

BANKING IN THE EC AFTER 1992

Working Paper #671

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Draft of a paper presented at the conference on "Europe After 1992" at the University of Michigan, September 6-7, 1991, co-sponsored by the Chicago Council on Foreign Relations. Pheng-Lui Chng provided research assistance. Professors W. James Adams, Michael Moffett and an anonymous reviewer provided helpful comments.

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I. Introduction: Focus and Objective

The integration of financial markets represents an important dimension of the EC 1992 initiatives ("EC 92"), laid out in the famous Commission White Paper of 1985. Through the subsequent adoption of the Single European Act of 1986, the endorsement of the Delors Report on Economic and Monetary Union in May 1989 by the Council of Ministers, and a whole series of "Directives" pertaining to banks, securities firms, and insurance companies, the stage has been set for the removal of barriers to free trade in financial services and for the acceptance of rights of establishment of one member country's financial institutions in any other.

The focus of this paper is relatively narrow. Of primary interest here are the consequences of EC 92 on the structure of the European banking industry; of secondary interest is its effect on markets for financial services. Indeed, under the heading of "Europe 1992: Financial Integration," there exist actually three dimensions that while related, are at the same time very distinct:¹

First, there is the objective of creating a European monetary and economic union whose essential element is the creation of a common European currency (generally referred to as European Currency Unit, or ECU) and ultimately a European central bank with powers to print that money.

Second, financial integration entails the dimension of freedom with respect to the flow of financial resources among the members of the European Community. Specifically, it involves the removal of barriers to the free flow of financial assets throughout the Community. That is not only a theoretical aim, as attested by the fact that as late as of the beginning of 1989 only four member countries, (Germany, The Netherlands, Denmark, and the United Kingdom), did not restrict foreign exchange transactions and the cross-border flow of capital in some way. The other eight member

¹They are "independent" to the extent that one can exist without the other; "related" in this context means that they reinforce each other.

countries practiced varying forms of exchange and capital controls. It is true, within a political climate of worldwide liberalization and driven by specific EC initiatives, these eight countries had already earlier begun a process to dismantle and abolish such restrictions which was completed by 1991. The notable exceptions are Greece and Portugal, which still maintain considerable regulatory obstacles to cross-border financial flows.² Apart from the "classical" exchange and capital controls, there remains, however, a whole host of tax issues where there is little or no EC coordination and which effectively impede and distort cross-border capital flows.³

The third dimension of financial market integration pertains to the markets for financial services, i.e., commercial banking; securities underwriting and trading; and insurance. In considering this dimension, it is necessary to point out that the market for services is not the same as the structure of the underlying delivery system, i.e., the industry. Two extreme structures illustrate this distinction. A market for services can exhibit a very high degree of integration, while the ownership/control of the institutions that supply such services can, for a variety of reasons, be characterized by a high degree of segmentation -- as long as the users of such services have the ability and the freedom to shop across borders. Vice-versa, a market can be fragmented by either various regulatory- or cost factors even if the suppliers are the same in every market.⁴

²For details see Kredietbank, *Weekly Bulletin*, "The Liberalization of Capital Movements in the European Community," No. 34, Sept. 25, 1987, pp. 1-6. Also, the U.S. Department of the Treasury issues (periodically) a comprehensive "Report on Foreign Government Treatment of U.S. Commercial Banking and Securities Organizations," Washington, DC, Nov. 1990.

³The only *de facto* "coordination" is the adoption of the principle of the imputation tax for corporate profits. This attempt to integrate personal and corporate taxation has been adopted, in *principle*, by all EC member countries but in such a variety of versions that one cannot speak of integration. In any case, EC considerations were at best implicitly at work when member countries adopted the principle of this "tax credit" system. See also Section IV.

⁴The classic example is the market for automobiles in Europe where the major suppliers of automobiles market their models in virtually all markets in the European

When reviewing the literature on the state of the financial services industry in the EC, this seems to be a point that is sometimes overlooked.

This paper considers both the evolving market structure for financial services, with emphasis on banking services in the EC, and the likely development of the structure of the banking industry.

II. Markets for Financial Services in the Community

It is tempting to follow the conventional wisdom and characterize the financial markets in the EC as fragmented, without noting some major qualifications. It is true, a widely cited study by Price Waterhouse, undertaken as part of the Cecchini Report of 1988,⁵ found considerable price discrepancies for frequently used financial services products in the retail and middle market, which are summarized in Table 1. The Cecchini Report concluded that by reducing these differences and by removing some of the sources of the discrepancies, major savings could be harnessed for European consumers of financial services. Indeed, such savings and various related efficiency gains in the financial services sector were projected by the Cecchini Report to account for roughly one-third of all the expected gains of the EC 1992 initiative.⁶

Table 1 about here

The data presented and the conclusions arrived at in the Report have been subject to considerable criticism. For one, most of the services mentioned are considerably differentiated in the market place; further, what constitutes a fair sample of financial products differs from country to country. For essentially the same reason, price comparability of financial products is notoriously difficult to assess -- even

Community but prices of even the same models are different by amounts significantly exceeding the relatively small transportation costs.

⁵The Cecchini Report has been published inter alia in The European Economy, No. 35, March 1988.

⁶Ibid., pp. 86-93.

within a country. Anyone who has ever engaged in comparison shopping for financial services, for example a mortgage loan, has learned that the banking industry's ability to differentiate even simple products is highly developed. Last, but not least, to distinguish price reductions stemming from a general improvement in communications technology, global deregulation and other factors from those attributable to specific EC initiatives, is next to impossible.

However, while one can easily take issue with the more ambitious conclusions of the Report as to the welfare effects of financial market integration, the fact remains that for many retail customers as well as small businesses in Europe, cross-border alternatives are not easily available, especially when one uses the United States as a standard of comparison.⁷ Thus, significant parts of the market for financial services must be characterized as being fragmented.

Before considering the causes of such fragmentation in detail, it is necessary to recognize that for customers at the other end of the market spectrum (financial services for large corporations, particularly those with operations in more than one European country, the major banks, securities brokers, insurance companies, as well as international institutions and various governments and their entities), the process of market integration has increasingly become a reality. In fact, this process has been going on for some time. However, it must also be noted that market integration at the "wholesale" level does not have a uniquely European dimension; the process is simply the result of "globalization" of financial markets in general. This phenomenon is based on improvements in data processing and communications technology which compelled widespread liberalization of government policies. Notably, the globalization process included many non-EC countries such as the United States, Japan, Australia, Hong

⁷Even in the United States there appear to be some regional differences in the pricing of financial services at the retail level. See, for example, reports on retail deposit rates and rates for home mortgages as reported in *The Wall Street Journal*.

Kong, and many others, while it excluded the southern members of the European Community, such as Greece, Portugal, and Spain.

In this broader globalization process, the so-called Euromarkets have played a special role. Beginning in the early 1960s, banks began to accept time deposits in convertible currencies and fund loans in those currencies, outside the respective country where the currency served as means of payment. At first this business was done almost exclusively in U.S. dollars, later virtually in all currencies which were convertible for nonresidents. Much of that activity was pioneered by banks based in London. This explains the misleading "Euro" label. But the practice quickly spread to New York (international banking facilities -- IBFs), Toronto, the Caribbean, and along the Pacific Rim, where banks based in Tokyo, Hong Kong, and especially in Singapore, took up this kind of intermediation business eagerly, often with the support of the local authorities.

Banks operating in EC member countries, with the notable exception of those with branches or subsidiaries in Luxembourg and London, were handicapped by costly regulations, especially reserve requirements that did not exempt foreign currency deposits. In contrast, their large customers were unrestrained and quickly took advantage of this burgeoning market, acting as both borrowers and depositors. Through innovative syndication techniques, the banks who made the market were able to intermediate large amounts of funds to sovereign and large corporate clients worldwide. In fact they became so good at this technique that a large portion of LDC- as well as East Bloc credits that became ailing wound up on the books of the very same banks active in the market for syndicated credits.⁸

⁸For more extensive analysis of these markets see G. Dufey and T. Chung, "International Financial Markets: A Survey." In *Library of Investment Banking*, Robert L. Kuhn (ed.), Dow Jones-Irwin, 1990, and Arie L. Melnik and Steven E. Plaut, "The Short-Term Eurocredit Market," Monograph Series in Finance and Economics, 1991-1, New York University Salomon Center, 1991.

