early adopters of open architecture distribution, French banks will be well positioned to pursue this kind of European expansion without having to worry about cannibalizing their home market.

Brexit is also likely to advance Eurozone banking integration. It presents French wholesale banks with a unique opportunity to consolidate their position with European corporate and institutional clients that are currently served out of the UK.

The report looks at the need (or not) for further European integration/consolidation as this happened in the US post crisis; it also looks at what banks can do as well as what the regulators will need to do to foster that.

By design the report looks at how the French banks can position going forward, hence the "French case"; Other European banks have a card to play and could be equally well positioned to take advantage of further European integration; these are not covered in that report.

EUROZONE BANKING INTEGRATION AND THE FRENCH UNIVERSAL BANKS

POST-CRISIS DEVELOPMENTS IN THE US AND EU BANKING MARKETS

US authorities responded to the financial crisis by forcing troubled lenders to merge. This significantly increased the size of the four main US banks, whose share of total US banking assets increased by 26% between 2007 and 2008 alone.[1]

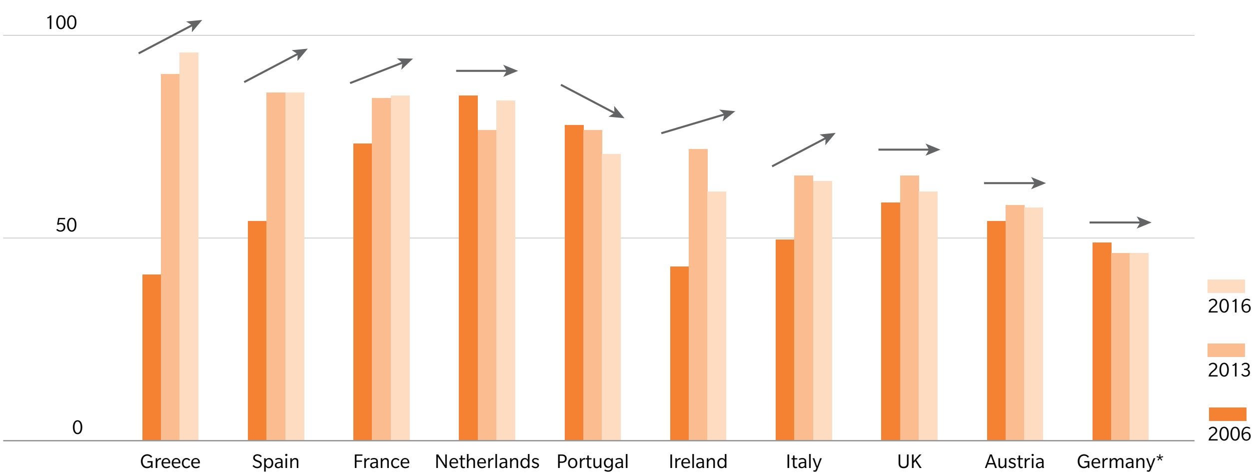
The crisis created similar opportunities for consolidation across the European Union (EU). But they were not taken. Consolidation occurred within the European countries hardest hit by the crisis: Greece, Spain, Ireland and Italy.

But there was little consolidation across European borders, and little consolidation within some of the larger European markets, most notably Germany (see Exhibit 1).

The net result is that, by contrast with the US, there has been no appreciable banking consolidation at the EU level (see Exhibit 2), and the largest European banks have not grown significantly.

Banking in Europe remains largely domestic. Only interbank exposures ignore borders. Retail, small business and even corporate lending are largely "in country" (see Exhibits 3 and 4).

Exhibit 1: Top 5 domestic banks' share of total domestic assets (selected EU countries, 2006-2016)

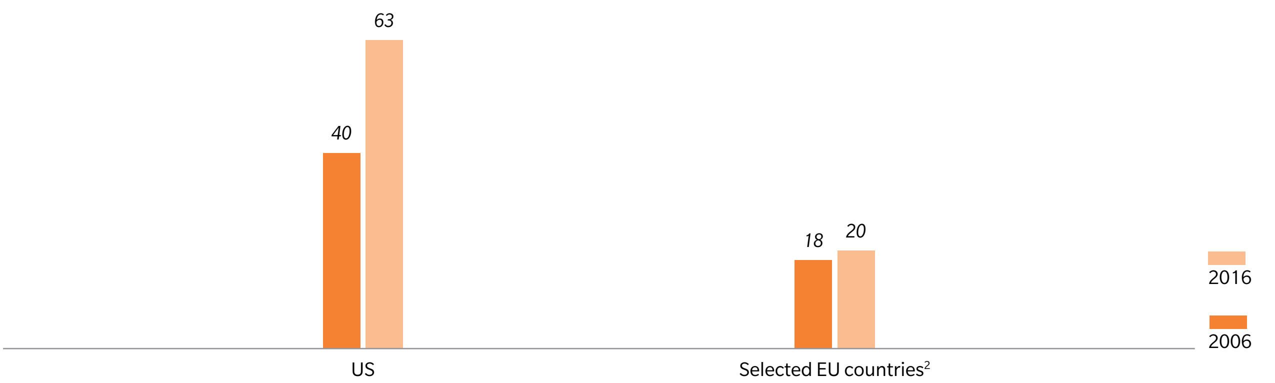


* Sparkassen and Volksbanken are treated as a series of independent entities in this chart

Source: GMI data, Oliver Wyman analysis

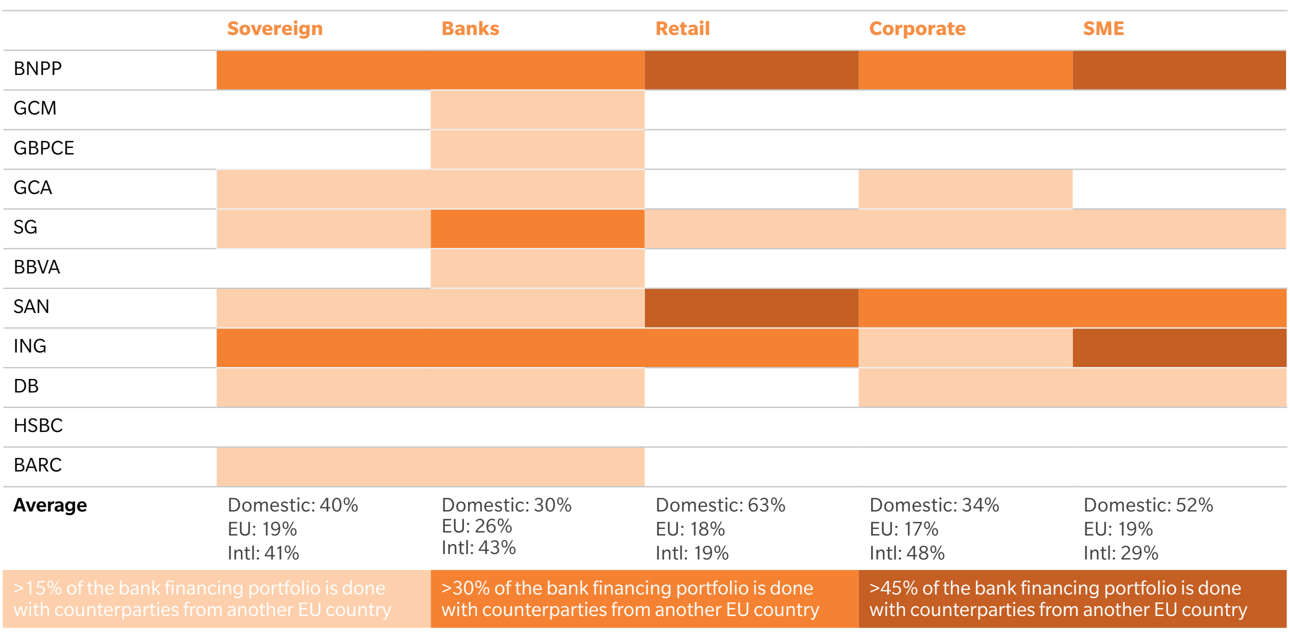
1 GMI data. Main transactions in the US following the crisis include: purchase of Bear Stearns & Washington Mutual by JP Morgan; Countrywide Financial, LaSalle Bank and Merrill Lynch for Bank of America; Wachovia and First Union bank for Wells Fargo

Exhibit 2: The top 5 banks' share of total domestic banking assets (2006 & 2016, %)[2]



Source: GMI, Eurostat, Oliver Wyman analysis

Exhibit 3: Banking group loans to counterparties in other EU countries (June 2016, %)



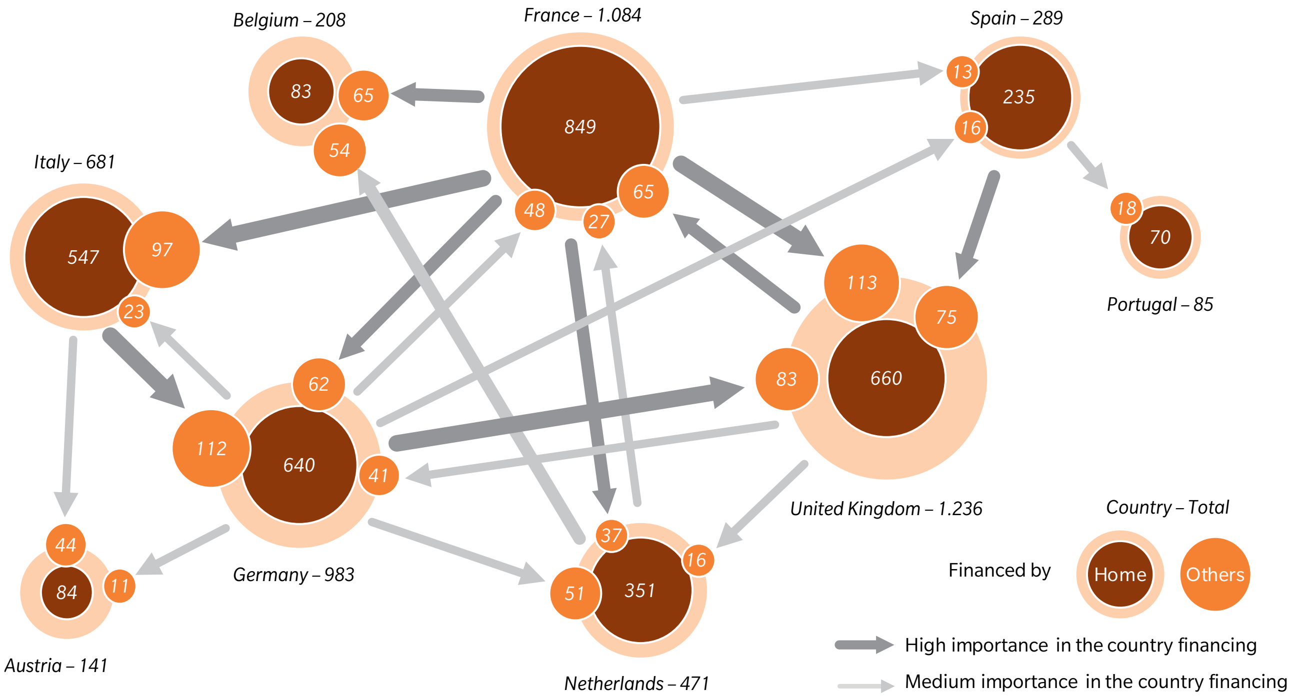
Source: EBA Transparency exercise, Oliver Wyman analysis

A genuine single European banking market would provide significant economic benefits (see "The economic benefits of cross-border European banking"). And large, pan-European banks could play an important role in creating such a single market – an idea supported by the fact that while the leading American banks have grown rapidly, they have also captured a larger share of the European, Middle Eastern and African (EMEA) wholesale banking market (see Exhibit 5). It is little surprise that European politicians and regulators have publically spoken in favour of cross-border banking consolidation within Europe. According to Danièle Nouy, Chair of the Supervisory Board of the ECB, "Cross-border mergers would do more than just help the banking sector to shrink. They would also deepen integration. And this would take us closer to our goal of a truly European banking sector"[3].

