

G.E.B.

Groupement Européen de Banques



EU Position Paper

June 2017

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1. Executive summary:

basing our discussion mainly on ECB consolidated data for 2015 and institutional publications, we suggest that the current regulation and the extraordinary monetary policy could be implicitly incentivizing larger banks to expand into the retail market to gain higher interest income, at the expenses of smaller banks.

The current consolidation of smaller banks could thus be a consequence of the lower profitability induced by these policies and the related disproportionately higher compliance costs, not by their inability to adapt the cost structures to the new environment.

In this context of low profitability, it appears irrational for smaller players to maintain discretionary capital buffers renouncing to optimal capital allocation, unless a strong uncertainty, for instance in future regulatory and supervisory capital requirements, is considered.

2. General Proposals:

We, at GEB, strongly believe that smaller banks, with their usual devotion to excellence and outperformance, are beneficial to the diversification of the financial sector and to its stability. Concentration in the industry should thus happen as a consequence of purely economic factors and should not be driven by the unlevelled playing field created by discretionary policies and regulation biases.

A stronger implementation of the proportionality principle, a stricter monitoring of the competitive practices implemented by larger banks and a “dimensional” check on the effects of regulation and economic policies in the EU would eventually allow a sounder financial environment in the area.

About GEB

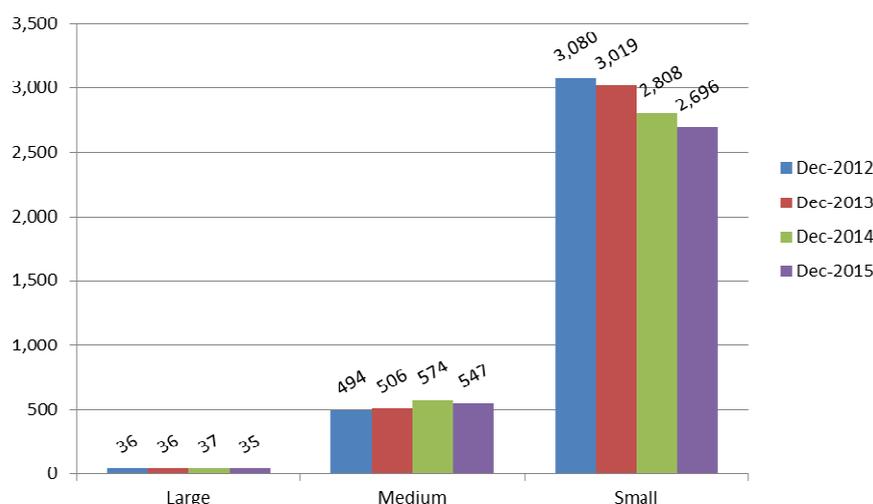
The Groupement Européen des Banques (GEB E.E.I.G.) is a European Economic Interest Grouping. It was founded in 1981 as an association of financial institutions from 8 European Countries. GEB is a not for profit organisation and focuses on exchanging information on the financial and banking situation of the countries represented. Observing different markets and studying trends helps the members adapt to an ever-changing financial environment, improve competitiveness and develop customer care. In brief, acquiring knowledge leads to improvements in existing and new services.

More information at: www.gebanks.com.

3. Consolidation in the banking sector

According to ECB consolidated data, the number of credit institutions headquartered in the EU continued to decrease in 2015 from 3,419 to 3,278. Decreases are almost entirely attributable to smaller institutions (part of which were probably merged in medium institutions or taken over by large institutions).

Number of credit institutions headquartered in the EU



Source: ECB Consolidated Data

EU Council Regulation 1024/2013 of 15 October 2013, conferring tasks of prudential supervision on the ECB, states in art.1 that: “When carrying out the tasks conferred on it, and without prejudice to the objective to ensure the safety and soundness of credit institutions, the ECB should have full regard to the diversity of credit institutions and their size and business models, as well as the systemic benefits of diversity in the banking industry of the Union.”

We, at GEB, strongly believe that a diversified banking sector is necessary to maintain financial stability; it mirrors the variety of financing needs expressed by its customers and allows stronger competition; on the contrary, the highest concentrations on a virtually singular business model for all European banks would only enhance systemic risks. Moreover larger, cross-border banks have played a key role in the recent global financial crisis and should not be considered as exemplary models for stability.

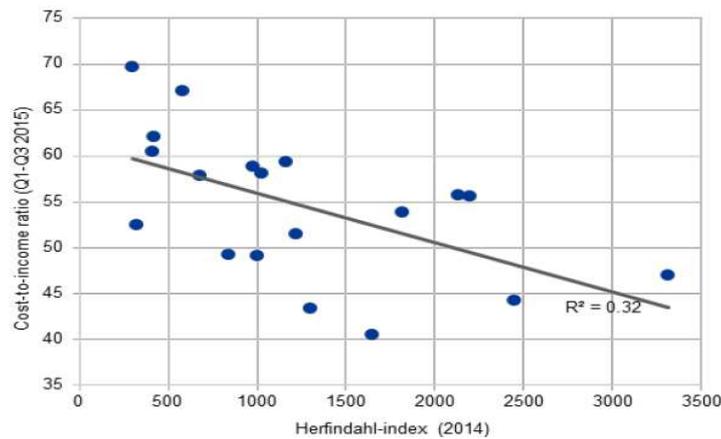
Nevertheless, an higher concentration in EU bank industry is often said to be beneficial to efficiency and to profitability, the latter being currently considered as the main issue for the sector¹. Vitor Constancio, ECB Vice President², has

¹See for instance: “ECB Banking Supervision: SSM supervisory priorities 2017” and the Introductory statement by Danièle Nouy before the European Parliament’s Committee on Economic and Monetary Affairs (ECON) on 9 November 2016

²Challenges for the European banking industry”, Vitor Constancio, University of Navarra 7 July 2016. https://www.ecb.europa.eu/press/key/date/2016/html/sp160707_1.en.html

recently affirmed that “...there are signs that overcapacity in some banking sectors could hinder the recovery of profitability also given still subdued demand for loans. In fact, there is some empirical evidence that EU banks operating in less concentrated markets tended to be less profitable in the period between 1991 and 2013.” (graph below).

