June 2005

Position paper by the Association of German Banks on obstacles to cross-border mergers and acquisitions in the EU banking sector

1. Introduction

In autumn 2004, the European Council of Economics and Finance Ministers (Ecofin) asked the European Commission to draw up a report by autumn 2005 about possible obstacles to cross-border mergers and acquisitions in the banking sector. The Commission subsequently launched a consultation on the issue and has solicited comments from market participants and industry associations by 15 June. The background to this initiative is the realisation that, in regard to consolidation, the European banking industry is not performing as well as other sectors in the European Union or as the US banking industry. While the focus was initially on individual aspects like Article 16 of the Codified Banking Directive (ban on the acquisition of participations) or deposit protection, all possible obstacles to cross-border mergers and acquisitions are now to be considered. This paper therefore also focuses on a wide spectrum of possible obstacles and evaluates their importance.

2. Executive summary

Although the European Commission's work focuses on the issue of mergers and acquisitions, it should nevertheless be seen in the context of the creation of an integrated internal market for financial services in the European Union. It marks an important step in a process which has been underway for many years. Among the most important milestones to date have been the introduction of the common currency and the Financial Services Action Plan (FSAP). The Commission's consultation is a welcome continuation along this path. The European single market for financial services will be able to promote prosperity only when it becomes possible to provide such services across borders on a large scale and whenever it would be economically beneficial to do so. The acquisition (takeover) of, or merger with, a foreign financial institution are merely two, albeit very important, means for a bank to expand business beyond the borders of its own country. There is a wide spectrum of possibilities at the bank's disposal, which differ in their degree of intensity:

- direct foreign sales by post, telephone or the Internet;
- establishment of legally dependent branches;
- establishment of a legally independent foreign subsidiary;

- (partial) acquisition of a foreign bank;
- merger with a foreign bank.

Mergers and acquisitions are not ends in themselves. Nor, in consequence, can promoting and facilitating mergers and acquisitions be considered a political objective in itself. The decisive point is the potential benefit for bank customers and consumers. From the customers' perspective, mergers or acquisitions offer two possible advantages. Economies of scale and economies of scope enable retail and corporate customers to be supplied more efficiently and with a wider range of banking services than would be the case by smaller and/or regional financial services providers only.

Another key point concerning mergers is the question of in which country to locate the headquarters of a merged entity. This will have an effect on the number and kind of (in particular highly-qualified) jobs in the financial sector and the quality of the provision of the real economy with financial services.

The number of legal obstacles to mergers and acquisitions in the narrow sense is comparatively small; their significance can be extremely serious, however. They include the possibility of blocking (foreign) participations (Article 16 of the Codified Banking Directive), the legally prescribed public ownership of large sections of the banking industry in certain member states and the lack of a company-law mergers directive.

Indirect obstacles are much more numerous. These are normally caused by certain rules and regulations which, while not directly standing in the way of mergers and acquisitions, nevertheless often make them unprofitable and thus result in them never even getting onto the drawing board. In these cases, possible legal obstacles will only become relevant when the circumstances making a merger or acquisition economically unattractive have been eliminated. In particular, the fact that much EU legislation is based on the concept of minimum harmonisation and that the country of origin principle does not always apply, especially where the economic activity of citizens and consumers is concerned, often makes mergers and acquisitions an unattractive proposition. Such transactions thus often fail to take place even though, in a truly integrated single market for financial services, they would most certainly be profitable and increase prosperity.

Finally, there is a third category of obstacles which are neither of a legal nor of an economic nature in the strict sense of the term (e.g. language and cultural differences). These factors are unlikely to change in response to political measures, however.

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3. Concrete obstacles and possible ways of eliminating them

Below, a number of obstacles are identified and proposals are put forward for overcoming them.

