Banking in the euro area: structural features and trends

Over the past decade or so competition in the banking sector has increased considerably, both in those countries which now comprise the euro area and in others, as a result of a number of fundamental forces pressing for change in the financial system. Of these factors, financial liberalisation, innovation, technological progress and the diversification of savings and investment portfolios are the most significant. The introduction of the euro is likely to act as a catalyst for further competition and structural change in the banking sector by speeding up the emergence of a genuine single market in financial services. However, in terms of the timing and nature of the effects, the impact of the euro is likely to vary significantly across different types of financial services and markets. A single money market in the euro area has been seen to develop very rapidly, but the market for retail banking services is still significantly segmented owing to a number of fiscal, legal and cultural differences, as well as to divergences in the way business is conducted. The largest proportion of retail banking activity in the euro area countries has remained in the hands of national institutions.

1 Monitoring the euro area banking sector

Together with the single market legislation liberalising the cross-border provision of financial services within the European Union, the introduction of the euro facilitates the development of a more integrated and competitive banking industry in the euro area. This is likely to involve further strategic adjustment on the part of banks and, hence, ongoing structural changes in the banking sector. The trend towards increased consolidation and concentration taking place via bank mergers and acquisitions is the most visible sign of this process of adjustment.

In the first weeks and months after the changeover to the euro a substantially integrated and highly competitive single money market has emerged in the euro area as banks' treasury functions have adapted to the new environment and the TARGET system has been very actively used for cross-border payments. Differences in overnight rates in the euro area now mainly reflect differences in the credit standing of banks, rather than of the country in which overnight funds are obtained or lent. This indicates that the overnight money market has begun to operate smoothly across the euro area and provides an example of how profoundly the functioning of financial markets might change as a result of the changeover to the euro and the single monetary policy.

However, the timing and nature of the effects of the euro are likely to differ substantially across financial services and markets. By contrast with money market and many other wholesale banking activities, fiscal, legal and cultural aspects as well as divergences in the way business is conducted seem to perpetuate the segmentation of national markets for retail banking services which can be observed at present. The mortgage market is a good example of this, as it continues to be subject to substantial national regulations, taxation, subsidies and administrative procedures. The need to become familiar with the conditions in the national markets and the difficulty of developing standard "pan-European" banking products constitutes a barrier to cross-border activity. The sooner these differences diminish, the faster the single currency can be expected to contribute to the integration of the markets for retail banking services.

The Eurosystem has a strong interest in those developments in the banking industry which have implications for the stability of the banking system and the functioning of payment systems (see Box 1) – both of which are relevant to the successful conduct of monetary policy in the euro area and closely linked to the other tasks of the Eurosystem (see Articles 105 (2) and 105 (5) of the Treaty). Against this background, this Article first characterises the structural features of the euro area banking systems and then proceeds to evaluate certain developments which could be triggered by the introduction of the euro. It also draws to a significant extent on a recent ECB publication entitled *"Possible effects of EMU on the EU banking systems in the medium to long term"*, in which the analysis of likely longer-term trends in banking is based on an extensive collection of data from national sources.

Box 1

The Eurosystem's perspective on monitoring developments in the banking industry

The Eurosystem – the ECB and the euro area national central banks (NCBs) – has a clear interest in closely following developments in the euro area banking sector. In the first instance, the Eurosystem is interested in the structural features of the banking sector and in developments affecting its stability owing to their role in the monetary policy transmission mechanism. In particular, the structure and stability of the banking sector can have an impact on overall macroeconomic performance, the efficiency of monetary policy implementation and the functioning of payment systems. In this respect, it should be noted that all central banks have developed expertise and collect information about the banking system in the area of their monetary jurisdiction, irrespective of their supervisory responsibilities, analysing in particular the structural features and stability issues relating to the banking sector and the financial system as a whole. This reflects the fact that banks constitute the key sector in the monetary policy transmission mechanism as they are the Eurosystem's counterparties in monetary policy operations, onlending funds to the public, and as they are the primary collectors of deposits, which form a large part of the monetary aggregates monitored by the Eurosystem.

