

Integration of European Banking: The Way Forward

Monitoring European Deregulation 3

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Foreword

The regulation of network industries has emerged as a key issue on the European policy agenda; yet there is little high quality research capable of informing European policy debates on these issues. In 1997, the Centre for Economic Policy Research (CEPR) and the Swedish Center for Business and Policy Studies (SNS) therefore launched a new series of reports on Monitoring European Deregulation. The aim is to bring together a team that includes some of Europe's leading researchers in the field of network industries to specifically address the issues of regulation and deregulation in Europe. The first Report was published in September 1998. The initial section of the 1998 Report concentrated on the general issues that arise in the regulation of network industries, with a second section focusing specifically on the telecoms industry. A second Report was launched in 1999 and dealt with the liberalization of the European Electricity Market.

Research in this area remains as timely and policy-relevant today as it was in 1997. Eleven Member States have, for example, still not transposed the directive on energy liberalization into national law. The Commission will send a formal warning letter to those countries in March, giving them two months to implement the rules or face the European Court of Justice. In addition, Competition Commissioner Neelie Kroes announced that she would launch a competition investigation into the energy sector as part of the revived Lisbon competitiveness strategy, and that the Commission would propose solutions wherever it finds markets that are not sufficiently liberalized.

This third Report launched as part of the Monitoring European Deregulation initiative focuses on the European banking sector. The authors begin by examining the current level of integration amongst European banks. They move on to consider the structure and regulation of the market. Both the retail and wholesale markets are analysed separately reflecting the much greater level of integration in corporate finance. The report is published almost a year after the EU expanded its borders to 25 countries and it is appropriate that the authors also look at the banking industry in the accession countries. Additionally certain policy recommendations are made in the context of implementation of the European Union's Financial Services Action Plan (FSAP).

A Reference Group consisting of representatives from BBVA, Bank Austria Creditanstalt and Lloyds TSB, commented on drafts and provided advice to the authors on the issues raised in the report. CEPR is very grateful for the commitment and support of these organizations, and for the help and assistance provided by the Reference Group members (Carmen Hernansanz, Head Economist Sectoral Analysis, BBVA Research Department; Marianne Kager, Chief Economist, Bank Austria Creditanstalt; and Patrick Foley, Director of Group Strategy & Corporate Development, Lloyds TSB – who chaired the Reference Group). We are

also particularly grateful to the Fundación BBVA for their generous financial assistance in support of the research and publications costs – without this, the project would not have been possible. The authors enjoyed complete academic freedom in writing the Report, but the industry practitioners in the Reference Group thereby played a valuable role in its preparation.

We would also like to thank the authors for their work in producing this insightful Report, which will, we are confident, be of great value to anyone interested in deregulation issues. The views expressed in the Report are those of the authors writing in their personal capacity and neither CEPR nor the reference group take any institutional policy positions.

Stephen Yeo
Chief Executive Officer
Centre for Economic Policy Research
March 2005

Executive Summary

Five years ago, the Centre for Economic Policy Research (CEPR) produced a report on the Future of European Banking in which it concluded that European Union (EU) financial markets are fundamentally segmented. ‘On the supply side – savings behaviour – is the “home bias” of European households. On the demand side – the behaviour of firms – one needs to understand why European corporations stay clear of the bond market and typically borrow from banks’.¹

A lot has happened since then. The euro has been firmly established in several Member States. Stock markets have been through a boom and bust. A number of Eastern European countries have joined the EU. Perhaps most significantly of all the European Union has launched its Financial Services Action Plan (FSAP). The goal of the FSAP is to create a single integrated market in Financial Services in Europe. This is regarded as critical for providing individuals with the best savings opportunities and companies with access to ‘deep and liquid markets for raising capital’. It is an extension of the principles of free trade to financial services and the same benefits associated with the elimination of barriers to trade are anticipated in financial services.

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

1. The establishment of institutions to ensure the effective implementation and enforcement of the FSAP.
2. The pursuit of home country regulation and minimization of host country regulation.
3. The creation of lead regulators to coordinate cross-border activities.
4. Strengthening of competition policy at the EU as well as the domestic level to prevent discrimination against cross-border activity.
5. The determination of lender of last resort facilities in the EU.

¹ The Future of European Banking, *Monitoring European Integration* 9, Centre for Economic Policy Research, London, 1999.

Chapter 2 assesses the extent to which the single market programme and the euro have contributed to the construction of an integrated EU banking market, and analyses the implications of these for the structure of national banking systems. The analysis is carried out at the level of banking institutions, since a more detailed study by lines of business is undertaken in the following chapters.

The main finding of Chapter 3 is that integration in retail banking has been slow and it is lower than in corporate finance described in the next chapter. In particular, loans to residential consumers are markets where local presence and nationality still matter. A natural reference point to assess retail banking integration is the cost of cross-border transactions and, by this measure, barriers are still significant. Amounts traded are small and bank charges have shown little change over time.

A main unresolved issue is what lies behind the barriers to further market integration in retail banking. The easy and immediate answer is proximity to customers, advantages from local information, and relationship business. However, the several unsuccessful attempts at entry into foreign retail banking markets, namely in the smaller European markets, suggest that other factors may be at play as well. The mere deployment of branch networks does not guarantee the success of cross-border expansion.

Chapter 4 documents an interesting and in some respects surprising picture of the corporate finance aspects of integration in European banking. Theories of corporate finance suggest that information problems are more serious in equity than in debt finance as a consequence of the greater information sensitivity of equity finance. In addition, the participation of a large number of investors requires information to be more widely available in public securities than in private capital markets. We would therefore anticipate that in a ranking of financial integration it would be most in evidence in public debt markets, least in private equity markets and somewhere in between in private debt and public equity markets. In fact what is observed is a high level of cross-border flows in private equity and only modest integration of syndicated bank lending.

Chapter 5 provides a careful look at the banking systems of the accession countries. It considers the extent to which they are already part of the European market and how prepared they are for full-fledged competition within the EU-wide marketplace. It finds that the banking systems of these countries have gone through a remarkable institutional development and integration of ownership, with West European banks controlling most of the important institutions in the new Member States. Old institutions have been transformed, and new ones created. However, the integration project is far from over. Real integration has proceeded quite far in response to the liberalization of trade, but financial integration remains incomplete.

1 Introduction

1.1 The policy objectives and the Financial Services Action Plan

Five years ago, the Centre for Economic Policy Research (CEPR) produced a report 'The Future of European Banking', in which it concluded that European Union (EU) financial markets are fundamentally segmented. 'On the supply side – savings behaviour – is the 'home bias' of European households. On the demand side – the behaviour of firms – one needs to understand why European corporations stay clear of the bond market and typically borrow from banks'.¹

A lot has happened since then. The euro has been firmly established in several member states. Stock markets have been through a boom and bust. A number of Eastern European countries have joined the EU. Perhaps most significantly of all the EU has launched its Financial Services Action Plan (FSAP). The goal of the FSAP is to create a single integrated market in financial services in Europe. This is regarded as critical for providing individuals with the best savings opportunities and companies with access to 'deep and liquid markets for raising capital'. It is an extension of the principles of free trade to financial services and the same benefits associated with the elimination of barriers to trade are anticipated in financial services.

Specifically the FSAP is seeking to establish:

- A single wholesale market to allow corporate borrowers to raise finance on an EU-wide basis and to give investors and intermediaries access to all markets from a single point of entry.
- An open retail market that removes barriers to cross-border retail services and gives retail customers the information and assurance required to access services on a EU-wide basis.

Barriers to trade in financial services arise from two sources – regulatory/legal and non-regulatory/institutional causes. Regulation can act to discriminate explicitly or implicitly against the provision of services by non-domestic institutions. For example, in the past there have been limitations on the proportion of overseas securities that pension funds have been allowed to hold in their portfolios. In banking, prior to the Second Banking Directive and the principle of mutual recognition through the single passport, banks faced significant regulatory hurdles to opening foreign branches and subsidiaries.

In principle, there is now free trade in banking services and branching. Central to this is mutual recognition and the single passport enshrined in the Second Banking Directive. According to this, responsibility for prudential supervision rests with the home country and banks authorized in one member country are free to offer financial services in any other. For example, a French bank that

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wishes to operate in Germany seeks authorization to do this from the French not the German authorities and while the German authorities are informed about the intention of the bank to operate in Germany, they have no right to object.

Home-country authorization has played a fundamental role in eliminating regulatory restrictions to cross-border flows in financial services. Superimposed on it, however, is host-country supervision, which gives host countries the right to impose regulation to uphold national interests. These relate in particular to conduct of business rules and consumer protection. By requiring firms selling in more than one country to undertake their activities in different ways, host-country rules undermine their ability to exploit economies of scale from operating at a pan-European level. They therefore constrain the development of a single integrated market by imposing regulation at the national level. Furthermore, since national legislation evolved in conjunction with domestic financial systems, they inevitably favour domestic over foreign institutions. They are therefore not only an impediment to the creation of a single market but also a source of discrimination and promotion of domestic over foreign institutions.

This report reviews the progress that has been made in eliminating regulatory and non-regulatory barriers to trade in banking services and the degree to which European banking markets have become integrated. Before reviewing the evidence, however, we set out some key policy recommendations that relate to the assessment of the FSAP. We also suggest that the pursuit of financial integration raises fundamental questions about the ownership of banks that have not been adequately considered to date.

1.2 Policy recommendations

A: New institutional arrangements are required to implement the FSAP

The FSAP provides a framework within which the harmonization of legislation regarding financial services regulation can occur. Harmonization refers to the minimum set of rules that are required to support the development of an EU-wide market. The FSAP is to be implemented through the Lamfalussy process.² Agreement is to be achieved on broad general principles through the coordination of national regulatory bodies in consultation with industry and consumer groups and then specific implementation is supposed to take place at the Member State level, using coordinating committees of national regulators to ensure that translation of principles and the enforcement of rules occur in comparable ways across the EU.

