BRIEFING

Overcapacities in the European Banking Sector

This briefing explores the issue of possible overcapacities in the European banking sector, in particular looking at the euro area. Overcapacities might be one reason, among others, for the low levels of profitability currently seen in the banking sector. This briefing highlights that the discussion about overcapacities is linked to different policy areas, and it analyses statistical data for the euro area to describe the changes seen since 2008 regarding the size of the branch network and number of people employed in the banking sector.

Context

Lately, a number of institutions involved in banking supervision highlighted that the European banking sector may have excess capacities and may be overbanked.

In September 2016, for example, Mario Draghi, President of the European Central Bank (ECB) and Chair of the European Systemic Risk Board (ESRB), made a link between the low level of profitability seen in European banks and the excess capacity in that sector, saying at the ESRB's first annual conference that "*...overbanking is also a factor in the current low level of bank profitability. Over-capacity in some national banking sectors, and the ensuing intensity of competition, exacerbates this squeeze on margins*".

Shortly thereafter, Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, raised in a similar vein the straightforward question "*Are there too many banks*?" in a speech at the general meeting of the Austrian Society for Bank Research, specifically looking at the situation in Austria and Germany.

The perception that Europe is overbanked is not restricted to supervisory authorities, some bank representatives argue along the very same lines. Axel Weber, for example, Chairman of the Board of Directors of the very large Swiss UBS Bank, not only stated very clearly in an interview with CNBC that Europe is overbanked, but he also argued that the rescue programmes [EU financial assistance] in place prevent a correction of that situation, as weak banks would not exit the market and would hence not give room for other, healthier banks.

Disentangling the issue of overcapacity

The discussion about overcapacities, however, addresses three different aspects that are related but not the same:

The size of the banking sector

The first aspect concerns the question whether the size of the banking sector is considered to be too large in comparison to the size of the economy, and whether it handles a too large share of the funding of the real economy. The Advisory Scientific Committee of the ESRB published in June 2014 the often cited report "Is Europe Overbanked?" which finds that Europe's banking system has seen excessive growth in recent years. The authors point out that the ratio of bank

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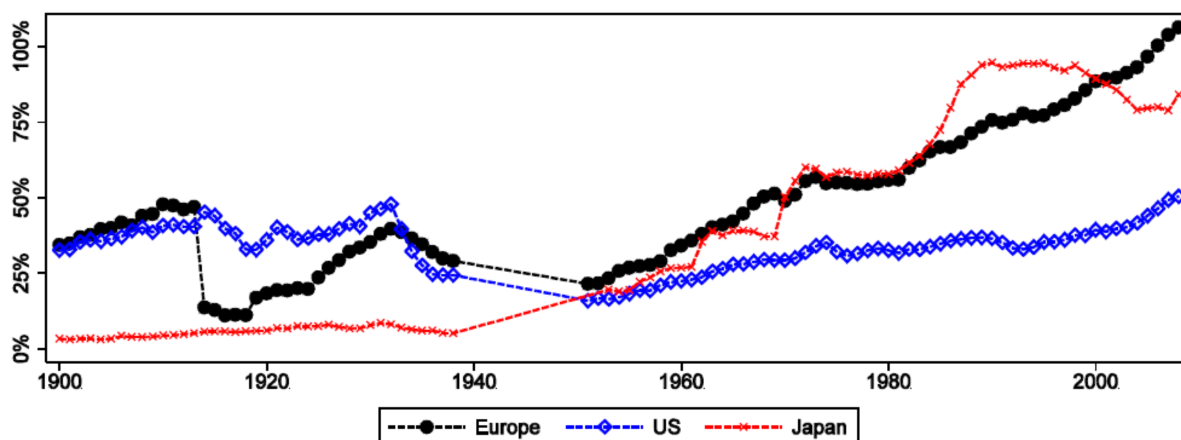
credit in relation to the Gross Domestic Product (GDP) has increased everywhere in Europe, and that this ratio is considerably higher than in the US (see figure 1):

Figure 1: Bank loans to GDP in US, Japan, and Europe



Source: Report of the Advisory Scientific Committee "Is Europe Overbanked?", no. 4, June 2014, p. 3 (original source: *M. Schularick and A. M. Taylor (2012) "Credit booms gone bust: Monetary policy, leverage cycles, and financial crises, 1870-2008", American Economic Review, 102(2), p. 1029-61*).