2 Selected countries are the same countries as in Exhibit1: it includes Greece, Spain, France, Netherlands, Portugal, Ireland, Italy, UK, Austria and Germany

3 Speech by Danièle Nouy, Chair of the Supervisory Board of the ECB, at the VIII Financial Forum, Madrid, 27 September 2017

Exhibit 4: Financing of European corporates by domestic banks and banks that are part of other European Banking groups (2016, values in billion)



Note: Transparency exercise, Oliver Wyman analysis. Note: above graph does not include Corporate funding from non-EU banks

Source: EBA, transparency exercise, Oliver Wyman analysis

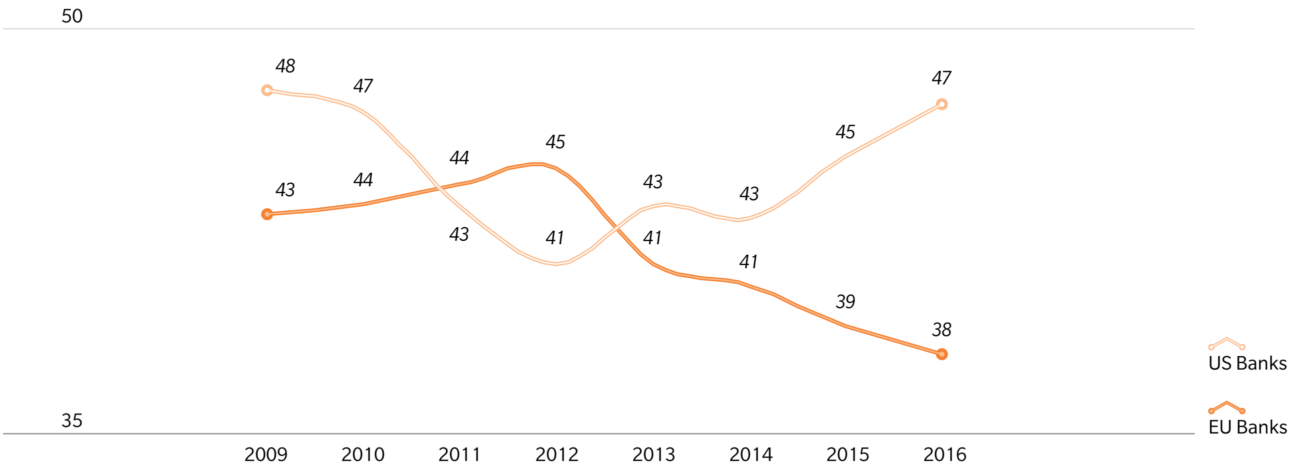
THE ECONOMIC BENEFITS OF CROSS-BORDER EUROPEAN BANKING

The financial crisis showed that complex banking groups with many subsidiaries and interbank counterparties can be channels of contagion to the rest of the banking ecosystem. And, when they fail, they can be difficult to wind up. Having larger, pan-European banks may therefore seem to increase systemic risk.

However, large banks are less prone to failure in the first place. Being more diversified in their exposures – across products, customer segments and countries – they are less vulnerable to shocks than banks with more concentrated exposures. Moreover, post-crisis regulations have significantly increased the capital that large banks must hold and required them to adopt simplified legal structures and resolution plans that will facilitate an orderly wind-up should they become insolvent.

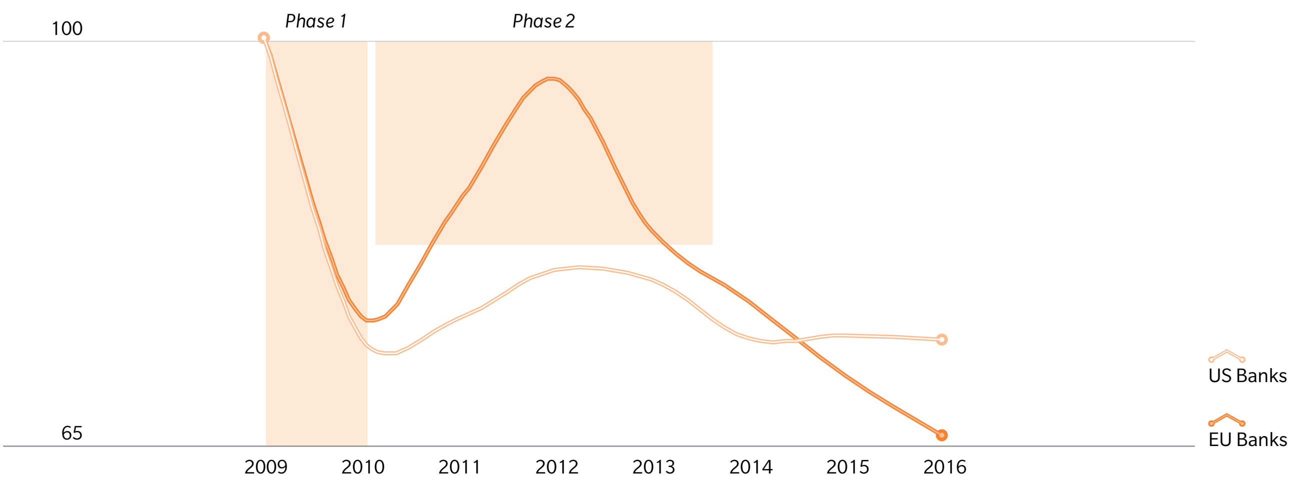
As illustrated in Exhibit 5, US banks have acquired a dominant role in EMEA wholesale banking. There is no evidence that this is an obstacle to the smooth implementation of EU monetary policy during normal economic conditions. However, an economic shock could require US banks to prioritise their domestic market, creating a credit or liquidity crisis in the EU. Following the financial crisis, both US and EU banks significantly decreased their CIB activities (see Exhibit 6). But EU banks were quicker to return to the market in response to client demand. This experience suggests that EU banks playing a larger role across the EU wholesale markets would be a source of stability during economic shocks.

Exhibit 5: Share of EMEA CIB revenues by bank's origin (2016, %)



Source: Oliver Wyman proprietary data

Exhibit 6: Evolution Corporate and Investment Banks revenues of EU and US banks in EMEA (base 100, 2009)



Source: Oliver Wyman proprietary data base

It is not only in the wholesale markets where pan-European banks would improve economic stability. Because SMEs typically lack access to the wholesale capital markets, they are highly vulnerable to domestic banking shocks. A recent study has shown that SMEs with access to credit from non-domestic banks performed much better during the Great Recession than SMEs in countries where access to foreign banks is more restricted.[4]

4 Mathias Hiffmann, Bent. E. Sorensen, Small firms and domestic bank dependence in Europe's Great recession, European Commission Discussion Paper 12, September 2015. The authors concluded in saying *"enhancing access of SMEs to bond and equity markets [...] is an important complementary solution. However, a working capital market union will still only work in conjunction with real banking integration because, even with more highly developed and integration bond and equity markets, most SMEs in Europe will remain bank-dependent due to their small size and opaqueness. [...] We therefore believe that, if financial integration in Europe is to succeed, real banking integration will have to be an important part of it".*

Stability is not the only economic benefit that pan-European banks would provide. They would also help to allocate savings to investment opportunities more efficiently across Europe, thereby promoting economic growth. Excess savings in Europe are estimated at €350 billion.[5] Pan-European banks would help them flow to those parts of Europe where the most attractive investment opportunities exist. And, by increasing competition in domestic markets, they would drive down the margins paid by savers and borrowers – again, increasing investment and economic output.

FRENCH BANKING GROUPS ARE WELL POSITIONED TO PLAY A PAN-EUROPEAN ROLE

A bank can be a serious candidate for growing into a pan-European player only if it has the financial strength to pursue this goal – a high capital capacity and a low cost/income ratio – and, ideally, experience in making acquisitions. Using these criteria, few European banks are positioned to pursue a cross-border expansion strategy (see Exhibit 7). French banks, however, rate well.

While French banks encompass a variety of institutions[6] with different ownership structures,[7] they are generally diversified universal banks. This provides them with diverse revenue streams, going beyond the core banking activities of deposit gathering and lending to include insurance and investment banking services (see Exhbit 8).

Exhibit 7: Readiness to make cross-border acquisitions (main Eurozone banks)

	# Acquisitions (13-17)	C/I 2016	Average Net Income 13-16, Bn€	Fully loaded CET1 2016, %	Stress test depletion, (CET1 bps)	Return on Equity, 2016, %
ABN Amro	1	67.0	1.5	17.0	597	11,8%
BBVA	9	54.5	2.7	10.9	375	6,8%
BNPP	26	67.1	4.8	11.5	246	9,4%
BPCE	4	69.7	3.2	14.3	329	6,9%
Commerz.	1	79.3	0.4	12.3	636	0,9%
DB	5	95.9	-1.5	11.8	540	-2,6%
GCA	4	66.1	5.2	14.5	303	6,3%
GCM	4	64.2	3.0	15.7	199	6,5%
ING	4	54.8	3.4	14.2	394	10,1%
ISP	6	62.3	0.6	12.9	274	6,4%
Rabo.	1	70.0	2.0	13.5	538	5,8%
Santander	22	53.5	5.5	10.6	402	6,7%
SG	18	68.5	3.1	11.5	339	7,8%
UniCredit	11	79.6	-5.5	7.5	347	-26,7%

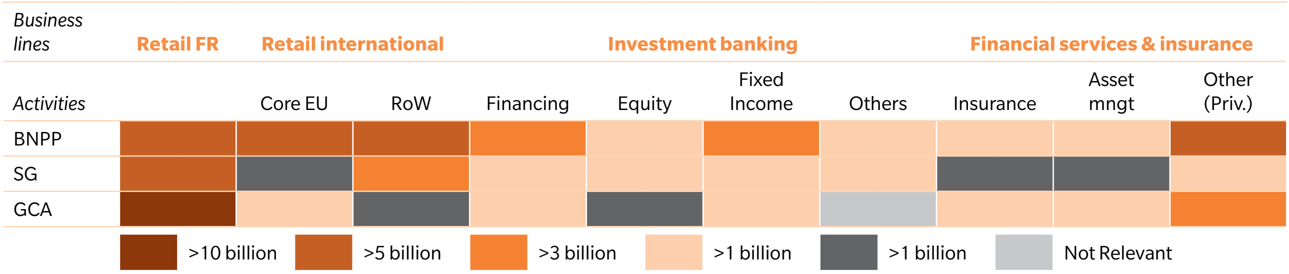
Source: Merger Market, GMI, Oliver Wyman analysis

5 Speech by François Villeroy de Galhau, Governor of the Bank of France, at "Future of Saving" conference, 4 November 2016

6 At end 2015, 472 credit institutions are licensed by ACPR, of which 21 are from Monaco, in *Les chiffres du marché français de la banque et de l'assurance 2015*, ACPR p.20