In the second instance, the Eurosystem is interested in developments which could possibly affect the stability of the banking system in relation to the task laid down in the Treaty (Article 105 (5)), which states that "*the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system*". In particular, monitoring the stability of the euro area banking sector and providing suggestions to strengthen the stability of the financial system represent contributions that the Eurosystem can make in this area. This task is pursued with the assistance of the Banking Supervision Committee, which is composed of representatives of the NCBs and banking supervisory authorities of the EU countries. The latter are either part of the respective national central banks or separate bodies.

2 Structural features of the euro area banking sector

A number of indicators are used in this section to characterise in broad terms the present structural features of the euro area banking sector. As these features may vary significantly from one country to another, it is useful to provide national information as well.

Size increasing in terms of total assets

The size of a banking sector can be described in terms of the amount of assets that are held by banks and which reflect the activity of financial intermediation by banks, i.e. the provision of funds to the various sectors of the economy. The aggregated balance sheet of the euro area Monetary Financial Institutions (MFIs) excluding the Eurosystem was €14,233 billion (see Table 1) at end-1998 (see Box 2 for statistical definitions). This figure only slightly exceeds the amount of assets of euro area credit institutions. However, the assets and liabilities of the MFI sector vis-à-vis the rest of the economy are considerably less than the above-mentioned figure, since many assets and liabilities relate to activity between MFIs. (Please refer to the statistical annex, Table 2.3, of this Monthly Bulletin.)

Table 1

Aggregated balance sheet of the euro area MFIs (excluding the Eurosystem)

(EUR billions)

	end-1997	% share of total	end-1998	% share of total
Total assets	13,366.4	100.0	14,233.2	100.0
Cash	36.5	0.3	37.2	0.3
Loans	9,748.2	72.9	10,318.1	72.5
of which:				
Domestic	7,716.8	57.7	8,215.3	57.7
Rest of the euro area	719.3	5.4	832.7	5.9
Rest of the world	1,312.1	9.8	1,270.0	8.9
Debt securities[1)]	2,099.5	15.7	2,292.5	16.1
of which:				
Domestic	1,559.7	11.7	1,630.2	11.5
Rest of the euro area	308.9	2.3	403.0	2.8
Rest of the world	231.0	1.7	259.2	1.8
Money market paper	99.6	0.7	102.6	0.7
of which:				
Domestic	82.0	0.6	83.7	0.6
Rest of the euro area	17.5	0.1	18.9	0.1
Shares and other equity	379.8	2.8	481.6	3.4
of which:				
Domestic	289.6	2.2	365.1	2.6
Rest of the euro area	40.3	0.3	57.9	0.4
Rest of the world	50.0	0.4	58.6	0.4
Fixed assets	238.9	1.8	243.3	1.7
Remaining assets	763.9	5.7	757.9	5.3
Total liabilities	13,366.4	100.0	14,233.2	100.0
Currency	0.4	0.0	0.4	0.0
Deposits	9,148.7	68.4	9,749.2	68.5
of which:				
Domestic	6,900.8	51.6	7,243.6	50.9
Rest of the euro area	864.8	6.5	989.4	7.0
Rest of the world	1,383.0	10.3	1,516.2	10.7
Money market fund shares/units	252.0	1.9	244.2	1.7
Debt securities	1,925.1	14.4	2,091.0	14.7
Money market paper	138.8	1.0	165.3	1.2
Capital and reserves	687.5	5.1	727.5	5.1
Remaining liabilities	1,214.0	9.1	1,255.6	8.8

Source: ECB (MFI balance sheet data).
1) Securities other than shares.