The comparison to the situation in the US, however, mainly reveals fundamental differences in the way the real economy is financed: In Europe, enterprises typically turn to banks to fund themselves, whereas in the US, they more often place corporate bonds on the financial markets.[1] Those fundamental differences cannot simply be confined to the availability, depth, and breadth of financial markets, they are rather embedded in the wider fabric of the economic and financial system, the abundance of institutional investors such as pension funds, the average size of companies seeking credit etc. In any case, the perception that investment in Europe relies too heavily on banks is one of the key drivers for the Commission's Capital Markets Union project that aims to develop a more diversified financial system in which capital markets shall play a more prominent role for the financing of the real economy.

The number of banks

The second aspect of overbanking is related to the market structure, the number of banks and banking groups in Europe, and the resulting level of competition between them. In October 2016, Claudia Buch, Vice-President of the Deutsche Bundesbank, pointed in an interview specifically at the consequences of having too many banks compete for too little business volume: "*Overcapacity becomes apparent when there is extremely fierce competition in the market, which can, in turn, result in a greater willingness to enter into excessive risk*." Strong competition among European banks certainly has an impact on their profitability - the IMF's Global Financial Stability Report "Potent Policies for a Successful Normalization", published in April 2016, for example, comments on the more challenging income situation for European

[1] A publication by the European Banking Federation EBF ("EU Banking Sector: The world's largest banking system in the world's largest economic space") actually shows that the US and EU banking sector are much more alike if size is not measured in terms of total assets held but simply in terms of the number of banks; the number of bank employees in relation to the size of the population is also quite similar (in 2010, there was on average one bank employee per 165 citizens in the EU-27, in the US one per 150 citizens).

banks (p. 45): "*There is room to boost fee and commission income. Large European banks only earn half to three-quarters of what their American peers do relative to their asset base. This process will likely be slow, however, particularly in many euro area markets where competition dynamics limit banks' ability to charge fees*". The IMF draws the conclusion that overcapacities will have to be reduced and that the merger of some banks might improve the situation (p. 37): "*Excess capacity in the European banking system will have to be steadily addressed over time. In many countries, a consolidation and downsizing of the system might be required so that the remaining banks can enjoy pricing power and sufficient demand to increase the system's capital generation capacity of the system*". That argument suggests that banks operating in a market with a higher concentration (measured, for example, by the share of assets held by the top five banks, see table 1) and fewer competitors can generate higher profit margins – yet one must not forget that on the flipside, the higher fee structure is actually borne by the banks' customers.

Table 1: Concentration - share of total assets of the five largest credit institutions (2016)

Luxembourg	27.6%	Latvia	66.5%
Germany	31.4%	Finland	66.5%
Austria	34.5%	Portugal	71.2%
Italy	43.0%	Croatia	73.0%
Ireland	44.3%	Malta	80.2%
France	46.0%	Netherlands	84.7%
Slovenia	61.0%	Lithuania	87.1%
Spain	61.8%	Estonia	88.0%
Cyprus	65.7%	Greece	97.3%
Belgium	66.2%		

Source: ECB Structural Indicators for the EU Banking Sector, May 2017

The operational features of banks

The third aspect of overbanking, finally, is related to the size and efficiency of the operational infrastructure, and addresses the question whether banks run a too wide branch network and employ too many people. A diagnosis suggesting that that there are too many people employed in a particular banking system is certainly sensitive as for its social impact, yet some reports openly argue the case for branch network rationalisations and staff ("workforce") reductions based on cost efficiency considerations (see, for example, ATKearney: The 2015 Retail Banking Radar - Time to Reinvent your Banking Model), while others link future staff level reductions to the rapid technological development ("fintech revolution") that is currently emerging (see, for example, EY: Accelerating the technological transformation of banking, June 2016).