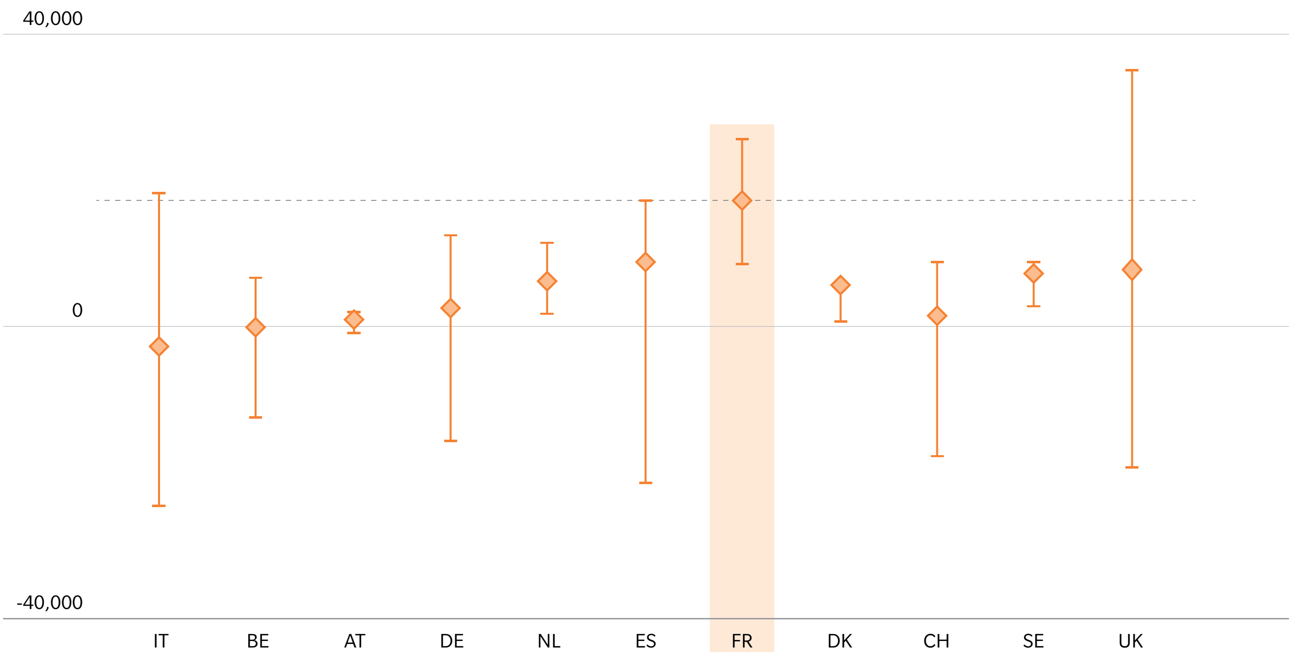
7 French banks are often split into two groups: mutual banks with a shareholder structured composed of "sociétaires" with no or limited quoted shares (Crédit Agricole, Groupe BPCE, Crédit Mutuel) and other banks that are publicly listed with more "traditional" shareholding structure (BNPP, Société Générale).

Exhibit 8: P&L generated by business lines and departments for French G-SIBs



Source: annual reports and results disclosures from the 3 French G-SIB, Oliver Wyman analysis

Exhibit 9: Min., max. and average net incomes generated by French banks (EUR million, 2007-2016)



Source: GMI data, Oliver Wyman analysis

This diversity of revenue streams stabilises overall income, with under-performance in one area being offset by over-performance in another. Between 2007 and 2016, the total revenues of any of the large French banks have declined by more than 10% only three times, even though revenues from particular activities has declined by more than 10% over 50 times.[8]

Although French banks have not achieved the highest yearly net income (UK banks), they have maintained the highest average income between 2007 and 2016. Along with Denmark, Sweden and the Netherlands, France is one of the few European countries to have avoided a negative annual net result since the crisis (see Exhibit 9).

French banks have benefitted from an economic context and lending policies that have limited their non-performing loan (NPL) ratios and cost of risk (see Exhibit 10).

8 Source: annual reports and results disclosures from French G-SIB banks, Oliver Wyman analysis

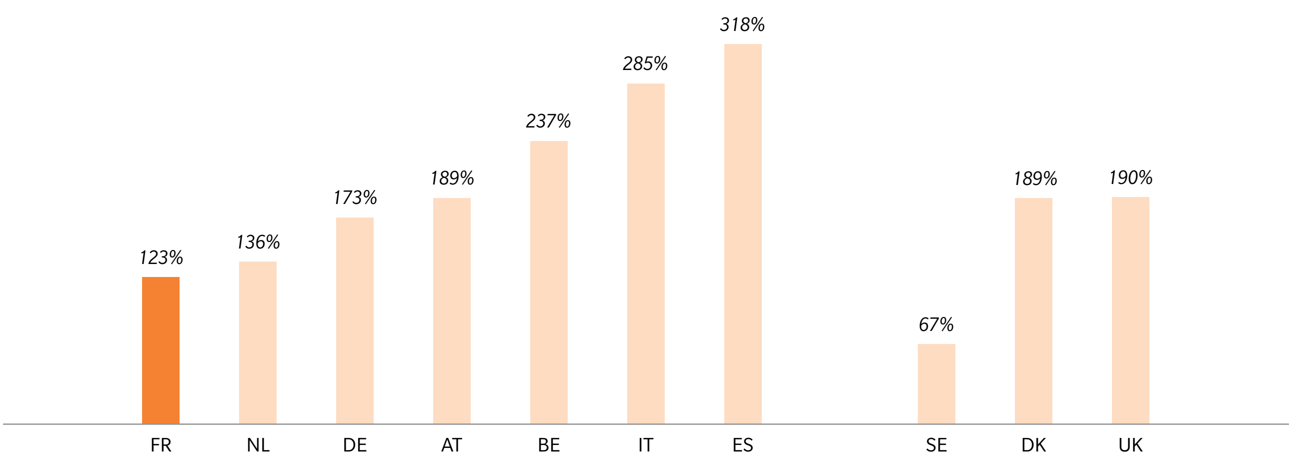
This helps to explain the strong performance of French banks since the crisis, generating cumulative net profits of €173 billion. France is the only country where banks have generated more than €100 billion of cumulative net profit (Exhibit 11). This allowed French banks to strengthen their capital ratios.

The soundness of French banking system is considered one of the strengths of the French economy.[9] It has relieved French taxpayers of the burden of bailing out ailing banks (see Exhibit 12). And it has resulted in relatively cheap financing costs for French borrowers – both in the Corporate space, where the average cost of credit is 70 bps below the European average (and 40 bps below the German cost of credit), and in the Retail space, where mortgage rates are now the second lowest in Europe (behind Finland).

French banks are not only diversified, stable and profitable but large, even by international standards. France has three out of Europe's 12 Global Systemically Important Banks (G-SIBs) – more than any other Eurozone country and third in the world, behind the US and China.[10]

As argued in recent literature, bank size is an important driver of internationalisation. Not only do large banks need to seek growth outside already concentrated domestic markets, but they have scale advantages in absorbing the fixed costs entailed by cross-border expansion, such as regulatory compliance and IT systems extensions.[11]

Exhibit 10: Cumulative cost of risk for European banks in a crisis decade (2007-2016) compared to a normal year (2016) operational incomes



Source: GMI data, Oliver Wyman analysis

Exhibit 11: Comparative analysis of cumulated net profits generated by banks since 2007

Banks' countries	Cumulative net results (EUR billion, 2007-2016)
France	173
Spain	92
UK	76
Germany	22
Italy	-28

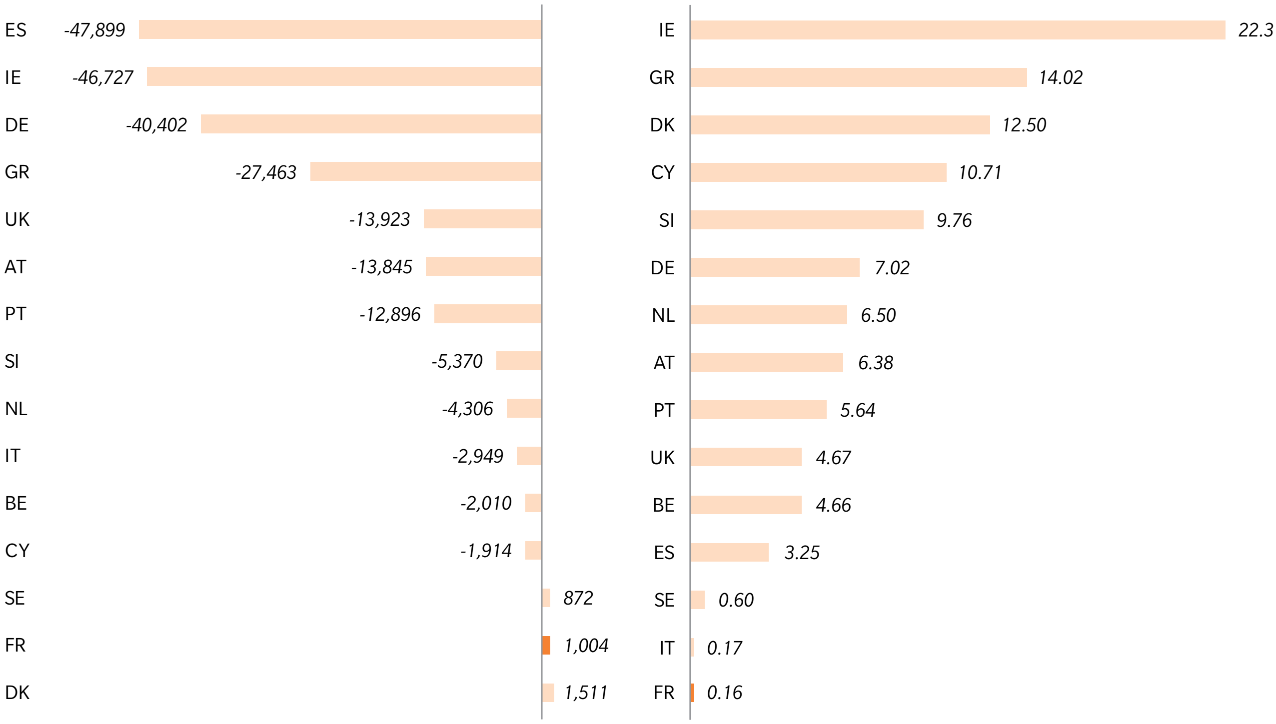
Source: GMI, ECB, FSB, Oliver Wyman, analysis

9 OECD report on the French economy, 2015

10 Based on FSB list, with Standard Chartered considered as a non-European bank.

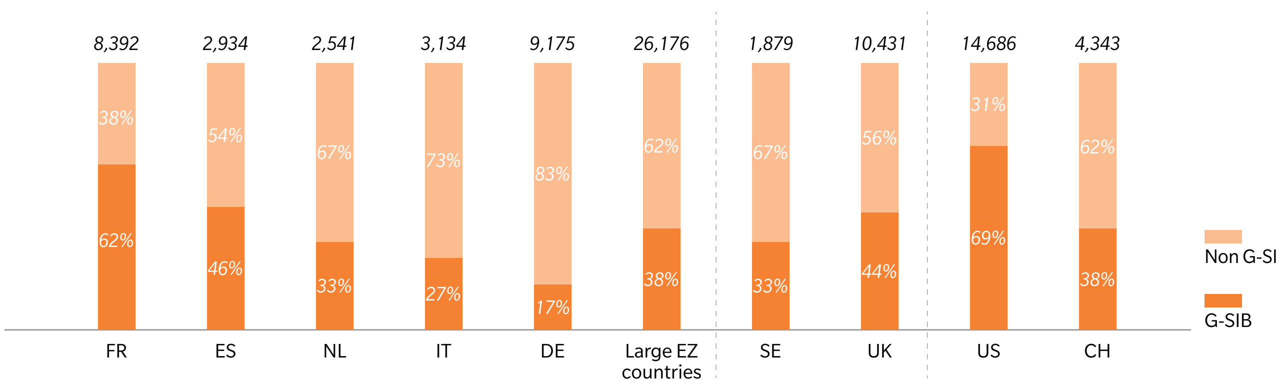
11 See, for example, *Les banques Européennes se retirent-elles de la scène internationale*, Dirk Schoenmaker, Revue d'Economie Financière, Q1-2017. In this paper, analysis of internationalisation is based on the size and geographical coverage of G-SIBs.