It is questionable whether peer pressure is adequate. Member States will face strong representation from interested domestic parties to resist changes that undermine their competitive position and consumer groups will argue against policies that are perceived to weaken existing safeguards. To ensure that domestic legislation takes a broad Community-wide rather than narrow domestic perspective, stronger implementation systems will be required. There are two that have been considered.

The first is to give greater powers to a central organization, such as the Commission or the Committee of Regulators, to ensure that rules are enforced according to agreed principles and to veto specific legislation that runs counter to the FSAP.³ The second proposal is to avoid stalemate in the implementation process by fostering 'enhanced cooperation' among an inner club of members. The risk of losing business through trade diversion will provide incentives for

non-member countries to join and thereby progressively extend the degree of harmonization across Europe.

B: Financial integration rests critically on the principles of mutual recognition and home-country rule and the avoidance of host-country regulation

Integration of EU banking (and security) markets has progressed on the basis of minimal harmonization, home-country rule, and mutual recognition of the authorization of institutions. It has not been assisted by continuing reliance on host-country regulation. Host-country regulation has operated as a protectionist device that has intensified market segmentation. It is supported by regulators concerned about maintaining their autonomy and preferring regulatory coordination over competition.

A move from host- to home-country regulation is realistic only if in the process the protection of domestic consumers can be assured.⁴ This is unlikely if aggrieved customers have to seek remedies through foreign courts in the home country of authorization of the financial institution. An EU-wide body that can at least provide central arbitration services may be required and in due course, though probably not at present, a central regulatory body (Financial Services Authority or Securities and Exchange Commission) may be desirable.

A move towards removing host-country regulation would also appear to be warranted in the context of securities regulation.

C: Lead regulators should be established to coordinate the regulation of cross-border activities, particularly in relation to conglomerates operating in more than one field of business

The supervision of financial institutions which operate cross-border is hampered by the existence of a multiplicity of regulators. This increases the costs and complexities of supervision. Instead, in the spirit of home-country rule and mutual recognition, the role of a lead regulator should be recognized, with a clear acknowledgement of its powers to undertake supervision of entities with substantial cross-border activities.

D: Strengthening of competition policy, both at the domestic and the EU level

Competition policy is critical to the development of cross-border banking in Europe. In particular, the European Commission should use competition policy to prevent barriers to cross-border takeovers being erected. These are frequently justified explicitly or implicitly on grounds of protecting national champions or industrial policy. The EC competition authorities will have to be alert to this, particularly as cross-border and domestic mergers have contrasting effects on domestic concentration: domestic acquisitions typically result in increased concentration, while cross-border acquisitions allow foreign firms to gain access to domestic markets, thereby increasing competition. EU competition policy will be assisted by the adoption of the directive on cross-border mergers and also by the disclosure directive on enhanced transparency on the ownership and governance of EU institutions. Similarly, domestic competition authorities should have the resources and competences to deal with concentrations and foreign acquisitions in the financial sector through a rigorous application of competition policy principles.

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E: Lender of last resort and systemic risk

The one area where host-country control may be justified is in relation to systemic risks. The threat to national financial systems may require intervention at the national rather than the individual institution level. Home-country authorities will not on their own take adequate account of the spillover effects of their actions on other host-country institutions. Host-country authorities will therefore quite properly wish to give consideration to the wider national effects of institutional failure. In the presence of integrated financial markets, however, the repercussions of substantial financial failures are unlikely to be restricted to the institutions of a single country. They are more likely to be felt at the European or international level. In particular, host-country supervisory authorities will face information problems regarding branches of foreign banks, and conflicts of interest between home and host supervisors may arise.

This raises the question of whether the institutional structure exists within the EU to deal with international failures. The concern that arises here is coordination of lender of last resort interventions by central banks and the European Central Bank and the degree to which large calls on deposit insurance schemes may have fiscal implications. Thus far the European Central Bank has been unwilling to commit itself to providing lender of last resort facilities (except for the euro area), partly on account of the moral hazard problems that such explicit commitments can create. It is one thing, however, for a central bank to be reluctant to make the form of its responses transparent for fear of their effects on risk-taking by financial institutions, it is another not to have in place or even make explicit the institutional arrangements for dealing with a crisis. The absence of adequate arrangements to deal with international systemic crises may in itself prove to be the catalyst for a crisis where the right conditions prevail.

1.3 Implications of ownership

At the heart of debates about the integration of financial markets lie questions about ownership. When thinking about integration of banking services, one has in mind the equivalent of purchasing a consumer good. A customer should be able to source their consumer goods from the most efficient producer. Likewise, a saver should be able to invest their money in an institution that offers the most attractive terms; a house purchaser should be able to raise a mortgage from a lender offering the most attractive terms; a company should be able to raise a loan from the lowest-cost supplier; and a firm issuing new securities for internal investment or acquisitions of other companies should be able to go to a bank of any nationality to provide this service.

The principle of financial integration appears straightforward. The elimination of barriers to trade ensures that financial services can be sourced from the lowest-cost suppliers wherever they happen to be located. As in other markets, free trade raises familiar questions about conflicts between the interests of consumers and producers. A French saver may decide to deposit money with a German bank because German banks offer better terms and may be more efficient producers of deposit services. Indeed, German banks may be so much more efficient that they drive French banks out of business and lead to a wholesale replacement of French deposit taking by German deposit taking. But these are the normal workings of the market and they allow resources to be reallocated to other activities in France.

Is there anything wrong with this? Is there anything special about banking that

makes international competition in it any different from, for example, the car market where German car producers may be more or less more efficient than French car producers to a degree that one country's car production is driven out of existence?

There is at least one respect in which it is sometimes thought that the answer to these questions may be yes. Banking is different from the provision of other goods and services in so far as it is not just about the supply of deposit taking and lending services. It is also about the financing of economic activity and a country's monetary system. If the two countries' banking systems are part of the same monetary system, as in the case of France and Germany, then the substitution of German banks for French banks may be of little consequence. It is little different from monetary services in one part of a country being provided by banks that are headquartered in another.

Where the banks are not part of the same monetary system, for example if German banks take over the British banking system, then the consequences may be more significant. The concern that arises is that in the face of an adverse shock, foreign banks may be more concerned about preserving their domestic than foreign activities. For example, one study of lending by Japanese banks in the United States found that the collapse of Japanese stock prices during the 1990s led to a substantial curtailment of lending in the United States (Peek and Rosengren, 1997). In addition, since prudential supervision is at the level of the home country, the focus of regulatory attention may be more on the consequences of failure for domestic rather than foreign monetary stability.⁵

Now suppose that the efficient supplier of banking services is not a French or a German bank but a US bank. As we will describe below there is a range of banking services for which US banks have emerged as being clearly dominant in relation to their European counterparts. One form that financial integration may take is for US banks to replace European banks as the suppliers of financial services across Europe. Again if US banks are more efficient than European banks at providing these services then we should presumably welcome this. After all it is no different from more efficient US car producers driving out European car producers – or is it?

One issue that we might worry about at this stage is reciprocity. Is it as easy for a European bank to enter the US market as it is for the converse to happen? If it is not then European banks may be disadvantaged from being able to compete in the same markets as US banks. The 'greater efficiency' of US banks might therefore merely derive from the larger market that is available to them than European banks. But we will leave this aside and assume that reciprocity is not an issue.

We then need to distinguish between two different types of banking services – transaction and relationship services. Transaction services, for example the issue of new corporate securities, are precisely the area in which US banks have made substantial inroads into Europe. For instance, while the City of London is one of the most successful financial centres in the world, British investment banks have been one of the least successful competitors in the City. They have in large part been eliminated by foreign, in particular US, investment banks.

There are good reasons why this has happened. Traditionally, the issuance of corporate securities in the United States has involved widespread distribution through chains of wholesale and retail networks. Until recently that is not the way in which European banks have for the most part operated. US banks had expertise in what is termed 'book-building' to a degree that European banks did not and they were as a consequence able to replace European banks as the providers of investment banking services to European corporations. One consequence of this

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has been to reduce the costs of investment banking services to European companies by allowing European customers to tap into US banks' pools of capital, expertise and networks of investors. There have been substantial benefits to trade in financial services, even though much of it has come at the expense of European banks.

Where US banks have been much less successful is at the smaller end of the corporate market. There has been less integration of financial services in regard to lending to small and medium-sized companies. There has been one area of Europe where even here there has been significant integration, however, and that is in the accession countries. There have been substantial inflows of foreign banking into East European economies. The question that this raises is whether we mind if, for example, Czech banking is taken over by French, German or UK banking.

As noted above, there may be worries about the monetary consequences, so long as they are not part of a single monetary system. But there is now a second issue that arises because the foreign dominance relates not only to transaction-based saving and borrowing activities but also to ongoing relations of banks with firms. The issue that this raises is whether ownership matters from the point of these relations between lenders and borrowers.

There is an emerging body of literature that suggests that relationships may be important in particular in the financing of small and medium-sized companies (see Box 1.1 on Ownership). Relationship banking occurs when banks incur current losses on loans to companies in anticipation of compensating profits in the future. Companies are in turn willing to incur relatively high costs in purchasing services from their relationship banks when they are doing well in return for assurance that they will receive support from the banks when they are doing badly. Relationships require commitments from both banks and borrowers to persist with their partners even when they could transact more profitably with others.

A good example is the rescue of failing companies. In transaction banking, loans are withdrawn and firms put into liquidation when the liquidation value of collateral exceeds the ongoing value of the firm. In relationship banking the ongoing value to the bank of providing refinance is increased by the commitment of the firm to the bank even once it has recovered and is profitable. In the presence of relationships, banks therefore play a more important role in financing failing firms and the early stages of corporate development.