A similar phenomenon could be observed in the markets for fixed income securities where large, parallel markets for bonds and short-term paper emerged outside of the various countries on the basis of (a) restraints on the access of foreign borrowers to national markets, and (b) the preponderance of many investors to hold a portion of their savings outside of their domestic jurisdiction, either directly or through financial institutions. Investors from many countries did this in order to escape existing or future exchange controls, taxes, or simply political and economic turbulence. Over the years, this Eurobond market, including its segment that provides equity related issues (convertibles and bonds with equity warrants attached), has consistently ranked among the top three or four national markets for new issues. But as with the deposit market, the Eurobond (or, more correctly, offshore bond) market had no germane link to the European Community and its efforts to integrate national markets. Indeed, it preceded it by many years.⁹

In terms of trading and listing of corporate equity instruments abroad, one finds a similar story: markets have become quite integrated, in the sense that most major European corporations are listed on one or more exchanges in other countries -- frequently on the exchange of another EC member country, and that a number of major stocks are traded in significant volume outside their home market. For example, Europe's major screen-based market, SEAQ International, displays prices of 750 non-U.K. stocks, of which 200 (not all European) are traded actively in a market that is tailored to the needs of large, institutional investors.¹⁰ Once again, however, there is

⁹As a matter of fact, the EC occasionally seems to attempt to get these markets under their control simply because its activities are concentrated on two major centers that are Community members, London and Luxembourg. What the proponents tend to forget is that there are a number of alternative which are outside the EC and, therefore, outside its regulatory reach.

¹⁰"Europe's Capital Markets," *The Economist* Survey, December 16, 1989.

no specific EC aspect to this phenomenon; relevant EC Directives dealing with the organization of European markets for securities have not been adopted as of late 1991.

III. Changes in the Regulatory Environment

In the previous section it was argued that European markets for financial services are characterized by a considerable degree of integration -- essentially at the "wholesale" level. However, considerable fragmentation is present at the level of retail services as well as services used by small and medium size business enterprises -- the so-called "middle market." Since it is with respect to the retail and the middle market that the EC 92 initiatives will have the most promise, the following section will focus on these particular market segments.

If one takes price differences as indicators of market segmentation, it is important to recognize that a number of diverse factors can cause such discrepancies. Markets can be segmented by regulations that limit access of financial services providers and/or regulatory barriers on the cross-border provision of such services.¹¹ However, markets can also be differentiated by consumer characteristics, i.e., tastes and risk preferences, which is particularly relevant for financial services. Finally, markets can appear to be differentiated and exhibit large price variances, but such discrepancies are caused by differences in terms of costs and risks existing in the various market segments, i.e., national markets of EC member countries, in the present context, rather than obstacles to crossborder transactions or investments. Of course, such cost differences are based also on regulatory conditions, but it is important to keep in mind that the particular regulations that matter here are rules pertaining to activities within a national market. The most important characteristic of such regulations is that they apply in a non-discriminatory manner.

¹¹"Cross-border services" refers to the provision of services by a credit institution located in one member state to consumers of these services in another member state without the establishment of a branch or subsidiary in the host country.

How then does the EC 1992 initiative affect this situation? A first-level answer is, of course, that regulations are changing with respect to those rules and regulations that affect (a) market access by financial services providers from other member countries and (b) barriers to the cross-border trade and services. This is where the EC 1992 initiatives have their most dramatic impact. One must hasten to add, however, that it is the secondary, or indirect effects on national, non-discriminatory rules where the impact of directives, and even recommendations,¹² issued by the Commission as part of the EC 1992 package are most relevant.

The regulations that change the financial services field in general, and the banking area in particular, comprise the following three basic principles.

First, EC directives and recommendations establish that **cross-border trade** in banking-, securities-, and insurance services will have to be **liberalized**. National laws and regulations, to the contrary, must be altered.

Second, the EC 1992 directives introduce a general license, or principle of a "**European passport**" for providers of goods and services. Thus, institutions authorized to operate in one individual EC member country have the right to establish themselves in other countries and operate throughout the community.

Third, while home country authorization and supervision is fundamental, in a number of crucial areas **minimum community standards** will have to be followed by all institutions operating in the EC.

While these three principles characterize the regulatory philosophy of all EC activities under the 1992 initiative and are, indeed, emphasized in the White Paper of 1985, banking and financial services pose their own particular challenges. Indeed, attempts to remove barriers to banking in the EC preceded the EC 92 initiatives by many years. Already, the First Banking Directive of 1977 provides a common legal

¹²Directives bind member states to whom they are addressed but each leaves the national governments free to choose the form and methods to implement them. Recommendations are just that; they have no binding force. See Uwe H. Schneider, "The Harmonization of EC Banking Laws: The Euro-Passport to Profitability and International Competitiveness of Financial Institutions," *Law and Policy in International Business*, Vol. 22, No. 2, 1991, pp. 273.

definition of "credit institution."¹³ This concept applies only to institutions that take deposits and grant credit. By implication, separate rules and regulations must be drawn up for the securities industry and the insurance industry.

The First Banking Directive, issued when the members of the European Community were buffeted by the oil shocks of the 1970s, represented a rather modest program of harmonizing banking regulation. The essential thrust of the directive was to gradually shift control of EC bank activities in host countries to the regulatory authorities of the home country of the parent institution.¹⁴ While the First Banking Directive was a modest first step, it illustrates two characteristics of EC regulations in general that became important themes with respect to the banking field. First, its major tenet, "parental responsibility," had very little specific European content. It simply paralleled provisions agreed on within the so-called Cook Committee. This committee, comprised of the central bank governors representing the major economic powers of the free world, and meeting under the auspices of the Bank for International Settlements (BIS), issued a report that established the principle of the parent bank and its regulators having primary responsibility for an institution's branches abroad. It was binding for all major countries and, thus, for the global banking market place -- not specifically for the EC.

Second, the major effect of the directive was not so much on cross-border activities but on its effect on the **internal** organization and regulatory environment of national markets. A statement by a high-level Italian central bank official illustrates this point very well.

In banking, the most important of these rules is the 1977 Directive, which has already brought about some of the most fundamental changes in Italian banking

¹³Schneider, op cit., p. 268.

¹⁴Jean Dermine (Ed.), *European Banking in the 1990s*, Cambridge, MA: Basil Blackwell, Inc., 1990, pp. 21-22.

regulations since 1936 -- reopening, among other things, the possibility of founding new banks, which had been precluded in practice for many years.¹⁵

Whatever the merits of the First Banking Directive, it was overshadowed by the Second Banking Directive that came into force during 1988-89 as part of the 1985 Single Market Initiative. One important shift in direction of EC banking regulation was towards a more comprehensive concept of banking. Indeed, the list of activities mentioned in the directive suggests that the Commission had turned from a narrow concept of commercial banking toward universal banking. The list of services compiled by the Directive includes all activities of universal banks, with the notable exception of the delivery for insurance services.¹⁶

The Second Directive also introduced the concept of the "European passport." The idea underpinning this concept means, once licensed in one country, a financial services provider is authorized to offer services not only by selling them across borders within the EC, but it included the right to operate a local establishment in another EC market. Thus, the Second Banking Directive incorporates the general EC principle of the mutual recognition of technical standards to banking supervision.

The new directive was also not conducive to excessive segmentation of markets. It established one set of principles for all kinds of credit institutions and that included traditional commercial banks, savings institutions, credit unions, building societies and a host of others. Again, this measure like others had the effect of changing rules within member countries. Most EC members segment financial markets among various credit institutions. However, reforms in national markets, prompted in part by the Second Directive, enlarge the scope of various institutions and make them more alike, reducing the degree of institutional segmentation throughout the Community.

¹⁵Tommaso Padoa-Schioppa, "Towards a European Banking Regulatory Framework," *Banca D'Italia Economic Bulletin*, No. 6, February 1988, p. 49.

¹⁶Dermine, op cit., p. 23.