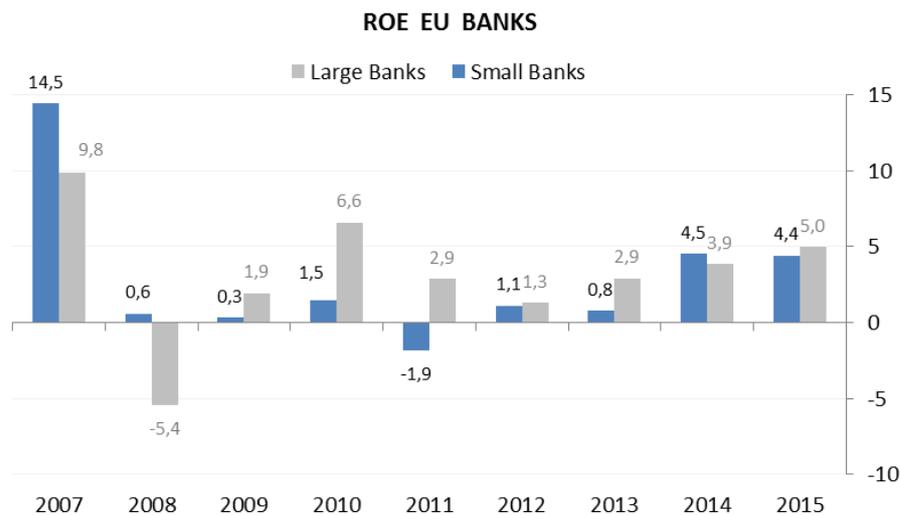
Market concentration and efficiency ratio in euro area countries
 x-axis: Herfindahl index; y-axis: cost-to-income ratio



Source: ECB

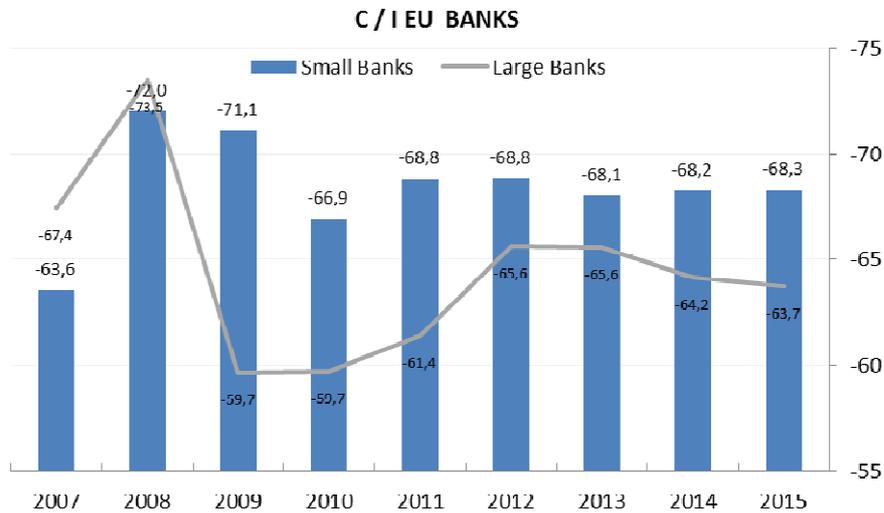
4. Small banks’ profitability as a driver of consolidation

Do smaller banks need consolidation? Are they less profitable and less efficient than larger players? Although profitability in smaller banks was relatively more resilient during the 2008 financial crisis, it has since recovered very slowly, turning even negative in 2011 and usually remaining below the levels of the largest banks (see the graph below).



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

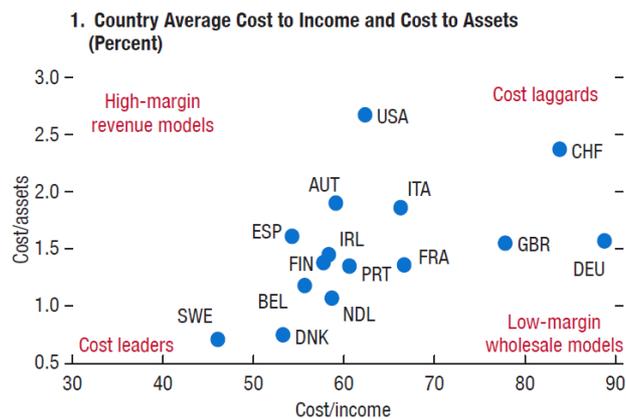
ECB data reveal that smaller banks have been characterized by higher cost to income ratios compared to larger players, which is commonly considered as a signal of lower efficiency and an argument to call for consolidation of these players.



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

As recalled by the IMF³ in its comparison of efficiency in bank systems across several countries, the first element to be considered when dealing with cost structures in banks is the diversity in business models: banks in countries like US despite heavy cost structures (on assets) score average in cost / income ratios because of high margin /revenue models while other systems like the German one have average cost structures but high Cost to income due to low margins models.

Appropriate cost structures vary by business model.



Source: IMF

³ Global Financial Stability Report, Oct 2016

Are smaller banks characterised by a peculiar business model? A comprehensive study by BIS in 2011 indicated that smaller banks are usually characterized by a high deposits/asset base and a higher share of income from commercial interest margins⁴, paired with lower reliance on securitization which, as a whole, identifies a more traditional and retail-oriented business model compared to larger institutions.

