**ESSEX BUSINESS SCHOOL**

**University of Essex**

**2319416**

**BE650: *Modern Banking* 2000 Word Essay**

**QUESTIONS:**

(Part a) Choose one European country and analyse the interplay between competition and performance of its banking sector over the past 10 years. Justify your choice of competition and performance indicators. Utilize 'Bank Focus' to generate a maximum of two relevant charts and/or tables to augment your analysis and identify trend shifts. Support your findings with relevant academic literature.

(Part b) Choose one OECD country and examine the rationale and consequences of consolidation resulting from M&As (mergers and accusations) in the banking sector. Support your arguments with relevant academic literature. Utilize industry reports and publicly available sources such as central banks, the IMF, etc. Include a maximum of two relevant charts and/or tables to identify major trends over the past 5 years.

**Part 1:  
  
Introduction**

France, a key player in the European Union, has undergone significant changes in its banking sector over the past decade. This analysis looks to investigate the dynamic relationship between competition and performance in the French commercial banking sector. Utilizing relevant indicators and data from 'Bank Focus,' the chosen competition metric is the learner index, while performance will be assessed through Return on Assets (ROA) and Return on Equity (ROE).

**Banking performance**

"Banking performance is a critical metric for assessing a bank's financial standing over a defined period (b). Given the pivotal role of banks in fostering economic growth Berger, et al. (1998), commercial banks are actively involved in soliciting deposits and extending loans to both investors and consumers, thereby making substantial contributions to the overall economic expansion Alam, S.M., Chowdhury, et al (2021). It is worth noting that measuring a bank’s performance is not only essential for gauging its financial health for potential investors (i.e., shareholders and depositors) but also offers a broader understanding of economic stability and development."

**Return on Asset**A bank's performance, gauged by its ability to generate sustainable profits (Alzoubi, T. 2018), attracts investors and satisfies existing ones. Return on Assets (ROA), a crucial profitability metric, measures the ability to generate profits from assets. Calculated as Net Income divided by Total Assets, ROA directly reflects a bank's asset management efficiency. ROA is a ratio calculated as follows:

Investors use ROA as their primary tool when analysing a bank’s performance as it directly shows how well a bank can manage their assets to generate profits. A rising ROA indicates goal achievement and shareholder satisfaction, while a declining ROA signals the need for strategic shifts to avoid losses. Despite its common use, Return on Equity (ROE) falls short in offering a comprehensive view during economic crises, as argued by researchers (European Central Bank (ECB) 2010), highlighting the need for reliable metrics amid changing investment strategies.

**Competition**

Banking competition, the measure of rivalry between banks, significantly impacting the economy, influencing operations, offered products, and customer interactions (AP-Podpiera et al). While fostering a competitive banking market can benefit consumers with lower interest rates and fees (van Leuvensteijn, M. *et al.* 2008), the potential drawbacks of high competition, such as reduced efficiency, have been debated. Contrary to initial expectations, AP-Podpiera et al found a negative correlation between banking competition and efficiency. (Carlson and Mitchener 2005) argue for regulated competition, emphasizing its advantages in promoting efficient banks. In non-competitive markets, like Ghana, evidenced by Kefela, Ghirmai T., (November 11, 2008). strict regulations are essential to address challenges and prevent anti-competitive practices.

**Learner Index**  
When assessing competition, investors traditionally employ the Learner index ((Akhmatova 2016)). Economists use the Learner index to measure monopoly power or market power. The higher the learner index, the lower the competition.   
  
the equation index is measured on a scale of 0 and 1 where 0 is a perfectly competitive firm since its price (P) is equal to its marginal cost (MC). Conversely a monopolistic firm will have a Learner index tending to 1 as the firm will have a marginal Cost (MC) of 0.

**Performance and Competition in French banks**

This analysis investigated how competition influences the performance of the French banking sector. Using 'Bank Focus,' data from 123 French banks categorized under C\*, C1, and C2 was examined. ROA, an accessible data point on Bank Focus, was downloaded for the period 2013-2022. However, since the Learner Index was not readily available, it was computed. Subsequently, data for the years 2013-2022 was downloaded for comprehensive analysis.

* Bank Name, BVID, Consolidation Code,
* ROA,
* Total Assets, Staff Expenses,
* Total Operating Expenses,
* Other Operating Expenses,
* Other Admin Expenses,
* Total Customer Deposits,
* Total Interest Customer Deposits,
* Interest Income & Fee and Commission Income.

**Data cleaning and Regression Analysis**

Upon downloading the data, the process involved converting it from wide format to long format. Due to variations in bank coverage across countries, many entries were marked as "not available" (with values labelled as "n.a.") in the database. To address this, those values were left blank instead of dropping the entire row or replacing them with zeros.