Relationship banking has been documented in Germany, Japan and the United States. In Germany, it is associated with firms' 'housebanks' (the main banks with which they transact). Consistent with housebanks providing insurance to firms, it has been found that when firms' performance deteriorates then the proportion of financing coming from a firm's housebank increases (see Elsas and Krahnert, 2004). Deterioration in borrower quality is associated with more housebank lending, not more lending by arm's-length lenders.

The provision of such commitments is easier when banks and firms are in close proximity. Local banks are more likely to make commitments to local industries and firms than banks that are headquartered in a distant capital, or still worse overseas. A distant headquarters will seek to allocate loans to its most profitable current activities irrespective of location. So geographical separation of bank and corporate headquarters favours transaction rather than relationship banking.

The purchase of a domestic banking system by foreign banks reduces the commitment of domestic banks to domestic borrowers. It reduces the availability of risk capital and funds for refinancing failing firms. In particular, when banks encounter financial difficulties, they are most likely to withdraw resources

Box 1.1 Relationship lending and the ownership of the banking firm

Does the nationality or regional origin of the ownership of a bank matter? We know from received theory that the location of a bank relative to a borrowing firm is important on several scores. This happens because geographical proximity facilitates the establishment of a fruitful relationship between a borrowing firm and its lending bank. Relationship lending facilitates the lending process because it helps overcome impediments due to asymmetric information and contract incompleteness. This happens for several reasons. (See Boot, 2000, and Rajan and Zingales, 2003, for exhaustive discussions of the costs and benefits of relationship banking.)

First, the establishment of a continuous relationship with borrowing firms allows banks to accumulate useful information that can be used by the bank to maintain an accurate assessment of the actual conditions and of the default risk of the borrowing firm. This may happen either because the firm is more willing to reveal confidential information to the lending bank with which it has a continuing relationship, or because the bank may be more willing to collect costly information on the borrowing firm if it expects the relationship to last over time.

Second, the presence of a long-term contractual relationship between borrowers and lenders may also help the two parties to use contractual forms that produce outcomes that may not be feasible when only short-term contracts are involved. This may happen either because these contracts do not break even on a period-by-period basis (so that the participation constraints are not satisfied sometimes), or because one of the two parties to the contract would behave differently in the context of a short-term rather than a long-term contract (so that the incentive constraints in a long-term relationship and in transaction lending differ). This possibility is particularly important in cases where the presence of unverifiable soft information is crucial to the contract itself, making contracts effectively incomplete. In these cases, relationship lending may alleviate the shortcomings of contract incompleteness.

Finally, relationship lending and geographical proximity may be desirable whenever direct monitoring of borrower's activities is important.

For all these reasons, relationship banking should lead to more abundant and cheaper credit, especially for those firms that are more exposed to asymmetric information, such as small and medium-sized enterprises. The advantages of a direct, long-term relationship between lenders and borrowers come, however, at a cost. First of all, the very fact that the bank acquires proprietary information on borrowers confers lenders an informational monopoly that effectively 'locks in' borrowers, exposing them to potential financial expropriation. As a result, firms may be less willing to borrow and to invest in otherwise profitable investment opportunities. Note that the presence of multiple banking relationships may alleviate such informational monopoly, but at the cost of reducing a bank's incentives to make those relation-specific investments that make relationship banking desirable to begin with. Second, a close relationship between a firm and its lending bank may facilitate collusion between these two parties at the potential expenses of other stakeholders of the firm. Third, a close relationship with borrowing firms may soften a bank's attitude towards borrowers. A softer bank's attitude may make it more difficult for the bank to terminate unprofitable loans or to impose costly actions that are necessary to improve a firm's profitability. Since borrowers (and lenders) anticipate the bank's future behaviour, the effect of such 'soft budget constraint' is to induce inefficient choices (for example, to a lower effort by borrowing firms) and thus greater lending costs.

Whether relationship banking has lowered the cost of lending and made credit more easily available, especially to small and medium-sized firms, is an open issue. Rajan and Petersen (1994) find that the primary benefit of relationship banking is to make credit more available, but with little effect on its cost. Also, borrowing from multiple lenders increases the cost of credit and reduces its availability. However, Degryse and Van Cayseele (2000) find that the borrowing rate increases with the duration of the bank-firm relationship, ...

Box 1.1 continued

...a feature that is consistent with the lock-in effect of the information monopoly of relationship banking.

While the overall case in favour of relationship lending and geographic proximity between borrowers and lenders may be a relatively clear one, the issue of why the national (or regional) origin of the ownership of a bank should matter is much less understood. Whether there is a desirable match between the nationality of borrowers and lenders becomes quite important if the exploitation of the economy of scale leads a country to the formation of a small number of very large domestic financial institutions. In this case, competition can be sustained only by allowing foreign banks to be active players in the domestic market.

There is empirical evidence to support the potential beneficial effect of foreign banks. (For an extensive review, see Berger *et al.*, 2004.) For example, foreign banks have faster loan growth, larger provisions and greater loss-absorption capacity (Crystal *et al.*, 2002; Goldberg *et al.*, 2001). They do not worsen access to finance, and are less vulnerable to liquidity fluctuations (Mian, 2003), and their presence in the domestic market leads to a reduction of profit and overhead expenses in the banking industry (Huizinga *et al.*, 1998). At the same time, however, Mian (2003) finds that domestic private (as distinct from state-owned) banks are more aggressive in lending and earn higher returns than foreign banks while maintaining the same default rate (presumably reflecting the better ability of domestic banks to use 'soft' information on borrowers). Also, Berger *et al.* (2003) find that national banks may have an advantage in offering certain banking services, limiting the degree of possible future bank globalization.

Whether or not foreign banks can be effective (and desirable) competitors in the domestic market will hinge crucially on the issue of whether domestic banks have a natural advantage over their foreign competitors because of their domestic ownership.

We believe that there may be important reasons why foreign banks may not be effective, and in some cases, even desirable competitors. In what follows, we articulate reasons why the proximity of the national/regional origin of the lending bank and the borrowing firm may indeed matter. As the case for a common nationality of the ownership of lending banks and borrowing firms is less clear, our considerations are rather tentative, and should be taken only as exploratory.

There are arguably several reasons why the national origin of banks' ownership in a lending relationship may matter. If a domestic firm borrows from a foreign bank, the lending bank's headquarters will be presumably located in another country. The lending officers responsible for the loan will respond, directly or indirectly, to headquarters located far away geographically and organizationally. (See, for example, Berger and Udell, 2002. Petersen and Rajan, 2002, however, argue that progress in the information transmission and processing technology has allowed the distance between borrowers and their lenders to grow steadily in the US in the last two decades, and it has facilitated banks' restructuring and consolidation.) The foreign lending bank will presumably be a more complex organization, which may be less able to offer the same services and respond with the same flexibility as a local domestic bank. This implies that large multinational banks, to ensure effective internal controls, may be obliged to operate with internal procedures that are quite standard across countries. Thus, by their very nature, large multinational banks may not be able to be flexible enough to adapt themselves to the realities and specific needs of local borrowers. Local banks, instead, are better able to respond to the specific needs of local firms, and may become better partners in situations where relationship banking is important. Thus, foreign banks may be at a competitive disadvantage when competing with a domestic bank very much for the same reasons that a small local bank may be a better partner for a small local firm than a larger, nationwide bank whose headquarters are located in a faraway financial centre.

A second reason why geographical proximity may matter relates to the nature of ...

Box 1.1 continued

...the contractual incompleteness that gives relationship lending an advantage over transaction banking in the first place. As we argued earlier, an advantage of relationship lending is that, in a dynamic context with incomplete contracts (for example, as to the conditions at which loans are renegotiated), the anticipation of the response of the different parties in different contingencies becomes an essential feature of the lending process. As contracts are incomplete, it may be expected that parties behave in a quite different way depending on the match between the national origin of the lending bank and of the borrowing firm. More generally, a bank's behaviour may in part be dictated by the bank's perception of the national composition and the relative importance of its stakeholders. Especially in a time of crises, the behaviour of a local bank *vis-à-vis* its borrowers may be quite different from the behaviour of a foreign bank that responds to foreign shareholders.

A third reason why the national origin of a bank may matter is because of the banks' dealings with a country's regulator. As domestic regulators respond to a great extent to local political constituencies, their behaviour towards banks they regulate may differ depending on their national origins. In a context where bank regulation is centralized in a super-national entity, it may be possible that the regulatory agency acts in a way that is blind to the national origin of the banks it regulates. In a regulatory setting where national regulatory bodies still have an impact on important areas of a country's regulatory environment, the national ownership of banks may affect the behaviour of national regulators. In situations where the relevant legislation is subject to some form of contractual or regulatory incompleteness, the residual right to make discretionary regulatory decisions may be exercised by a regulator in ways that are not totally blind to the national ownership of banks. As firms, and all other customers in general, anticipate a more benevolent attitude of a domestic regulator towards a domestic bank, foreign banks may find themselves to be at a competitive disadvantage when competing with local banks.

In summary, these considerations raise the more general issue of what is the appropriate 'political economy' of the banking firm. Banks have different stakeholders in a society, ranging among borrowers, depositors, shareholders and regulators. The ownership structure of a bank may be important in that it may dictate how the bank and the banking system in general respond to external shocks.

from foreign subsidiaries and branches than from their domestic corporate customers with whom they have a closer relationship. An example of this was the withdrawal of bank lending from South America in 1998 in the wake of the Russian default in August 1998. When Russia was not bailed out by the International Monetary Fund (IMF) and announced its suspension of payments on debt servicing, banks drew in their credits from other emerging markets around the world, especially countries with overvalued currencies and large bank debts.