TableA1: Correlation matrix ^a

	ain(Loans)	LIQ	SIZE	SEC	EDF	Tier1	NII	DEP	STF	div	NSPM	SUP	RESCUE	C	REG
ain(Loans)	1.000														
LIQ	-0.020 0.000	1.000													
SIZE	0.004 0.387	0.140 0.000	1.000												
SEC	0.003 0.562	0.036 0.000	0.103 0.000	1.000											
EDF	-0.068 0.000	-0.024 0.000	-0.083 0.000	-0.005 0.400	1.000										
TIER1	0.057 0.000	0.190 0.000	-0.240 0.000	0.003 0.634	-0.009 0.000	1.000									
NII	-0.031 0.000	0.155 0.000	0.075 0.000	0.009 0.096	-0.015 0.016	0.036 0.000	1.000								
DEP	0.024 0.000	-0.205 0.000	-0.569 0.000	-0.019 0.000	0.074 0.000	0.263 0.000	-0.214 0.000	1.000							
STF	0.015 0.003	0.235 0.000	0.438 0.000	0.090 0.000	-0.055 0.000	-0.140 0.000	0.138 0.000	-0.754 0.000	1.000						
div	0.065 0.000	0.023 0.000	-0.004 0.477	0.006 0.165	-0.106 0.000	0.021 0.000	0.005 0.292	-0.008 0.129	0.020 0.000	1.000					
NSPM	-0.022 0.000	0.050 0.000	0.009 0.054	0.008 0.099	0.128 0.000	-0.015 0.005	-0.012 0.016	-0.018 0.000	0.000 0.986	-0.177 0.000	1.000				
SUP	0.007 0.146	-0.006 0.249	0.131 0.000	0.028 0.000	0.000 0.990	-0.031 0.000	-0.025 0.954	-0.073 0.681	0.036 0.726	-0.004 0.000	-0.010 0.000	1.000			
RESCUE	-0.035 0.000	-0.026 0.000	0.080 0.000	-0.003 0.554	0.144 0.000	-0.002 0.954	-0.002 0.681	-0.002 0.726	-0.019 0.000	-0.076 0.000	0.174 0.000	0.027 0.000	1.000		
C	-0.096 0.000	-0.054 0.000	0.030 0.000	-0.006 0.175	0.281 0.000	-0.035 0.000	-0.019 0.000	-0.037 0.000	-0.023 0.000	-0.350 0.000	0.317 0.000	0.000 0.944	0.266 0.000	1.000	
REG	0.021 0.000	-0.206 0.000	-0.364 0.000	-0.011 0.013	0.067 0.000	0.148 0.000	-0.138 0.000	0.510 0.000	-0.345 0.000	-0.067 0.000	-0.018 0.000	-0.200 0.000	0.006 0.215	-0.052 0.000	1.000

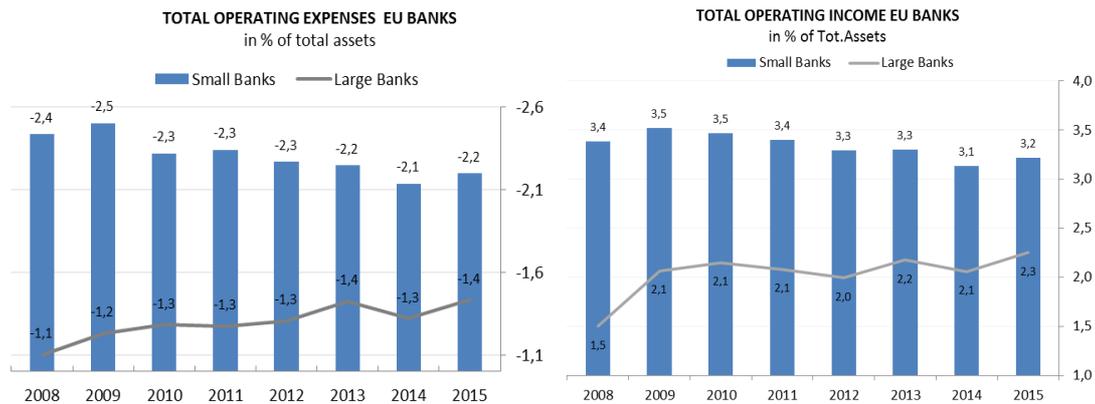
^a The sample period goes from 1999:Q1 to 2009:Q4. P-values in italics.

Source: L.Gambacorta and D.Marques-Ibanez in BIS Working Paper N345; see note for details.

5. Operating expenses perspective

ECB consolidated data shows us that small banks have higher total operating expenses than large banks; in contrast with the view of a system resisting to adapt its costs to structurally lower revenues, smaller banks have actually reduced their operational cost base in the aftermath of the crisis, even more than larger banks, despite the disproportionately higher compliance costs (largely fixed) created by the increased regulation lacking proportionality. But at the same time, smaller banks had to face a progressive decrease in revenue generation after 2010 while larger institutions have experienced a progress in their sales.

⁴ L.Gambacorta and D.Marques-Ibanez in BIS Working Paper N345, may 2011, The very comprehensive study (1008 banks, 10 years-quarterly time series), shows that the SIZE variable (total asset) is significantly inversely related to the deposit/asset ratio (DEP) and positively related to short term funding (STF) and Non-Interest Income (NII). Thus traditional deposit-based commercial banking is more often associated with small bank dimensions.



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

As far as expenses are concerned, *proportionality* in regulation is a key element for smaller banks⁵: compliance costs to cope with new rules and evolving supervision have increased exponentially over recent years and nowadays they contribute for a large slice in their profit and loss accounts. Although small banks persistently control operational costs, they continuously have to deal with strong growth in “regulatory” costs which, largely lacking proportionality and thus being invariant to scale, result to be much higher than for large banks.