Exhibit 12: [Left] Cumulative impact on public deficit of intervention to support ailing institutions (EUR million, cumulated 2007-2016); [Right] Average yearly cost of intervention on national debt (% of GDP, average between 2007 and 2016)[12]



Source: Eurostat, Oliver Wyman

Exhibit 13: G-SIBs share of total domestic assets[13] in 2016



GSIBs	3	1	1	1	1	7	1	3	8	2

Source: GMI data, public data, Oliver Wyman analysis

Note: Standard Chartered has been listed as a non-European G-SIB.Strengthening European banking integration: tail winds

12 Note: The left graph answers the question: what is the current gain or loss to governments from interventions? The right graph answers the question: what the average magnitude of debt needed to provide financial support each year? State intervention is registered in the deficit (loss) only if the intervention is made at a price higher than the market price; it is therefore possible that some state intervention increases government debt without worsening the government's net position.

13 Data for France excludes BPCE from G-SIB banks

STRENGTHENING EUROPEAN BANKING INTEGRATION: TAIL WINDS

Further integration of the European banking market is being encouraged by political and regulatory initiatives, the rise of digital banking, and opportunities created by Brexit. Each is considered below.

POLITICAL AND REGULATORY INITIATIVES

With the creation of the European Banking Authority (2011), the Single Supervisory Mechanism (2014) and the Single Resolution Board (2015), banks are now subject to almost identical banking regulations across the entire Eurozone. This reduces the complexity and cost of compliance for banks operating across European borders.

The Single Supervisory Mechanism (SSM) has helped to harmonize supervisory methodologies. The elaboration of a common SREP methodology provides consistent judgements about the position of Eurozone banks and their capital requirements. Two other ongoing initiatives will further align capital requirements: namely, the harmonized treatment of options and discretions (O&D) previously determined by national authorities and an improved comparability of risk-weighted assets through the TRIM review. And pan-Eurozone regulatory exercises, such as the AQR and stress-tests, have increased market transparency, providing investors with a clearer view of banks' asset quality and risk position.

Besides this harmonization of the institutional framework for bank regulation and supervision, a set of European sectorial regulations aim at making it easier to conduct banking activities across European borders. These initiatives include:

- UCITS IV (2011) and AIFMD (2011), which removed barriers to the cross-border distribution of European funds
- The second payment services directive (DSP2), which from 2018 will open up the payments market in Europe, now dominated by domestic banks and large US non-banking actors.
- The Capital Market Union action plan, which will reduce among other things the costs associated with cross-border expansion of banks.

DIGITAL BANKING

The "digital revolution" is changing customers' behaviour. Young people in particular are comfortable buying online and, as a consequence, less inclined to buy locally. They seek the latest innovations and best products regardless of their countries of origin. And digital technology massively reduces the cost of satisfying consumer demand across borders.

Several players in the banking market are already using digital technology to build successful European and international franchises. Aggregators such as Meniga are decoupling distribution from production in banking and thereby dramatically cutting the costs associated with cross-border expansion (of distribution). This is likely to accelerate when DSP2 and GDPR comes fully into play.

Similarly, in wealth management customer demand for international funds in addition to the in-house funds that banks have traditionally offered is driving a trend towards open architecture models. Pan-European distribution platforms, such as Allfunds, are now gaining ground. And in payments, pan-European champions such as Adyen have disrupted the businesses of established competitors by providing turnkey solutions to clients. GAFAs are investing heavily in payments, promising to deliver cost-efficient solutions around the world.

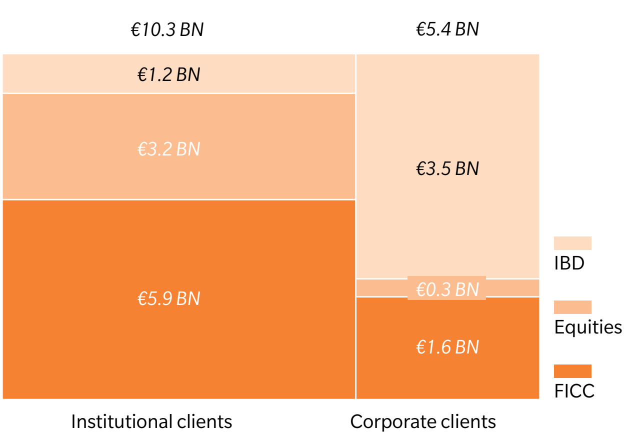
Telecom and retail firms have also recently tapped the banking sector. Taking advantage of their large networks, they have created "Phygital" services. Orange Bank was launched in November 2017 with the aim of selling its banking products to its base of over a million French telecom customers. Orange Bank already offers mobile payments, current accounts, transfer services and may expand into consumer credit. It plans to eventually offer the same range of services as a traditional bank.

OPPORTUNITIES THAT MAY EMERGE FOLLOWING BREXIT

Investment banks based in London earn annual revenues of about €16 billion serving EU clients (see Exhibit 14). This represents 23% of EMEA investment banking revenues.

For reasons made familiar by extensive public discussion, Brexit could make it more difficult and expensive for banks licenced in the UK to serve EU clients. If it does, the €16 billion of investment banking revenues now going to London will become more contestable by EU-based banks. Indeed, large US or UK banks may exit parts of the EU market, leaving the field clear for EU banks to pick up new business. Alternatively, US or UK banks may shift operations to the EU. In both cases, the reduced role of UK-based banks in the Eurozone will advance the consolidation and integration of Eurozone banking.

Exhibit 14: Cross-border sales from EU clients served in the UK



Source: Oliver Wyman proprietary data

OBSTACLES TO EUROPEAN BANKING INTEGRATION

There is a strong case for cross-border expansion by European banks and, especially, by French banks. Yet there are also significant barriers to it. These arise from variations in relevant domestic law, the difficulty of creating value through cross-border M&A, and continued regulatory obstacles.

LEGAL VARIATION ACROSS THE EU

Banking products vary across European countries, partly because of customary differences in markets which developed separately and partly because of differences in relevant laws and fiscal specificities. A vivid example is real estate financing. European markets vary in consumers' preferences for mortgage types (fixed vs. floating, amortizing vs. bullet), legal requirements concerning consumer protection and collateral enforcement, national credit reference schemes (e.g. Crédit Logement in France) and creditor selection criteria (LTV vs. monthly incomes). These differences influence product design, distribution strategies and back-office operations. And they prevent banks from sharing processes and systems across European countries. Large banks consequently lose their scale advantage when moving into new European markets.

Because these domestic variations are greater in some lines of business than others, the potential for Europeanisation also varies by line of business (see Exhibit 15).

Exhibit 15: Europeanisation potential of various banking activities

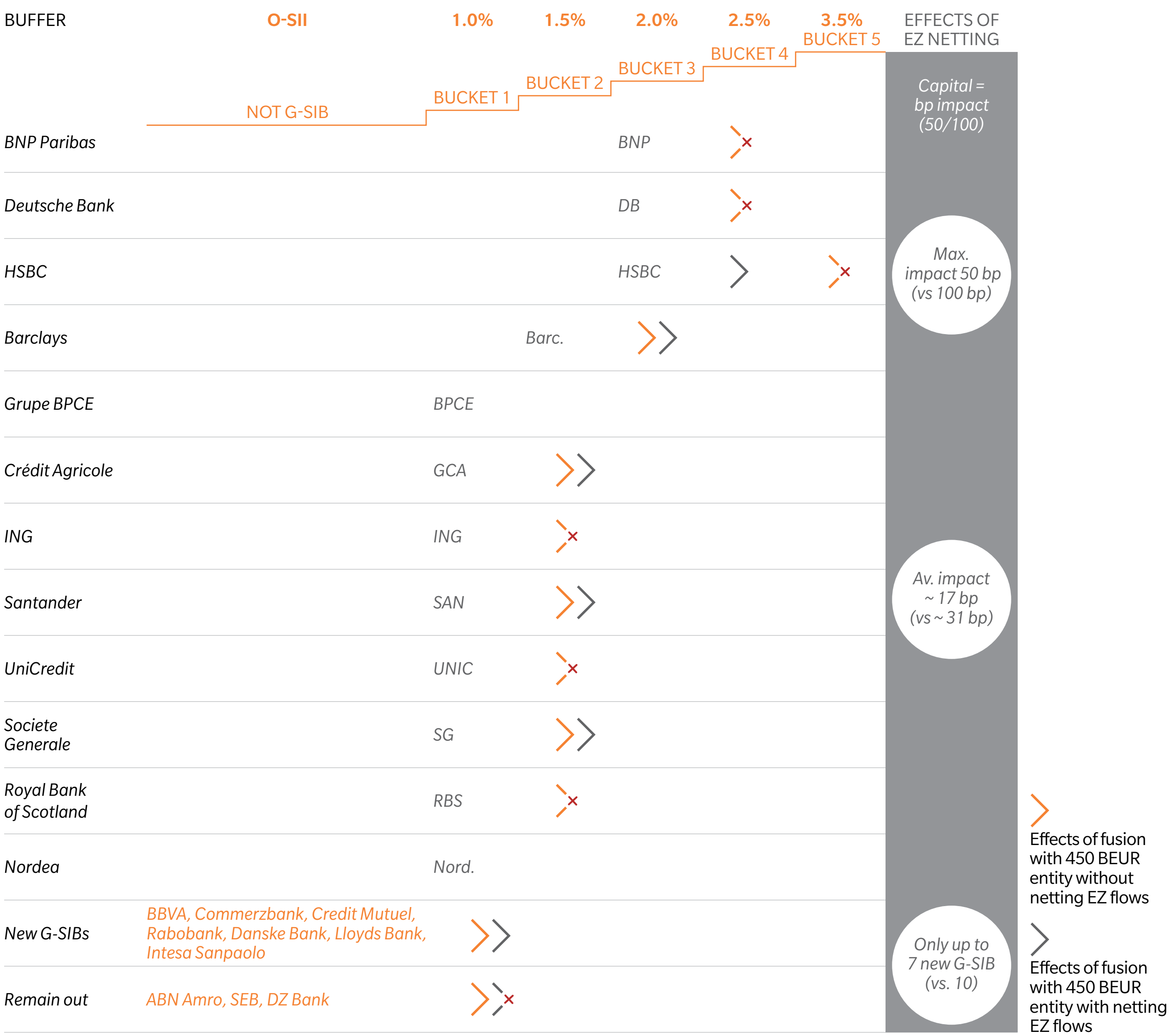
Banking activity	Banking products	Structurally domestic	Europeanisation potential	Being currently Europeanised	Already fully international
Credit	Mortgages and regulated loans	■			
	Consumer loans		■		
	Vanilla loan		■		
	Structured loan			■	
	Leasing		■		
Investments	Funds			■	
	Deposits		■		
	Regulated deposits	■			
	FIC and Equity				■
Protection	Insurance	■			
	Hedging				■
Payments & transaction banking	Credit cards		■		
	Transaction banking			■	
Advisory	M&A				■
	ECM/DCM				■

Source: Oliver Wyman analysis

DISINCENTIVES CREATED BY PRUDENTIAL REGULATION

Following the crisis, banks deemed Global Systemically Important Banks (G-SIBs) have been subject to additional capital requirements to account for the system-wide losses, the "contagion", that would be caused by their failure. Given the FSB methodology for identifying G-SIBs, a merger is likely to trigger additional requirements for the post-merger entity. Intra-Eurozone flows are actually considered cross-border exposures for G-SIB calibration. In this regard, a European G-SIB has no reason to prefer expanding into another Eurozone country to expanding outside the Eurozone. This treatment of intra-Eurozone flows fails to acknowledge the improved harmonization of Eurozone banking markets, with a single currency, a single rulebook, and a single supervisory authority.

