What effects is EMU having on the euro area and its member countries?
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Session III:
Financial integration

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EUROPEAN CENTRAL BANK

Financial Integration Session:

Integration of European Banking

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Open issue

- Why has integration of the European banking sector been so much slower than that in the securities markets?

History of economic thought

- "Banking Competition and European Integration", in *European Financial Integration*, A. Giovannini and C. Mayer, editors, Cambridge University Press, 1991.
- "Regulatory Reform in European Banking", *European Economic Review,* 1991.
- *Monitoring European Integration: The Making of Monetary Unio*n, (joint with D. Begg, P-A. Chiappori, F. Giavazzi, C. Mayer, D. Neven, L. Spaventa, and C. Wyplosz), CEPR, 1991.
- *Monitoring European Integration: The Future of European Banking*, (with J-P Danthine, F. Giavazzi and E-L von Thadden), CEPR 1999.
- “Restructuring Financial Regulation in the European Monetary Union”, *Journal of Financial Services Research, 2001.*

"Banking Competition and European Integration“ (1991)

- Expectations in Cecchini Report (1988) of convergence to lowest prices in financial services in Europe as a result of SMP of seamless market where law of one price would prevail ill founded because banking is imperfectly competitive and not contestable
  - Switching costs, asymmetric information and reputation, institutional barriers to entry,…
- However, Single Market Programme represents a credible commitment to the liberalization of the banking and financial sector in Europe

Main theses (BC & EI,1991)

- The main effect of integration will be to change the focal point of the strategies of banks from collusion and regulatory capture to competition.
- Nevertheless, competition will be imperfect owing to the presence of important economic barriers to entry, yielding an upper bound for the integration benefits lower than the competitive benchmark.
- The banking market will remain segmented, with different degrees of competition, and the benefits of integration will be unevenly distributed.
- Mergers, acquisitions and cross-participation agreements will tend to soften competition.

Monitoring European Integration 1999

- European Union financial markets are fundamentally segmented

  'On the supply side – savings behaviour – is the "home bias" of European households. On the demand side the behaviour of firms – one needs to understand why European corporations stay clear of the bond market and typically borrow from banks'
- There is room for an increase in competition in banking even tough there has been some increase during the 1990s
- Domestic mergers: There are limited benefits for banks to diversification in the EU

JFSR (2001): Impact of the euro

- The most important effect of the single currency will be the deepening and expansion of financial markets
- Market solutions will become more attractive than intermediated solutions
- The euro will
  - reduce segmentation in retail banking but will not eliminate it
    (degree of cross border penetration is small because of barriers in retail, differences in preferences and culture between countries, and regulatory restrictions)
  - accelerate the restructuring of the sector

JFSR (2001): Obstacles

- Political obstacles to cross-border banking mergers:
  problems of BBVA in Italy with Unicredito, BSCH in Portugal with Champalimaud, or protectionist attitude of the French authorities in the triangular battle BNP-SG-Paribas
- Need to establish and consolidate an active domestic and EU wide competition policy which limits local market power and national champions which are too big to fail.

Integration of European Banking - The Way Forward

CEPR Report on Monitoring European Deregulation

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Outline MED Banking

- The transformation of banking
- Cross border mergers
- Does ownership matter?
- Measuring financial integration
- Key results
  - Retail
  - Corporate
  - Accession countries

Different segments have different levels of competition

- Local/geographical dimension for
  – retail (reputation, branch network as entry barriers and switching costs) and
  – SME market (established relationships and asymmetric information)
- Electronic banking does not make banking contestable:
  – not widespread yet, subject to exogenous and endogenous switching costs,
  – more impact on deposits than loans?
- Global for wholesale/investment banking
    - Providing services -underwriting, trading, brokerage, rating, M&A- to multinational corp. & medium-sized firms with international operations
  – Natural oligopoly?