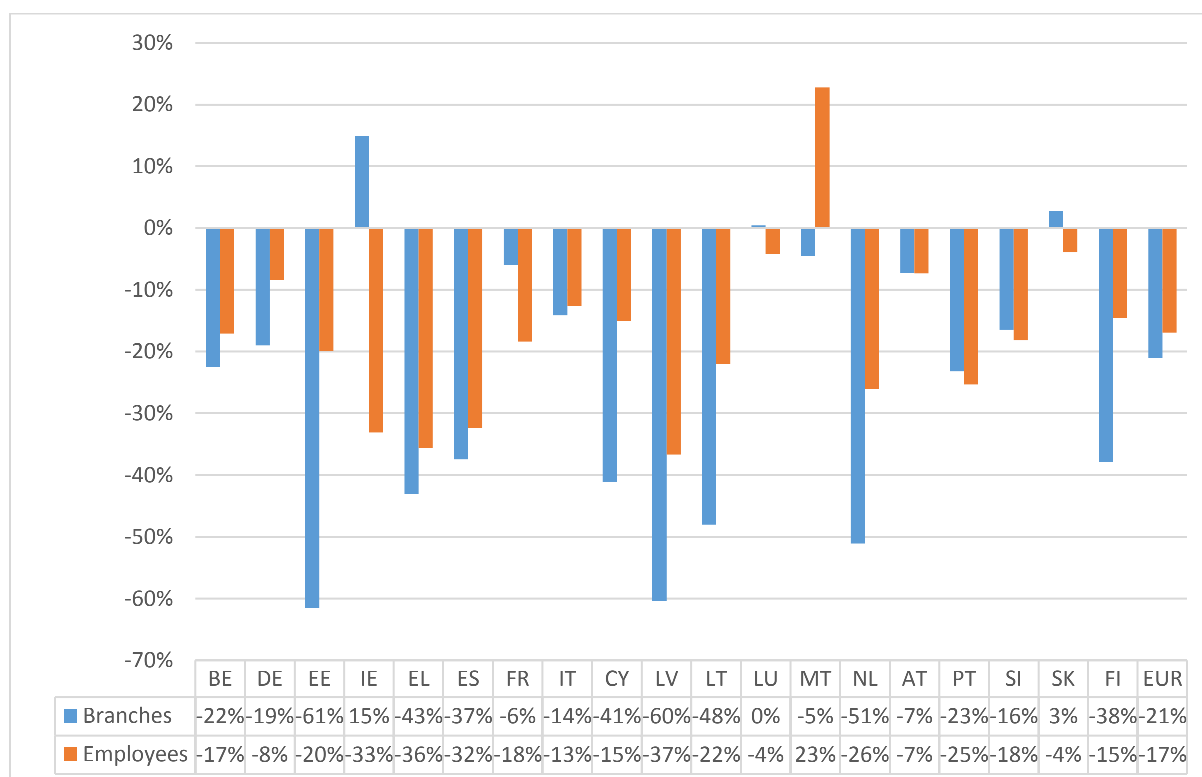
Focus on: Branch network and workforce reduction in the euro area

Statistical data published by the European Central Bank (ECB) sheds some light on the development of the operational infrastructure in the euro area, it reveals to what extent the size of the branch network and the number of people employed in the banking sector have changed since the financial crisis started in 2008.

Across the euro area, the number of bank branches decreased on average by 21% in the period from 2008 until 2016. This downward trend can be observed in most Member States using the euro (see figure 2), but there is a considerable dispersion of the extent to which the branch network was rationalised, with a range of more than 75%. In eight Member States the size of the branch network was reduced by more than a third (Estonia, Greece, Spain, Cyprus, Latvia, Lithuania, The Netherlands, and Finland), while in other Member States there were smaller adjustments, no significant changes, or even small expansions of the branch network.

The number of people working in the banking sector decreased everywhere, except in Malta (see figure 2). Across the euro area, that reduction amounts on average to 16.9% in the period from 2008 until 2016. Again, the actual workforce reduction varies across Member States, but the variation is smaller. Overall, the numbers suggest that the branch network was downsized more aggressively than the number of employees.