A first official acknowledgement of this is given by EBA in its opinion about proportionality in application of the remuneration principles in Directive 2013/36, released in December 2015: “...both effects lead to a situation where [in complying with the Directive] the administrative costs per staff member and the total costs relative to the total administrative costs *are higher in small institutions than in large institutions, creating a competitive disadvantage*”⁶.

In some business areas these costs make it economically impossible for small banks to continue operational activities. More proportionality doesn't necessarily undermine the coherence of the regulatory framework. We do appreciate the increased attention for proportionality but the principle is still weakly interpreted in new regulation, damaging smaller banks; moreover the whole legacy regulation usually doesn't even consider proportionality at all.

Examples of a lack in proportionality reported by our members are:

1. High reporting frequency and volume: perhaps quarterly or half yearly reporting, as opposed to monthly, and lower amount of details would reduce the reporting burden, although we understand that the regulator may not be able to consolidate summary data.
2. Over complex lending regulation. Prescriptive documentation. Over legalistic documentation is usually bad for customers (they do not want to read lengthy legal documents) and creates the wrong impression; banks

⁵ https://www.gebanks.com/gb/auth/doc/2015_06_GEB_PP_proportionality.pdf

⁶ Opinion of the European Banking Authority on the application of the principle of proportionality to the remuneration provisions in Directive 2013/36/EU
<https://www.eba.europa.eu/documents/10180/983359/EBA-Op-2015-25+Opinion+on+the+Application+of+Proportionality.pdf>

- would be happy to take responsibility for their own documentation being clear and not misleading.
3. Rigidity over complaint handling and reporting. The rules are designed for mass market and not all banks' customers are interested in the bureaucratic approach dictated by regulation.
 4. Capital to assets equalization with larger banks. This is well known and understood. Some adjustment is needed given the wide discrepancy of IRB banks to standardized ones.

6. Income perspective

The low profitability of smaller banks, as seen, seems more related to the decrease in revenues they have experienced than to higher operating costs. As will be cleared in the following, this is in turn due, once more, to their peculiar business model.

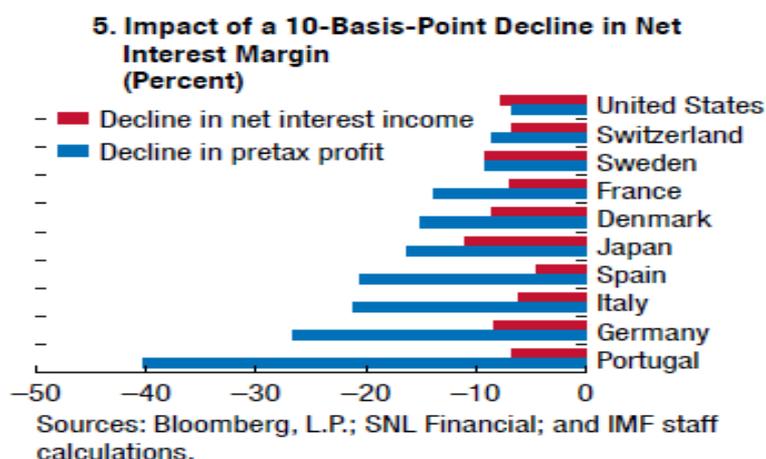
According to the GFSR published by IMF in april 2016, the banks most affected by a decrease in interest rates are those having:

- more short term deposits and less market funding (debt securities, having higher starting rates, benefit more from a lowering rates environment than sight deposits whose rates are already low and bounded by zero)
- more assets indexed to interest rates (typically commercial loans) and less fixed income assets (typically trading securities)
- more dependence on net interest income and less diversified income sources

This profile closely resembles to the business model of smaller banks outlined above which ends to be the most exposed to the decline of interest rates determined by extraordinary monetary policy measures.

The Italian and the German banking systems, among the least concentrated in EU, were forecast to be the most hit, preceded by the Portuguese system (following graph).

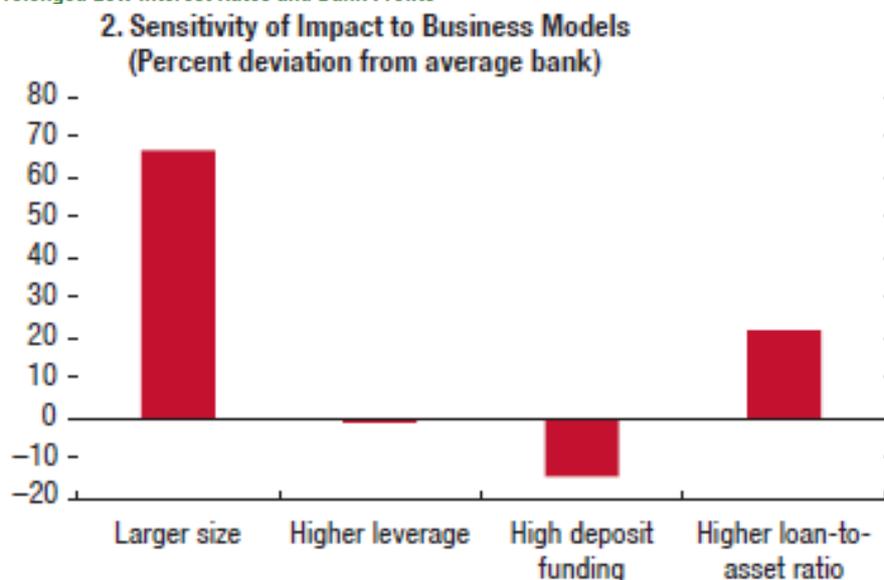
Declining net interest margins will hit profits of European banks more strongly.