The Second Directive was followed by a large number of others (see Appendix) designed to establish certain minimum regulatory standards. The most important of these is the directive of February 1989 establishing minimum standards for capital adequacy. Once again, there was nothing uniquely European about this capital adequacy standard as it simply reflects (a) the minimal capital ratios and (b) the measurement/definition agreed on by regulators during their BIS meetings. This agreement is generally referred to as the Basle Agreement which brought forth the so-called BIS Capital Adequacy Requirements.

The Second Banking Directive in its **revised** version also incorporated an important message with respect to banking institutions based in countries **outside** the EC. It establishes that so-called third country banks operate under the same principles as EC banks: but upon entry into an EC member state they are subject to review by the Commission. One of the review criteria is **reciprocity** with the home country's treatment of EC institutions. The entry of banks from third countries is then subject to a final decision by the Council of Ministers upon the Commission's recommendation. Importantly, however, this review does not apply to third country institutions that are already established in the EC through a **subsidiary** (not merely a branch). However, Commission review may be triggered in case of an ownership change including nationalization.¹⁷

The period between 1986 and 1990 saw a large number of other directives and recommendations dealing with such issues as solvency ratios, public disclosure of annual accounts of banks operating in the EC, concentration of large credits, and deposit guarantee schemes, among others. These EC measures have reinforced the basic principles of EC 92 with respect to banking: there will be no community wide central authority, but home country rule, subject to minimum EC standards.

¹⁷For details see Douglas Croham, *Reciprocity and the Unification of the European Banking Market*, New York and London: Group of Thirty Occasional Papers 27, 1989.

These minimum standards are only that, a minimum; they do not preclude that individual national authorities, either by legislation or interpretation of existing rules, impose higher standards on their own banks. Thus, there may be the distinct possibility of reverse discrimination.¹⁸ For example, some countries (e.g., Germany) do not recognize accounting provisions taken for lower market values on real estate, securities, and financial investments. However, BIS/EC guidelines regard such provisions as "second tier" capital. In fact, this would force German banks to maintain higher capital ratios. German bankers claim that this role puts them at a disadvantage in the market place as the (larger) equity capital has to be serviced with the stream of earnings from the same EC market place where they confront their competitors.¹⁹

Another contentious issue pertains to the different organization of commercial banking and the securities business in various EC member states. On the Continent, universal banks play a significant role in the securities business; hence, the same capital supports both traditional commercial banking as well as securities activities, such as underwriting and trading. According to EC definitions, however, securities houses are not banks (credit institutions). Thus, they do not have to comply with the various EC requirements for commercial banks. This provision may give non-bank competitors of universal banks an advantage because their business is not subject to the same regulatory constraints as their banking competitors. This advantage pertains to investment banks from countries where banks and securities firms are separated (U.K.

¹⁸Schneider, *op. cit.*, p. 270.

¹⁹It is not clear whether the market would reward these higher capital ratios with lower deposit rates, due to lower risk perceptions. Of course, such an advantage is offset when the risk in other banking systems is thrown on the industry at large (insurance principle) or the public taxpayers in the country concerned through expected central bank rescue operations.

and possibly Italy). But then again, the securities companies do not have the opportunities of the European passport either.²⁰

IV. Remaining Obstacles

It was shown in the previous section that the EC 92 legislative initiatives leave many uneven spots on the "level playing field" of competition -- both because of the regulatory structure chosen and because of the uneven progress with respect to various sectors of the financial services industry toward achieving the goals of EC 92. In addition, there are serious cost differences and perhaps differences in consumer characteristics that will cause persistent price discrepancies consistent with the pattern shown in Table 1. This will be true even if the regulatory program is a success in terms of providing at least potential access of external service providers, thereby increasing competition. While the detailed analysis of every product-segment of the banking market is beyond the scope of this survey, a review of just one of such services, housing finance, serves as a good illustration as summarized in the following insert.

Housing Finance in the EC: A Confusing Kaleidoscope

Financing the purchases of homes and condominiums represents a significant proportion of total financing activity in all EC member countries, with proportions

²⁰As of mid-1991 there were still some significant gaps in the 1992 program for financial services. While a draft of the Investment Services Directive has been submitted in early 1989 to the Council, it faces a number of obstacles, particularly differences among member countries to what extent, if at all, to permit the trading of securities outside of recognized exchanges.

On the insurance side, while the Life Insurance Directive particularly faces severe obstacles that make it likely that the deadline of January 1, 1993 will be missed. Since life insurance and the securities business compete directly with the banks for the intermediation of savings, this delay itself could introduce distortions in markets for financial services. This effect is of particular concern due to the institutionalization of this competition in terms of "Allfinanz" in Germany and "bancassurance" in France.

ranking from 20-40 percent of all credit activities. The move toward a single market in mortgage financing lies, however, far in the distant future. In part, this is due to the nature of the business. Since mortgage finance is based on using property as security for the lender, it is closely tied to the respective national legal system governing ownership rights on real estate. Further, since "housing" is an important consumption good, the market tends to be often politicized and housing finance is frequently subsidized. However, individual countries have chosen very different ways to do this! For the same political reasons, consumer protection motives affect the national regulation of housing finance -- again manifesting in different ways from country to country. Here are some illustrations for the points made generally above:

1. Home owners' rights conflict with the rights of mortgage lenders' rights to take over control of property upon default.
2. The default event itself is defined differently in various markets.
3. Countries tend to have specialized institutions that offer mortgage financing and they endow them with special privileges designed to lower the cost and increase the availability of housing credit. Again, this is true for most EC countries but unfortunately not all!
4. Some of these mortgage institutions are government owned, presumably lowering the cost of equity capital and, therefore, the cost of housing finance (Credit Foncier de France).
5. France, together with other countries, offers prospective home owners a wide variety of subsidized mortgage plans.
6. Regulations aimed at consumer protection vary widely. In some countries, like France, mortgage lenders must provide binding offers for 30 days during which the applicant has the option to accept or reject the loan offered.
7. Talking about free options, in some European countries, but by no means all, fixed rate mortgages are repayable without penalty.
8. Related to this feature, in some countries fixed rate mortgages are virtually prescribed, in others mortgage terms are so short the rates are de facto variable, in others mortgage rates float over many market rates.
9. In some countries mortgage loans are tied only to the property per se, in others they are due on sale, i.e., when the borrower sells his home.

It comes as little surprise then that prices for mortgage loans differ widely. Cost factors alone account for substantial price discrepancies.

Adapted from BHF-Bank, Wirtschaftsdienst, Nr. 1632, April 6, 1991, pp. 1-4

Taxes represent another special regulatory cost factor and an obstacle to financial market integration. Again, it is necessary to distinguish in this context between taxes that affect costs of financial services by affecting cross-border financial transactions directly, and taxes that affect them indirectly, by virtue of being imposed within countries at different effective rates that cause comparative prices of financial services to differ. As it turns out, the latter are virtually impossible to change.

The EC has tried its hand at tax harmonization, particularly Value Added Taxes, but has not been very successful in the past. Even those efforts that aimed at harmonizing withholding taxes on cross-border financial transactions have failed. However, an EC directive to eliminate withholding taxes on cross-border payments on interest and royalties between **related corporate entities** is expected to be issued in late 1991 or early 1992.²¹ Further, a proposed EC Loss Directive would allow a parent company or other entity located in one EC state to offset profits with losses in another member country.

While some of these initiatives will undoubtedly yield results, remaining differences abound. Particularly noteworthy are rules and enforcement of taxes that pertain to interest and dividend income received by individual investors. Some countries apply very high rates to certain categories of such income, others have relatively low flat rates, irrespective of the taxpayer's other sources of income. Others again, notably Germany, require that interest be included in personal income, but since

²¹Among the EC member states, rates of withholding taxes on interest vary between 0-48.4 percent.

there is only haphazard enforcement, large proportions of total interest income escape de facto taxation altogether.²² In contrast, dividends received from domestic corporations are subject to a 30 percent withholding tax.

Even greater discrepancies can be found when one looks at the tax treatment of interest paid. The rules on deductibility differ vastly among member states in terms of who claims it and what the loan is being used for. A detailed analysis is beyond the scope of this paper; the crucial point, however, is that since people in each member state have successfully adjusted to each system, the constituencies objecting to reform are very powerful and they have successfully stymied EC tax harmonization efforts.