Figure 2: Changes to the number of bank branches and employees in the euro area from 2008 to 2016 (in %)



Source: "ECB Structural Indicators for the EU Banking Sector 2017", "ECB Structural Indicators for the EU Banking Sector, 2011", own calculations; data for Ireland refers to the year 2015, 2016 figures were not available

Are there still too many people employed in the banking sector? As a rough indicator for the overall efficiency of the banking system one can look at the size of the workforce compared to the size of the population ("Population per bank employee"). ECB data shows that there are still remarkable differences in this respect (see table 2). Even though a proper analysis needs to take the specific situation in each Member State into account – for example the fact that a country like Luxembourg has established itself as an international financial centre in which banks and their staff do not mainly serve national clients but rather clients from abroad – the

data generally suggests that in the future, some Member States will very likely see further downward adjustments of their banking sector workforce.

Table 2: Population per bank employee in the euro area (2015)

Luxembourg	22	Belgium	201
Cyprus	77	Italy	203
Malta	94	Latvia	210
Austria	118	Greece	236
Germany	126	Spain	236
France	163	Finland	251
Ireland	171	Estonia	264
Netherlands	188	Slovakia	287
Portugal	197	Lithuania	344
Slovenia	198	euro area	169

Source: ECB Report on financial structures October 2016, table 10, p. 77

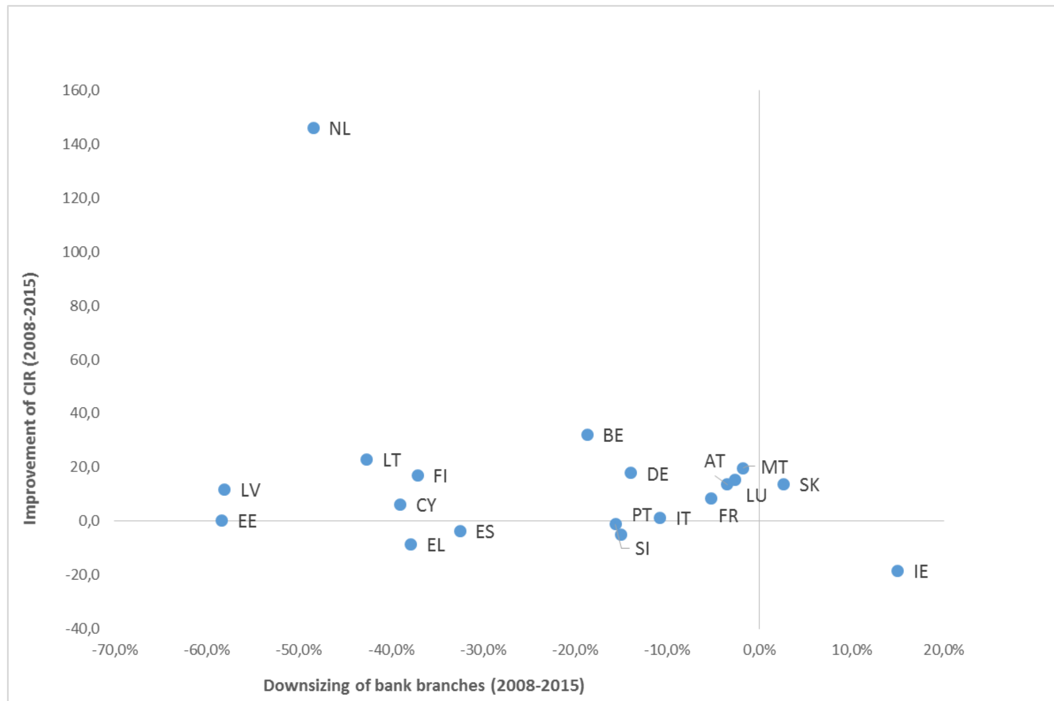
Relationship between restructuring and efficiency

One would usually expect that restructuring efforts undertaken in the banking sector result in efficiency gains. However, if one compares the branch network and workforce reductions that were implemented in the euro area from 2008 until 2015 with the development of efficiency indicators in the same period, one finds that those measures have neither systematically resulted in higher cost efficiency nor in a higher overall profitability, the correlation is rather weak.