Referring to data from national sources, total banking assets amounted to 176% of GDP in 1985 when measured in terms of the total assets of credit institutions resident in the countries which now comprise the euro area. At end-1997 this figure already stood at 234%. This indicates that the growth of the banking sector has been significantly faster than that of the economy as a whole. Furthermore, there has been a general increase in derivative, guarantee and other off-balance-sheet activities of banks that do not enter into the above measurement; hence the changes in total assets do not fully reflect the changes in the volume of services offered by banks.

Loans predominant on the assets side

The aggregated total assets of the euro area MFIs are still dominated by loans. At end-1998 the overall share of loans in total assets was 73%, including loans both to residents of the euro area and to those outside the euro area (see Table 1). Total holdings of debt securities constituted 16% of total assets, while shares and other types of equity

Box 2

The ECB's main data sources for monitoring developments in the banking industry

For the purposes of the current analysis, harmonised data are available from the euro area money and banking statistics collected for monetary policy purposes, published in the statistical annex to this Monthly Bulletin and on the ECB's Web site and defined in the Regulation of the European Central Bank of 1 December 1998 concerning the consolidated balance sheet of the Monetary Financial Institutions sector (ECB/1998/16). The reporting population covered by the statistics, namely Monetary Financial Institutions (MFIs), comprises resident credit institutions as defined in Community legislation, and all other resident financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than MFIs, and, for their own account (at least in economic terms), to grant credits and/or make investments in securities. These other resident financial institutions notably include money market funds. For statistical purposes, MFIs consolidate the business of all their offices (head office, subsidiaries and/or branches) located within the same national territory.

At the moment, the analysis of the longer-term trends in the euro area banking sector can only be based on the information collected from national sources. These national data may be fragmented and are generally not based on a harmonised statistical framework. For this reason, the data collected from national sources presented in this Article in Tables 3 to 7 should be read with caution, particularly when cross-country comparisons are made. Any further reconciliation of the banking sector statistics remains an important task for the future. It should also be noted that the population of credit institutions referred to in Tables 3 to 7 does not fully coincide with the list of MFIs published by the ECB.

holdings had only a 3% share. Investments in debt securities grew faster than loans in 1998, but equity holdings were the fastest growing asset item, partly reflecting share price increases over the year as a whole. Two features of the composition of assets appear to be especially prominent. First, interbank loans represent more than 20% of total assets (or more than 30% of total loans), which makes them the second-largest asset component after loans to the non-bank private sector (i.e. households and firms). Second, lending to general government is relatively important for euro area banks (around 15% of total assets), when both loans and purchases of the securities issued by general government are taken into account. Indeed, nearly half of all debt securities held by MFIs are government paper – for the most part debt securities issued by the respective national government.

In general, the assets of the euro area MFIs are still predominantly domestic. Loans and securities holdings related to residents in euro area countries other than the country of residence of the MFI itself had a 9% share in total assets at end-1998. Nevertheless, loans to residents in other euro area countries and the holdings of the respective debt securities grew by 20% in 1998, which far exceeded the growth in the respective domestic assets. External assets (i.e. assets vis-à-vis residents outside the euro area) were mostly loans and amounted to 11% of total assets. These assets started to exhibit a downward trend during the second half of 1998, which may mostly be regarded as a result of the crises in emerging economies. According to statistics published by the Bank for International Settlements, lending (i.e. loans and debt securities) to emerging and developing economies (mostly Latin American and Asian countries) and Russia accounted for around 25% of the external assets of the euro area banks in mid-1998.

Deposits as the main source of funding

Deposits constituted 69% of the total liabilities of the MFIs at end-1998 (see Table 1), of which interbank deposits have a sizable share, reflecting the importance of interbank activities for euro area banks. The largest proportion of total deposits (74%) is collected from the domestic market, with broadly uniform distribution across the various maturity types: overnight, agreed maturity or redeemable at notice. However, deposits received from euro area residents from countries other than the country of residence of the MFI increased more rapidly than domestic deposits in 1998. Debt securities issued by MFIs accounted for 15% of total liabilities at end-1998, and capital and other reserves for 5%. The publicly available data on risk-weighted assets, which cover the larger banks in the euro area, show that average capital ratios (i.e. ratios of capital to risk-weighted assets) have tended to increase over the past few years.