Source: IMF

The International Monetary Fund provides further evidence of this in its latest Global Financial Stability Report published in april 2017⁷: as reported in the summary: “Chapter 2 analyzes the potential long-term impact of a scenario of sustained low growth and low real and nominal rates for the business models of banks,(...). It finds that yield curves would likely flatten, lowering bank earnings—particularly of smaller, deposit-funded, and less diversified institutions— (...). If bank deposit rates cannot drop (significantly) below zero, bank profits would be squeezed even further. *Smaller, deposit-funded, and less diversified banks would be hurt most.*“. The IMF later on adds: “Banks that are smaller, rely more on deposit funding, and have fewer lending opportunities tend to experience a significantly bigger dent in their profits. For example, a one-standard-deviation increase in the size of a bank’s balance sheet significantly tempers the damage from prolonged low interest rates by raising bank profits an estimated 67 percent relative to the sample average for such periods. By contrast, a one-standard-deviation increase in the share of deposit funding and in the share of loans in the asset portfolio are associated, respectively, with estimated bank returns lower by 14 percent and higher by 22 percent than the sample average for such periods. Clustering the banks by business model confirms these results. *Large, internationally more diversified, wholesale-funded banks tend to outperform other types of banks when interest rates are low for a long time.* Their estimated average profit is 2.2 percentage points higher than that of deposit-funded domestic banks with small lending portfolios, which have the lowest estimated average profits during such episodes”.

Figure 2.6. Prolonged Low Interest Rates and Bank Profits



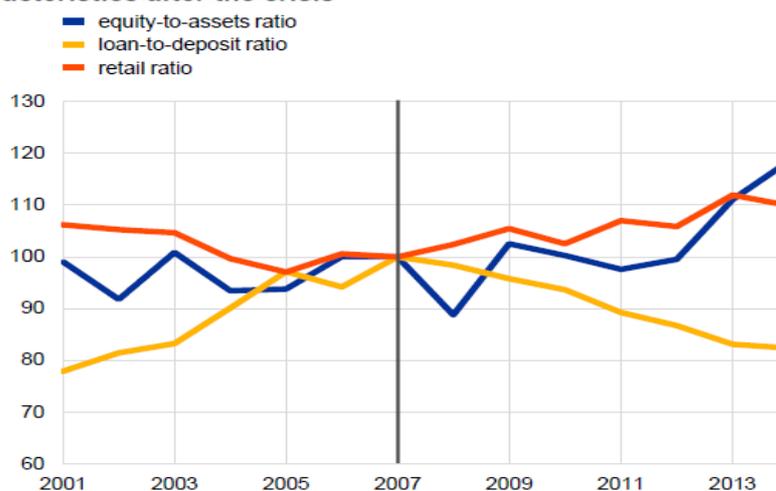
Source: IMF

⁷ <https://www.imf.org/en/Publications/GFSR/Issues/2017/03/30/global-financial-stability-report-april-2017>

7. Increased unfair competition in local retail markets

Presumably related with this scenario, an increased competitive pressure has been mounting in the retail business in recent years: ECB data⁸ (graph below) suggest that after 2011 many large banks in Europe have re-oriented their business towards the local retail market because of stricter regulation on other business and incentives to increase the weight of deposits in funding structures, a path which the IMF itself considers as a way to regain profitability⁹.

Changes in EU significant banking groups' key business model characteristics after the crisis

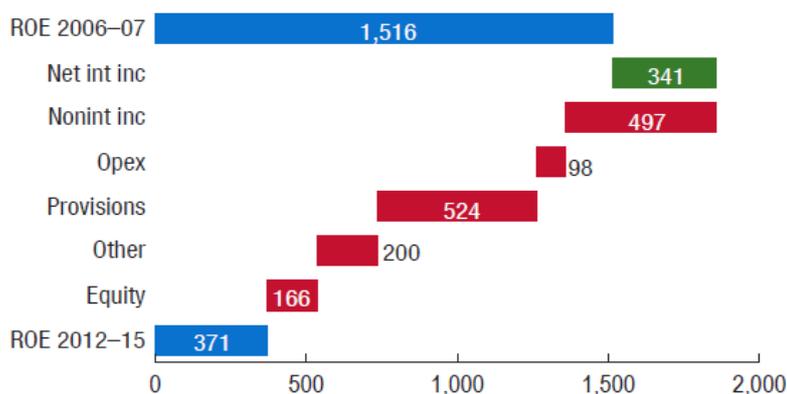


Source: ECB FSR 5/2016

Another evidence of this can be found in the profitability analysis performed by IMF on large European banks (graph below).

European bank profitability has deteriorated, driven by falling noninterest income and rising provisions.

2. Developed European Banks



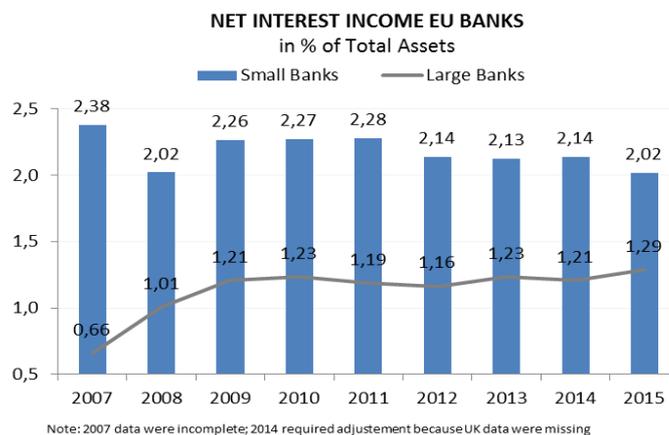
Source: IMF

⁸ The Retail Ratio is the ratio of aggregate deposit and loans on total assets; it is considered as a proxy of how much retail oriented is a business

⁹ IMF, GFSR 10 2016

IMF finds that the decrease in profitability of larger players since 2007 is mainly determined by higher provisions and lower Non Interest Income; not surprisingly, then, the net interest income contributed positively, adding 3.4% to the ROE in the period.