Size and concentration

- Size important again:
  – from investment in bricks to investment in IT, specialized human capital and financial engineering
  – Diversification
- Size and concentration increase in European national markets because of domestic mergers (mostly)
  – Domestic mergers have predominated to cut costs reducing branching overlap, increase or maintain market power, prevent a hostile takeover, or form a financial conglomerate

Size of credit institutions

(Totals assets/Number of equivalent institutions)

	1997	2003
Belgium	46238	171183
Denmark	45039	63372
Germany	54432	110608
Greece	10145	24088
Spain	24077	78560
France	135884	238456
Ireland	9240	32324
Italy	32219	51010
Luxembourg	10850	20663
Netherlands	127198	256809
Austria	21193	32666
Portugal	12823	36403
Finland	22568	44958
Sweden	32298	39465
United Kingdom	80118	214283
Standard deviation (1)	40409	83507
Average (2)	44288	94323
Coefficient of variation: (1)/(2)	0,9124	0,8853

Total assets in € million
Number of equivalent institutions: inverse of Herfindahl index (number of symmetric institutions that entail the same level of concentration)

Banking concentration in European markets

(CR5 in total assets)

	1997	2003
Belgium	54	83
Denmark	70	67
Germany	17	22
Greece	56	67
Spain	32	44
France	40	47
Ireland	41	44
Italy	25	27
Luxembourg	23	32
Netherlands	79	84
Austria	44	44
Portugal	46	63
Finland	88	81
Sweden	58	54
United Kingdom	24	33

Source: ECB

Mergers and Acquisitions (M&A) in Europe

(Number of M&A, 1997-2004 H1)

	Domestic		EEA		Third Country		Total	
	MU12	EU15	MU12	EU15	MU12	EU15	MU12	EU15
1997	68	73	8	9	30	35	106	117
1998	69	69	12	12	34	41	115	122
1999	72	75	30	35	42	52	144	162
2000	71	73	24	26	46	54	141	153
2001	48	50	14	17	35	41	97	108
2002	42	50	13	16	33	37	88	103
2003	54	63	6	6	25	31	85	100
2004 H1	23	27	5	6	6	9	34	42

Source: ECB

Mergers and Acquisitions (M&A) in Europe

(Percentatge, 1997-2004 H1)

	Domestic		EEA		Third Country	
	MU12	EU15	MU12	EU15	MU12	EU15
1997	64%	62%	8%	8%	28%	30%
1998	60%	57%	10%	10%	30%	34%
1999	50%	46%	21%	22%	29%	32%
2000	50%	48%	17%	17%	33%	35%
2001	49%	46%	14%	16%	36%	38%
2002	48%	49%	15%	16%	38%	36%
2003	64%	63%	7%	6%	29%	31%
2004 H1	68%	64%	15%	14%	18%	21%

Source: ECB

Cross-border mergers in Europe

- What has held them back: information or regulatory barriers?
- Obstacles to cross-border mergers in Europe (which are not present in the US):
  - more limited economies of international diversification,
  - labor market rigidities,
  - differences in language, regulation, corporate culture, and
  - political interference (fostering of national champions).

The time has come for cross border mergers?

- Cross border mergers may develop to acquire local expertise, access high margin deposits or diversify, at the same time that size is gained to compete in the global market segments
- Intermediate step: Cross border regional mergers
  - Scandinavian countries and Benelux (late 90s)
- More recently:
  - SCH takes over Abbey
  - ABN Amro and BBVA try, respectively, with Antonveneta and BNL

Ranking of bankings mergers

Date	Target	Acquirer	Value of operation (million €)
2005?	HVB (Germany)	Unicredito (Italy)	16000
26/07/2004	Abbey National (UK)	Santander (Spain)	13900
18/05/1998	Generale de Banque (Belgium)	Fortis (Benelux)	11600
01/04/2000	CCF (France)	HSBC (UK)	11200
11/04/2000	Robert Fleming (UK)	Chase Manhattan (EEUU)	7500
22/07/2000	Bank Austria (Austria)	B. Hypo-und Vereinsbank (Germany)	7200
2005?	BNL (Italy)	BBVA (Spain)	6700
2005?	Banca Antonveneta (Italy)	ABN Amro (Netherlands)	6300
06/03/2000	Unidanmark (Denmark)	Nordic Baltic (Sweden)	4800
13/10/1997	Merita (Finland)	Nordbanken (Sweden)	4100