3.1 Banking legislation

3.1.1 Bar on the acquisition of qualified participations under Article 16 of the Codified Banking Directive

Article 16 of the Codified Banking Directive (2000/12/EC) requires natural and legal persons to advise the competent authorities of any plans to acquire a qualified holding in a credit institution (normally defined as 10%), exceed a participation threshold of 20, 33 or 50%, or turn the institution into a subsidiary. The competent authorities then have a period of three months to oppose such a plan if they are not convinced of the suitability of the person involved to ensure sound and prudent management of the bank. The objective of Article 16 is to safeguard the integrity and stability of the financial system. Since the possibility cannot be excluded, however, that it may also be used for protectionist purposes in a cross-border context, the European Commission has put forward proposals for a possible modification of the Article.[1]

In principle, it is to be welcomed that Article 16 will be scrutinised for possible abuse. It should be borne in mind, however, that there is very little, and mostly only anecdotal, evidence of its application for protectionist purposes. The number of banks under foreign ownership in Germany proves that the German supervisory authorities have raised no artificial barriers to market access. Even if consolidation in the European banking sector lags behind that in other industries, Germany's private banks are unanimous in their view that Article 16 cannot be considered a major – let alone *the* major – explanation.

On the other hand, it must be remembered that Article 16 plays a key role in safeguarding the integrity of the financial system. Any amendments should therefore be considered and examined very carefully in advance to avoid lowering (undesirably) the level of protection from unsuitable owners without promoting the desired consolidation in the banking industry in any meaningful way.

[1] Cf. *Cross-border mergers and acquisitions in the banking sector: follow-up to Scheveningen informal ECOFIN*, paper by the Banking Advisory Committee (MARKT/1072/04).

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The Commission has put forward five concrete proposals for amending Article 16. Any explicit specification of the criteria which apply when reviewing qualifying shareholdings should be consistent with national law and bear in mind that a blanket clause is often better able to take account of the diverse nature of potential circumstances than are highly detailed rules. In any event, it might make good sense to add a provision to Article 16 explicitly stipulating that it serves prudential purposes only and may not be applied for national considerations or focus on the country of origin of the acquirer.

Revising thresholds and time limits is highly unlikely to yield positive results. Thresholds of 10 or 20% play no role in mergers or takeovers, where the aim is to build up a majority holding, yet they are most certainly important when it comes to safeguarding the integrity of the financial system (e.g. preventing money laundering). And before shortening the period for lodging an objection, a careful look should be taken at whether sufficient time would then remain for a thorough review of a potential acquirer's suitability (especially if located outside the EU) and at whether arbitrary exploitation of the period by supervisors merely delays and complicates mergers and acquisitions or can really prevent them.

The concept of mutual recognition of decisions taken by competent authorities (an investor meeting no objections in one country would be allowed to acquire holdings in other member states without being subject to an investigation) must be criticised in that it fails to consider that investors are not suitable (or unsuitable) owners *per se* or under all circumstances. This proposal could undermine the objective of ensuring sound and prudent management. Depending on the size, business strategy and regional market focus of the bank concerned, a natural or legal person (e.g. another bank) may be a perfectly suitable potential owner in one case, yet totally unsuitable in another. What is more, suitability to become an owner can change over time (also for the worse), so any mutual recognition should be subject to a time limit. The idea of creating a database of "qualified shareholders", on the other hand, is to be welcomed. This could significantly speed up the review process and relieve affected banks of the need to duplicate work.

The addition of transparency provisions would also be extremely welcome. This would be in line with the principle of supervisory disclosure currently envisaged in the directive implementing Basel II in the EU. Requiring competent authorities to provide the shareholder concerned with detailed reasons for a negative decision would most certainly have a positive effect. A requirement to make public the reasoning behind *individual* refusals, on the other hand, would usually – as pointed out by the BAC itself – damage the interests of potential acquirers. This could be counterproductive and even undermine the promotion of consolidation in the banking sector. A sensible compromise might be to require all

supervisory authorities in the EU to publish pertinent and comparable aggregate annual statistics on notifications and negative decisions.

Before establishing an out-of-court redress mechanism, it should first be examined whether the existing right of appeal through the courts (under Article 33 of the Codified Banking Directive) has really proved inadequate. Should this be the case, an out-of-court redress mechanism could certainly be considered. It is nevertheless important not to underestimate the time and effort involved in creating such a mechanism, which would possibly have to be established at EU level in order to avoid protectionism and competitive distortions. In particular, a lot of convincing would need to be done at the political level. A redress mechanism would only make sense if its decisions were binding, meaning that the national supervisory authorities and their member states would have to be prepared to cede a degree of sovereignty. It should therefore be weighed up whether it might be possible to prevent protectionist decisions simply by requiring the disclosure of the authorities' rulings and intensifying and institutionalising the dialogue between supervisors (within CEBS, for example).