Exhibit 16: Cumulative effects of netting intra Eurozone flows and purchasing a major bank (EUR 450 billion) for G-SIB calculation (2016 data)[14]



Note: EUR 450 billion size refers to the total leverage exposure as per FSB indicator

Source: FSB data, EBA data, GMI, Oliver Wyman analysis

14 Analysis was conducted before BPCE was excluded from G-SIBs and before BNP moved down to Bucket 2

We estimate that the acquisition by a European G-SIB of a bank with €450 billion of exposures will result in a 31 bps increase in CET1, all else being equal (see Exhibit 17). If these intra-Eurozone flows were netted, the cost of such acquisitions would be reduced to 17 bps of CET1. Non-Eurozone banks would also benefit from such a re-calibration, especially after adapting their structures to a post-Brexit context.

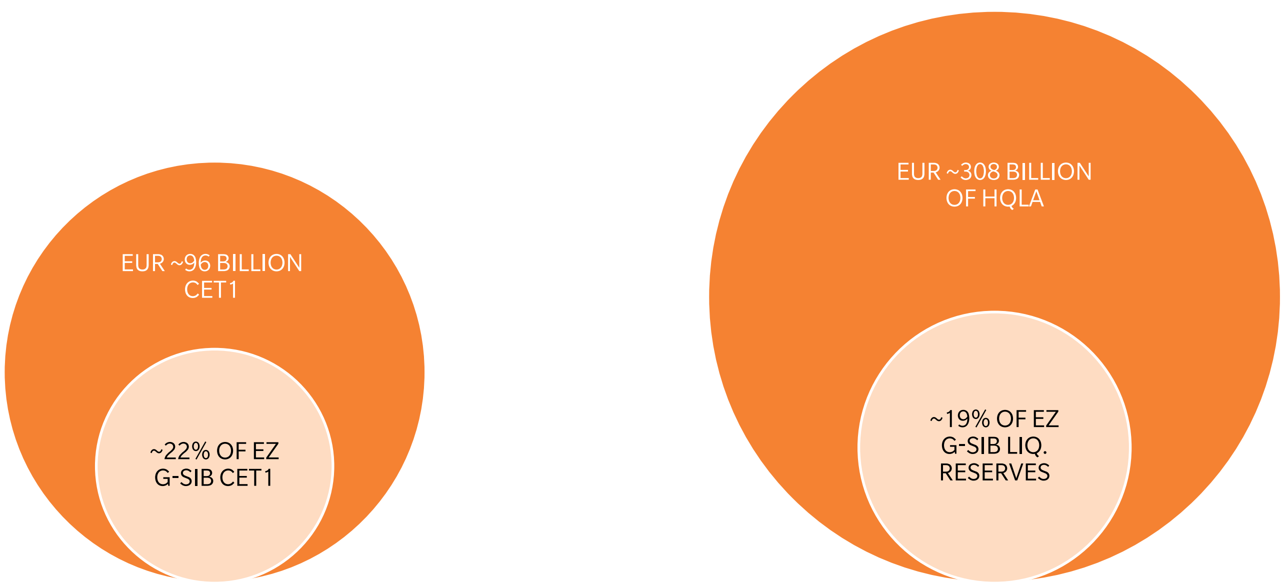
The way banks' contribution to the Single Resolution Fund (SRF) is calculated also discourages acquisitions because it makes not only risk but also size a factor.

Another barrier to European integration is the persistence of domestic capital and liquidity requirements, despite the advent of SSM. In several areas, domestic regulators still have discretion, which they exercise in ways that create regulatory divergence across the Eurozone. This creates redundancies and inefficiencies that impede an efficient allocation of capital and liquidity. A preliminary estimate for Eurozone G-SIBs suggests that removing these regulatory impediments would allow for better allocation of about €21 billion of CET1 and €59 billion of liquidity now trapped in various entities of these GSIBs (see Exhibit 18).

The Commission has recently tried to remove these impediments by granting capital and liquidity waivers on a cross-border basis[15] if specified conditions are met. However, several countries have voiced opposition to such waivers. In addition the approach of resolution of small banks and the impact on MREL disincentivizes consolidation moves.

Another barrier to pan-European banking could arise from the close relationship between sovereigns and domestic banks. Most European banks have a significant portfolio of debt issued by their home sovereign. More than half of the sovereign debt held by German, French and Italian banks is from their respective domestic governments. This is not a concern in itself (diversification issues aside); it simply reflects the primary dealer roles that domestic banks often play. However, member states' dependency on domestic banks as local buyers of their bonds could make some reluctant to see home banks diluting their sovereign holdings with other primary dealer mandates, or to see foreign banks taking material domestic market share without also acting as primary dealers. Some countries have also added additional local constraints (example: Poland requires the local listing of subsidiaries).

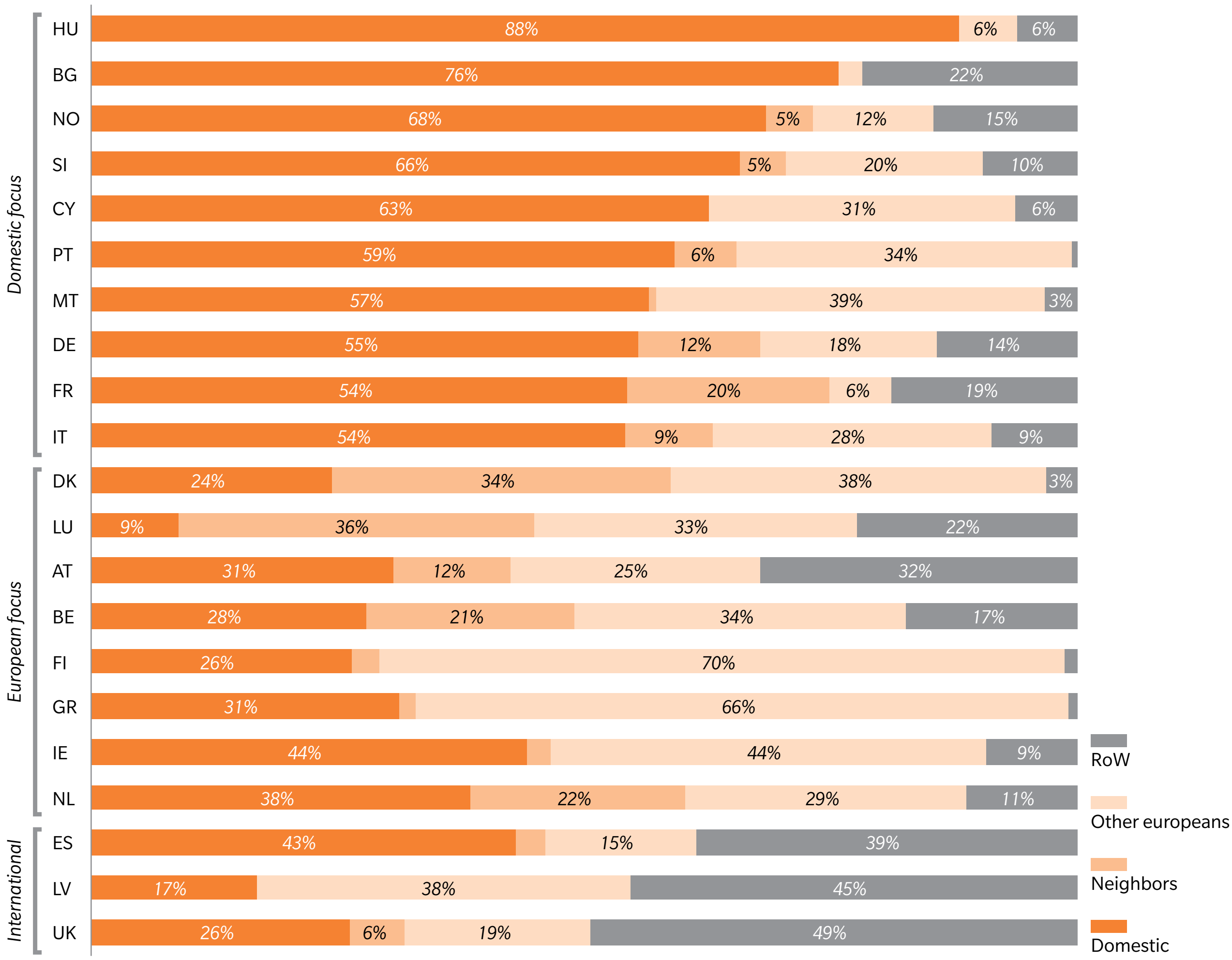
Exhibit 17: CET1 and liquidity as % of total trapped at local level by current regulation for Eurozone countries G-SIBs (2016, EUR billion)



Source: SNL, Oliver Wyman

15 Commission proposal on CRR2

Exhibit 18: Split of banks' sovereign portfolio by country (June 2016)



Source: EBA transparency exercise, SNL, Oliver Wyman analysis

Populist anti-globalization sentiment could also make European politicians unenthusiastic about Eurozone banking integration. Despite some signs that the populist wave is weakening in Europe,[16] it remains a potential game changer. Vote-seeking politicians may favour national champions by maintaining or increasing the barriers to foreign entrants, including banks from other European countries.

DIFFICULTIES IN REALIZING CROSS-BORDER SYNERGIES

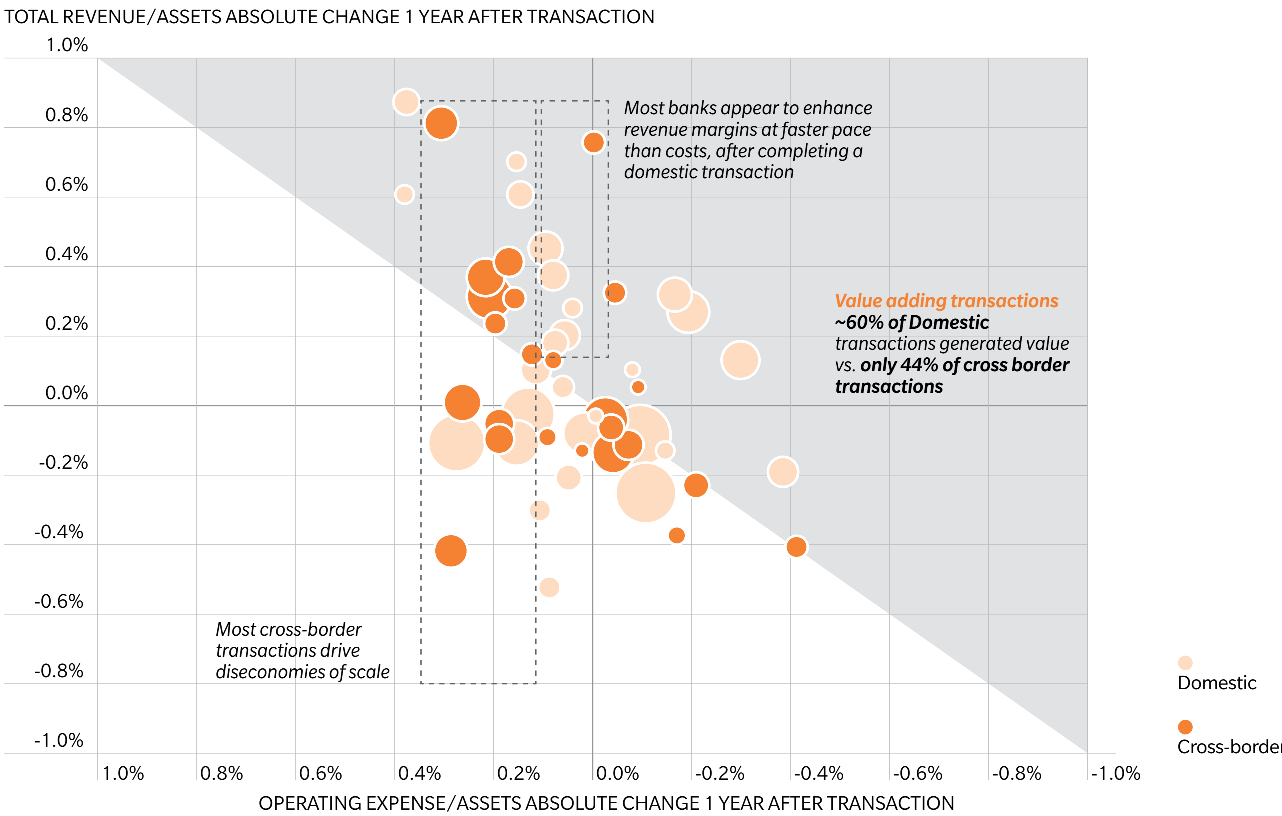
Despite the apparent benefits of cross-border expansion in Europe, cross-border M&A has remained limited. The number of such deals fell to a record low of 57 in 2016, compared to an average of 151 a year between 2000 and 2015. This trend is explained by growing scepticism about the acquiring bank's ability to extract value from of cross-border deals.