While noting the limited amount of comparable historical data available, the changes in the aggregate asset and liability structure of the euro area MFIs imply the growing importance of debt securities in both lending and funding activities. In addition, the share of assets and liabilities vis-à-vis foreign residents in the euro area seems to be growing at a faster rate than the respective share of domestic assets and liabilities.

Institutional structure fragmented

The euro area banking sector is still very fragmented in terms of national and sometimes even local characteristics. In some countries a large part of the banking activity is in the hands of a few nationwide banks, while in some others the market share of banks that operate on a nationwide basis is rather small. The total number of credit institutions in the euro area was 8,249 at the beginning of April 1999 according to the list of MFIs published by the ECB (see Table 2). This reflects the large number of savings and co-operative banks – often operating at the local level – and specialised credit institutions in a number of countries. Conversely, the number of institutions that operate on a nationwide basis is rather small in proportion to the total number of institutions. In the United States, where population size is comparable with that of the euro area, the number of credit institutions is even higher, as there were more than 10,400 insured commercial banks and savings institutions at end-1998 according to statistics published by the Federal Deposit Insurance Corporation. In addition, there were almost 11,000 insured credit unions, based on the statistics maintained by the National Credit Union Administration. Obviously, this fragmentation reflects the legislation in the United States that imposed restrictions on the geographical breadth of banks' operations.

Table 2

Number of credit institutions, 1 April 1999

BE	121
DE	3,218
ES	395
FR	1,210
IE	78
IT	933
LU	210
NL	612
AT	899
PT	228
FI	345
Total	8,249

Source: the ECB's Web site (http://www.ecb.int), item MFIs and assets: Monetary Financial Institutions and institutions subject to minimum reserve requirements", April 1999.

Strong domestic consolidation trend

On the basis of the national data it can be observed that, particularly since the early 1990s, the number of credit institutions has shown a declining trend, reflecting the ongoing consolidation process within national banking industries. In 1985 there were more than 11,200 credit institutions in the current euro area countries. The decline in the number of credit institutions reflects mergers rather than closures of existing institutions. There have been, first, "offensive" mergers, involving at least one large player, aimed at repositioning the bank in the financial markets or enlarging to a size better enabling it, for example, to invest profitably in modern banking technologies or enter into a new banking activity. Second, "defensive" mergers have been conducted, especially among smaller credit institutions, to reduce excess capacity, meet capital adequacy and large exposure regulations, or resolve capital adequacy problems stemming from bad loans or limited access to new equity. Indeed, the largest reduction in the number of institutions has taken place among co-operative and savings banks, while the number of commercial banks has actually increased since the mid-1980s. This reflects the establishment of new banks and the changes of corporate form undergone by some savings and co-operative banks to become limited liability companies.

Consolidation has been a global phenomenon in the financial services industry, leading to the conclusion that it is not only related to the effects of the single market legislation and Economic and Monetary Union (EMU), but rather to more intense global competition and the need to increase efficiency and reduce costs. In addition, the favourable longer-term stock market development has facilitated new equity issues and hence has helped to finance mergers and acquisitions.

Table 3

Concentration at the national level: assets of the five largest credit institutions as a percentage of the total assets of domestic credit institutions

	1985	1990	1995	1997
BE	48.0	48.0	54.0	57.0
DE	.	13.9	16.7	16.7
ES	38.1	34.9	45.6	43.6
FR	46.0	42.5	41.3	40.3
IE	47.5	44.2	44.4	40.7
IT	20.9	19.1	26.1	24.6
LU	.	.	21.2	22.4
NL	69.3	73.4	76.1	79.4
AT	35.9	34.6	39.2	48.3
PT	61.0	58.0	74.0	76.0
FI	51.7	53.5	68.6	77.8

Source: the ECB publication entitled "Possible effects of EMU on the EU banking systems in the medium to long term", dated February 1999.