This is confirmed by ECB data (below): large banks have seen their Net Interest Income increase by 11% in the years from 2012 to 2015, while smaller banks had a decreasing path in Net Interest Income.



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

It can be thus inferred that the current environment has allowed huge savings in funding costs by those institutions, mainly the largest ones, moving their business to a more retail-oriented one, at the expenses of the existing players; *in other words, large wholesale banks had the opportunity to leverage on these savings to challenge the business models of smaller banks.*

A research paper commissioned by the Greens / EFA group in the EU Parliament¹⁰, synthesizing eight different academic and institutional papers, estimates in 89 basis points the *implicit* subsidies in terms of lower cost of funding received on average by EU banks during the period 2007-2012; the author points out that "...In addition several studies show an important size effect, i.e. large financial institutions benefit significantly more from implicit subsidies than small or medium sized institutions". This competitive advantage attributed to larger banks is consistent with the ECB data on the net interest income above and with our perception of what happens on the credit market.

On top of the implicit subsidies, the study cited above adds 634,1 bln Euros of *explicit* state aid in the period using EU Commission data (the updated figure, as of end 2014, is 746,8 bln¹¹) which are then netted by a mere 125 bln in revenues (the updated figure is 118,8 bln, net of guarantees called); once more, these state aids were in large part used to avoid the failure of those big players that are now squeezing out the smallest ones.

¹⁰ Implicit subsidies in the EU banking sector. A.Gloeck, The Greens/EFA. December 2013.

¹¹ http://ec.europa.eu/competition/state_aid/scoreboard/financial_economic_crisis_aid_en.html

Moreover, as we at GEB had pointed out in the past¹² and has been outlined by several institutional analyses, the largest banks still benefit from a regulatory advantage on the capital absorption through the A-IRB models on credit risk: these models typically require important fixed investments and huge data sets on loans which are usually out of scale for smaller banking players. The latest analysis by BCBS on RWA consistency across the world¹³ shows that the average risk weights “measured” by A-IRB models to corporate and retail exposures is:

Average risk weights (RWA/EAD) for corporate and retail portfolios

Table 1

	Number of banks	In per cent						
		Mean	Median	Minimum	25th Percentile	75th Percentile	Maximum	Range
IRB	30	29.4	28.7	12.5	25.7	33.4	52.6	40.1
Corporate	30	46.2	47.6	25.1	39.0	53.9	62.5	37.3
Large Corporate	20	44.8	46.5	25.1	38.2	49.6	61.0	35.9
SME Corporate	14	60.9	59.8	46.2	50.8	63.8	91.2	45.0
Retail	30	25.4	21.0	8.9	17.8	30.3	59.9	51.0
Mortgages	29	24.1	16.9	5.2	14.1	30.7	80.1	75.0
SME Retail	17	47.5	46.8	23.4	38.2	54.2	90.8	67.4
QRRE	25	34.5	33.2	11.2	23.1	39.8	82.5	71.3

Average risk weights calculated by dividing RWA for each asset class by the unweighted exposure of that asset class.

Data as at year-end 2013, collected by the BCBS's Capital Monitoring Group (CMG). Annex 1 shows resulting portfolio distributions based on the data submissions for this study of Retail/SME exposures.

Source: BCBS

So comparing the median risk weights used by the banks in the BIS sample with those in the standard method, an ample difference emerges, especially considering the importance of the credit business for smaller and traditional players.

	IRB	STANDARD
Corporate	47,6%	100%*
Retail	21,0%	75%
Mortgages	16,9%	35/50**%
SME retail	46,8%	75%/57%***

*The use of ECAI allows a reduction of these weights for the exposures with highest ratings; typically for a GEB member bank the total figure remains anyway in the 80-90% range. **The 35% weight is assigned to mortgages secured by residential collateral while 50% is for commercial collateral. Typically, for a GEB member bank, the total figure remains in the 35-40% range. ***The SME supporting factor, amounting to 0,7619, allows a reduction of the figure depending on the number of exposures qualifying for it. For a typical GEB member bank, the figure is 60-65%

8. The capital ratios puzzle

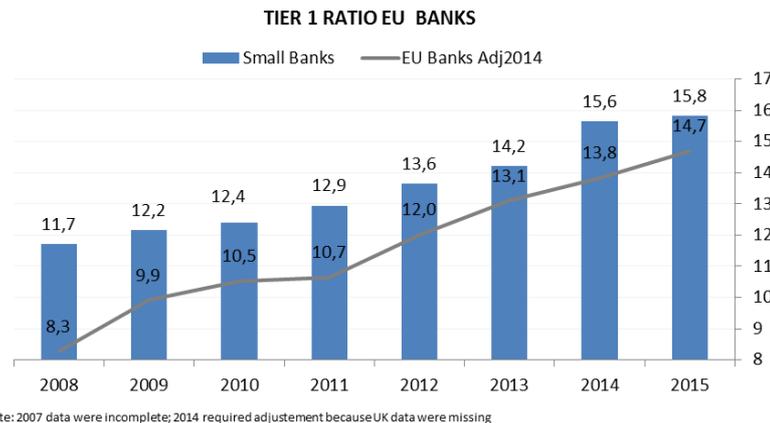
ECB consolidated data suggest that small banks have, on average at the end of 2015, Tier1 ratios around 15,8%, compared with an average 14,7% in the whole

¹² https://www.gebanks.com/gb/auth/doc/2011_07_GEB_EU_PP.pdf

¹³ Regulatory consistency assessment programme (RCAP) – Analysis of risk- weighted assets for credit risk in the banking book, Basel Committee on Banking Supervision, April 2016