Fortunately, the Stata code for analysing competition and efficiency in the banking sector was provided by the module supervisors. This code aimed to estimate and compare the efficiency (by calculating the marginal cost MC) of banks over time using three models: Ordinary Least Squares (OLS) regression for estimating the relationship between variables, Stochastic Frontier Analysis (SFA) performed through Maximum Likelihood Estimation (MLE), and finally, the Panel Data Model (PDM) used for analysing efficiency over time. After applying all models, summary statistics are presented for each

**Results**

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **ROA** | **Learner Index** |  |
| 2013 | 0.555625 | 0.5645239 |
| 2014 | 0.527069 | 0.555581 |
| 2015 | 0.5842241 | 0.5390392 |
| 2016 | 0.4981579 | 0.5163959 |
| 2017 | 0.6280702 | 0.5129969 |
| 2018 | 0.4802609 | 0.4973645 |
| 2019 | 0.4700862 | 0.4840795 |
| 2020 | 0.2917391 | 0.4768602 |
| 2021 | 0.4489381 | 0.4796399 |
| 2022 | 0.4125 | 0.5208689 |
| Figure 1: ROA and Learners index over time | | | |

Figure 1 depicts the historical evolution of Return on Assets and the Learner Index, exploring the impact of competition on performance from 2013 to 2022. However, charting these figures alone does not provide a sufficiently profound understanding of the relationship between competition and performance. Subsequently, additional linear regression analysis was carried out to investigate their relationship.

**Relationship between Learner index and performance**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **ROA** | **Coefficient** | **Std. errs.** | **t** | **P>|t|** | **[95% conf. interval]** | |
| **Learner Index** | 1.852848 | 0.8594751 | 2.16 | 0.063 | -0.1291051 | 3.834801 |
| **Constant** | -0.4640587 | 0.4431267 | -1.05 | 0.326 | -1.485911 | 0.5577934 |

**observations**=10

|  |  |  |
| --- | --- | --- |
|  | **ROA** | **Learners Index** |
| **ROA** | 1 | 0.6062 |
| **Learners Index** | 0.6062 | 1 |

Figure 2 linear regression analysis ROA and Lerner Index

Figure 2 reveals a positive correlation between banking performance and competition. Upon analysing the correlation data, the Learner Index showed a coefficient of 1.852848 with a p-value of 0.063, indicating slight significance at the (p < 0.05) level. This implies a positive relationship between ROA and the Learner Index. Additionally, the correlation coefficient between ROA and the Learner Index is 0.6062, signifying a moderate positive correlation between the two variables. The higher the Learner Index, the higher the ROA. Given that the Learner Index suggests lower competition, the regression results suggest a link between low competition and high banking performance.

**Conclusion**

In conclusion, the analysis of the French banking sector over the past decade, using the Learner index and ROA, uncovers a positive correlation between competition and performance. The visual representations from 'Bank Focus' charts provide insights into market trends, aiding in the identification of shifts. Academic literature supports these findings, highlighting the nuanced dynamics in the French banking landscape. This study contributes to the ongoing discourse on the relationship between competition and performance in European banking, emphasizing the need for continued monitoring and regulatory measures to ensure a healthy competitive environment.

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**Part 2:  
  
Introduction:**

The UK banking sector, responding to the internet age and shaped by post-2008 financial crisis and COVID-19 challenges, has witnessed transformative shifts. Neo banks, exclusively offering online financial services, have disrupted traditional models. This essay explores the consolidation resulting from M&As in the UK banking sector, emphasizing the impact of neo banks, utilizing academic literature, industry reports, and public sources to unveil the transformation over the past 5 years.  
  
**What are Neo Banks?**  
Since the financial crisis in 2008 and the covid-19 pandemic of 2019, there has been a massive shift in the way consumers interact with financial services. This shift prompted banks to invest in research and development to enhance their digital financial services. Fuelled by the distrust consumers harbour for traditional financial services (Sutton, 2023), a new banking concept has emerged known as "neo banks." Neo banks exclusively offer all their financial services online (Bellard, 2018).  
  
**How have they impacted the UK banking sector, and have they filled a void?**  
Unlike traditional banks, neo banks do not require a banking license to offer their services in the UK. Revolut, for instance, has been in the process of applying for its banking license in the UK. However, thanks to a successful special license application in Lithuania in 2001 Venkataramakrishnan et al (2023), Revolut has been permitted to offer its banking services in the UK. This is attributed to its cross-border passporting, enabling EU-based banks to sell and offer services within the European Economic Area.  
  
As a result of the regulatory flexibility granted to neo banks through their banking licenses, they can provide a range of services, as outlined by Arun, T. *et al.* (2023)

* Customers enjoy 24/7 access to their banking transactions, accessible entirely from their phones or personal computers via the internet.
* The absence of physical locations contributes to lower operating overhead, enabling neo banks to charge lower fees compared to their traditional banking counterparts.
* Neo banks offer near-instant wire transfers of payments. While this feature is not exclusive to neo banks, the entirely digital nature of their services accentuates the appearance of digital transactions.
* The online signup process is convenient, with some neo banks, such as Monzo, boasting a current account signup process that takes less than 15 minutes (Monzo Bank (2023)).
* Neo banks excel in the digitization of all possible aspects of banking, including loans, investments, and insurance.