Questions

- How is it that SCH from inefficient Mediterranean South takes over Abbey from efficient Anglo-Saxon North?
  - Because the UK does not have a protectionist attitude
  - Because Spanish banks have become efficient in an increasingly competitive domestic market they have been able to expand internationally (e.g. Latin America)
  - SCH diversifies portfolio (Brazil concentration) in a stable non-euro country; challenge to integrate IT platforms and derive synergies
- Why major British banks did not bid?
  - For fear of antitrust intervention (after Lloyds TSB was not allowed to take over Abbey in 2001)

Does ownership matter?

- Is free trade in financial services any different from free trade in any other good? What is the impact of foreign ownership on
  - domestic liquidity:
    - Will the foreign (home) supervisory authority take into account the liquidity effects in the host country?
  - the financing of domestic economic activity (in relationship banking, particularly lending to SMEs)?
    - Proximity matters for long term commitments
    - And this may explain how difficult is to enter SMEs lending markets
- Foreign ownership may reduce the commitment of domestic banks to domestic borrowers because a distant HQ
  - may use hard information and rigid protocols instead of soft information;
  - may not internalize the welfare of local stakeholders
- Domestic regulator is not blind to national origin because it responds to local constituencies

Integration and ownership

- Caveats above do not justify in general protectionism in relationship banking since close relationships, may
  - lead to high cost of finance (“lock-in”)
  - delay the closure of non-viable firms
  - lead to collusive arrangements that prevent entry
  - eliminate healthy competition and innovation from foreign institutions
- Furthermore, the alternative to foreign bank ownership may be semi-public banks, vulnerable to political influence and a soft budget constraints

MED Banking (2005) Assessment

- A variable level of integration in banking:
  - High in wholesale banking and in certain areas of corporate finance,
  - modest in relationship aspects of banking,
  - low in retail banking, and
  - patchy and heavily dependent on foreign financial institutions in the accession countries.
- For the most part, integration has been greatest where economic theory predicts it to be so.
- Care therefore needs to be taken not to attempt to correct perceived low levels of integration through excessive harmonization of regulation in areas in which only modest amounts of integration can be expected.
- However, the report rejects the use of arguments about ownership and relationship banking to justify the retention of artificial barriers to integration.

How much integration?

- Integration is not an end it itself:
  - Key objective is improved access to financial services, and that may lead to uneven degrees of integration
  - Adaptation to local preferences may imply efficient discrimination
- Naive integration goal could lead to unwarranted harmonization

Barriers to Entry

- Regulatory
  – Restrictions (e.g. limitations on the proportion of overseas securities that pension funds allowed to hold)
  – Regulatory hurdles to opening foreign branches and subsidiaries; takeovers
  – Discrimination against foreign providers
  – Non-discriminatory but different
- Non-regulatory barriers

  relating to patterns of savings and borrowings, proximity of savers to borrowers, brand loyalty

Measuring integration

- Integration is driven by the euro, the FSAP, and information technology improvements-globalization. Disentangling effects not easy.
- The impact is different across Member States
- How do we assess the extent of integration?
  – Qualitatively: obstacles to cross-border transactions
  – Quantitatively
    - Prices of financial service across countries
    - Magnitude of cross-border transactions (both holdings of assets and liabilities, plus corporate transactions)
    - Wholesale versus retail cross-border activities and the importance of domestic competition
  – What is the proper benchmark for market integration?
    - Discriminatory versus non-discriminatory regulation that hampers cross-border trade
    - The type of banking under examination: transactions-based versus relationship-based banking

Main results for retail markets

- Retail banking remains regional, since proximity to clients, access to information and long term relationships are key competitive drivers
- Integration remains very modest, but deregulation has had indirect effects: market structures converge, through domestic consolidation and expansion beyond commercial banking (e.g. insurance)
- Cross border bank transactions increase (particularly after the euro); more branches opened abroad but subsidiary form remains important
- Cross-border mergers and *de novo* entry remain marginal