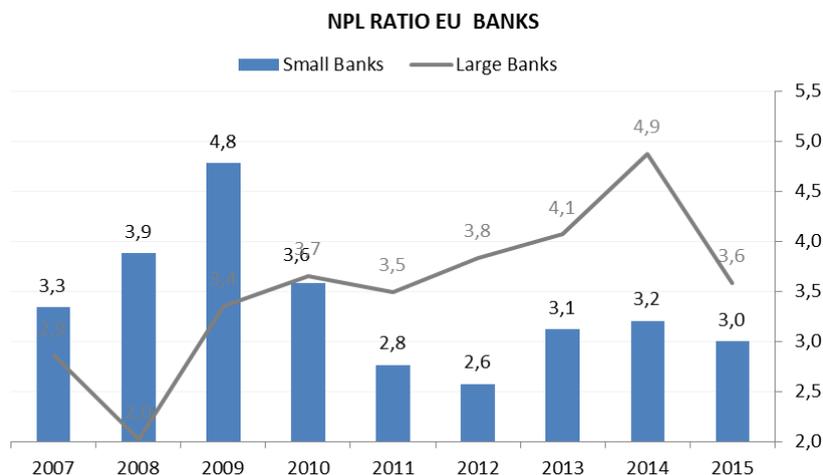
system (the largest banks data have some discontinuities but it is historically close to the total average).

Even if the distance between dimensional classes has decreased over time, how it comes that small banks still preserve higher capital ratios compared to larger ones which are asked by regulators to have higher requirements (being G-SIBs and D-SIBs)? Why are small banks still preferring capitalization to higher returns on equity¹⁴ in a period of historically low profitability and high risk premium?



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

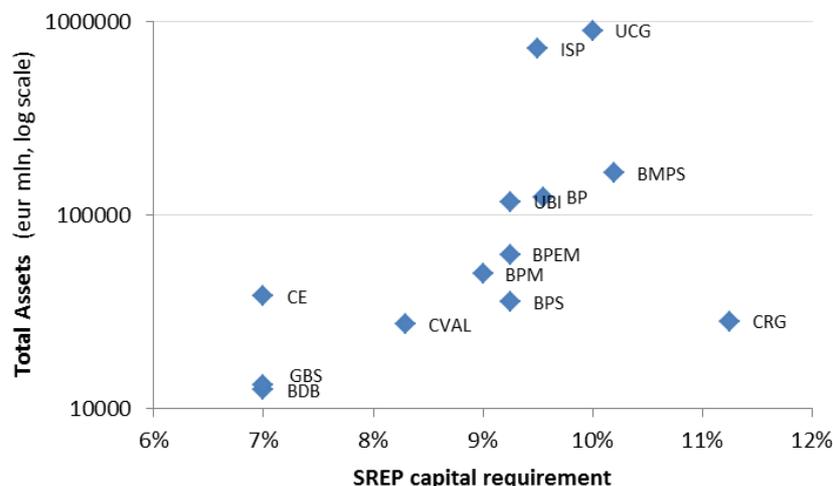
Considering that these ratios of small banks don't receive, as said above, the large benefits on RWA denominators deriving from the use of internal models on credit risk, the difference with large banks is even more surprising. Moreover, these capital levels appear inconsistent with the lower riskiness of smaller banks which is, for instance, reflected in lower levels of NPL/Loans ratios (graph below).



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

¹⁴ More equity capital expands the denominator of the ROE ratio: as shown, in large EU banks this effect is estimated by the IMF (GFSR 10 2016) to be trivial compared to others (mainly revenue decrease and provisions increase): around 14,5% (166 basis points on a total decrease by 11%).

The relatively low riskiness of smaller banks is also supported by arguably lower second pillar requirements, as SREP results for Italy seem to point out¹⁵ (second pillar requirements are still confidential in many countries).



Source: ECB Consolidated Data, BSH Studi ed Analisi Finanziaria

So, what could explain this overcapitalization in smaller banks?

In financial theory¹⁶ it is commonly believed that any firm should build up more capital than currently required if it is anticipating uncertainties and/or extra costs in issuing new equity at short notice, which is the case when risk premia on the sector are unusually high.

Reasonable sources of uncertainty for European banks are, for example:

-the evolution of regulatory requirements: despite several reassuring messages given by most authorities, new rules (TLAC-MREL, IFRS9, stress tests...) will probably increase capital needs in future years and their impact nowadays can just be broadly estimated; smaller banks, having usually a lower control over the regulation flow could be less able to estimate correctly future capital needs, suffering an higher uncertainty.

-structural changes in broader economy: the undergoing “digital revolution” will likely lead to the creation of new businesses and the disappearance of others, creating uncertainty on the asset side of the bank balance sheet (loans, securities, long term investments and fixed assets) and on the banking business itself: some banks could anticipate they will need huge investments in the future to keep up with first movers, but decide to hold capital while awaiting for a market standard to emerge before investing on it.

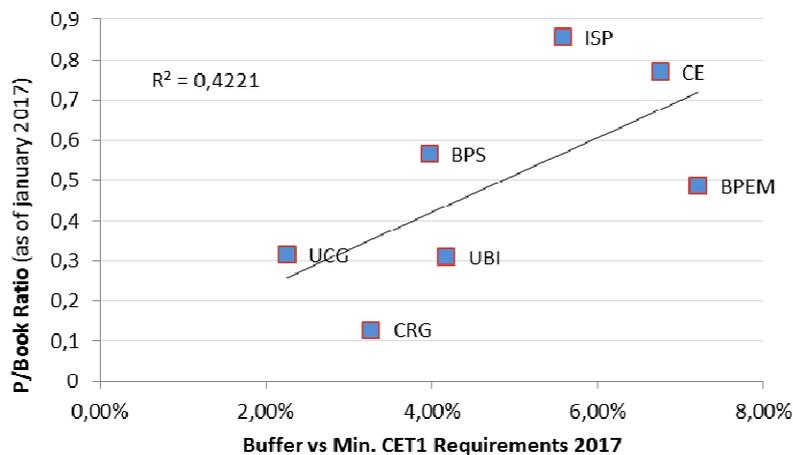
¹⁵ The graph plots the relation between bank dimensions (measured by total assets) and regulatory capital requirements after SREP analysis that Italian listed banks have reported to the market. The relation appears to be stronger when outliers are excluded.