The consolidation trend is common to almost all euro area countries and has significantly increased the concentration of banking activity in the largest institutions at the national level, especially in the smaller countries (see Table 3). However, a meaningful analysis of concentration depends on an appropriate definition of the relevant market, which differs according to the banking service in question. For some retail banking services the relevant market can still be the local community, although "direct" or "remote" banking techniques, such as telephone and Internet banking, are widening the relevant market in geographical terms, while for some wholesale banking services the relevant market already encompasses the single currency area and, possibly, an even wider area. Therefore, while concentration tends to be lower in large countries at the national level, this may not necessarily be the case in comparable local markets. The series of mergers has increased concentration further in 1998, notably in Spain, France and Italy, and the trend is continuing.

Although the establishment of the single market and EMU have triggered an expectation of cross-border mergers, consolidation has so far taken place mainly within national banking industries. Cross-border mergers and acquisitions between large universal banks have been quite exceptional, although some such transactions have recently been effected. Cross-border mergers and acquisitions have so far been largely intended to facilitate expansion into specific market niches rather than the "mass" segment of the retail banking market.

Little change in overall capacity

While the number of credit institutions has fallen almost everywhere, the conventional measures of bank capacity – bank branches and employees per number of inhabitants – present a far more mixed picture, with considerable variation across countries in terms of both level and trend in the euro area (see Table 4). It should be noted that

Table 4

Number of credit institutions' branches and employees per 1,000 inhabitants

	1985		1990		1995		1997	
	Branches	Employees	Branches	Employees	Branches	Employees	Branches	Employees
BE	0.87	7.26	0.90	7.94	0.76	7.56	0.72	7.57
DE	0.61	9.46	0.63	11.10	0.59	9.28	0.57	9.16
ES	0.76	6.06	0.83	6.22	0.93	6.35	0.97	6.29
FR	0.47	7.71	0.45	7.63	0.44	7.05	0.44	6.89
IE	0.24	4.23	0.27	4.99	0.29	6.40	0.32	6.29
IT	0.23	5.66	0.31	5.92	0.41	6.23	0.44	6.00
LU	0.68	25.37	0.78	41.78	0.85	44.90	0.75	45.75
NL	0.59	7.54	0.54	7.86	0.44	7.13	0.44	7.19
AT	0.54	8.94	0.58	9.86	0.58	9.78	0.58	9.43
PT	0.15	5.90	0.20	6.20	0.35	6.09	0.41	5.97
FI	0.89	9.61	0.58	10.15	0.38	6.31	0.32	5.21
Euro area weighted average	0.51	7.38	0.54	7.97	0.55	7.52	0.56	7.37

Source: the ECB publication entitled "Possible effects of EMU on the EU banking systems in the medium to long term", dated February 1999.

the comparisons across countries are affected by differences in the size and functions of branches; this is also demonstrated by the fact that the countries with the largest number of branches per capita do not necessarily have the highest number of bank employees per capita.

With few exceptions, the decline in the number of banks has not so far generated corresponding reductions in the numbers of bank branches and employees. Overall, by end-1997 the total number of branches seems to have stabilised at around 160,000 in the euro area (around 0.6 per 1,000 inhabitants). Since the early 1990s the number of bank employees has been declining slightly in the euro area as a whole, and amounted to around 2,139,000 at end-1997 (around 7.4 per 1,000 inhabitants). Given the development of "direct banking" and automated teller machines, the banking industry seems to be becoming a less labour-intensive industry, and pressure to reduce the number of branches and employees could intensify.