V. Structural Change in the Banking Industry After 1992

The preceding review of the legislative changes coming about as part of the EC 92 initiative has shown that some regulatory operating conditions for financial institutions in the EC member countries are about to change significantly. While some obstacles remain,²³ there is no doubt that the entry of financial institutions into other markets of the EC have been significantly liberalized. However, it must be clearly recognized that legislative changes only enlarge the scope and the ability of financial institutions to provide services on an EC-wide basis. To what extent it is strategically viable for an individual financial institution to actually use this freedom is quite a different matter!

The following part of this survey will review first the lessons learned from the performance of international banking activities in general. Second, the question of the extent to which market integration requires the entry of new institutions and to what

²²In November 1991 the German government proposed a 25 percent flat tax on domestic interest income with DM 5,000/10,000 tax free allowances for single/married taxpayers respectively. No consideration was given for tax systems in other EC countries.

²³Schneider, op. cit., p. 272 .

extent it can be effected by providing financial services across borders will be addressed. Third, a scheme is introduced that incorporates a standard classification of markets for banking products in order to provide a framework for analyzing the previous issue. Fourth, we shall analyze, in some detail, the market segments where cross-border trade is effective and those that require control of the delivery system. In a final major section, we analyze the special conditions in the banking market with respect to foreign market penetration, using a framework based on foreign direct investment theory.

Before proceeding, it might be useful to disassemble the complex activities that hide under the term "international banking." Following the literature,²⁴ there is, first, **traditional international banking** that comprises cross-border transactions, i.e., payments and credits received from or extended to customers in other countries. This process often involves the use of foreign correspondent banks with whom payment arrangements and credit lines are established in order to facilitate the information flow and the agency costs (these are considerable in transactions that involve different political, legal, and social environments.)

Second, there are the intermediation activities in offshore centers. As explained in Section II, when describing the Euromarkets, it was pointed out that for largely regulatory reasons, a considerable proportion of total credit intermediation activities have been moved to foreign banking centers. Such activities are centered in Europe, in London and Luxembourg, because of the regulatory environment where financial

²⁴See Robert Z. Aliber, "International Banking: A Survey," *Journal of Money, Credit and Banking*, Vol. 16, No. 4, November 1983, Part 2, pp. 661-712; and Gunter Dufey and Ian H. Giddy, *The International Money Market*, Englewood Cliffs, NJ: Prentice-Hall Foundations of Finance, 1978, Chapter I.

institutions have virtually unlimited freedom²⁵ to do business in currencies other than the domestic one and with non-resident customers.

The third mode of international banking refers to entry into foreign markets through representative offices, agencies, branches, or subsidiaries. One specific issue here is the mode of new entry, i.e., whether entry is accomplished by creating de novo establishments, or whether foreign expansion occurs through the acquisition of an existing local institution, or whether market access is gained through a joint venture or some other cooperative venture. For reasons that shall be discussed below, most of the attention of bankers as well as public policy makers has dwelled upon the opportunities of penetrating markets in other countries through an establishment. This mode of international banking is where EC 92 regulations have most dramatically changed the operating conditions of the industry. Thus, this aspect shall be in the focus of the discussion that follows.

It is not very meaningful to address the specific conditions for international banking in Europe without reviewing the state of this activity in general. After all, the world has acquired considerable experience with international banking activities. While limited by various entry barriers, there has been significant activity in this respect worldwide, nevertheless.²⁶

Traditionally, most banks that have ventured abroad by establishing a presence did so in order to follow their clients. Originally, this motive was advanced not only to put at ease local competitors, but also to overcome regulatory hurdles to access. If one abstracts here from the colonial experience, the history of international banking clearly

²⁵Except, of course, the usual obligations under private contracts and criminal laws. Indeed, centers compete for business not only by their liberal regulations but by the quality of their regulatory climate.

²⁶See Sang-Rim Choi, Adrian E. Tschoegl, and Chwo-Ming Yu, "Banks and the World's Major Financial Centers, 1970-1980," *Weltwirtschaftliches Archiv* 122, 1, 1986, pp. 48-64.

shows that banking institutions went abroad to follow trade or to serve their own emigrant populations. After World War II an additional motive emerged: to follow the banks' own corporate customers whose foreign direct investment activities offered both the challenge of retaining traditional clients and the opportunity to provide new financial services such as foreign currency loans, international cash management services, and many others. This phenomenon affected first U.S. banks; later the Europeans and Japanese followed their corporate customers abroad.

However, it is clear that once foreign banks had established a presence in a foreign market, often after lengthy and sometimes acrimonious negotiations with local regulators regarding reciprocity, they quickly started to look around for opportunities offered by unmet needs for financial services in local markets.²⁷ After thirty years of experience, one can say by and large that the efforts to profit from such opportunities have been only modestly successful. The reason is simply that local market imperfections tended to disappear quickly when foreign competitors tried to take advantage of them. If they did exist because of regulatory discrepancies, the protests of the local banks quickly caused the regulations to change, usually toward more liberalization. Furthermore, local competitors quickly reasserted themselves and became much more efficient under the threat of actual or potential onslaught of foreign competitors.²⁸

²⁷Gunter Dufey and Adrian Tschoegl, *International Competition in the Services Industries: Institutional and Structural Characteristics of Financial Services -- with Specific Reference to Banking*. Report prepared for the U.S. Congress Office of Technology Assessment, February 28, 1986.

²⁸For a case study see Jack Lowenstein, "Foreigners Weather Aussie Onslaught," *Euromoney*, April 1991, pp. 39-42.

Success or failure in international banking expansion is not easily measured.²⁹ Most banks recognize that at first their operations will not be profitable. Furthermore, the nature of bank accounting is such that it is difficult to allocate costs to individual entities that are part of an integrated system with many intangible assets. Thus, it is next to impossible to measure precisely the marginal contribution of various entities, especially entities operating abroad. Last, but not least, international tax differences and regulatory discrepancies provide a strong incentive for banks to allocate profits in ways that may minimize taxes and the cost of regulatory constraints, but distort a bad evaluation system even further. Nevertheless, banks recognize that it will take an investment to buy market share and, therefore, it is only after several years that the success or failure of foreign banks becomes clear.

One reasonable proxy for the success or failure of foreign banks might be the market share that they ultimately gain. Tables 2A and 2B show the market shares of foreign banks in several countries where institutions from abroad have a reasonably long history. If we eliminate the United Kingdom and Luxembourg, where the numbers are representative of the considerable non-resident business or other special factors, the data show that the market penetration by foreign banks has been very modest.³⁰ Even in the United States the frequently cited proportion of commercial and industrial loans (C&I) held by foreign banks is not representative of the activities of foreign banks in general. Not only do these loans reflect purchased loans, which were

²⁹*International Competitiveness of U.S. Financial Firms: Products, Markets, and Conventional Performance Measures*, Federal Reserve Bank of New York Staff Study, May 1991.

³⁰Even these numbers overstate the real market share since much of the book of a foreign bank in a local market tends to be filled with assets that are related to international activities, particularly corporations that do business with the home country of the bank. Further, special factors often affect the data. Belgium, for example, includes the activities of coordination centers which are essentially finance companies of multinationals who, due to tax incentives given, concentrate liquid assets in those institutions.

originated by U.S. banks and then sold off, but C&I loans are only a small proportion of total bank assets. As of December 1988, for example, total U.S. bank assets were \$2,430 billion, while C&I loans amounted to only 24.9 percent of that total.³¹

Tables 2A and 2B about here

Careful students of the international banking scene recognize quickly that there are very few success stories in this business, especially when looking at operations in a foreign national market. There seem to be some unique conditions in the banking industry, which will be addressed later. First, however, we must deal with an issue that is more directly relevant for EC 92. Following the recent literature on international trade in financial services,³² the effects of liberalizing the activities of competitors in international financial markets depends greatly on the specific nature of the services concerned. Particularly, one must distinguish between (a) those that can be offered across borders and (b) those that require a physical presence near the location of the customer.

With respect to the first category, the competitive factors that influence the pattern of trade are primarily regulatory costs that determine the location of the producer. It must be noted in this context that the factor "regulatory costs" comprises not only the existence of costly regulations, but includes, at the same time, (a) the presence of a regulatory framework that improves the safety of the transactions and provides an appropriate infrastructure in terms of technical infrastructure, (b) skilled personnel, (c) access for expatriate managers and specialists, and (d) competitive costs

³¹Data on U.S. commercial banks' loan portfolio can be obtained from the Annual Statistical Digest, 1988, Washington, D.C., Board of Governors of the Federal Reserve System, November 1989.