The point about relationships and ownership is not that it justifies impediments to competition but that it explains why competition is difficult to achieve in certain segments of banking. Locality may matter more than in other markets and international penetration may be difficult.⁶ Foreign ownership may not therefore be a perfect substitute for a domestic banking system, and this is particularly relevant to accession countries. But even here care is needed in interpreting this conclusion. What is important in the behaviour of banks is the location of their headquarters. In most cases the ownership of banks is highly dispersed among a large number of investors. It may be difficult to identify the

geographical location of owners of a bank. Instead, it is the proximity of the main decision takers to corporate borrowers that may be important in establishing long-term relations.

Set against these arguments for local ownership or control are several significant deficiencies. Close relationships prevent firms from being able to seek the lowest-cost sources of finance. They allow suppliers of finance to exploit their monopoly position to the detriment of borrowers. They create potential collusive arrangements between firms and banks that can be used to prevent new entry. Ongoing relationships can be used to support viable firms in financial distress but can also discourage the closure of unviable firms. They can create soft-budget policies that prevent the effective disciplining of poorly performing firms.

Most seriously of all, these arguments about ownership have been used to justify protectionism. They can be used as the basis of simplistic reasons for keeping out foreign banks and investors. We see no justification for these arguments and believe that the promotion of financial integration in Europe is critical to the efficiency of both financial and corporate sectors. As we will document below, there remain serious deficiencies in banking integration in Europe that have impeded the provision of services to both individuals and corporations. The elimination of these must be a priority and foreign banks will play a critical part in that process.

In particular, we see cross-border mergers between banks as a key to the elimination of existing barriers to competition. Difficulties of establishing branch networks make entry through merger and acquisition particularly important. Impediments to the takeover process should therefore be eliminated as a matter of priority and the implications for ownership should not be used as an excuse for erecting barriers.

In sum, we reject the view that relationship or ownership considerations justify the imposition of barriers to the free flow of capital or location of banking institutions and on the contrary argue that cross-border acquisitions are important in promoting integration. Attempts to develop domestic banking systems should not therefore be pursued against the background of protectionist policies.

1.4 Measuring financial integration

There are several methodological problems that arise in undertaking an assessment of European financial integration. First, the process is driven not only by EU policies but also by broader industry trends, technological developments in communications and data processing, and the globalization of capital and financial markets in response to the liberalization of trade in financial services and capital movements. Second, EU policies impinge upon member states to varying degrees. Disentangling the magnitude of effects is not easy.

Third, financial integration has been promoted not only by the FSAP but also by the introduction of the single currency, which affects 12 out of 25 EU members. The ten countries that joined the EU in May 2004 have been subject to delay in the implementation of the new regulatory framework. Variations in the degree and speed of integration of financial markets may shed some light on the success of policies in achieving integration.

The main methodological issue that arises concerns the type of information that should be used in the assessment of integration. Qualitative analyses rely on an examination of legal or institutional obstacles to cross-border financial

activities, and an assessment of the extent to which these barriers have been removed over time. This is the approach that has often been taken by the EC and recognition of the slow progress in eliminating these obstacles was one of the motivations behind launching the FSAP.

If a quantitative approach is chosen then there are two empirical methodologies that can be employed. The first is to look at how prices of comparable financial services have evolved in different Member States. Market integration should promote convergence of prices through arbitrage and competition. It is therefore natural to assess the degree of integration by comparing prices across countries. An alternative method is to assess the extent to which cross-border activity is occurring by looking at actual transactions. This set of indicators is broader because it not only includes measures of cross-border retail holdings of financial assets (deposits, loans, investment funds, etc.) but also cross-border corporate activities through, for example, foreign direct investment and penetration of foreign markets. Note, however, that observing that few cross-border activities are taking place does not necessarily mean that markets remain segmented. If structural and monetary conditions are similar in different countries, there might be little incentive for financial institutions to penetrate neighbouring markets, but the mere threat of them doing so may maintain price alignment and lead to market integration.

Since the financial sector is an intermediation industry, the benefits of financial integration may be primarily felt at the wholesale rather than the retail level. The emergence of EU-wide markets for bonds and equities, together with the internalization of investment funds, allowing many of the gains of integration to be realized without integration of retail activity. Provided that there is strong competition policy at the domestic level that ensures that the gains from wholesale integration are transferred to retail customers, then internationalization may not be necessary at the retail level.

This report summarizes the evidence from the most recent studies in this area and provides an interpretation of the facts. It does so by looking first at retail markets, then at the corporate sector and finally at countries that joined the EU in the recent enlargement.

The interpretation of the evidence about the extent of integration is not possible unless there is a clear benchmark against which to assess integration. For example, if we use qualitative evidence how should we judge the significance of barriers to trade that have been removed? Or, if we use quantitative evidence, how should we assess the degree of price convergence that should occur in the presence of non-legal frictions that naturally segment domestic markets?

A distinction has to be drawn between barriers to financial integration that are legal and sector-specific, created by regulations that discriminate against foreign providers (for example, regulations that penalize investment funds that invest in foreign securities), from institutional barriers that reflect the general legal and commercial environment in which institutions operate. Regulatory and institutional differences across countries may hamper cross-border trade in financial services even if they are non-discriminatory. The welfare implications of removing these barriers are very different from the elimination of discriminatory regulation.

The interpretation of integration evidence will have to take into account not only the nature of the barriers that are being removed, but also the type of banking activity under consideration. The degree of integration would be expected to be greater in transaction-based services than in relationship banking. There are two reasons for this. First, obstacles to integration in relationship

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banking are likely to be related to general regulatory and institutional differences across countries and therefore less easy to eliminate. Second, relationship banking revolves around the informational advantage of incumbent institutions over potential competitors. This creates a natural barrier to competition and integration.

In summary, market integration should not be regarded as an end in itself. Instead, the ultimate goal of a single market is to improve access to financial services which may or may not require (or result in) a high degree of integration. The proper benchmark for integration is the removal of artificial barriers to entry or trade, and in particular discriminatory regulation. Integration need not imply full convergence of prices or the harmonization of regulatory regimes. Moreover, in terms of outcomes, in certain areas, most notably retail banking, the natural degree of integration may be rather low. Even if all artificial barriers to entry or trade are removed, markets may remain segmented due to the information advantage of local providers, or the preferences of consumers for the conduct of business according to domestic, unharmonized conventions. This is important because the apparent failure to achieve integration will otherwise encourage the regulatory authorities to pursue an unwarranted degree of harmonization that is damaging to the efficient operation of domestic markets.

1.5 Integration in EU banking: the evidence in retail markets

The evidence reviewed in this report shows that financial integration in European markets has been gradual and quite uneven, with substantial advances in corporate finance markets and fewer in retailing. This uneven pace of integration is undoubtedly related to differences in the nature of competition in the two segments of financial services. Proximity to clients, access to information and long-term relationships play a key role in retail banking. Corporate markets for large companies are largely transaction-based services with some relationship lending. Retailing has a strong regional dimension, since advantages of size are much more limited than in investment banking and information asymmetries are much more pervasive.

The degree of integration that has been achieved to date at the retail level has been very modest, particularly in some products such as loans to consumers. Nevertheless, deregulation has had a significant effect on domestic EU markets. As a consequence of domestic consolidation, EU banking markets have become similar in terms of their market structure, with large increases in concentration in the more fragmented markets. The process of restructuring has allowed banks to rationalize their activities and to profit from scope economies, expanding their business beyond conventional commercial banking into insurance and other financial markets.

In contrast, there have been very few cross-border mergers. The absence of significant cross-border mergers and acquisitions or *de novo* entry into foreign markets is a repeated cause of concern among policy-makers. In the United States, the repeal of the Glass-Steagall Act resulted in a substantial cross-state wave of consolidation. To date, this has had no parallel in Europe and it has led some to conclude that the lack of progress in creating pan-European banks is a reflection of significant political impediments. It is clear that competition policy authorities have a critical role to play in ensuring that takeover markets do not discriminate against cross-border activity.

1.6 Integration in EU banking: greater progress in corporate markets

Information theory would predict a greater degree of financial integration in bond than equity markets and in public bond markets than in banking. It would also predict that information asymmetries are more serious in relation to corporate financing of small than large companies. To a certain extent, this prediction is borne out by the evidence. Integration has been greater in corporate bond markets than in equity markets and in bond markets than in bank lending to large corporations. It has also been higher in transaction-based investment banking activities such as securities issuance and acquisitions. However, it has also been high in private equity and relatively low in syndicated bank lending to large corporations. Therefore the information sensitivity of securities and the size of the borrower are not perfect predictors of the degree of integration.

The unexpectedly high degree of integration of EU private equity markets and the slow progress in integrating bank lending irrespective of firm size have important policy implications. The integration of private equity markets has been encouraged by the separation of managerial expertise and sources of finance that is a feature of private equity but not conventional bank lending. Policy may therefore have been misguided in trying to promote integration in bank lending when it is more readily achievable in private equity.

EU corporate finance also displays another important feature and that is the dominance of foreign, in particular US banks, in investment banking. This is quite different from what is observed in retail banking. Should EU policy-makers care about the dwindling market share of EU financial institutions in investment banking? Since investment banking is concentrated at the transaction rather than the relationship end of the market, this is precisely the area in which integration would be expected and where its effects in terms of cheaper and better provision of financial services are likely to be most beneficial.

1.7 Integration in EU banking: accession countries

The uneven and variable degree of European financial integration is even more pronounced in the Central and Eastern European countries (CEECs) that joined the EU in 2004 (and other countries, such as Bulgaria and Romania, that will most likely join in future years).

While there has been rapid real integration in the CEECs, financial integration has lagged behind. The pace of change has been uneven across countries, with the most significant progress in the Baltic area and much less in countries such as Poland, Bulgaria and Romania. Regulatory frameworks are in place, but the remaining task of ensuring timely and effective enforcement is daunting.

Financial integration has mainly occurred in the banking sector. This has experienced a rapid change from state to foreign ownership, sometimes via domestic private ownership. These developments have resulted in a strong banking sector, integrated through ownership with West European banking. The evolution of banking contrasts with that of other parts of the financial sector, namely equity and bond markets. These remain weak and illiquid.