16 See Oliver Wyman Point of View, *Financial institutions in an age of populism*, March 2017

The risk diversification achieved by cross-border acquisitions delivers benefits. Of the 30+ banks that became distressed during the crisis, only two had followed an inorganic cross-border strategy. And regulatory exercises, such as the ECB comprehensive assessment, show that capital destruction at banks following an inorganic cross-border strategy is 25% lower than the average for other banks.

But these diversification benefits have not translated into better returns for shareholders. Cross-border deals have not delivered strong synergies. Between 2006 and 2016, only 45% of significant cross-border deals in Europe delivered synergies within a year, compared to 60% of domestic deals (see Figure 14). Cost reductions from cross-border deals were 70% smaller than the savings delivered by domestic deals. This is largely due to local specificities of certain banking products, as described in "Legal variation across the EU".

Exhibit 19: % Value creation in European bank consolidation loking back at 2006-2016



Source: Dealogic, annual reports, Oliver Wyman analysis

EUROPEAN INTEGRATION

The Europeanisation of banking can be arrived at by three paths, with different amounts of time and political will required for each:

	Options	Speed of Europeanisation	Intensity of pol./reg. agenda	Typical bank's strategies
1	Europeanisation driven by banks	Slow	Medium-low	• Digital/aggregator retail banking model in EU • Pursing EU focused strategies in corporate banking and capital markets • Selective acquisitions
2	Europeanization backed by legislators	High	High	• Major mergers/acquisitions to benefit from increase scale economies
3	Internationalisation driven by new entrants	Medium	Medium	• Defensive strategies to maintain market share

EUROPEANISATION DRIVEN BY BANKS – FRENCH CASE

In this scenario, no major political or regulatory change occurs. The Banking Union remains incomplete. French banks maintain their current strategies, not particularly targeting an improved European footprint. However, they might still promote European expansion through new digital strategies, an integrated sectorial offering to serve corporate clients and an EU-focused strategy in capital markets serving financial institutions.

DIGITAL STRATEGIES IN EUROPEAN RETAIL

We estimate that the revenue opportunity for aggregators is between €15 billion and €40 billion (1.5% to 4% percent of revenue) in European banking. The new Payment and Service Directive (PSD2) will strengthen the position of aggregators by allowing third parties to collect a wide range of financial data from banking product providers.

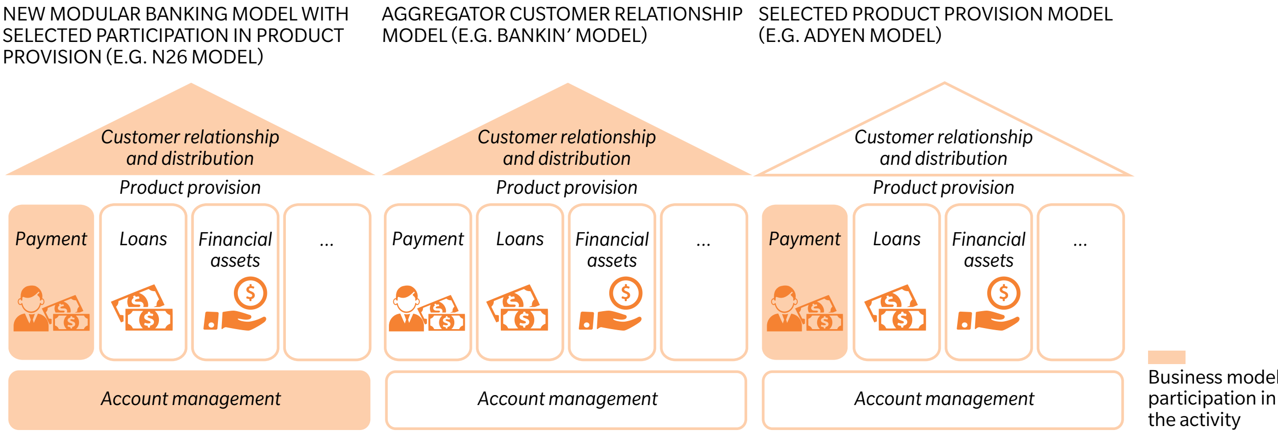
In retail banking, aggregators or Account Information Service Providers (AIS) may come to manage the relationship between customers and banks, capturing the revenues that come from distribution and reducing traditional banks to the role of low-margin manufacturers of commodity products.

AIS allow banks to enter new markets quickly and without incurring the costs of acquiring a domestic franchise or setting up domestic production. For example, ING has re-entered the UK through its aggregator, Yolt. Aggregators can start by acting as brokers for the products of local providers, and selling side products for which international barriers are low (e.g. investments products). In the long run, the bank might consider selling its own products on the platform, provided the gains outweigh the additional compliance costs.

In this context, several cross-border models can be considered for European expansion (see Exhibit 20).

Exhibit 20: Three potential digital cross-border banking models

NEW ECOSYSTEM



Source: Oliver Wyman analysis

- **New modular banking models.** These banks cover the full value chain from distribution to account management. But they manufacture only selected products, also distributing 3rd-party products, and provide a basic banking offering (e.g. N26 neo-bank).
- **Aggregator customer relationship model.** Pan-European positioning of account information services. Banks would act as independent aggregators and take ownership of consumer relationships and data with their product providers (e.g. Bankin').
- **Selected product provision model:** specialists positioning in particular products (such as payments, consumer credit, factoring) with targeted a high level of efficiency (e.g. Adyen). These specialists may have no direct access to clients, at least when their products are acquired through certain channels.

INTEGRATED SECTORIAL OFFERING TO SERVE CORPORATE CLIENTS

French banks have built a leading position in lending to corporates, both in vanilla products and more specialized structured finance (see Exhibit 21).

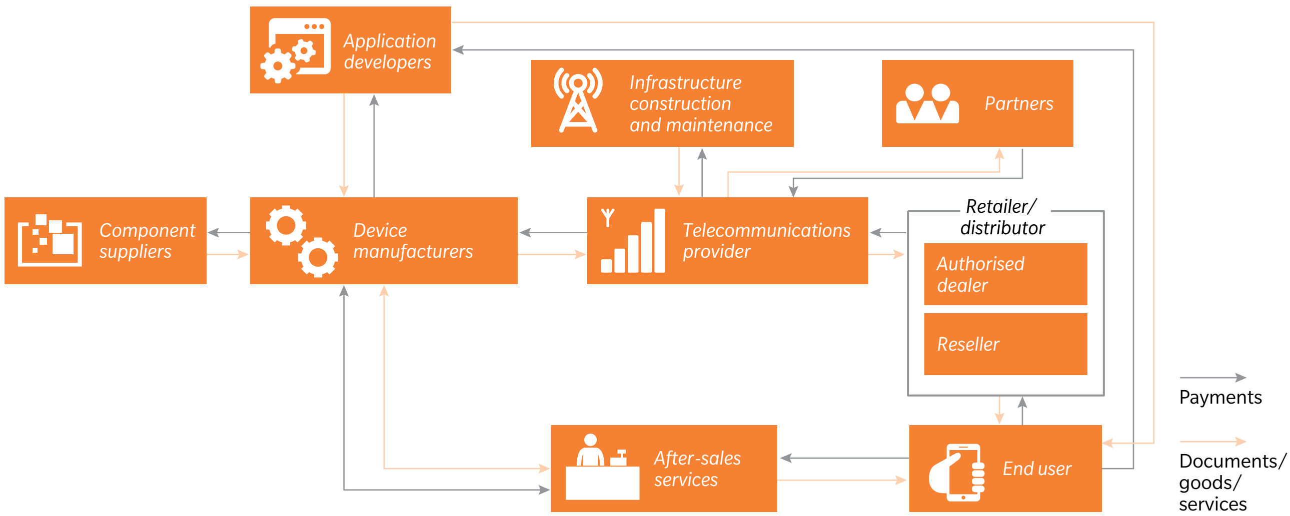
French banks can expand their share of EU corporate client business by moving away from a "product push" model to become more client centric. This will require them to coordinate across their various lines of business, bringing together sector specific advice (M&A, ECM, etc.) with financing (vanilla, structured, DCM), hedging products and cash, trade and transaction banking – the last requiring digital platforms integrated with the sector ecosystem. Not only will this integrated offering help banks serve sectoral players more efficiently (see Exhibit 19) but it will contribute to the competitiveness of the sector in Europe and globally.

Exhibit 21: EMEA structured finance volume 2016 table across different asset classes

Asset class	Real estate	Acquisition & Leverage	Oil, gas & power	Project finance	Aircraft	Shipping
# of French banks in TOP 10	1	1	1	4	3	1
Market share of French banks	9%	8%	13%	33%	31%	5%

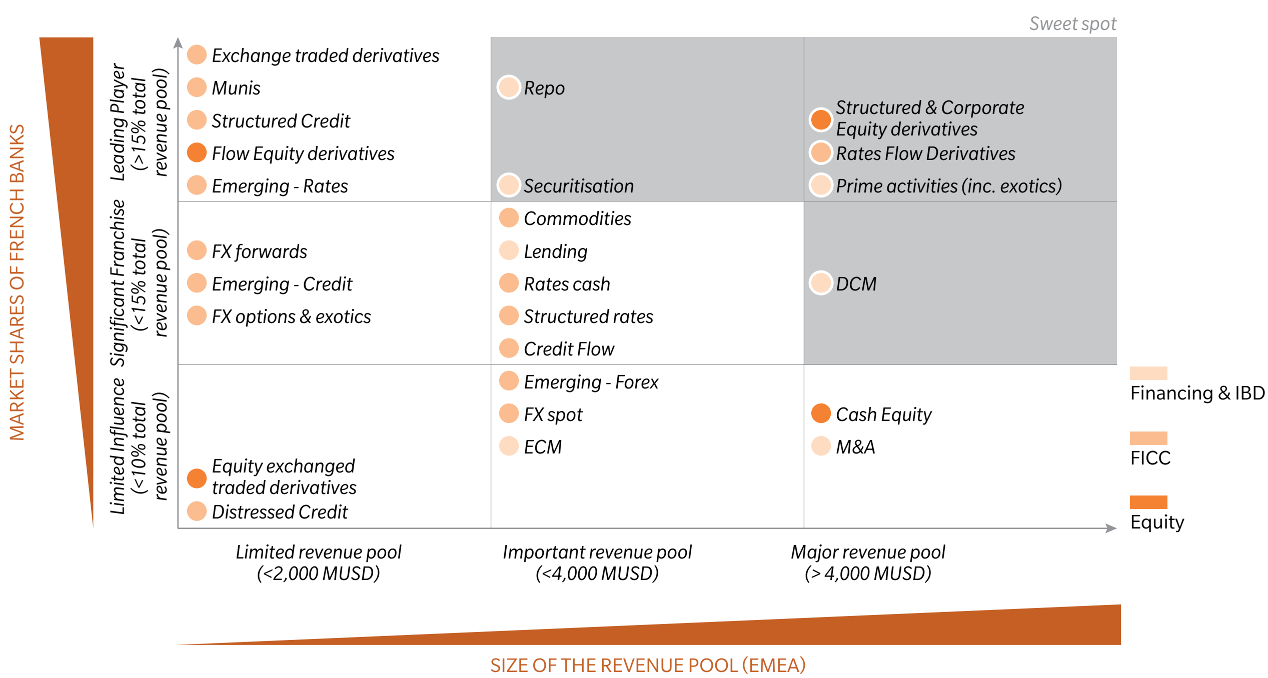
Source: Idealogic, Oliver Wyman analysis

Exhibit 22: Illustration of sector ecosystem and corporate players that could be served by specialized corporate banks (example of telecom sector)



Source: Oliver Wyman analysis

Exhibit 23: EMEA market share and positioning of French banks



Source: Oliver Wyman proprietary data

The best opportunities for French banks to provide a comprehensive service is in the selected sectors where they already have a strong franchise, such as energy, transport, infrastructure and real estate. Here, they should aim to provide services along the entire value chain. Insofar as these targeted industries operate across Europe, French banks can become pan-European wholesale banks and strengthen their Global positioning.