³²Rachael McCulloch, "International Competition in Services," NBER Working Paper No. 2235, May 1987, and John D. Montgomery, "Market Segmentation and 1992: Toward a Theory of Trade in Financial Services," Board of Governors of the Federal Reserve System International Finance Discussion Paper, No. 394, April 1991.

of maintaining such an expatriate community (which range from the magnitude of hardship compensation all the way to the tax treatment of the compensation packages). These factors are relevant for the competition among international financial centers.³³

Alternatively, services are offered across borders if they are uniquely tied to a particular currency or access to market segments in a national market. To use a European illustration: if a large German company wants to raise funds in the commercial paper market of France, it is obvious that French investment banks, who have the distribution capabilities in that particular market, will have a significant advantage in capturing this business.

Clearly, such considerations apply to those markets that are listed in the last two rows of Figure 1. Large corporations and financial institutions have the ability to absorb the information costs that must be incurred in shopping across a number of markets for the most economic service offer. Indeed, to the extent that the services are available out of an international financial center, the shopping costs are often less than when prices and conditions of financial services must be compared across a number of different jurisdictions.³⁴

Markets that provide services for high net worth individuals are also characterized by cross-border transactions. There is a long tradition in Europe for the upper middle class to hold a portion of their savings in Switzerland, Luxembourg, or London.³⁵ Just like savers elsewhere, they are motivated by the historical experience of economic and political turmoil and, more recent, by actual or threatened exchange

³³Yoon S. Park and Musa Essayyad (eds.), *International Banking and Financial Centers*, Boston: Kluwer Academic Publishers, 1989.

³⁴One little vignette: English has become the sole language of the international wholesale markets for financial services.

³⁵Jurisdictions like the Channel Islands and Isle of Man are treated simply as parts of the London financial market in every respect but taxation.

controls, as well as high levels of personal taxation. They are attracted to these offshore centers by confidentiality assured by law, or practice (London).

While each of these locations represents a unified jurisdiction, the nature of private banking servicing the offshore accounts of high net worth individuals clearly shows national segmentation. To illustrate: the banks in Luxembourg that are attractive to German customers are not exactly the same as those that attract the bulk of French customers. By the same token, the services that attract investors from various countries are different by currency as well as by instrument. For example, investors have a preference for instruments expressed in their home currency. Fixed income securities are particularly attractive to Germans, reflecting an investment pattern practiced at home; the French in turn like short-term money funds and equities. However, portfolios offshore are not quite as concentrated as they are in national markets: while German investors, for example, have (almost) all their funds in DM bonds and, to a much smaller extent, in shares or equity based mutual funds, once they transfer their portfolios to Luxembourg the proportion of non-German assets in their portfolios increases. The same is true with respect to institutions: savers from Germany having accounts in Luxembourg have a strong preference for maintaining them in the Luxembourg subsidiaries of German banks. However, these institutions do not have a lock on those customers and some German investors will use indigenous banks or even subsidiaries of banks from third countries.

This observation is important because it shows the extent to which banking markets are contestable. To assess this characteristic one must find answers to essentially three questions:

- To what extent can competitors match others in terms of costs, brand loyalty, technology, reputation, and similar characteristics?
- How will entrenched competitors react to a competitive move in terms of price and quality?
- How costly is it to exit a market?

It is difficult to answer these questions in a definitive way for banking overall. One can do a little better by looking at individual segments of the market differentiated by product and major customer characteristics.

The analysis offered in the Cecchini Report made clear that if there would be advantages from European financial market integration they would show up primarily at the level of retail/consumer banking and in providing more competitive services for so-called middle market customers, i.e., small and medium size business firms. It is also clear that many of these services will require a delivery system that is close to the client.

Lending to consumers, small business, and the middle market represents a good example of the differentiated nature of the market for banking services. Consumer lending in markets all over tends to be a matter of playing the law of large numbers. The creditworthiness of the individual is assessed on standard measures and in many banks such credits are evaluated in an automated fashion according to "standard scores." On the other hand, middle market lending requires the availability of skilled credit officers who are intimately familiar with both the market, and therefore the industry, of the applicant as well as the financial conditions of the individual enterprise which requests the loan. Such services cannot be provided from a distance. Indeed it is easier to service retail markets with highly standardized products from a distance, provided it is possible to do so at a significant cost or other characteristic that provides a competitive advantage.

The markets for consumer lending are characterized by very high volume, where the cost of entry represents a substantial barrier. To illustrate the underlying issue: is it feasible that, say, French consumers will utilize credit cards from Belgian banks? This is hardly likely. What is more likely is that new suppliers from the national market, such as automobile finance companies or professional associations, will use their marketing clout to offer these products on a franchised basis.

With respect to standard deposit and payment services, retail customers are motivated by convenience, error free service, and, to a certain extent, cost. Research in many banking markets of industrialized countries shows that consumers tend to resist changing banks because of the effort required to change accounts, relative to the benefits gained. For the overwhelming proportion of retail customers, **locational convenience** of their bank is the major determinant; a close relationship with individuals who work at a given bank office is secondary. This characteristic of the market obviously gives established competitors a very strong position and the only way to contest the market is for a foreign bank to purchase an established competitor. This issue will be analyzed below.

Turning to middle market customers, they are more price sensitive and it is in general the credit relationship that tends to dominate the deposit, payments, and other processing operations required. Familiarity and relationship with the account officer of the bank seems to be the dominant factor. Once again this requires a strong and established presence in the market. Developing customer relationships must be viewed by any new competitor as a fixed cost, on a present value basis.

To the extent that retail customers save by investing in securities, there is much to be gained in terms of efficiency and convenience by having the customer's payment and savings account in the same institution as the brokerage account. In those parts of the world where one does find universal banking, which happens to be in Continental Europe, it is invariably true that the basic account relationship of the customer captures also whatever securities activity there may be.³⁶

³⁶It is not without reason that major brokerage houses in the United States consider the ability to offer a money market fund with checking account features as a major competitive tool to maintain customer loyalty; many of these money fund activities per se are of very marginal profitability for their sponsors.

In the middle market where customers tend to have multiple credit relationships already, they are willing to split their brokerage business from the credit relationship.³⁷ The access to a trusted and competent investment advisor is a major concern in this business; thus, even if the relationship happens to be within the same institution, the bank officer handling the investment activities tends to be a different person than the one who approves business loans. For that reason, the market here is more contestable.

In any case, the availability of an investment advisor who at least speaks the same language, severely limits cross-border transactions, except for the most sophisticated investors (who will work through offshore center accounts in any case). Institutional presence is of essence, and that presence cannot be easily established. This has been found out by U.S. brokerage houses who have tried to penetrate European middle markets. Overall, their market share is very small and they have gained a foothold only with respect to those countries and clients who were willing and able to trade unique products such as financial futures on foreign exchanges, where domestic equivalents were not available.

Mutual funds represent a particular challenge as they make securities investment feasible for individual retail investors. Here again, however, access to these retail investors can only be gained through a local delivery system. This is less true for middle market customers where the market seems to be truly contestable since the target clientele can be approached through advertisements in newspapers and magazines, or reached through direct mail. This seems to be a market where the EC Directive on Mutual Funds of October 1989 (see Appendix 1) can be expected to make a difference. This regulatory change is particularly relevant with respect to money market mutual funds in Germany, which so far have not been available. The change in regulations is also pertinent to the entry of U.K. based equity funds into markets of

³⁷To the extent that the securities holdings of owner-managers often serve as collateral for business loans there is, however, a strong linkage.

other member states. Such funds have shown superior performance relative to their Continental competitors and will benefit from the EC 92 initiative.

Some observers see modest in-roads with respect to corporate finance activities in the middle market.³⁸ However, one can already see the beginning of an interesting phenomenon: even the threat of entry of foreign competitors causes domestic financial institutions to "gear up" and strengthen their own offerings of such services. Financial products, after all, are not patentable and if and when foreign entrants show that there are profit opportunities in a particular market, local competitors freed from regulatory constraints by the impact of the various EC directives will quickly jump into the breach. This is a general point that is probably most significant in an overall assessment of EC initiatives on the state of the EC banking financial services markets!