Some concern has been expressed about the financing of small and medium-sized enterprises (SMEs) in a context where the banking industry is controlled by foreign institutions and capital markets are fragile and underdeveloped.

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Difficulties in the access of SMEs to credit can easily be blamed on the dominance of the domestic financial market by foreign banks, and a protectionist backlash could occur under the right conditions. As argued above, however, there is little evidence that foreign-controlled banks are less apt at providing finance to domestic enterprises than banks controlled by domestic interests. On the contrary, foreign institutions improve access to capital through product innovation and greater efficiency. The problem does not appear to be the banks themselves, but rather the general investment climate in which they operate. The policy focus should be on bringing down risk levels rather than, as suggested by some observers, introducing new semi-public development banks, which are vulnerable to political influence and soft budget constraints.

1.8 Conclusion

This report documents a variable level of integration in banking. It is high in wholesale banking and in certain areas of corporate finance, modest in relation to relationship aspects of banking, low in retail banking, and patchy and heavily dependent on foreign financial institutions in the accession countries. For the most part, integration has been greatest where economic theory predicts it to be so. Care therefore needs to be taken not to attempt to correct perceived low levels of integration through excessive harmonization of regulation in areas in which only modest amounts of integration can be expected. We reject the view, however, that questions of ownership and relationship banking can be used to justify the retention of artificial barriers to integration. Further efforts are required to eliminate these through:

1. The establishment of institutions to ensure the effective implementation and enforcement of the FSAP.
2. The pursuit of home- and the minimization of host-country regulation.
3. The creation of lead regulators to coordinate cross-border activities.
4. Strengthening of competition policy at the EU as well as the domestic level to prevent discrimination against cross-border activity.
5. The determination of lender of last resort facilities in the EU.

Chapter 2 describes the structure and regulation of European banking. Chapter 3 considers retail markets and Chapter 4 corporate finance. Chapter 5 examines developments in EU accession countries.

2 Regulatory Changes and the Structure of European Banking

2.1 Introduction

The goals of the EU include the development of a competitive single EU market that promotes efficiency and increases consumer welfare. European financial integration is seen as a stepping stone in this process. A well-functioning financial system is perceived as indispensable to achieving an economy's growth potential and financial integration is expected to provide the necessary conditions for an enhanced economic performance.

Banks in Europe are important in most financial market activities – from mutual funds and venture capital to the organization of stock exchanges. The last decade witnessed important changes in the European banking industry. Some of the transformations were driven by external forces such as technological change and increased free trade in financial services across the world. Others resulted from the evolution of banking business models. These changes have been, potentially, magnified by the euro. The single currency affected banks in several different ways. For example, the euro fosters the development of capital markets and increases the importance of financial market products in relation to traditional bank products. This hurts traditional deposit and lending businesses of commercial banks and benefits the more market-based asset management and investment banking activities (Danthine *et al.*, 2000). Nevertheless, and despite the extraordinary expansion of investment funds and other non-traditional products in recent years, financial intermediation through deposits and loans is still the main activity for most European banks.

Banking activities have been under closer scrutiny by the European Commission since the mid-1970s and the creation of a single financial market has been a key EU objective. It is true that the European financial services industry has been affected by a range of factors in the last 20 years but the actions taken by the EC and the Council of Ministers to promote European integration and financial system development have unquestionably been major ones. On the regulatory framework, as detailed below, steps were taken in order to achieve an integrated European market. The reaction of banks to the changes in the legal framework, however, has not been as significant as originally thought. The last few years have highlighted a few characteristics of banking that had been traditionally overlooked, in particular, the role of local competition and the importance of the country of ownership of financial institutions.

The importance of proximity to clients, due either to the trust that consumers hold in known institutions or to superior knowledge about market conditions (fostered by long-term relationships), seems to have created a natural limit to the degree that market integration can act as a force for greater competition in

banking. This also implies that entry into new markets may be more attractive if done by acquisition of existing institutions rather than by deploying new branch networks. Thus, cross-border merger activity should reflect the relative attractiveness of entry by acquisition versus *de novo* entry, although other market conditions will also matter.

The possibility of acquisitions by institutions located in other countries raises the issue of ownership. The nationality of ownership has become a highly politicized issue and the challenge is to assess whether it matters from the viewpoint of economic analysis. Several arguments may be put forward: banks are an essential component of the payment system in any country, and therefore generate significant externalities; acquisitions by foreign institutions may lead to the transfer of management positions to decision-makers with a different background and lead to the break-up of (economically valuable) long-term relationships. In such cases, cross-border mergers and acquisitions (M&A) may be welfare reducing. Thus, if nationality of ownership matters, M&A may have unexpected welfare effects. Of course, from the empirical viewpoint, we must also consider the possible achievement of greater efficiency as a competing explanation for acquisitions. A key issue is how to distinguish between alternative explanations.

Overall, deregulation and the removal of entry barriers at the EU level may have produced some of the benefits associated with market integration, but also have given more relevance to other questions, such as the role of nationality of bank ownership. These are the questions we want to address in this chapter. Has the single market legislation and the euro led to a more integrated EU banking market? What are the channels through which this integration has taken place and what have been the implications for the structure of the EU banking industry? If integration has been blocked, what are the reasons for this? Is it a question of political interference? Is it due to the existence of unavoidable local regulations that are unlikely to go away even with the disappearance of all restrictions on cross-border activities? Or is it due to the predominance of relationship banking, which limits the geographical span of the markets?

2.2 Regulatory changes

There is a widespread belief that the main benefits of integration are exploitation of scale and scope economies and the boost to competition between financial intermediaries. Integration should generate lower transaction costs, higher market liquidity, better risk diversification and more efficient securities' pricing. Furthermore, an increase in the breadth and depth of the financial market should reduce the cost of capital of borrowers and increase returns for investors. An increase in the number of competitors together with market expansion should eliminate X-inefficiencies and promote labour force rationalization and financial innovation.¹

But financial integration is not without risks. With banks facing more competition, profit margins are expected to fall, inducing financial institutions to increase their risk exposure to maintain profitability. Moreover, the internationalization of EU banks and more intense cross-border financial activities force national supervisors to strengthen their collaboration. The new challenges with regard to prudential supervision raise the question as to whether a pan-European supervision entity could respond with more efficiency and effectiveness to cross-border activities problems or be better placed to prevent and manage potential

systemic crisis. This concern has been raised in several European Commission documents.² The main conclusion to emerge is typically that current institutions and legal provisions are adequate, but that greater cooperation between different authorities (within and between countries) is required. Different researchers, however, have questioned the wisdom of maintaining institutions and regulations which may prove inadequate for systemic problems in Europe (see Vives, 2001a).

We begin by briefly reviewing the regulatory changes that have occurred before moving on to an assessment of the changes in integration and the structure of EU banking markets. In the early 1980s the European banking industry was very fragmented. Although the 1973 Directive recognized freedom of establishment,³ national restrictions severely limited cross-border trade in banking activities. Banks were subject to supervision rules that raised the operational costs of international expansion. Heavy regulations were the norm. Examples of these restrictions were controls on interest rates, capital controls, restrictions on stock exchange membership, branching limits, and restrictions on foreign banks and credit ceilings. Some countries like Germany, the UK, the Netherlands and Luxembourg had a lighter regulatory regime (Dermine, 2002).

The First Banking Directive in 1977 attempted to harmonize banking regulations. But the inability to achieve an agreement led to a change in the integration methods of the EC. The new method favoured minimal harmonization of national regulations, but included also the principles of mutual recognition and home-country control. Subsequently, the 1986 Single European Act (and the White Paper on 'The Completion of the Internal Market'), the Second Banking Directive,⁴ the 1998 Council directive on the liberation of capital movements, the creation of the euro in 1999 and the Financial Services Action Plan (1999-2005) dismantled most legal barriers and provided a favourable environment for the development of a Single European Financial Market.

Mutual recognition implies that each country acknowledges the regulation of its partners and accepts service provision by foreign institutions as if they were domestic entities. This procedure results in a high degree of integration, and leads to the disappearance of regulations that either increase the cost of domestic institutions or divert banking activities abroad. These include prudential rules, and to a lesser degree information regulation and economic regulation.

Thus, mutual recognition has been complemented with the establishment of harmonized standards with regard to prudential regulations. The EU integration process does not set minimum standards with regard to economic regulation. As for the risk of excessive regulatory competition in the area of information regulation, the EU has tackled the problem by introducing an exception to the mutual recognition principle, namely it allows the host country to regulate this.

Overall, the process of mutual recognition coupled with the harmonization of prudential regulation and the rules on host-country control for consumer protection issues have allowed the process of EU banking integration to proceed much faster than in the past – when full harmonization was attempted – and to achieve a greater degree of integration than was possible through the use of the national treatment principle (as in the NAFTA process). Banking integration under NAFTA is limited to the non-discrimination rule embedded in the national treatment principle: foreign banks cannot be treated differently from domestic banks, but national rules can be very different from the rules in place elsewhere in the free-trade area.⁵

A very important integration step in recent years has been the introduction of the euro. There are several effects of the single currency programme. First, the introduction of the euro erodes market segmentation based on national

currencies. It is, therefore, a major contribution to cross-border activities. The euro makes it easier to compare prices of financial products across countries, lowering the transactions costs, at the retail level, of doing business with banks located in other countries. Secondly, it creates a common framework for accessing central bank liquidity (Padoa-Schioppa, 2000). As the Central Bank procedures do not discriminate by country of origin, banks in the euro zone have come to use similar rules and internal procedures. This contributes, in a natural way, to the integration of the banking systems in the zone.

Since not all EU countries adopted the euro, a major issue regarding banking in the EU is whether it is possible to speak of banking integration at EU level, or does it only include the euro zone? This is not a simple question. We need to assess whether indicators of market integration are significantly different in the euro zone and in the EU as a whole. We would expect both single market efforts and the single currency to promote integration of banking markets (and financial markets in general) across Europe even if the magnitude of the effect is different.