3.1.2 Public ownership of significant sections of the banking industry

The public ownership of large sections of the German banking industry, the legal restriction of the use of the name "Sparkasse" to German public savings banks and the "regional principle", which largely excludes competition within the savings banks' and co-operative sectors, are extremely serious obstacles to consolidation in the European banking sector. The Savings Banks Acts of the German Länder stipulate that Landesbanken and Sparkassen must be publicly owned, thus totally excluding a significant section of the German banking industry from mergers with, or acquisitions by, foreign banks. There can be no question of any misapplication of Article 16 by supervisors where these banks are concerned, since cross-border consolidation is ruled out from the outset.

This ownership structure, which does not exist in this form in any other member state, including the eastern European accession countries, is a far greater obstacle to the development of the European financial services industry than is Article 16. Germany's Savings Banks Acts should therefore be amended to allow all (foreign) investors the same rights to acquire holdings in all German banks. The principle of reciprocity will be violated as long as this is not the case, because German public-sector banks can, in contrast, already acquire private foreign banks and have on occasion already done so.

It will also be necessary to lift Section 40 of the German Banking Act, which restricts use of the name "Sparkasse" to public-sector banks. Only if an acquirer is allowed to continue operating

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a bank under the name with which it has become established on the market will any real investor interest – a prerequisite for consolidation – be able to develop. Moreover, the regional principle needs to be abolished, as it would prevent an acquirer from expanding in line with its business strategy.

Germany is not the only country with a high proportion of public-sector banks, however. There is a comparable situation in Spain, for example, where savings banks have a large market share, which is excluded from consolidation.

3.1.3 Insufficient harmonisation of the supervisory framework

One of the greatest challenges facing the European banking industry at present is the revision of the capital adequacy rules for banks and investment firms (implementation of Basel II in the EU). The task of aligning capital requirements much more closely with the actual risks involved than was the case under Basel I requires a more complex framework with greater emphasis on qualitative rules. Although the implementation of Basel II is a major step forward from a risk angle, the current draft of the Capital Requirements Directive is not unproblematic for internationally active banking groups or in its implications for cross-border mergers and acquisitions.

As things stand, the draft contains around 100 options, which may be exercised differently from one member state to another. There is also a danger of qualitative supervisory rules – even if they are binding and thus apply uniformly throughout the EU – being interpreted and applied in differing ways by national competent authorities. If a cross-border merger between two banks takes place, this means that the part of the bank which is not located in the future home country of the merged entity will have to adapt its business processes and structures to a new supervisory regime in all areas where there are differences in the way an option is exercised or a qualitative rule interpreted. Though it is true that this “only” involves one-off adjustments, these can be extremely costly and thus make a potential merger less attractive.

Even more serious problems arise when it comes to cross-border takeovers. Because the subsidiaries and parent company of the newly formed banking group may continue to be located in different countries and thus be supervised by different authorities, the obstacle is not the cost of one-off adjustments, as is the case with a merger. The major difficulty here is the permanent need to file (duplicate) solvency reports at group and solo level, to which different supervisory rules will apply on account of the entity’s cross-border structure. Countries such as Italy, Denmark, Sweden, Finland and Germany monitor solvency at the level of the individual bank as well as at consolidated level. The problem is not so much that a solvency report has to be submitted for individual banks both at solo and at group level. If the

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rules were identical in all member states, this would "merely" entail more red tape. The serious burden on the banks arises instead from the fact that submitting solvency reports based on different supervisory rules requires different IT systems and business processes. In risk management, the associated costs can sometimes be prohibitive, since in many areas setting up reliable risk measurement systems is nowadays only viable at group level.

To solve these difficulties there is a need, when implementing Basel II in Community law, to ensure that the regulations for banks competing on the European market are largely uniform. This will mean reducing the number of national options as far as possible ("appropriate harmonisation"). It is to be welcomed that CEBS has already begun work in this area. In addition, the European supervisory authorities should harmonise their supervisory practices (e.g. in the context of CEBS), especially when *implementing* qualitative supervisory rules. In addition, the authority of the supervisor responsible for the parent company (home supervisor) could be expanded to areas where parallel home and host country supervision leads to prohibitive costs or insurmountable practical difficulties. Such an approach is currently being discussed in the context of the consolidated supervisor concept for the recognition of internal rating systems.