Even these rough and sketchy illustrations show that it is necessary to segment markets for financial services by customer group as well as by products, in order to arrive at meaningful conclusions about the mode of entry to foreign banking markets. Vice versa, general statements about "banking" are not very meaningful because of the excessive level of aggregation of what are very different business lines. By the same token, one can find significant segments where an effective market penetration can only be achieved by the acquisition of an existing intermediary. We have also shown that while EC regulations do not remove all barriers to transborder acquisitions in the banking industry,³⁹ the implementation of the EC Directives reduce them considerably. Thus, since 1985 the EC 92 initiatives gave rise to a wave of anticipatory transborder mergers, acquisitions, and joint ventures in commerce and industry. Indeed,

³⁸"The Single European Market: Survey of the U.K. Financial Services Industry," *Bank of England Quarterly Bulletin*, August 1989, pp. 407-412.

³⁹Spain had outright restrictions on the entry of foreign banks; Italy, France, Spain, Greece and Portugal required consent of the authorities to enter by **acquisition**.

substantial activity has occurred since the announcement of the EC 92 initiatives in 1985.⁴⁰

In contrast to the nonfinancial sector, there has been relatively little activity in banking and the financial services industry, particularly as far as large scale mergers and acquisitions are concerned. Tables 3A and 3B document the trend of such activities in banking in the EC member states between 1986 and 1989 in terms of the **number** of activities as well as **value** of these undertakings. A cursory glance reveals already that intra-market mergers and acquisitions (banks in the same EC country) account for more than half (56 percent) during the 1985-89 period of all such activities of banking institutions in the Community. Indeed, buyers from **outside** the EC were more active than acquirers based within the community, i.e., 123 transactions vs. 106.

In terms of the volume (billion ECUs) of the mergers and acquisitions, Table 3B shows that most of these transactions were less than 5 billion ECUs (\$ECU = approximately \$1.4). Large scale M&A activity has been notably absent. While the motive of obtaining a foothold in an EC member country provides a rationale for the activities of institutions from third countries, the question remains, however, why overall there has there been so little activity in the financial field.

It is true, some of the implementation of regulatory changes are yet to come, after all the starting date for Europe 1992 is January 1, 1993! However, there are reasons to suspect that there are more fundamental reasons at work. The theory of foreign direct investment (FDI) may provide some suggestions. Indeed, we shall argue that, when applied to the banking industry, FDI theory suggests that it would be wrong to expect a wave of big mergers and acquisitions among financial institutions in the European Community.

⁴⁰For data see Report on Competition Policy, Annual, EC (Table 3A for more) and *The European Deal Review*,

VI. Foreign Direct Investment and the Banking Industry

A basic tenet of FDI theory⁴¹ purports that to obtain ownership and control of asset abroad, the foreign acquirer must pay present owners more than their reservation price. Since prices are established on the basis of expected net cashflows, discounted by the cost of capital, the foreign acquirer can economically justify to pay above the current market price only if the (a) his cost of capital is less, or (b) his expected net revenues are higher. While there is a wide ranging debate about differences in the cost of capital for companies based in various countries, the debate usually involves countries like Japan, the United States, and West Germany (as a proxy for Europe). There seems to be very little support for an argument supporting systematic cost of capital differences among member countries of the European Economic Community, particularly after measures to liberalize capital flows have been implemented with respect to all member countries that really matter. Thus, any acquirer of a foreign bank must anticipate increased net cashflows!

When considering future net cashflows that a foreign acquirer can extricate from a local company, FDI theory emphasizes the fact that the foreign acquirer incurs special costs of controlling and managing an operation in a foreign environment. These costs are particularly relevant with respect to banking.

While technology has made an important impact, no institution in the financial services industry has that managed to obtain a lasting technological advantage. All banks use equipment procured from a limited number of global suppliers. Beyond bricks and mortar and technology, banking is a people business. The management of highly skilled specialists and large numbers of clerical personnel requires considerable

⁴¹For a good review on the FDI literature see John H. Dunning, "The Eclectic Paradigm of International Production: A Restatement and Some Possible Extensions, *Journal of International Business Studies*, vol. 19, no. 1, Spring 1988, and Peter J. Buckley, "The Limits of Explanation: Testing the Internalization Theory of the Multinational Enterprise, *Journal of International Business Studies*, vol. 19, no. 2, Summer 1988.

skills. Indeed, among domestic banks it is often those management skills that differentiate among various banks.⁴² To manage such a workforce across borders in a multicultural environment is extremely difficult and to find success stories proves to be a frustrating exercise. The difficulties are compounded because not only is it necessary to alter the old culture of the acquired enterprise, which is often difficult in a domestic context as many failed bank mergers attest, but to do so across borders is a feat that is elusive and the success stories are few and far between.⁴³

To the extent that banks can develop a competitive advantage, it relies largely on an internal management culture, i.e., ways of informal cooperation, decentralization, and control systems that motivate thousands of employees to move in directions that are consistent with corporate goals. For short, it is "management" that distinguishes successful and unsuccessful institutions in the financial services industry. This is exactly the area where transborder mergers of financial institutions had their biggest problems, even involving those that have managed to develop such a corporate culture in their home organization.⁴⁴

Thus, the combination of the facts that (a) with respect to most banking products profitability is difficult to defend from competition, while (b) the management, control and integration costs are very high, leads to the conclusion that

⁴²Jean M. Hiltrop, "Human Resource Management in European Banking: Challenges and Responses," *European Management Journal*, vol. 9, no. 1, March 1991.

⁴³As a matter of fact, U.S. based institutions seem to have been somewhat more successful at managing multicultural white collar workforces. See Gunter Dufey and Adrian Tschoegl, *International Competition in the Services Industries: Institutional and Structural Characteristics of Financial Services -- with Specific Reference to Banking*. Report prepared for the U.S. Congress Office of Technology Assessment, February 28, 1986, pp. 170-171. For a review of recent trends see Richard Philips, "Trouble Abroad for Banks," *Euromoney - Corporate Finance*, Sept. 1991, pp. 23-26.

⁴⁴The few successes in international banking are typically institutions that went into less developed countries where their unique skills and capabilities were not challenged by local competitors and where they found a political environment that gave them protection from competitors from other developed countries. This is a typical situation for colonial or quasi-colonial situations.

FDI strategies are unlikely to succeed. This is true especially in view of the fact that economies of scale in banking -- as opposed to many manufacturing industries -- have proved to be ephemeral and may be negative for cross-border consolidations.

Having concluded that cross-border mergers will not occur on a significant scale due to lack of sufficient economic incentives, the temptation is to argue for the status quo after 1992. This would overlook, however, another significant arena of change: under the threat of competition from the outside, there will likely be a wave of mergers where domestic competitors will use the new freedoms and the upcoming dynamic changes in the nonfinancial markets introduced by EC 92 initiatives to strengthen their position by consolidating through **intra-market** mergers and acquisitions. Such intra-market mergers are easier to manage and, most importantly, create value by reducing competition and allowing the achievement of economies of scale in select areas such as data processing, number of branches, corporate overhead, etc. What we will find then, in terms of transborder mergers, is small scale "beachhead" investment and, possibly, a few new intra-European joint ventures;⁴⁵ indeed, these phenomena may have already occurred.

VII. Conclusions and Outlook for Banking After EC 1992

None of the trends outlined above are new. What we find is that they comprise largely activities that financial institutions have already started to undertake in **anticipation** of the regulatory situation after January 1993.⁴⁶

The major impact of the EC 92 initiatives in the financial field is to achieve free trade in financial services across borders, thereby facilitating the unhindered flow of capital among member countries if not the global financial market place in general. In

⁴⁵"European Banking Alliances: Let-Down," *The Economist*, Sept. 7, 1991, pp. 82-83.

⁴⁶These conclusions have been affirmed by country specific studies; for examples, see Bernard Marois, "The Impact of European financial Integration on the Strategies of French Banks," HEC Discussion paper, Nov. 1991.

those (few) instances where access to local market opportunities necessitates a presence, EC competitors will find the level of legal barriers significantly lowered, although some obstacles will remain. However, since many of these remaining obstacles are subject to discretionary decisions by national governments, the "European passport" will have value, provided member countries will comply not only with the letter, but also the spirit of EC 92 directives. A set of minimal common standards will have wide ranging effects on harmonizing standards of bank supervision among the various member countries.