**Rationale for Consolidation in the Banking Sector:**At face value, the rationale behind larger banks engaging in M&A with neo banks is evident. Neo banks have emerged as leaders in customer acquisition in recent years. In 2022, Monzo bank claimed the second spot on the list of the most downloaded banking applications in 2022 (Jarrett, F.G. 2023) According to the bank merger paper, banks typically pursue M&A to enhance shareholder value. This objective can be realized by increasing profitability and market power Pillai, S. (01 2018).

**Traditional Banks' Response to Neo Banks:**In 2021, NatWest acquired Rooster Money, a startup specializing in child banking applications for financial education. NatWest rebranded it as NatWest Rooster Money, aiming to expand its under-18 banking services and capitalize on Rooster's 200,000 monthly active users (Rooster 2022). In 2023, NatWest continued its expansion, acquiring Cushon, a fintech company offering workplace pensions and investment accounts. Post-acquisition, Cushon's assets under management surged from £840 million to £1.7 billion (Cushon, 2023).

Lloyds Banking Group strategically acquired Cavendish Online in 2022, emphasizing its commitment to "deepen and innovate" customer relationships and achieve a top-three position among "protection providers" by 2023 (Lloyds Bank, 2022).  
  
**Lack of Neo Bank Acquisitions**  
Despite these recent acquisitions of financial technology companies, there haven't been any known acquisitions of neo banks. Researchers at Citi Research argue that, despite neo banks excelling in customer acquisition, especially in deposits, they exhibit a low revenue per user (£14 per day) compared to the top established banks in the UK (£370 per user). Established banks may prefer acquiring technology companies for their intellectual property to launch their digital banking offerings, thereby reducing the justification for acquiring neo banks.

Lastly, despite the significant transformation in the financial market, there is little to no evidence that digital banks have outperformed traditional banks. Zhu and Jin (2023) concluded that the digitization of banking had little to no significant impact on the overall performance of banks. Since performance is a measure of how well a bank's strategies are working, the lack of evident performance gain challenges the rationale for engaging in M&A.

Moreover, the justification for larger, more established banks acquiring smaller banks becomes muted when considering the continued dominance of larger banks in the UK online banking sector. According to the Figure 1, Barclays has maintained its leadership in online banking since 2018, registering 12.4 million downloads in 2022, while Revolut, a neo bank, trails in second place with 11.7 million downloads. Furthermore, in the same study, traditional banks collectively account for 50.6 million downloads across the UK, surpassing neo banks at 34.7 million.

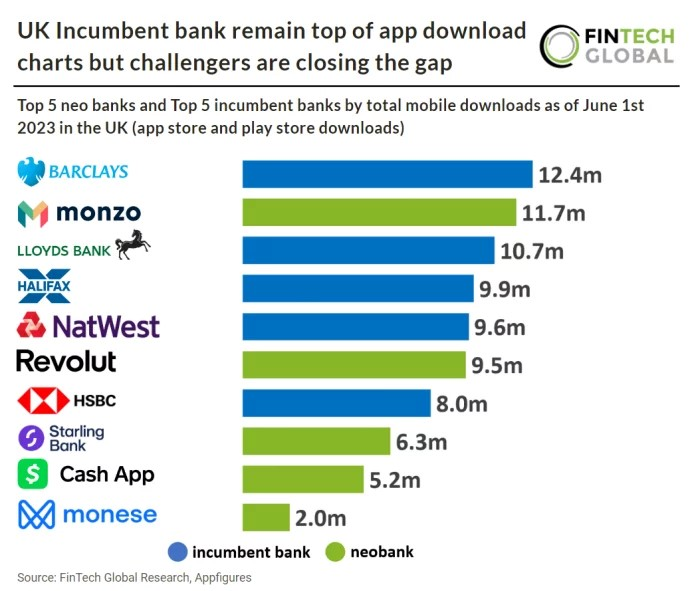


Figure 1: Top 10 downloaded banking applications Jjarrett, F.G. (2023)

However, it is essential to note that while traditional banking has demonstrated its ongoing leadership in the digitization of the UK banking sector, there may still be room for neo companies to rise. The future of the banking sector undeniably resides on the internet, opening numerous possibilities for innovation and growth.  
  
**Conclusion:**

In conclusion, the UK banking sector's evolution, influenced by neo banks and traditional responses, embodies a nuanced blend of innovation and consolidation. Traditional banks seek market reinforcement through acquisitions, while the limited M&A involving neo banks prompts reflection. Despite traditional banks' current dominance in online banking, the future holds potential disruptions. As we anticipate the unfolding internet-driven narrative, questions persist about the rise of neo banks and the ongoing evolution of this dynamic financial landscape.

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