3.1.4 Deposit protection

The Association of German Banks believes that deposit protection presents no obstacles to cross-border mergers and acquisitions. The takeover of a bank by another bank in another member state does not affect the acquired bank's membership of its national deposit protection fund. In the event of a merger, the merged bank is only required to be a member of one fund – that in the country in which it has its head office. Under the home country principle enshrined in the Deposit Insurance Directive, on which banking supervisory EU rules are based, deposits not held in the country of the bank's head office are deemed deposits of the branch offices of the merged bank in another member state. As such they are no longer protected by the fund of the host country, but by that of the home country.

In practice, the home country principle has worked smoothly so far in the area of deposit protection. The Directive contains no rules on the banks' contributions to the funds, and these vary from one member state to another. (This also applies, moreover, to the funding arrangements for banking supervision, which differ widely across Europe.) Banks involved in a merger will therefore sometimes have to pay higher, and sometimes lower, contributions. Any differences between the level of protection in the host country and that in the home country can be levelled out – should they be considered relevant in practice – by the topping-up mechanism envisaged in the directive.

3.2 Consumer protection

A not-to-be underestimated economic obstacle to cross-border mergers and acquisitions is the legal restrictions that still exist on the use of the Internet. This may initially seem puzzling, as the Internet is a distribution channel which allows the cross-border provision of financial services independently of branches or subsidiaries (established by providers themselves or resulting from a merger) in a target market. Yet, it is actually often an advantage, when opening up new markets abroad, to be able to also use both local staff who are familiar with the market and the well-known name of a bank that has been taken over or integrated through a merger. A foreign market can be opened up particularly well following the takeover of a comparatively small bank if potential customers can be broadly contacted and supplied with financial services via the Internet.

However, it is not possible at present to open an account (across borders) via the Internet, although opening an account is the basis for an online (long-distance) customer relationship. While in some countries there are alternative ways of opening an account such as the Post Office's "PostIdent" procedure in Germany, these are expensive for both customers and banks, as they impose a manual workload and straight-through electronic processing is not possible. To remedy this shortcoming, European law (particularly the Electronic Commerce Directive and the Money Laundering Directive) should be amended accordingly to allow accounts to be opened throughout the EU with a qualified electronic signature.

A further obstacle is that it is not possible at present in countries such as Germany or France to conclude consumer loan or guarantee agreements via the Internet. In Germany, for example, Section 492 of the Civil Code prohibits contracts in "electronic form". This is why the amendment of the Consumer Credit Directive currently under discussion is expressly welcomed. It should require the member states to allow electronic contracts in their jurisdictions. Legitimate consumer protection concerns are already taken fully into account by the fact that the Distance Selling Directive grants customers a reasonable cooling-off period.

An unnecessary burden is also placed on retail banking by the generally excessive civil-law formalities designed to protect consumers (information requirements, instruction on right of cancellation), which vary from one member state to the next. They hinder cross-border expansion because they make costly and time-consuming examinations of different national legal regimes necessary and business processes cannot be standardised company- or group-wide but have to be adapted individually for each country at considerable additional expense. For this reason, it is necessary, on the one hand, to harmonise consumer protection law at an

appropriate level in the EU and, on the other hand, to dispense with any additional national provisions.

The above-mentioned factors do not constitute legal obstacles, in the strict sense, to cross-border mergers and acquisitions or make these impossible. Instead, they are obstacles in that different legal conditions in the member states make mergers and acquisitions less attractive in many cases than they would be under the conditions existing in a full-fledged internal financial market. Ultimately, therefore, the problem is the absence of a single European market. The aim of creating such an internal market in the financial sector as well and the harmonisation of the relevant areas of law this requires are often challenged by arguing that legal harmonisation in the field of retail banking is not necessary and in fact harmful, as retail banking is local business that does not need to be aligned within the EU.