That high-level observation would certainly merit a more granular analysis that should, for example, better take into account the technological changes with which the restructuring efforts have to keep pace with, the time lag between restructuring measures and the benefits thereof, as well as effects in the opposite direction, like the losses of business volume that go along with a restructuring. Moreover, it seems questionable to what extent restructuring efforts are an independent variable, and to what extent they are actually a dependent variable (low levels of profitability force banks to shut down branches and lay off employees).

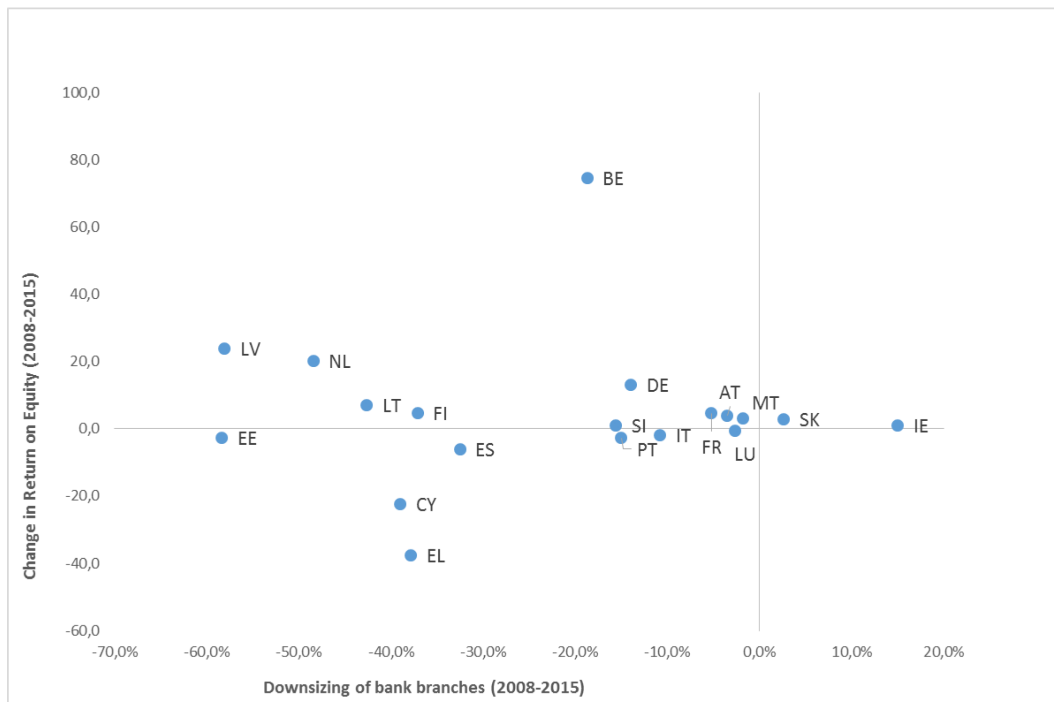
Figure 3, comparing the branch network reductions from 2008 until 2015 with the improvements of a cost efficiency indicator (Cost-to-Income ratio/CIR) achieved over the same period, and figure 4, comparing the branch network reductions with the improvements of the overall profitability (Return-on-Equity ratio/ROE), illustrate that the causal relationship between restructuring efforts and efficiency gains eludes a simplistic interpretation.

Figure 3: Branch network rationalisation vs. improvement of the Cost-to-Income ratio



Source: "[ECB Structural Indicators 2017](#)", "[ECB Structural Indicators 2011](#)", "[ECB Supervisory and prudential statistics](#)", own calculations

Figure 4: Branch network rationalisation vs. improvement of the RoE ratio



Source: "[ECB Structural Indicators 2017](#)", "[ECB Structural Indicators 2011](#)", "[ECB Supervisory and prudential statistics](#)", own calculations

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