It is noteworthy that only a few months before the beginning of an integrated market for financial services, regulatory changes have only been implemented with respect to banking (albeit for a list of banking services that is very comprehensive). However, for institutions in the securities business and the insurance industry, the timetable of EC 92 has not been kept up. Thus, there will be at least transitory consequences on competition.⁴⁷ In light of the increasing competition among different categories of financial services providers, distortions in markets may not be trivial.

The regulatory changes will provide added impetus toward already existing trends in terms of integration of additional segments of financial markets. This phenomenon of globalization of financial markets precedes the EC 92 initiatives and exceeds the scope of the EC.

Looking at specific segments for banking products, it was noted that the wholesale market is largely integrated on a global scale already. However, markets for

⁴⁷This paper has focused on the banking industry as compared to all financial services. For excellent surveys on the investment banking industry in Europe see Ingo Walter and Roy C. Smith. "European Investment Banking: Structure, Transactions Flow and Regulation. Chapter 4 in Jean Dermine (Ed.). *European Banking in the 1990s*. Cambridge, MA: Basil Blackwell, Inc., 1990, pp. 105-147. For a comprehensive survey of the European insurance industry, see "Pieces on the Board," *The Economist* Survey of European Insurance, February 24, 1990.

financial services offered to retail customers are fragmented and probably will remain differentiated for some time. This is due less to lack of competition from abroad, but due to persistent cost differences in various national markets. Also, with respect to retail markets, access to distribution systems is required for almost all products. Experience has shown that such access is difficult to gain. Cooperative ventures, particularly in banking, have not worked because of the coordination and agency problems. However, large scale cross-border expansion of institutions through acquisitions cannot be expected either, because of the absence of economies of scale and the substantial costs incurred in managing such service organizations across borders.

These factors do not preclude limited integration of markets through institutional interpenetration via so-called "beachhead" investments. It must be noted to a large part of this strategy has already been implemented by financial institutions from outside the EC, primarily American, Japanese, and Swiss banks. Where there are perceived gaps in the market for financial services, such as certain national markets in southern Europe, opportunities to penetrate these markets through acquisitions of local institutions will be tempting. It has been argued in this paper that such attempts will have modest outcomes because the liberalization of the regulatory environment in these markets, stimulated largely by EC 92 initiatives, will prompt local service providers to become more efficient.

Such increases in efficiency can be gained through **within** market consolidation. Indeed, it is with respect to the latter efforts that the most noticeable changes in the structure of European banking will occur. EC 92 initiatives will accomplish this through a combination of actual or perceived threats of foreign competition, liberalization of rules, especially antitrust rules, and political concerns about the international standing of institutions which will further promote intra-market consolidation. If this is done through mergers and acquisitions, limited economies of

scale may be realized and, at the same time, the cost of managing disparate workforces across borders can be avoided.

A related effect will particularly affect the middle market business of banks. There, restructuring, including cross-border mergers, in the nonfinancial sector will cause substantial changes to established client relationships by making many of those clients that used to be captive to become susceptible to both foreign as well as larger national competitors. Thus, even without a large-scale restructuring of the banking industry in Europe, it is safe to predict substantial changes in competition for most sectors of banking (except for the most basic retail banking services) not so much because of changes in the financial service industry per se, but because of changes among their cliental.

While it is difficult to make a case for dramatic changes in the demand for financial services, changes in nonfinancial markets and the structure of European industry will increase the demand for cross-border financial services within the EC. Undoubtedly, this will affect the nature and organization of financial services suppliers.

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Table 1

EUROPEAN PRICES FOR FINANCIAL SERVICES

(Percent Above or Below the Average of the Lowest Four National Prices Found)

Standard Service	Belgium	W. Germany	Spain	France	Italy	Lux.	Holland	Britain
Banking Services								
Consumer Credit ¹	-41	136	39	NA	121	-26	31	121
Mortgages ²	31	57	118	78	-4	NA	-6	-20
Foreign-Exchange Drafts ³	6	31	196	56	23	33	-46	16
Commercial Loans ⁴	-5	6	19	-7	9	6	43	46
Insurance Services								
Life Insurance ⁵	78	5	37	33	83	66	-9	-30
Home Insurance ⁶	-16	3	-4	39	81	57	17	90
Commercial Fire & Theft ⁷								
Brokerage Services								
Private-Equity								
Transactions ⁸	36	7	65	-13	-3	7	114	123
Institutional-Equity								
Transactions ⁹	26	69	153	-5	47	68	26	-47

¹Annual cost of consumer loan of 5090 ECU. Excess interest rate over money market rates.

²Annual cost of home loan of 25,000 ECU. Excess interest rate over money market rates.

³Cost to a large commercial client of purchasing a commercial draft for 30,000 ECU.

⁴Annual cost (including commissions and charges) to a medium sized firm of a commercial loan of 250,000 ECU.

⁵Average annual cost of term (life) insurance.

⁶Average annual cost of fire and theft cover for house valued at 70,000 ECU with 28,000 ECU contents.

⁷Annual cover for premises valued at 390,000 ECU 7 stock at 230,000 ECU.

⁸Commission costs of cash bargain of 1,440 ECU.

⁹Commission costs of cash bargain of 288,000 ECU.

Table 2A

Estimates of Percent Total Banking Assets
Held by Foreign Financial Institutions
(End of 1987; figures in percent of total banking assets)

Belgium ¹	46%
Denmark	1
France	16
Germany	4
Greece	n.a.
Ireland	11
Italy	3
Luxembourg ²	91
Netherlands	10
Portugal	3
Spain	11
United Kingdom ³	60

¹Figure includes activities of "Coordination Centers" (finance companies) of MNCs.

²Figure includes private banking activities for global customers.

³Figure includes international syndicated loans and Eurobonds.

Source: Hawawini and Rajendra, *The Transformation of the European Financial Services Industry: From Fragmentation to Integration*, Salomon Brothers Center for the Study of Financial Institutions, Monograph Series in Finance and Economics, #1989-4.

Table 2B

Volume of Commercial Lending by Foreign Banks
as Percent of Loans and Assets
(\$ Billion and Percent)

	1986		1987		1988		1989	
	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign	Domestic	Foreign
<u>USA</u>								
Commercial loans (C & I)	392	104	389	126	406	150	424	166
Total Assets	2,449	539	2,473	606	2,615	674	2,779	750
		21		24.5		27		28.1
		18		19.7		20.5		21.3
<u>Japan</u>								
Loans and discounts*	1,867	41	2,103	49	2,318	45	2,862	49
Total Assets	2,939	82	3,315	94	3,671	95	4,716	95
		2.2		2.3		1.9		1.7
		2.7		2.7		2.5		2.0
<u>Germany</u>								
Commercial loans	1,001	18	1,022	18	1,075	20	1,152	21
Total Assets	3,412	144	3,620	151	3,852	168	4,131	190
		3.0		1.7		1.8		2.9
		4.0		4.0		4.2		4.4
<u>United Kingdom</u>								
Commercial loans**	78	39	104	47	121	60	165	82
Total Assets	213	352	219	572	248	633	314	769
		33.5		31.3		33.3		33.3
		62.3		11.7		60.8		59.2

* Figures include banking account balances only (trust account balances are not included).

** Commercial lending in the United Kingdom is defined as sterling and non-sterling private sector advances.

Source: J.B.T. Howe, G. Budzeika, G.G. Riela, and P.R. Worthington, "Competitiveness in Commercial Lending Markets." In International Competitiveness of U.S. Financial Firms, Staff Study, Federal Reserve Bank of New York, May 1991.

Table 3A
 Number of National, Community and International Mergers,^a Acquisitions,^b
 and Joint Ventures^c of Banking Institutions in the Community

	National ¹			Community ²			International ³			Total			Grand Total
	a	b	c	a	b	c	a	b	c	a	b	c	
1989/90	65	40	10	23	33	12	25	23	8	113	96	30	239
1988/89	51	32	11	16	19	6	16	11	7	83	62	24	169
1987/88	53	38	16	12	15	7	13	28	7	78	81	30	189
1986/87	22	11	18	3	9	5	10	13	1	35	33	24	92
1985/86	12	10	10	4	3	6	9	8	0	25	21	16	62

¹Activities of firms from the same Member States.