Cross-border establishment relatively limited

The combined market share of foreign branches and subsidiaries established by credit institutions domiciled in the European Economic Area (EEA) was at end-1997 below 10% in terms of banking assets in all euro area countries with the exception of Belgium, Ireland and Luxembourg (see Table 5). The market share of branches and subsidiaries of credit institutions domiciled outside the EEA was generally even lower. These data support the contention that significant national orientations exist in banking activity in the euro area. However, the market shares of foreign institutions have recently shown a gradual increase in a number of countries, reflecting an increase in the establishment of, in particular, branches of banks domiciled in other EEA countries, apparently as a result of the freedom to establish branches within the single market without the need to obtain a separate licence for foreign operations.

Assessing the degree of internationalisation of the euro area banks is, however, a complex task, since it can take a number of different forms. The actual market share of foreign establishments underestimates the extent of internationalisation, since direct lending and other operations not involving the establishment of branches and subsidiaries are not taken into account. Clearly, foreign operations are very important for a number of individual banks in the euro area. Moreover, given that banks operate simultaneously in many markets of different

Table 5

Market share of branches and subsidiaries of foreign credit institutions as a percentage of the total assets of domestic credit institutions, end-1997

	From EEA countries		From third countries		Total
	Branches	Subsidiaries	Branches	Subsidiaries	
BE	9.0	19.2	6.9	1.2	36.3
DE	0.9	1.4	0.7	1.2	4.3
ES	4.8	3.4	1.6	1.9	11.7
FR	2.5 1)	.	2.7 1)	.	9.8 1)
IE	17.7	27.8	1.2	6.9	53.6
IT	3.6	1.7	1.4	0.1	6.8
LU	19.4	71.1	1.4	8.1	99.9
NL	2.3	3.0	0.5	1.9	7.7
AT	0.7	1.6	0.1	1.0	3.3
PT	2.5	6.8	0.1	1.0	10.5
FI	7.1	0	0	0	7.1
Euro area weighted average	3.4	.	1.6	.	12.7

Source: the ECB publication entitled "Possible effects of EMU on the EU banking systems in the medium to long term", dated February 1999.
1) 1996 figures.

dimensions – local, national, European and global – some of the banks' activities are international, although banks may remain national in terms of their branch networks and organisation.

Increasing diversification of savings and investment

The diversification of savings and investment refers to the development whereby increased investment in higher-yielding and possibly more complex products, such as mutual funds, securities, pension funds and life assurance policies, reduces the overall share of retail bank deposits in household and company savings and investment portfolios. There are a number of factors behind this development: the absolute amount of financial wealth has risen, thus increasing the size of the market for asset management services, financial innovation has made more complex and more diversified investment portfolios possible, and technological improvements and greater liquidity in securities markets have reduced transaction costs.

This global diversification of savings and investment has also been quite visible in the euro area countries. Although ordinary bank deposits – as well as the total balance sheet of credit institutions – have continued to grow as a percentage of GDP over the past 10 years or so, the growth, in particular, in investment funds (undertakings for collective investment in transferable securities (UCITS) and other funds) has been much faster. For example, according to the ECB publication entitled *"Possible effects of EMU on the EU banking systems in the medium to long term"*, the annual growth rates of the assets of investment funds were usually higher than 20% in 1997 in the euro area countries. As a result, traditional banking has lost ground, in terms of its relative share, to institutional investors – investment funds, insurance companies and pension funds. However, assets of credit institutions still substantially exceed the assets under management by institutional investors (see Table 6). In addition, a large majority of UCITS are controlled by banking groups in the euro area. By diversifying into this area, the respective banking groups have "internalised" the changes in saving and investment behaviour. Within an individual banking group this has meant that a larger share of the activity is conducted outside the group's deposit bank and that the profits of the non-bank subsidiaries have become more important for overall profitability. The intensification of organisational links between banks and insurance companies has also characterised the development in the banking industry in many countries.