Although many banking transactions – like other transactions – are conducted mainly locally, this argument is incorrect. For one thing, customers who conduct banking business mainly locally are also interested in being able to use financial services as cheaply as possible. Insofar as the emergence of retail banks operating EU-wide allows this, cost reasons alone mean that cross-border mergers and acquisitions against the backdrop of a single retail market are in the interest of these customers as well. Significantly, the EU Internal Market Commissioner therefore recently questioned the claim that retail banking was local ("*The Commission cannot accept the blanket assumption that retail markets for all financial services should remain purely local.*" – European Commissioner Charlie McCreevy at a reception held by Lloyds TSB in Brussels on 26 January 2005). For another thing, retail customers too display a certain degree of mobility (e.g. either permanently, following a change of address, or temporarily, through travel) or wish to conduct cross-border transactions for other reasons (e.g. transferring money to children studying abroad) that give them an interest in being able to use comparable banking services at different places within the EU.

3.3 Civil law

Another reason why mergers and acquisitions are currently unattractive is the continued lack of harmonisation in the fields of civil law and contract law. In particular, creation of a single European retail banking market has not proved possible to date – national borders still constitute barriers for both consumers and banks in this area. The differences between substantive-law aspects of national civil-law regimes mean that, where banks operate across borders, many parts of business processes cannot be organised uniformly but have to be adapted in each case to take account of national particularities. As a result, the economies of scale and fixed-cost savings that are basically possible cannot be achieved to a large extent.

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The different civil-law regimes not only make the conclusion of contracts much more complicated, they also greatly increase the cost of enforcing claims arising from cross-border contracts.

Alignment of the regulations governing cross-border transactions at both European and national level with a view to achieving convergence is therefore urgently required. Because of the traditional and diverse nature of civil-law regimes in the individual member states, replacing national with European rules will probably be a long-term undertaking. The right way to achieve this is a gradual, careful approximation of the different legal regimes in the EU member states. This will inevitably mean a (partial) loss of national legal cultures and traditions, also in Germany.

It is to be welcomed that under the action plan on European contract law presented by the European Commission in October 2004[2] a Common Frame of Reference (CFR) will first be created as the basis for greater coherence in this area. In addition to fundamental principles of contract law and definitions of legal terms (e.g. contract, damages), the CFR will contain model contract rules (e.g. on the conclusion of a contract, form of a contract, authority of agents and interpretation). It will not only play an important role in further legislation and the interpretation of European rules but can also be a valuable instrument for contractual parties arranging cross-border contracts.

On the way to a more coherent European contract law, harmonisation of the conflict-of-law rules for contractual obligations (Rome Convention of 1980 – Rome I) and for non-contractual obligations (Rome II) is also required. In the process, it should be remembered that, although conflict-of-law rules can help to mitigate and overcome obstacles to cross-border transactions, the problem of acceptability will remain if one party is required under a choice-of-law agreement to recognise a foreign legal system with which it is not sufficiently familiar as the law applicable to the contract.

The long-term project of creating a more coherent European contract law could culminate one day in a European Civil Code that would not just be a special law governing cross-border activities, but – to avoid problems of demarcation and serve as a symbol of the European Union's common identity – would replace national codes.

3.4 Company law

[2]Cf. *European Contract Law and the revision of the acquis – the way forward (COM [2004] 651 final)*

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The legal form of the European Company (Societas Europea – SE), which has been available since the end of 2004, offers companies various means of cross-border restructuring and cooperation; in particular, the SE enables companies to merge across borders and to transfer their seat in a manner allowing them to retain their identity. The "employee participation compromise" found for the SE cannot, however, serve as a model, as it failed to achieve the aim of a level playing field. For German companies, involvement in an SE will scarcely be an option, as the rules on employee participation mean that, in the event of a cross-border merger with a German company, the German system of co-determination, which is based on equal representation, would usually apply. As the German "equal representation" model meets with little understanding among foreign investors and is seen as a serious obstacle to investment, German companies are unlikely to be welcome as partners in an SE. This unsatisfactory state of affairs could be rectified by an appropriate amendment of the EU Regulation on the SE, and the directive supplementing it, in regard to employee participation. Such a step is likely to pose major political difficulties, however. Alternatively, the problem could be addressed at national level by softening the law introducing the SE and, above all, by reforming and further developing the German system of co-determination to make it more workable in a European context. A key issue that needs to be tackled here is the representation of employees on the supervisory board by trade union officials.