²Activities of firms from different Member States.

³Activities of firms from Member States and Third Countries with effects on the Community Market.

^aMergers

^bAcquisitions

^cJoint Ventures

Source: *Sixteenth Report on Competition Policy*, 1987, Office for Official Publications of the European Communities.
Seventeenth Report on Competition Policy, 1988, Office for Official Publications of the European Communities.
Eighteenth Report on Competition Policy, 1989, Office for Official Publications of the European Communities.
Nineteenth Report on Competition Policy, 1990, Office for Official Publications of the European Communities.
Twentieth Report on Competition Policy, 1991, Office for Official Publications of the European Communities.

Table 3B

Number of Mergers and Acquisitions in Banking
Breakdown in Terms of National, Community, and International Activities
(Combined turnover billion ECUs)

Year	National ¹		Community ²			International ³			Total							
	>1	>2	>5	>10	>1	>2	>5	>10	>1	>2	>5	>10				
1989/90	22	19	14	10	10	9	7	2	8	8	5	4	37	32	22	12
1988/89	22	15	3	1	11	9	4	2	8	8	5	4	41	32	12	7
1987/88	19	14	7	4	10	10	8	4	7	5	4	2	36	29	19	10
1986/87	9	6	5	3	2	2	1	1	9	7	5	3	20	15	11	7

¹Activities of firms from the same Member States.

²Activities of firms from different Member States.

³Activities of firms from Member States and Third Countries with effects on the Community Market.

Source: *Nineteenth Report on Competition Policy*, 1990, Office for Official Publications of the European Communities, p. 215.
Source: *Twentieth Report on Competition Policy*, 1991, Office for Official Publications of the European Communities, p. 224.

Activity Service ₁ Market Segments ₂	Credit Related Activities	Transactions Related Activities		Securities Related Activities		Corporate Finance Activities
	Lending incl. Credit Cards	Deposits, Payments, F/X, Trade Fin. & Processing Operations	Swaps & Derivative Products	Underwriting, incl. Securitization, Trading & Brokerage	Asset Mgmt. Insurance Mktg, Mutual Funds	Fin. Advisory Svc, Merchant-Banking, Venture-Capital, M&A Services
Retail/ Consumers			N/A			N/A
High Net-worth Individuals						
Middle Market Commercial						
Large Corporations						
Financial Institutions incl. Correspondent Banking						

Figure 1. Banking: Products, Services, and Market Segments

* Incl. Securitization

¹Driven by technology, skills, and risks

²Determined by common demand factors, e.g., scale, risk and approach

Appendix

Europe 1992 Financial Market Integration:

A Timetable of Significant Agreements and Proposals

<u>Date</u>	<u>Event</u>
1951	European Coal and Steel Community (ECSC) Predecessor of EC -- established common market and policy for steel
1957	Treaty of Rome Establishes European Community
1968	Establishment of the Customs Union Creates common external tariff and schedule for removal of intra-EC tariffs
1970	"Werner Report" First comprehensive 10 year program for economic and monetary union
1973	European Fund for Monetary Cooperation Establishes short and medium term loan facilities to member central banks
1972 (Apr.)	Basle Agreement Establishes the " <u>Snake</u> " in Europe via 2.5% margin, after 1971 Smithsonian Agreement established 4.5% margins generally ("tunnel")
1975	European Unit of Account (EUA) as means of settlement for EC official transactions
1976	EUA adapted for ECSC
1977	First Banking Directive Establishes general program towards harmonization of regulation, calling for further directives

- 1973-79 EC stressed by oil shock
- 1978 EUA used for EC budget
- 1979 (Mar.) **European Monetary System (EMS)**
- Use of European Currency Unit (ECU) as numeraire for exchange rate management (replaced EUA)
 - Member countries' inflation and interest rate levels converge toward German levels
 - Political critique: dominance of Bundesbank without say in policy formation
 - Economically: Adjustment burden "asymmetric"
- 1981 **ECU replaces EUA for EC budget**
- 1983 (Jan.) **Consolidated Supervision Directive**
- Provides for the supervision of banks operating in the EC on a consolidated basis
- 1983 (July) **Directive on the Supervision of Credit Institutions**
- on a consolidated basis approved
- 1985 **Cockfield White Paper**
- Suggests freeing capital flows, financial services and intermediaries by the end of 1992
- 1985 (June) **EEC Commission submits "Europe 1992" Plan**
- White Paper identifies 300 areas for elimination of barriers to complete common market
- 1986 (Feb.) **Single European Act**
- signed by Council in February 1986, ratified by member parliaments in 1986/87, entered into force July 1, 1987
- 1986 (Dec.) **Annual and Consolidated Accounts of Banks Directive**
- Provides for a standardized format and content of the annual consolidated accounts of banks

- 1986 (Dec.) **Recommendation on Monitoring and Controlling Large Exposures of Credit Institutions**
- 1986 (Dec.) **Recommendation on Introduction of Deposit-Guarantee Schemes**
- 1986 (Dec.) **Directive on the Coordination of Laws, Regulations, and Administrative Provisions Relating to Consumer Credit**
- 1987 (Feb.) **Directive on Free Movement of Capital**
issued previously by Commission, establishing four categories of transactions and timetable for various member countries, came into force
- 1987 (May) **Proposal for a Directive on the Freedom of Establishment and the Free Supply of Services in the Field of Mortgage Credit**
submitted by the Commission to Council
- 1987 (June) **Mutual Recognition Amendment to Listing Particulars Directive**
Provides for mutual recognition of the "listing particulars" of the company's home country.
- 1988 (Jan.) **Second Banking Directive**
Proposed by EC Commission to allow banks to operate in all member countries with single license (revised July 1989 with respect to reciprocity principle applied to institutions from third countries)
- 1988 (Jan.) **Proposal for a Directive Concerning the Reorganization and the Liquidation of Credit Institutions and Deposit Guarantee Schemes**
- 1988 (June) **Program to Liberalize Capital Flows**
beginning July 1990 adopted by Council of Ministers
- 1988 (Dec.) **Mutual Recognition of Prospectuses Directive**
Provides for the drawing up, scrutiny and distribution of the prospectus when transferable securities are offered to the public

- 1989 (Jan.) **Investment-Services Directive**
Draft submitted by Commission to Council
- 1989 (Feb.) **Directive on the Obligations of Third Country Bank Branches**
Publication of annual accounting documents required
- 1989 (Feb.) **Proposed Withholding Tax Directive**
Proposal requiring member states to impose a minimum withholding tax of 15 percent on interest income paid to any EC resident (whether an EC or third country national) on domestically issued bonds and bank deposits
- 1989 (Apr.) **Credit Institutions' Own Funds Directive Adopted**
Incorporates BIS recommendation
- 1989 (Apr.) **Delors Committee Report**
Suggests three stage transition to economic and monetary union
- 1989 (Oct.) **EC Directive on Mutual Funds**
Undertaking for Collective Investment in Transferable Securities establishes freedom for such funds to be sold throughout the Community once approved in one country.
- 1989 (Nov/Dec) **Changes in Eastern Europe and especially East Germany**
raise specter of German Reunification; appears to accelerate Europe 1992 effort, especially monetary unification to bind Germany firmly into EC.
- 1989 (Dec.) **Solvency Ratio Directive for Banks**
Establishes capital adequacy standards throughout the EC from January 1991
- 1990 (Feb.) **EC Proposal on Capital Requirements of Securities Firms**
Study on minimum capital adequacy rules for securities firms by EC Commissioner for financial institutions.
- 1990 (Mar.) **Establishment of a "Eurofed"**
Proposal issued by EC executive commission for the formation of an independent central bank (modeled largely after the U.S. Federal Reserve) by 1996.

1990 (late) **Draft on Non-Life Insurance**

1991 (Feb.) **Third Life Insurance Directive**

Draft proposal to open market of member countries to life insurance products created by companies licenses in another member country.

1991 (Summer) EC Commission working on streamlining **European Payment and**

Settlement System and draft directive to eliminate **limits on cross-border investments by pension funds**