Table 6

Unconsolidated assets of investment funds, insurance companies and pension funds and credit institutions as a percentage of GDP, end-1997

	Investment funds (UCITS and other)	Insurance companies and pension funds	Credit institutions
BE	32.4	30.9	294.1
DE	24.7	36.9	255.8
ES	34.9	21.7	183.2
FR	35.0 [1]	45.0	244.6
IE	69.8	26.3 [2]	299.0
IT	18.9	19.4	155.4
LU	2,770.9	44.8 [2]	3,695.9
NL	19.0	146.0	227.0
AT	22.5	26.4	238.3
PT	26.0	31.0	220.0
FI	3.0	42.4	113.3
Euro area weighted average	31.3	41.2	234.4

Source: the ECB publication entitled "Possible effects of EMU on the EU banking systems in the medium to long term", dated February 1999.
1) 1996 figure.
2) 1995 figures.

Disintermediation refers to the decreasing share of banks and other financial intermediaries in the allocation of funds from savers and investors to borrowers. In practical terms it means that instead of borrowing funds from a bank, firms raise funds directly from the capital market. In the euro area disintermediation still seems to be at a relatively early stage. Medium to long-term corporate bonds have not been widely issued (see Table 7) and hence capital market issuance has not replaced bank borrowing to any significant extent. Either government bonds or financial institutions' paper have tended to dominate the bond markets in individual countries in the euro area. Moreover, according to the above-mentioned publication, commercial paper issues have been quite rare and lending by credit institutions has continued to grow as a percentage of GDP in the recent past.

Table 7

Nominal value of private non-financial enterprises' bonds, credit institutions' bonds and government bonds outstanding as a percentage of GDP, end-1997

	Private non-financial enterprises' bonds	Credit institutions' bonds	Government bonds
BE	10.0	38.3	111.0
DE	0.1	54.6	37.6
ES	2.6	4.5	52.9
FR	2.4	15.9	28.0
IE	0.01	1.6	32.2
IT	1.6	19.4	100.4
LU	115.7	307.6	1.1
NL	.	43.1 [1]	53.4
AT	2.7	31.1	30.6
PT	7.0	10.0	40.0
FI	3.7	7.1	35.5

Sources: the ECB publication entitled "Possible effects of EMU on the EU banking systems in the medium to long term", dated February 1999, and INSEE and the quarterly statistical supplement to the Bulletin of the Banque de France, first quarter 1999 (data for France).
1) Includes also bonds issued by non-financial enterprises.

3 The euro factor: speeding up integration in banking

The effects of the introduction of the euro should be evaluated against the background of the current regulatory framework for the single market, consisting of freedom of establishment and cross-border service provision and substantially harmonised prudential regulations (including those on own funds, solvency ratios and large exposures). The introduction of the euro can be expected to trigger a further increase in cross-border operations, mainly because the disappearance of national currencies reduces the risks and costs for both suppliers and users of financial services. To the extent that this takes place, the euro will significantly complement the single market legislation.

However – as noted at the beginning of this Article – further integration of the banking systems will depend on the degree to which the remaining fiscal and regulatory differences across countries are removed. This non-harmonised component of the fiscal and regulatory "platform" is important and diverse. It includes, inter alia, taxation, subsidies and other fiscal issues related to financial services, the tools used by banking supervisors (e.g. supervisory reporting and on-site inspections), provisions for the liquidation and restructuring of banks, and the definition and legal protection of financial instruments and contracts. It is likely that these non-harmonised aspects will come under pressure to converge as a result of increased consensus among legislators and regulators and perhaps also as a result of "regulatory competition" among national banking systems and financial centres. The more these differences are reduced, the faster the euro will have the anticipated effects.