EU FOCUSED STRATEGY IN CAPITAL MARKETS SERVING FINANCIAL INSTITUTIONS

Brexit may create a one-off opportunity for European banks to increase the scale of their wholesale banking activities, especially in capital markets. As mentioned above, a pool of €16 billion of annual revenues are potentially "up for grabs" in Europe (see Exhibit 14). While the RoE generated by these clients might not be high, due to intense competition to cover them, it represents an opportunity to strengthen the position of European CIBs in the EU landscape.

Exhibit 24: Acquisition heat map (2013 to 09/2017, Number of acquisitions)

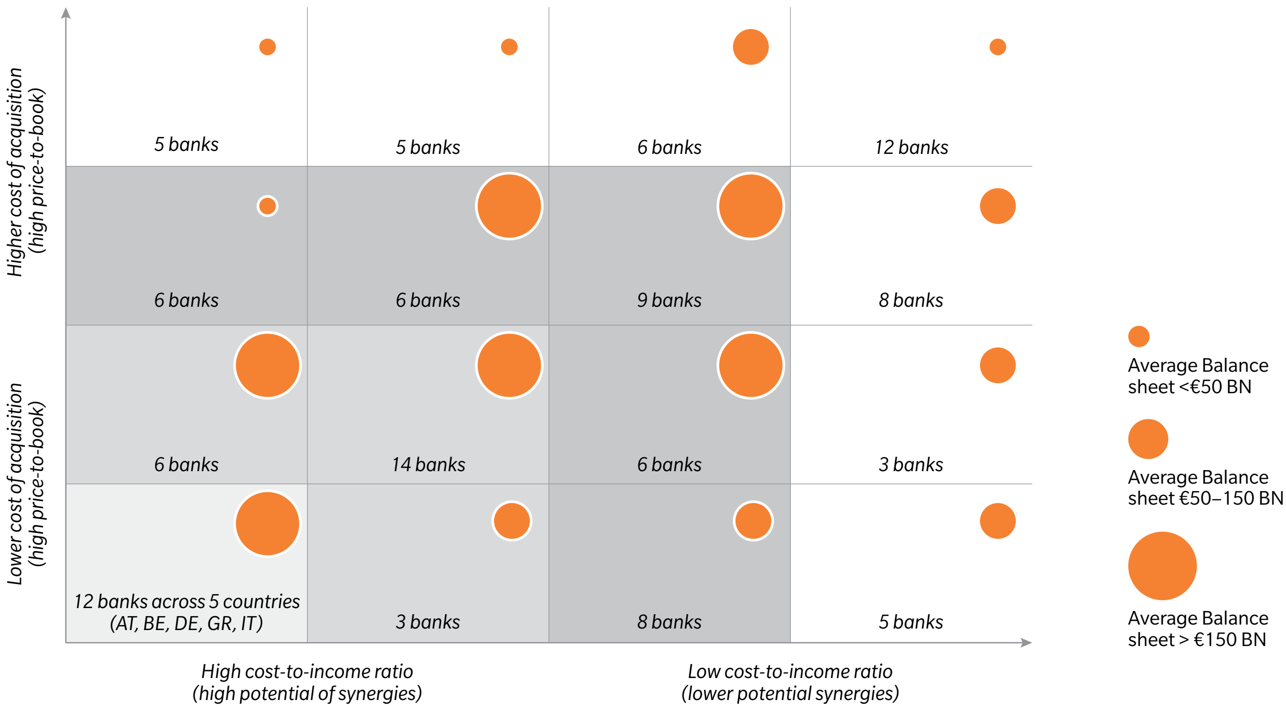
	Sectors	BNPP	CM	BPCE	CA	SG	BBVA	San	Intesa	UniC	DB	CB	ABN	Rabo	ING	Total
Retail banking	**Retail Banks**	3	1	0	0	3	3	4	2	6	2	0	0	1	0	25
	Online Banking	1	1	1	0	2	1	0	0	0	0	0	0	0	0	6
	Aggregator	0	0	0	0	1	0	0	0	0	0	0	0	0	1	2
Personal & financia services, Insurance	**Leasing**	3	1	0	0	5	0	2	0	1	0	0	0	0	0	12
	Insurance	6	0	0	0	2	2	0	0	0	0	0	0	0	0	10
	Wealth & Asset Mgmt	1	0	0	2	1	0	3	1	2	0	0	0	0	0	10
	Consumer Finance	3	0	0	0	0	0	4	0	0	1	0	0	0	1	9
	Payments	1	1	1	0	1	1	2	0	0	0	0	0	0	1	8
Investment banking	**Investment Banks**	0	0	2	0	0	0	0	0	0	0	0	1	0	0	3
	Securities Services	5	0	0	0	1	0	1	1	0	0	0	0	0	0	8
	Brokerage	0	0	0	0	2	0	0	0	0	0	0	0	0	0	2
	Capital Markets	2	0	0	0	0	0	0	0	0	0	0	0	0	0	2
Other	**Real Estate**	0	0	0	2	0	1	6	1	2	1	0	0	0	0	13
	Blockchain	1	0	0	0	0	1	0	1	0	1	1	0	0	1	6
	Total	**26**	**4**	**4**	**4**	**18**	**9**	**22**	**6**	**11**	**5**	**1**	**1**	**1**	**4**	**116**
	Of Which Domestic	*6*	*1*	*2*	*4*	*7*	*6*	*9*	*3*	*5*	*1*	*0*	*0*	*0*	*2*	*46*
	Of Which Other EU-19	*8*	*2*	*1*	*0*	*4*	*0*	*3*	*0*	*1*	*2*	*0*	*0*	*0*	*0*	*21*

0 1 2 3 4 5 >6

Number of acquisitions per bank per sector

Source: Merger Market, Oliver Wyman analysis

Exhibit 25: Overview of acquisition opportunities in the EU



Source: Oliver Wyman analysis

French banks are among the best positioned to compete in this space. They already have a leading role in structured equity derivatives and flow rates derivatives, with more than 15% of the EMEA markets. However there are several other areas where they can improve their positioning (see Exhibit 23). An EU-focused strategy in capital markets would require French banks to invest in building strengths where they are now capturing only a small share of business. Failing to do so will only pave the way for increased dominance from US players.

SELECTIVE EXTERNAL GROWTH

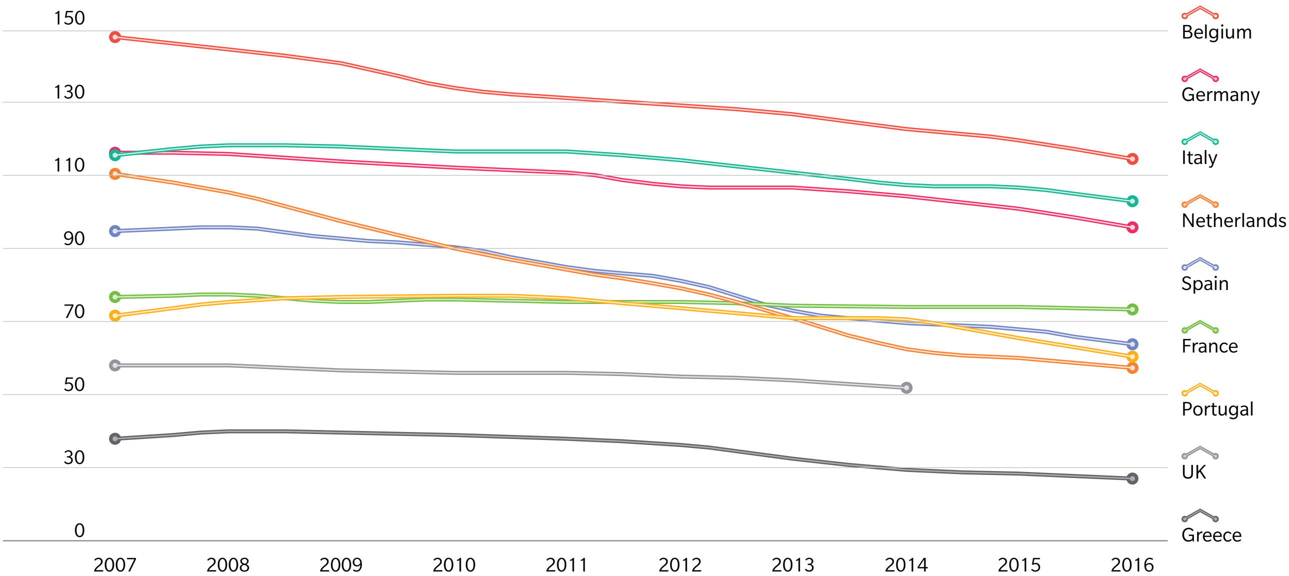
Within the current legal and regulatory context, and given uncertainty around the future evolution of the retail banking model, significant cross-border consolidation is unlikely. Nevertheless, we see four situations in which value could be delivered by cross-border M&A:

- Expansion within specialized businesses with clear scale and distribution benefits
- Expansion into markets where significant skills transfer is expected, typically from the acquirer to the target
- Acquisitions in markets that are sufficiently similar to make the deal effectively in-market: within Iberia or Benelux, for example
- Acquisitions of banks at well below their intrinsic value.

We expect cross-border acquisitions of specific activities to continue, especially where reaching scale is critical.

European banks are likely to pursue their specialisation strategies, as illustrated by the heat map of recent acquisitions (see Exhibit 24).

Exhibit 26: Branches per 1,000 sq. km



Source: ECB statistical data warehouse, Eurostat, Oliver Wyman analysis

Very low price-to-book ratios among European banks could also provide opportunities for cross-border acquisition (see Exhibit 25). Not only are these banks cheap to purchase but a takeover can signal confidence in the target bank's underlying position and an improvement in its management which will quickly push up its market value.

As noted in "Introduction", a low cost/income ratio is an advantage for banks seeking cross-border expansion; this is not French banks strongest advantage (see Exhibit 7).

In Retail Banking, Digital transformations have the potential to radically reduce banks' operating costs, most directly by closing branches while maintaining accessibility for customers. French banks remain near the Eurozone average for branch density, with 68 branches per 1,000 sq. km, and well below the density of the most over-banked markets, such as Italy and Germany. But French banks are not making as much progress as banks in other countries. Since 2007, the number of bank branches in France has decreased by only 5% while it has decreased by 19% across the Eurozone. Branch density in the Netherlands declined from 108 branches per 1,000 sq. km in 2007 to 51 at the end of 2016.

French Banks will need to push further on operational efficiency and digitisation, and not just in Retail Banking, to be better positioned for possible European consolidation.

EUROPEANISATION DRIVEN BY LEGISLATORS

The most effective and rapid delivery of European banking integration would be provided by European legislators. Their priority should be removing the remaining regulatory impediments to cross-border expansion and finalizing the Banking Union. Four measures are most important:

- **Establish a common European deposit insurance or reinsurance scheme.** This is as a prerequisite for finalising the Banking Union. It will not only foster financial stability and depositor confidence in foreign banks; it will help to overcome a governmental objection to foreign takeovers – namely, the risk that taxpayers will end up bailing out a foreign bank through domestic depositor protection.