The impact of the internal market measures, deregulation and the euro on the process of banking integration has been altered by globalization, demographic changes (with consequences for economic growth and levels of savings) and information technology progress. These are factors that one should control for when assessing the changes in integration and the structure of the EU banking system. Additionally, it must be kept in mind that the analysis in this chapter is done at a very aggregate level. Banks are multi-product firms, with wholesale and retail services, and therefore the correct methodology involves assessing market integration for each market segment. This is done in Chapters 3 and 4.

2.3 Measuring financial integration

Increased financial integration within the EU has been triggered by both government policies and financial innovation, and through the internationalization of trade, production and financing (Dermine, 2003). Barriers to integration reflect macroeconomic and political systems. However, countries may have homogeneous legal and monetary frameworks, but assets may still be priced differently (Pagano *et al.*, 2002). A broad range of microeconomic factors are likely to be important, including the degree of development of money and financial markets, the degree of competition within the banking system (and between banks and other financial intermediaries), the constraints on capital movements and the ownership structure of financial intermediaries (Cottarelli and Kourelis *et al.*, 1994). Hence, investors may require a different risk premium for holding financial assets generated and sold within a particular financial system. Market actors will bear direct costs of disintegrated financial markets in the form of existing capital controls and transaction costs, and will separately price indirect costs of investing in assets bearing idiosyncratic risks related to domestic policy, regulatory regimes and goods markets (see Box 2.1 'Financial integration').

There is no widely accepted measure of financial integration. The vast majority of analyses concentrate on variations in the law of one price – that is, if there is financial integration we should observe similar prices for similar products across geographic units. The application of this principle implies the use of comparable assets and markets. It also means focusing attention on price measurements of financial integration, both in terms of levels and in reaction to changes in the economic environment. With respect to retail banking, interest rates differentials

Box 2.1 Financial integration*Direct financial integration*

Financial integration is generally defined in terms of the concept of 'asset substitutability' or 'law of one price', as in Pagano *et al.* (2002) and Ayuso *et al.* (1999). Those concepts essentially mean that investors can expect the same return on identical financial assets in different markets, as in Shepherd (1994). That in turn implies that for financial integration to transpire, prices for comparable assets should equalize across borders.

One of the major prerequisites for achieving equalization of prices is free mobility of capital across borders. So, if there are no barriers to capital flows, segmentation of markets would be eliminated through cross-border arbitrage. Several authors refer to this type of financial integration as direct financial integration, as in Oxelheim (1990) and Buch *et al.* (2000). Major barriers that can prevent capital from flowing freely and thereby inhibiting perfect asset substitutability are transaction costs and direct capital controls, such as restrictions on trade of foreign assets and taxation differences.

Indirect financial integration

Market restrictions, however, can explain only a small fraction of disintegration of financial markets, especially when it concerns countries with heterogeneous risks, diverse governmental policies and domestic uncertainties. Given the risk-averse nature of investors, one would expect that investors would require a risk premium in order to compensate for holding assets denominated in different currencies and, hence, subject to idiosyncratic country and asset risks.

across countries in distinct products, and their time evolution, are the main indicators. For wholesale markets price comparisons are easier since markets tend to be more transparent.

Interest rate differentials may be due to the extent of competition within the banking sector and differences in costs, and they should disappear with integration except for possible arbitrage costs associated with cross-border transactions. Apart from price comparisons, it is possible to assess the extent of cross-border quantity flows. Obviously, the lack of evidence of cross-border flows is not indicative of insufficient integration, but the examination of quantity flows is interesting in its own right. For example, by looking at cross-border banking activity and foreign ownership researchers can estimate any 'home bias' and any unevenness of the playing field across banking sectors (see Buch, 2000). International portfolio composition across bond, money market and equity funds may signal increased financial integration, as investors facing improved investment opportunities are able to move funds instantaneously across borders and take advantage of the benefits of international diversification. (See Box 2.2 overleaf for a summary of the main indicators.)

Building on the idea of the law of one price, Baele *et al.* (2004a) argue that 'financial integration in euro area financial markets is achieved when all economic agents face identical rules and have equal access to financial instruments or services in these markets'. This certainly involves an analysis of price differentials, but also of other characteristics that may condition equal access. It should be recognized that institutional backgrounds might foster financial market integration or make it more difficult. Thus, the analysis of institutional differences is also of interest, in particular features that may be an obstacle to market integration. Legal and tax systems shape domestic financial structures and pose direct

Box 2.2 Indicators of integration of financial systems

- | | |
|---|---|
| <ul style="list-style-type: none"> • <i>Credit and bond market indicators</i> Interest rate differentials Price differentials for banking services Cross-border transfers of funds Cross-border banking activity Market penetration of foreign banks International portfolio composition | <ul style="list-style-type: none"> • <i>Indicators based on saving/investment decisions of households/firms</i> Saving-investment correlations Correlation of consumption growth rate Cross-border vs national M&As |
| <ul style="list-style-type: none"> • <i>Indicators of institutional differences</i> Tax system Legal system Corporate governance arrangements | <ul style="list-style-type: none"> • <i>Stock market indicators</i> Correlation of stock market returns International portfolio composition |

barriers to the mobility of capital or freedom of establishment. Institutional differences may also result in informational asymmetries between investors, for example due to low transparency of corporate governance arrangements and uncertainty of domestic legal and tax systems. Specifically, the degree of institutional ownership, privatization and restructuring is essential for the functioning of the financial system (see Wachtel, 2002). As argued in Chapter 3, however, the extent to which additional integration by harmonization of institutional differences improves welfare is another matter.

A third line of attack is to look at macroeconomic indicators of integration, like correlations between investment and savings at national level and the cross-country correlations in consumption growth. The high volatility of the macroeconomic series undermines their use in relation to retail banking market integration, and it is a methodology better suited to the analysis of wholesale markets. Indicators based on the household consumption patterns generally relate to the notion of international risk sharing, which in financially integrated markets results in homogeneous growth rates of consumption and no correlation between saving and investment decisions of households and companies.

Finally, it is worth pointing out that measuring financial market integration is a different issue from measuring the evolution of competition. Both are warranted. A simple example illustrates the differences. One aspect of market integration is international consolidation – cross-border mergers and acquisitions. Increased concentration, however, may also cause concern about lack of competition. In particular, interest rate charges may be equal across geographic units (market integration) and still judged to be high by competitive market benchmarks.

2.4 Changes in the structure of European banking

The chapters on retail and wholesale products analyse integration measures based on prices. This chapter will focus on a broad analysis of changes in the structure of the banking industry across Member States, with particular focus on the extent of increased penetration of the Member States banking systems, as well as an analysis of their structural differences and similarities, and whether they are being reduced over time.

The long history of the banking industry in Europe, and the institutional, economic and demographic differences of the Member States explain why at the beginning of the integration process, European banking systems were markedly different, particularly in terms of the nature and functions of the different financial institutions. A salient feature of the European banking industry still remains the sizeable market share of savings, mutual and/or cooperative banks, particularly in retail local markets.⁶ Their strong regional presence (particularly in the household and SME markets) and traditional lending and deposit-taking activities explain their strong profitability in some countries (e.g. Spain). It is not easy for foreign banks to enter the market and to increase competition.

We start with an analysis of the extent to which there are important structural differences across the EU and whether they are being reduced over time. Table 2.1 reports the evolution over the 1990s of some key indicators on branching and personnel. Using the standard deviation of branches and bank employees per 1,000 inhabitants as crude measures of differences across countries, we see that branching differences are rather persistent, while the number of bank employees per 1,000 inhabitants shows some degree of convergence to a common value, especially in the first half of the 1990s.⁷ Convergence was present in the period 1990-95 but not during 1995-2000. In addition, it has been stronger in the euro zone than within the EU as a whole.

This evidence has to be carefully assessed. On the one hand, a reverse causality problem has to be considered: because countries had banking systems and other economic characteristics that were becoming more similar, they participated in the single currency experiment. Indeed, the financial criteria for joining the euro involve requirements that may have impacted on the banking businesses promoting convergence.

On the other hand, the analysis of Table 2.1 focuses on two specific measures of bank structure, branches and employees which may be influenced by a variety of factors. For example, 'employees per 1,000 head of population' is partially determined by the degree of bank development of an economy (measured, for example, as bank assets as a percentage of GDP). Persistent differences across countries in branch density may be explained by geography and population factors such as population density, which are unlikely to disappear with integration.

If we had observed a strong movement towards a common average value, it would be hard not to conclude that the forces of market integration were reducing differences across markets. This is, however, not the case, and that means that evidence of market integration must be found elsewhere. Integration of markets, however, can be achieved without convergence in branches and employees per 1,000 inhabitants if these variables adjust to local circumstances. Integration should certainly imply some degree of convergence in the average size of bank entities.

Table 2.1 Structural similarities across EU banking systems: branches and employees

	<i>Number of bank branches per 1,000 inhabitants</i>			<i>Number of bank employees per 1,000 inhabitants</i>		
	<i>1997</i>	<i>2000</i>	<i>2003</i>	<i>1997</i>	<i>2000</i>	<i>2003</i>
Average: euro area	0.51	0.50	0.45	5.78	5.75	5.56
Std. Dev: euro area	0.23	0.23	0.21	2.49	2.57	2.44
Average: EU	0.48	0.48	0.43	6.51	6.68	6.47
Std. Dev: EU	0.22	0.23	0.20	2.38	2.46	2.36

Sources: ECB (2004); own computations.

Under segmented national markets economies of scale and scope may dictate quite distinct values of the average size of banks across countries. When a single market is achieved, however, the opportunities to take advantage of scale and scope economies are essentially the same for all players and we should observe a tendency for convergence across the market in terms of the average size of institutions. This is indeed what is observed for the period 1997-2001 (see Gual, 2004).