Branches vs. subsidiaries and Banking integration in Europe

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	1997	2001	2003	% var 97-01	% var 01-03	% var 97-03
Nº of branches of countries EEA						
MU	349	467	447	34	-4	28
EU	470	582	563	24	-3	20
Nº of subsidiaries of countries EEA						
MU	360	405	354	13	-13	-2
EU	394	438	390	11	-11	-1
Nº of branches of countries non EEA						
MU	157	130	102	-17	-22	-35
EU	311	259	201	-17	-22	-35
Nº of subsidiaries of countries non EEA						
MU	256	215	171	-16	-20	-33
EU	340	297	258	-13	-13	-24
Assets of branches of countries EEA						
MU	461.457	601.468	598.625	30	0	30
EU	1.331.461	1.905.029	2.001.958	43	5	50
Assets of subsidiaries of countries EEA						
MU	761.765	1.262.888	1.702.429	66	35	123
EU	824.139	1.334.878	1.833.413	62	37	122
Assets of branches of countries non EEA						
MU	193.851	123.720	70.006	-36	-43	-64
EU	1.089.541	1.261.056	1.193.804	16	-5	10
Assets of subsidiaries of countries non EEA						
MU	235.141	250.122	249.549	6	0	6
EU	441.608	528.076	799.239	20	51	81

MU: Monetary Union

EU: European Union

EEA: European Economic Area

Assets in € million. Source: ECB

Corporate Finance Areas

- Bond markets
- Bank lending to SMEs
- Syndicated bank lending
- Public equity markets
- Private equity

Theoretical Predictions I

- Information problems more serious in *equity* than in *debt* finance as a consequence of the greater information sensitivity of equity finance
- The participation of a large number of investors requires information to be more widely available in *public* securities than in *private* capital markets

Expect more integration in:

- Finance for large than small firms
- Market sources than intermediated finance
- Public than private transactions
- Debt than equity

Theoretical Predictions II

- Financial integration should be most in evidence in public debt markets, least in private equity markets and somewhere in between in private debt and public equity markets.
- However, what is observed is a high level of cross-border flows in private equity and only modest integration of syndicated bank lending (primarily to large corporations)

Corporate Finance: Results

- Degree of integration highly variable
- Most pronounced in public corporate bond issuance
- Significant integration in public equity market activity
- In both there is more integration at the large end of the market
- Integration significant in private equity
- Only modest in syndicated bank lending
- Largely absent from bank lending to SMEs

Main results for accession countries

- Real integration has outpaced financial integration, which remains uneven and partial
- Most of the progress in banking and Baltic area
- Integration has been achieved through ownership of West European banks
- Equity and bond markets remain weak and illiquid
- Access of SMEs to capital markets may be facilitated by a modern banking sector, but bringing down overall risk levels remains a key policy priority

General policy implications (1)

- Integration occurring where comparative benefits are greatest
- Failure to achieve integration in certain areas (retail banking) reflects mostly inherent impediments
  - Main deficiency in relation to SME , and in particular to high tech sector, may not be failure to integrate bank lending but to develop capabilities to manage early stage equity finance
  - The key bottleneck is limited managerial expertise and entrepreneurial capability and not lack of funds

General policy implications (2)

- In investment banking, integration has occurred largely on the back of penetration of European markets by US banks, which have injected a greater degree of competition and efficiency in the new issue process to the benefit of European corporations
- Ownership -and location of headquarters- does matter for relationship banking (as opposed to transaction-based activities to large corporations)
  - This may present perhaps a concern for accession countries but not for Western Europe and therefore no protectionism should be allowed
    - In accession countries: what is the alternative to foreign bank ownership?

Policy conclusions

- New institutional arrangements are required to implement the FSAP ("Lamfalussy process"). From peer pressure to
  - greater powers to central organization;
  - fostering enhanced cooperation of inner club
- Financial integration rests critically on the principles of mutual recognition and home country rule and the avoidance of host country regulation
  - An European SEC for conduct of business rules and consumer protection?
- Lead regulators should be established to coordinate the regulation of cross-border activities
- Competition policy to play a key role at both domestic and EU level (particularly for cross border mergers)
- Lender of last resort and systemic risk: increased need for coordination