- **Recalibrate the G-SIB buffer.** Netting Eurozone flows from the calculation of cross-border claims and liabilities is a legitimate consequence of belonging to a common currency zone, sharing a supervisory authority and applying similar resolution regimes. This recalibration will reduce the capital costs resulting from cross-border deals.

- **Removing domestic capital and liquidity requirements.** This could improve the allocation of a significant amount of capital (€21 billion for Eurozone G-SIBs) and liquidity reserves (€59 billion for Eurozone G-SIBs) and relieve institutions of the administrative burden resulting from the various associated reporting requirements. Granting cross-border waivers for capital requirements (including MREL) and enlarging cross-border waivers for liquidity are logical next steps. The prerequiste is to provide host countries with assurance that resolution mechanisms will be effective (e.g. Group resolution Vs Local legal entity resolution). If domestic requirements are not removed, banks will be inclined to transform their operating subsidiaries into branches, as the recent example of Nordea has illustrated.

- **Encourage direct financing** Corporate financing in Europe remains heavily dependent on bank lending, especially compared with the US, where firms more often raise funds directly in the capital markets. As long as this remains true, regulations that constrain bank leverage and scale act as restraints on the financing of business in Europe. Regulators may wish to maintain such constraints for the sake of systemic stability. If so, they should seek to encourage direct financing and securitization markets in Europe. This would help to integrate European business financing, since these securities can easily be traded across European borders if supported by the right infrastructure. The Capital Market Banking can be a step in that direction.

As noted in "Strengthening European banking integration: tail winds", however, it is not only banking regulation that can create a barrier to cross-border consolidation. Variation in laws relating to consumer protection and bankruptcy, for example, can also increase the cost of operating in several European jurisdictions. European legislators should work to remove any legislative variations that increase costs for banks and impede pan-European banking.

They might also take the opportunity presented by Brexit to renew discussions about making membership of the Eurozone a condition for membership of the EU. The single currency has played an important role in improving the economic and financial integration of the EU.

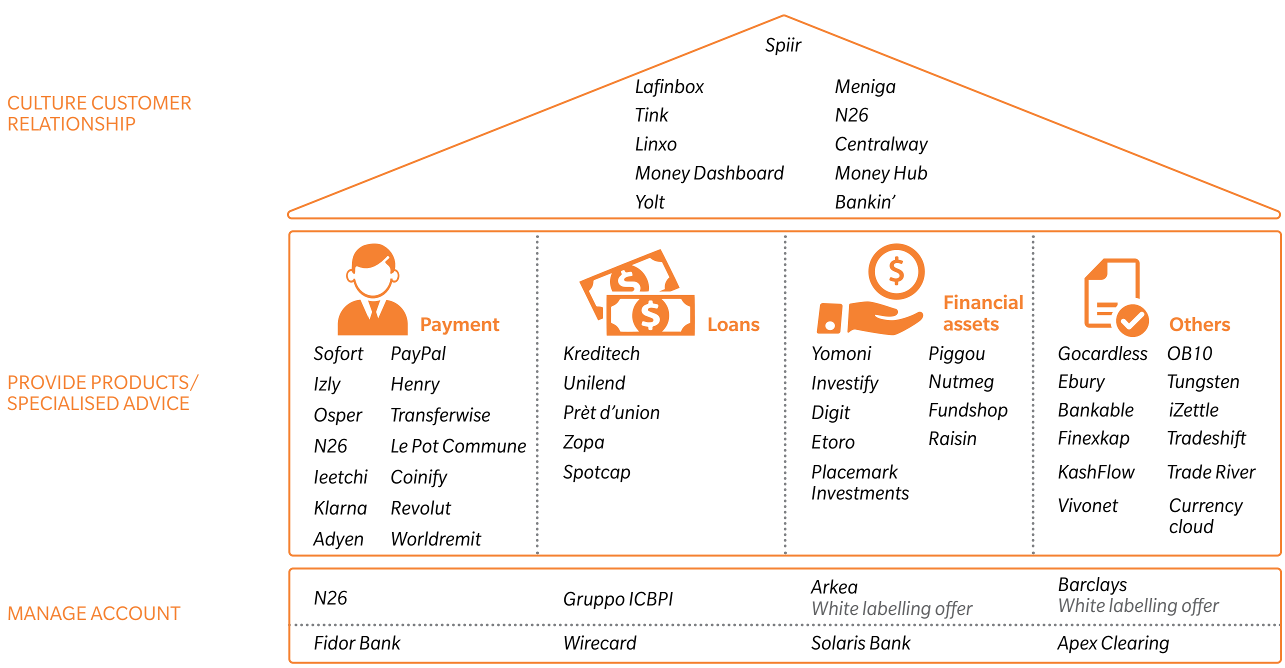
Finally, developing an overarching industrial policy for European banking would complement market-led initiatives. The policy should explicitly support the creation of large cross-border European banks and make sure these banks compete on a level playing field against their US counterparts. It should also aim to reinforce local expertise across Europe. A coordinated distribution of responsibilities would create local synergies, promote specialisation and avoid competition between "centres" within the Eurozone, especially in the context of the Brexit.

INTERNATIONALISATION DRIVEN BY NEW ENTRANTS

Even without material legislative reform, banking is likely to internationalize as a result of technological innovation. Digital technology is transforming the banking industry and blurring national borders. Fintechs build low-cost and scalable platforms that can easily be exported from one country to another. Many new entrants have business models premised on capturing client value cross-borders, and several segments have already been disrupted:

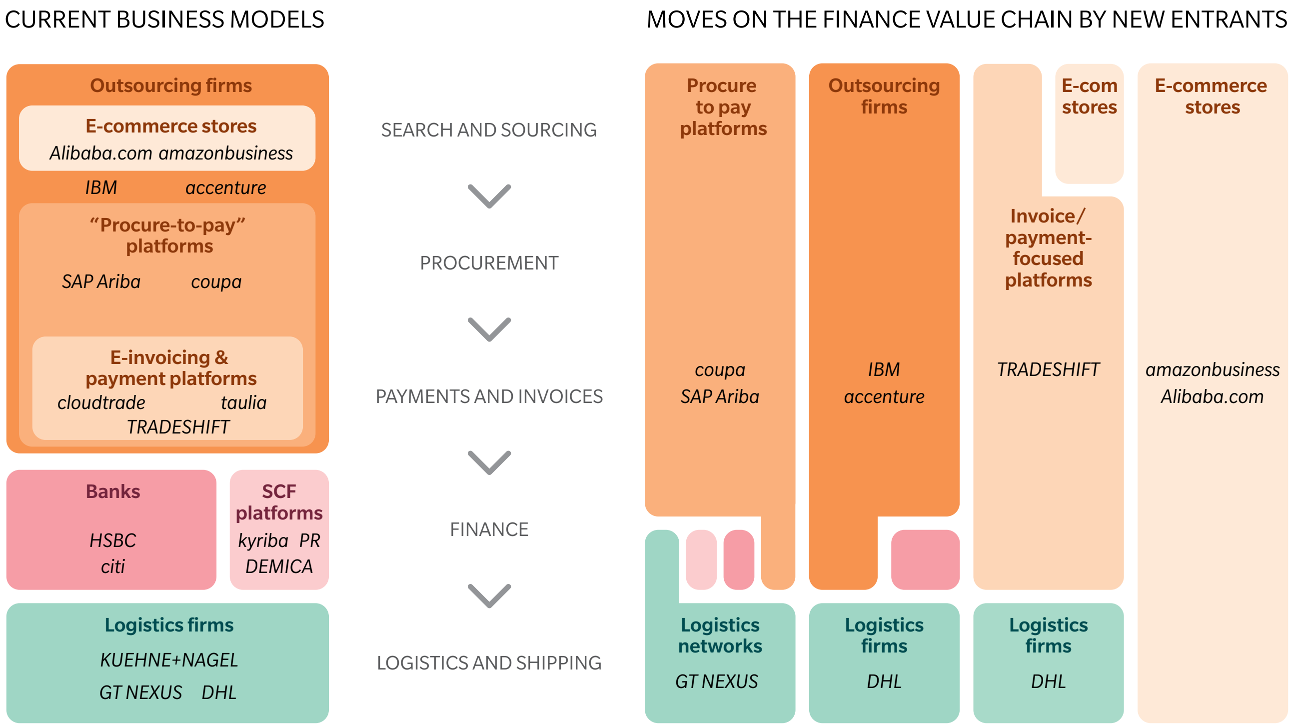
- **Aggregators.** Aggregator platforms and digital banks are already operating across borders (see Exhibit 27). We have witnessed a proliferation of these over the past few years. This model can accelerate significantly if it attracts interest from GAFA players.
- **Specific banking products.** Banks have maintained a competitive advantage in payments because of the reach of their international networks and their KYC and AML compliant processes. However, new technologies such as distributed ledgers could offer payment rails to new entrants. We are already seeing material disruption at the SME end of the market, where new payments providers are winning with easy-to-use propositions.
- **Blurring frontiers between FS players and Non-FS players.** Banks have traditionally played the role of linking buyers and sellers in the financial part of the trade value chain: that is, in payments and financing (including factoring, letters of credit and so on). Non-bank players are now moving into this space, especially the companies involved in other parts of the trade value chain, such as e-commerce firms, procurement platforms and logistics companies.

Exhibit 27: Banking new entrants: new client priorities & new competitors interfering in the relationship



Source: Oliver Wyman analysis

Exhibit 28: New FS and non FS players, with various moves on the finance segment



Source: Oliver Wyman analysis

CONCLUSION

The best way to promote the integration of European banking would be to remove the remaining legal and regulatory barriers to it. But that is not a trivial matter, requiring harmonisation of bankruptcy and consumer protection law, among other things. European legislators should not avoid the task. But, even with commitment, it will take many years.

In the meantime, integration is most likely to be advanced by digital banking technology and the open architecture distribution models built on it. And there will continue to be some opportunities for cross-border M&A in selected parts of the traditional banking offer. French banks are ideally positioned to engage in both kinds of European expansion, and to improve their wholesale banking proposition to compete with the increasingly dominant American banks.

Pan-European banking might not be with us any time soon. But it is visible on the horizon and it should be a target destination, not only for European legislators and regulators but for the banks that might feasibly end up playing the role.

APPENDIX: LIST OF ACRONYMS

AIFMD: Alternative Investment Fund Managers Directive
AML: Anti Money Laundering
AQR: Asset Quality Review
BL: Business Line
C/I: Cost/Income
CET1: Common Equity Tier 1
CIB: Corporate Investment Banking
CRR: Capital Requirement Regulation
DCM: Debt Capital Market
EBA: European Banking Authority
ACB: Adjusted Cost Base
ECM: Equity Capital Market
EMEA: Europe, Middle-East and Africa
EZ: European Zone
FICC: Fixed Income Clearing Corporation
FSB: Financial Stability Board
FX: Foreign Exchange
GAFA: Google, Apple, Facebook, Amazon
GDP: Gross Domestic Product
G-SIB: Global Systematically Important Banks
HQLA: High Quality Liquid Asset
IB: Investment Banking
KYC: Know-your-Customer
LTV: Loan-To-Value
M&A: Mergers & Acquisitions
MREL: Minimum Requirement for own funds and Eligible Liabilities
NPL: Non Performing Loan
O&D: Origin & Destination
OECD: Organisation for Economic Co-operation and Development
P&L: Profit & Loss
PSD2: The Second Payment Directive Service
RoE: Return on Equity
SME: Small and Medium-sized Enterprises
SREP: Supervisory Review and Evaluation
SSM: Single Supervisory Mechanism
TRIM: Targeted Review of Internal Models
UCITS: Undertakings for Collective Investments in Transferable Securities

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