Pressure for concentration in wholesale activities

The wholesale banking markets linked to interest rates and currencies are likely to become very closely integrated and highly competitive, since in these markets the traded instruments (e.g. certificates of deposit and short-term government paper) are relatively homogeneous in terms of credit risk and yield, and there is efficient arbitrage across national markets and financial centres. In these activities significant concentration of market turnover in a few financial centres and a few large active banks might emerge over time. There are three main reasons for this. First, the need for national "solutions" for trading and hedging purposes, such as currency or interest rate-linked derivative instruments, has diminished. Second, the pricing advantages of national institutions related to the information concerning "home" interest rates and currency have disappeared. Third, there seem to be increasing returns to scale in those activities related to homogeneous and mostly traded products, since both operating in euro area-wide markets and servicing large international customers require a "critical mass", and banks need to process not only national but also area-wide information.

Therefore, when national instruments and markets are replaced by euro area-wide instruments and markets, the largest banks at the euro area level could eventually capture a larger share of the activity than they have at present. This situation would correspond to the current situation in the United States, where the number of "money centre" banks is limited. For some banks this tendency could be a motive for mergers or acquisitions. For others it could mean a greater focus on retail banking activities in the home market and – to the extent that they have been active in dealing in the national currencies and money market instruments – revenue losses. The end result could be a further polarisation of the euro area banking industry, with a limited number of large banks active in the wholesale markets related to homogeneous foreign exchange and interest rate products and a large number of credit institutions concentrating on traditional intermediation at the national or local level. It should be noted, however, that the process of financial innovation constantly creates new financial instruments and products, supporting the existence of many smaller specialised institutions alongside the larger ones.

Capital market activities likely to expand

The single currency offers substantial opportunities for private issuers of debt and equity instruments, as the increase in the number of both issuers and investors operating in the same currency increases the liquidity of the capital markets and makes a larger issue size possible, thus reducing the cost of funds. It is also likely that the larger currency area will attract new investors and issuers to the euro area capital markets. A sustained low level of current and expected inflation and diminishing public sector borrowing requirements would be additional factors in support of private capital market activity. As a result, private non-financial debt issuance, in particular, can be expected to grow from the present low levels at the expense of bank borrowing. In the United States, which is a large single currency area and which has integrated capital markets, the market for private sector debt instruments is significantly broader and deeper than that of the euro area, as was reported in the article entitled "*The euro area at the start of Stage Three*" in the January 1999 issue of the Monthly Bulletin. By contrast, the outstanding amount of domestic bank loans – both in absolute terms and relative to GDP – is far greater in the euro area than in the United States.

For banks, the growth in capital market activities and increasing disintermediation would imply a structural change from on-balance-sheet lending towards "investment banking"-type activities. Accordingly, the income structure would shift from interest income to non-interest (i.e. fee and other) income. While the loss of interest income could be offset by underwriting commissions, some reallocation of income could take place among banks and other financial institutions. The need both for national information on issuer risk evaluation and for a close relationship between the securities issuer and the underwriter probably continues to offer some degree of competitive advantage to national banks, except where the issuer is a well-known international company. However, large European banks and investment banks with adequate capital, customer relations and expertise might become stronger competitors in the future.

As large firms may concentrate their treasury functions within the euro area and reduce their correspondent banking relations, some banks' income from money transmission and correspondent banking services may be affected. Multinational corporations may also tend to minimise the number of separate accounts they hold within the euro area.

Cross-border operations also likely to increase in retail banking

In retail banking, the introduction of the euro can be expected to lead to a more gradual change, as the forces maintaining national segmentation remain for the most part intact. A general view seems to be that the euro as such is not the most significant force for change at the moment in this area. Rather, the spread of "direct banking" and the shift in customers' preference for other forms of saving and away from bank deposits are generally regarded as more important factors. Both tendencies increase competition for established banks. The need to establish a branch network – which has always been considered a major barrier to entry into retail banking markets – will lose its importance with the spread of new distribution technologies. In this process those retail lending products requiring personal advice, extensive credit risk evaluation and local knowledge are considered to be the most sheltered, while many standardised retail banking products are already promoted via "direct banking" channels. The changes in saving and investment patterns bring in new competitors for banks, such as UCITS, insurance companies and securities brokers.