¹⁶ See for instance S.C.Myers and N.Majluf, “Corporate financing and investment decision when firms have informations that investors do not have”, Journal of Financial Economics, 1984: according to the “pecking order theory” a share issue signals to the market that the management has information about weak perspectives for the company, otherwise it would prefer internal cash flows or debt issuance: the announcement of a share issue in this conditions would decrease sharply the market value of equity.

-anticipation of weaker results: especially for retail-oriented banks, the extra pressure on revenues outlined above could have led the management to anticipate weak future results which could make it difficult to raise money on the market.

Among the most relevant theories on bank capital structure are probably the *regulation* argument and the *buffer* argument. According to the first one, capital regulation is an overriding departure for banks from the Modigliani-Miller theorem depending on incorrectly priced deposit insurance schemes which incentives banks to maximize leverage up to the regulatory minimum (requirements are thus necessary to limit the moral hazard based on having an external guarantee on own deposits): so the optimal capital level coincides with the regulatory minimum; smaller banks, in this perspective, at least before the new regulation addressing the bias, should have added a discretionary buffer to compensate for the “too big to fail” issue. As claimed by the second argument, instead, banks with a good market reputation are expected to face lower costs of issuing fresh equity at short notice and are thus supposed to maintain lower prudential buffers, signaling soundness to the market in this way.

Unfortunately, none of the arguments above has found ample support in recent research¹⁷ and the presence of large voluntary buffers in the industry, not seldom on well-regarded banks, appears in contradiction with these theories (see for instance the few data below referred to Italian listed companies).



Source: company data, Bloomberg, BSH Studi ed Analisi Finanziaria

It seems, at least in Italy, that even the best regarded banks on the market have piled up abundant discretionary capital buffers, deviating from the theoretical optimal structure and possibly reversing the direction in causality: large buffers seem enough to signal “soundness” to the market.

Maybe in an asymmetric information framework, with a new regulation which is declaredly making all ailing banks defaultable, even the largest ones, capital has

¹⁷ See for instance R.Gropp and F.Heider, “The determinants of bank capital structure”, 2009, ECB Working paper series.

become a key competitive factor to signal soundness and a lower probability of missing regulatory targets which are themselves uncertain. Capital can thus attract customers and shareholders, disregarding, at least temporarily, efficiency and value in capital allocation. Under this hypothesis of limited information, smaller banks, usually less known to the market and less conscious by themselves of the outcome in the regulation process, could have larger discretionality and higher signaling needs compared to large banks; this would justify the persistence of higher capital levels despite the changes to the “too big to fail” bias.

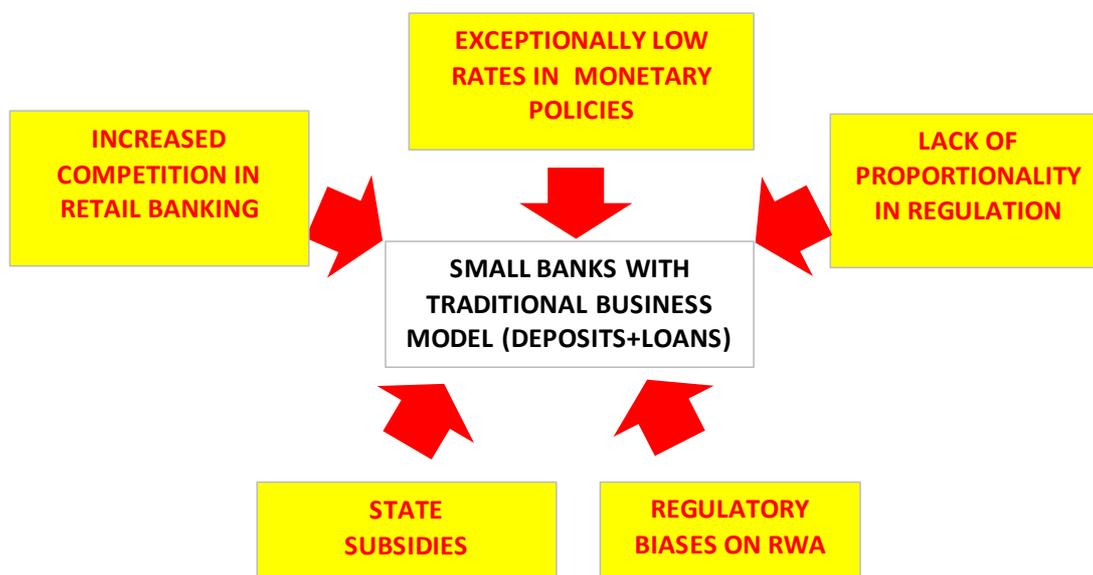
More data on SREP requirements could help the research to test these hypothesis and allow a progress in studies on capital structure in banking.

Conclusions:

Consolidation is already happening in the EU banking sector, mainly involving smaller players.

Even if the process is usually said to benefit profitability through gains in efficiency, it seems that the low profitability of smaller banks is due to a revenue decrease and cost increases which are more likely attributable to competitive biases hurting the profitability of smaller and retail banks; these biases are mainly induced by regulation and non-standard monetary policies.

Graph: the policy-induced challenges against smaller banks



In this context, the capital structure of smaller banks is even more puzzling: in this field there is no evidence of a reversal in the “too big to fail” bias and small banks still hold higher capital ratios, further depressing their profitability.