Cross-border mergers independent of the SE are not possible at present. For example, the German Reorganisation of Companies Act, which is based on the "real seat doctrine", does not permit cross-border mergers and merely governs changes in the legal form of companies based in Germany. The decision by the European Commission to call in its May 2003 action plan for *Modernising Company Law and Enhancing Corporate Governance in the European Union* for the creation of the legal framework for cross-border mergers and transfers of seat as soon as possible must therefore be welcomed. The proposal for a directive on mergers of companies from different member states (10th Company Law Directive – European Mergers Directive) that has since been presented is thus a step in the right direction. This will help to avoid complex company-law constructions and unnecessary transaction costs.

However, there is still room for improvement in the Mergers Directive, too. While the political agreement on the controversial issue of employee participation reached in the European Council on 25 November 2004 must in principle be welcomed, it is not sufficient to prevent the existing discrimination of German companies. The current rule, which stipulates that if negotiations on employee participation break down the higher (German) co-determination model is to apply – even if the company's seat is not in Germany – provided that German employees make up more than 33% of the total workforce of the merged company, remains a serious obstacle. Ultimately, this arrangement means that, for co-determination reasons,

German companies would only be attractive as "junior partners" in a merged company based abroad. In addition to raising the threshold of 33% to at least 50%, it would be advisable to further develop the system of co-determination in Germany. The latter would also be necessary to make Germany more attractive as the headquarters of merged companies.

3.5 Tax law

Further obstacles to cross-border mergers and acquisitions exist in the area of tax law. For example, the tax treatment of hidden reserves in cross-border mergers is not regulated satisfactorily under current European law. Companies involved in both cross-border and purely national mergers basically have an interest in avoiding any (tax-effective) disclosure of hidden reserves. This interest is taken into account also in a cross-border context by allowing a book value approach.

Under present Community law there is, however, the danger that if hidden reserves are liquidated this may result in double taxation in both countries concerned. This increases the tax burden for cross-border companies and creates a degree of legal uncertainty that makes an economic assessment of potential mergers with a cross-border dimension much more difficult. The European Commission's proposal to establish clear rules in the Taxation of Mergers Directive for the liquidation of hidden reserves by companies merged across borders and to prevent double taxation as far as possible – a proposal that has since been adopted by the EU Council of Finance Ministers - must therefore be welcomed. In addition, the provisions of the Taxation of Mergers Directive should also be brought into line with the rulings of the European Court of Justice on how fundamental freedoms (particularly freedom of establishment and freedom of capital movements) affect tax law.

Whilst the treatment of hidden reserves only concerns mergers and thus a once-only operation, the current taxation of earnings poses permanent obstacles to cross-border groups and thus to corporate takeovers. European tax law should therefore be amended so that loss offsetting for tax purposes between parent companies and subsidiaries is possible in future across borders as well. Although under national law non-offsettable losses can at present be carried over and deducted later, such loss carryover has little compensatory effect particularly where, for example, a foreign subsidiary of a profitable domestic parent company is expanded through heavy investment but does not in the long term make any profits that earlier start-up losses could be offset against. National loss offsetting arrangements, under which losses can only be offset against profits earned by the subsidiary, are largely ineffective in such cases.

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4 Summary

The number of obstacles to cross-border mergers and acquisitions analysed above shows that the initiative of Ecofin and the European Commission can make an important contribution to promoting the integration and competitiveness of the European financial services sector. This will mean, in part, moving forward and speeding up existing projects (such as aligning European banking supervision law), but new legislation will also be required. Aspects which were initially at the forefront of discussions (Article 16 of the Codified Banking Directive, for example) play a less important role in the context of cross-border consolidation than is often assumed or claimed.

Conversely, factors like differences in civil law (particularly those affecting retail banking), the lack of a company-law mergers directive or the public ownership of large sections of the banking industry in countries such as Germany have proved to be extremely serious obstacles. Even if it will only be possible to realise some of these projects in the very long term, they nevertheless merit vigorous political support so that a truly integrated and internationally competitive single market for financial services can develop in Europe for the benefit of both retail and corporate customers.

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