Other evidence of increased banking integration in Europe may come through four alternative channels, thus confirming the changing structure of the EU banking system. These channels are the increased flow of funds across borders,⁸ the expansion of activities across border by banks, particularly through the use of branches rather than subsidiaries, and increased cross-border M&A activity. All of these are quantity indicators, to be complemented later on with price indicators for specific retail and wholesale services, as well as with more refined quantity measures. We review these four channels next.

2.4.1 Cross-border flows

A natural piece of evidence in favour of market integration following the deregulation measures would be an increase in cross-border transactions, although as argued above the absence of cross-border trade is no proof of insufficient integration. On the issue of cross-border banking, we must make a clear distinction between retail, and wholesale and capital markets. It is in the latter that we observe a more significant increase in cross-border operations. The increasing integration at the EU level of wholesale activities has been accompanied by the integration of the payment systems at the wholesale level as well.

The diffusion of card-based payment systems, which extend naturally beyond national borders, works in favour of increased cross-border activities for retail. Recent technological developments, like the widespread diffusion of ATMs and the development of telephone and online banking, are likely to further enhance such cross-border activities, as they reduce the importance of physical proximity between the bank and the customer. Nevertheless, retail payment systems remain nationally segmented to a large degree and this restrains further integration in this area (see, for example, Kemmpainen, 2003).

Table 2.2 shows that cross-border activities increase for all balance-sheet items, except for non-banks' deposits, but cross-border activities at the consumer level continue to be almost negligible (Danthine *et al.*, 1999).

It is widely recognized that it is very difficult to change the strong tendency of households and SMEs to bank with local institutions. This perception is consistent with the virtually unchanged penetration of foreign credit institutions in individual EU retail banking markets in recent years (see Buch and Heinrich, 2002; ECB, 1999a).⁹ The reduced penetration of foreign banks in domestic markets does not necessarily contradict other trends that show that EU banks have become more internationalized over time. The data reported by the Bank for International Settlements (BIS) show that the share of foreign assets in total assets of EU-based banks has been growing continuously over the last ten years.¹⁰ What this shows is that internationalization takes place through the lending and funding activities of domestic banks, rather than through the penetration of foreign institutions.

Consequently, when we look at bank-to-bank relations we find a picture of much stronger integration. Cross-border interbank transactions have increased, mainly involving major banks, particularly after the launch of the euro. The share of unsecured transactions among euro area countries also grew, from 21% in 1998 to 42% in 2001. (Santillán *et al.*, 2000; ECB, 2002). The expansion of interbank

Table 2.2 Cross-border on-balance-sheet activities of euro area OMFIs

<i>% of total</i>	<i>Dec. 1997</i>	<i>Dec. 2001</i>
Loans to OMFIs	15.3	18.3
Loans to non-banks*	2.2	3.4
Interbank deposits	14.6	16.4
Deposits from non-banks*	5.4	5.0

Note: *including general government.

Source: Cabral *et al.* (2002), adapted.

business is the consequence of the introduction of EMU, vital to the unification of national money market segments in the euro area and the expansion of liquidity circulation (ECB, 2002). Accompanying this trend, cross-border transactions processed in the settlement systems have also increased (Cabral *et al.*, 2002).

The intensity of cross-border interbank flows depends on the size of national market and institutions. The larger the domestic market the smaller the share of cross-border business. The full integration of the wholesale market should lead to further intensification of cross-border interbank activities. The European Commission (2001) notices a two-tier development in the interbank market, with relatively large banks dominating cross-border transactions and smaller banks relying on these national big players for funding.¹¹ Economies of scale in information delivery for borrowing, information problems between different size institutions and the necessity to execute larger transactions are factors that restrict small banks' entry in a wide-area market.

The low level of cross-border retail banking is explained by several factors that make a local presence crucial, in particular the trust of the customer and the move towards client relationship management, as a way to retain the customer base.¹² The existence of significant consumer switching costs (customer inertia) is a powerful barrier to the entry of new players, even in the long run. The branch network provides consumers with access to simple services, such as deposits and cash withdrawals. Technological developments, primarily electronic payment media, may over time weaken this link, but this has not happened to a significant extent yet. Also, local market knowledge allows for better targeting of consumers and improved product design.

2.4.2 Branches versus subsidiaries

Even if market integration in the EU banking industry is taking place mostly indirectly, through interbank flows and cross-border investments, there is also a continued process of gradual integration through the opening of branches and subsidiaries abroad. That process is increasingly taking place through the opening of branches rather than subsidiaries. An examination of recent trends supports this assertion, although this is the case only in terms of number of units (Table 2.3a) and not so in volume of assets (Table 2.3b). As pointed out by Dermine (2002), however, the subsidiary form remains important and possibly indicates insufficient integration, at least judging by the US experience. Rosengreen (2002) analyses the persistence of subsidiaries in the United States, and finds that the choice of incorporation in different jurisdictions is often related to tax and legal advantages offered by the host state. Such differences are, of course, more likely in the EU. The table also shows how, in the period under examination, there is a sharp reduction of the presence of non-EEA institutions.

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Table 2.3a Number of foreign branches and subsidiaries in the EU banking market*

	1997	2001	% change
<i>Intra-EU branches</i>			
EU	420	497	18
EU except UK and Lux.	259	356	37
UK and Lux.	161	141	-12
<i>Intra-EU subsidiaries</i>			
EU	301	328	9
EU except UK and Lux.	183	222	21
UK and Lux.	118	106	-10
<i>Non-EEA branches</i>			
EU	297	216	-27
EU except UK and Lux.	138	95	-31
UK and Lux.	159	121	-24
<i>Non-EEA subsidiaries</i>			
EU	252	212	-16
EU except UK and Lux.	128	100	-22
UK and Lux.	124	112	-10

Notes: *Sample of ten countries in the EU (excluded countries are Austria, Denmark, Sweden, Greece and Ireland). EEA: European Economic Area.

Source: Gual (2004).

Table 2.3b Assets of foreign branches and subsidiaries in the EU banking market*

	1997	2001	% change 97-00	% change 97-01
<i>Intra-EEA branches</i>				
EU	1,261,184	1,941,947	44	54
EU except UK and Lux.	316,303	447,523	37	41
UK and Lux.	944,881	1,494,424	46	58
<i>Intra-EEA subsidiaries</i>				
	1997	2000	% change 97-00	
EU	802,898	1,189,829	48	
EU except UK and Lux.	412,486	681,378	65	
UK and Lux.	390,412	508,451	30	
<i>Non-EEA branches</i>				
	1997	2001	% change 97-99	% change 97-01
EU	1,076,806	1,314,853	-6	22
EU except UK and Lux.	179,618	98,740	-41	-45
UK and Lux.	897,188	1,216,113	1	36
<i>Non-EEA subsidiaries</i>				
	1997	1999	% change 97-99	
EU	485,899	472,122	-3	
EU except UK and Lux.	241,810	208,307	-14	
UK and Lux.	244,089	263,815	8	

Notes: *Sample of ten countries in the EU (excluded countries are Austria, Denmark, Sweden, Greece and Ireland). EEA: European Economic Area. Million euros and percentage change.

Source: Gual (2004).

Table 2.4 Domestic and cross-border mergers (1987-2001)

	Country of acquirer													Σ	%		
	AUT	BEL	DNK	FIN	FRA	GER	GRE	IRL	ITA	LUX	NET	PRT	ESP			SWE	UK
AUT	50	0	0	0	1	5	0	1	1	0	1	0	0	0	1	60	16.67
BEL	1	44	0	0	7	2	0	0	0	1	15	0	0	1	0	71	38.03
DNK	0	0	43	1	1	2	0	0	0	1	3	0	0	5	1	57	24.56
FIN	0	3	3	125	0	1	0	0	0	0	0	0	0	4	0	136	8.09
FRA	0	10	0	0	253	14	0	0	13	5	3	4	1	2	16	321	21.18
GER	8	0	0	0	15	292	0	1	4	4	10	0	2	3	4	343	14.87
GRE	0	0	0	0	0	0	17	0	0	0	0	0	0	0	2	19	10.53
IRL	0	2	0	0	1	1	0	11	0	0	0	0	0	0	6	21	47.62
ITA	2	0	0	0	8	3	0	0	290	2	2	1	2	0	4	314	7.64
LUX	0	4	1	0	3	2	0	0	2	6	2	0	0	0	1	21	71.43
NET	0	8	0	0	3	8	0	0	0	3	49	1	0	2	3	77	36.36
PRT	1	0	0	0	0	1	0	0	0	0	0	38	9	0	0	49	22.45
ESP	0	1	0	0	8	2	0	0	5	1	3	10	108	0	1	139	22.30
SWE	0	0	3	2	4	0	0	0	0	0	1	0	0	48	1	59	18.64
UK	2	4	0	1	17	15	2	13	0	2	7	1	2	4	311	381	18.37
Σ	64	76	50	129	321	348	19	26	315	25	96	55	124	69	351	2068	
%	21.88	42.11	14.00	3.10	21.18	16.09	10.53	57.69	7.94	76.00	48.96	30.91	12.90	30.43	11.40		

Notes: Σ is the sum of all mergers and % is the share of cross-border mergers. Database includes mergers where at least one of the partners was a commercial bank and the counterpart could be any type of firm. Up to 1992, only transactions with values above \$1 million were considered, and after 1992, all transactions were covered.

Sources: Buch and DeLong (2002); own computations.

2.4.3 Cross-border merger and acquisitions

The opportunities created by market integration at the European level could, in principle, eliminate the incentive to engage in cross-border mergers and takeovers with the goal of becoming an international player. However, if some significant barriers to *de novo* entry remain, even if informal ones, then we may observe a renewed interest in cross-border M&A. Entry through M&A may also be the preferred strategy in the presence of substantial excess capacity. In fact, part of the M&A wave in the mid-1990s was explained by overcapacity and the need for restructuring (see ECB, 1999b).

In fact, it is not clear what pattern of cross-border merger activity market integration should imply, in the absence of excess capacity. In an initial situation of totally separated markets, due to consumers' preferences, differences in national regulations and distinct market structures and business models, little cross-border mergers are expected, as banks concentrate attention in their own markets. With market integration, entry into similar markets becomes more attractive. Still, significant barriers to entry, especially *de novo* entry, remain in place (say, some national regulations and consumers' preferences). Cross-border mergers are an alternative to *de novo* entry in the market, as they avoid the barriers associated with *de novo* entry.¹³ Thus, market integration, in this first phase, originates an interest of banks in going to other markets, and doing it by acquisitions: as barriers to entry decrease from a high to a medium level, interest in cross-border mergers increases. At some point, however, entry barriers to *de novo* entry may become so low that such entry could be more profitable than acquisition. Consequently, as the market approaches full integration, cross-border mergers should decrease, as banks use other means to develop cross-border activities.

Currently, the market appears to still be in the first phase with little activity. Most of the M&A that occurred over the last decade was domestic, and research by the Group of Ten (2001) concluded that no significant economies from scale or scope had been achieved in European banking.¹⁴ Different sorts of reasons explain this fact: asset risk diversification can be achieved without resorting to cross-border mergers (Danthine *et al.*, 1999); opportunities for reduction of inefficiencies in the context of rigid national labour markets; and increases in market power in national markets. The empirical evidence points to an improved performance of EU banks that merged domestically, particularly where the partners were similar (Van der Venet, 1996). Other studies find gains from mergers within the same geographic market but not otherwise (Cybo-Ottone and Murgia, 2000; Dermine, 2000). Geographical distance, distinct regulatory frameworks, language and cultural differences have been pointed out as important obstacles to the penetration of national markets by foreign banks (Berger *et al.*, 2000b; Buch and DeLong, 2002).¹⁵

The apparent lower profitability of foreign-owned banks suggests that their international expansion strategies have not been very successful.¹⁶ The lack of penetration in foreign markets also implies that the realization of economies of scale and/or scope by this means has been rather small (European Commission, 2001).

Table 2.5 provides a measure of the intensity of international M&A for the EU15.¹⁷ It is clear that the level of cross-border activity is very low, probably as a result of the remaining (implicit or explicit) barriers to banking cross-border deals.¹⁸ Only two countries, Ireland and Luxembourg, have a higher intensity of international mergers than domestic ones. A second cluster is composed of Belgium and the Netherlands. In the remaining countries domestic mergers dominate strongly.

Two waves of bank mergers can be broadly identified during the 1990s. The first may be linked to the single market programme (early 1990s) and, the second to the introduction of the euro (late 1990s). The nature of each merger wave seems to be quite distinct: the first wave created large banks, mainly on a national basis; in the second wave, we find some cross-border expansion. More recently, we witness again more mergers among the smaller banks. The analysis of Buch and DeLong (2002) explicitly addresses the cross-border merger activity in European banking markets, making a distinction between before and after the Second European Banking Directive. They found no effect from this deregulation initiative (neither did Berger *et al.*, 2000b).

An alternative interpretation is that by making cross-border mergers and acquisitions easier, the Second Banking Directive has, in fact, induced defensive mergers between domestic banks. Consistent with these arguments, cross-border mergers within the EU do not seem to be very profitable. In particular, cross-border mergers generate, on average, lower returns than domestic mergers (Beitel and Shierek, 2001).

Merger activity has occurred mainly at the top of the distribution. According to Belaisch *et al.* (2001), more than half of the 30 biggest euro area banks resulted from recent mergers. Nevertheless, despite the growth in number and value of mergers in the EU, and the fact that many of the leading banks are the result of mergers, no financial institution has yet achieved a pan-European dimension (European Commission, 2001).

Danthine *et al.* (2000) interpret the evolution of bank mergers in Europe as following a pecking order: within-country mergers, cross-border mergers but inside restricted geographic regions (such as the Benelux, the Scandinavian, or the

Table 2.5 Intensity of M&A

	<i>Intensity of international M&A</i>
AUT	0.24
BEL	0.67
DNK	0.24
FIN	0.06
FRA	0.27
GER	0.18
GRE	0.12
IRL	1.14
ITA	0.08
NET	0.77
PRT	0.37
ESP	0.22
SWE	0.33
UK	0.18
LUX	2.83

Note: Let I be an index of intensity of international mergers and acquisitions, defined as:

$$I = \frac{\sum_{i \neq j} M_{ij} + \sum_{j \neq i} M_{ji}}{2M_{ii}}$$

where M_{ij} is the number of mergers where a bank of country i was an acquirer and a bank of country j was a target. Note that when cross-border deals exceed (in number) domestic deals, the index becomes larger than 1. Only mergers where all entities involved are banks are considered.

Source: own computations.

Mediterranean countries), and then mergers across all of Europe. By 2004, it was still not clear whether the third phase had really commenced.

Firms involved in M&A have invoked scale and scope economies, but until now efficiency gains have been hard to prove. The number of branches and employees between 1990 and 2000 remain roughly the same, and operational or staff costs remain more or less the same as a percentage of gross income (although staff cost shave decreased slightly). This may be explained by the difficulties in reducing labour costs, particularly at a time when banks have invested in technology and sophisticated human capital to deal with new business areas.

Merger activity could also increase the degree of concentration in smaller countries. The increase in concentration in banking markets is a reality, and the current level of concentration in some of the national markets is starting to raise the concerns of the competition authorities. However, an analysis of concentration levels (CR5 for 2001) and the evolution in the number of mergers (Table 2.6) seems to indicate that the increases in the concentration are not due to merger activity. Research by the Group of Ten (2001), however, shows a significant positive relation between the cumulative value of M&A and the change of CR5 in 1995-97¹⁹ and Gual (2004) shows that that there is a positive correlation between the size of the different EU markets and the increase in the level of concentration between 1997 and 2001. The increase in concentration (mostly driven by mergers) is most important in the larger markets, which were less concentrated to begin with.

Other factors have contributed to the observed merger pattern. Merger activity in some European markets has been linked to privatizations. There is also the possibility that the domestic authorities have tried to favour national incumbents, and promote the rise of 'national champions'. The creation of too-big-to-fail institutions could undermine competition and reduce efficiency because they enjoy lower funding costs (Soussa, 1999).

Table 2.6 reflects the trend towards financial conglomeration through the increase in the value of cross-industry deals. Despite the significant rise in cross-border transactions, domestic cross-industry M&A outweighed them, showing either that the gains from cross-border consolidation appear to be less than those from domestic mergers or that important obstacles for cross-border deals remain in place.

It is important to notice the general increase of the average size of the M&A deals that occurs after 1998. Cabral *et al.* (2002) and Padoa-Schioppa (2000) argue that this increase shows the concerns of banks with size, and the need to become large players in a more competitive environment. The size of the institution is of major importance in wholesale and capital markets, where scale economies are huge and banks compete in international markets. Additionally, the existence of economies of scope in mergers among retail and other financial firms functioned as an incentive to cross-industry mergers.

Another possible explanation for the majority of within-country mergers lies in the relatively large number of non-incorporated institutions in many euro countries. The importance of institutions like savings banks creates a barrier to foreign firms by reducing the number of institutions available for acquisition (Belaisch *et al.*, 2001) and may also explain the dominance of domestic deals.

One possible rationale for mergers is the expected increase in profitability. Using net margins as a short-run indicator, one may confront the intensity of merger activity with the attractiveness of the market, measured by the net margin. There seems to be no relationship, however, between the number of mergers and net margins of each country,²⁰ independently of their type –

Table 2.6 Average size of M&A deals in the euro area (euro million)

	1990–97	1998–2001 (August)	% of total deals (in value)	% of total deals (in number)
Average size	273.5	1,116.9	–	–
Domestic/Within industry	315.4	1,279.5	60	50
Domestic/Cross-industry	205.8	1,075.3	18	23
Cross-border/Within industry	163.6	1,011.7	11	13
Cross-border/Cross-industry	38.5	575.2	11	14

Note: Within-industry mergers: between banks; Cross-industry mergers: the target firm is a bank and the bidder is an insurer or a securities firm. The value of a transaction is defined as the total value paid by the acquirer within six months of the announcement date.

Source: Adapted from Cabral *et al.* (2002), Table 23.

domestic or cross-border – and as argued above, cross-border mergers do not seem to be particularly profitable.

This suggests that market power explanations alone are not sufficient. It must also be recognized that market integration *per se* is likely to induce higher concentration levels, measured at the country level. The increase in market integration means that each bank now faces more competition, from banks present in other national markets. This presumably exerts downward pressure on profits, eventually driving out of the market less efficient banks and increasing concentration. As mentioned above, we have indeed observed an increase in concentration all across the EU, and particularly in those countries with the lowest levels. As a consequence, there has also been a moderate increase in EU-wide concentration (Gual, 2004).

Overall, the nature of the merger process in European banking and the lack of significant international expansion through *de novo* entry imply that there are no financial institutions with a pan-European dimension. The movement of domestic consolidation clearly dominates cross-border M&A. Banks seem intent on preserving long-term business relationships, but they could also be pursuing defensive strategies, creating (or raising the level) of entry barriers in markets where differentiation, in the eyes of consumers, plays an important role. As the welfare assessment is conditional on which interpretation holds true, more empirical work is needed to distinguish among the competing explanations.

On the issue of *de novo* entry versus entry by acquisition, in the latter case any profits of domestic firms that are lost are paid in the acquisition price. If the acquirer is more efficient, there is an overall benefit from the takeover. The market equilibrium is changed in a way that increases domestic welfare.

Entry *de novo*, on the other hand, implies a change in the market equilibrium. The entry of a new foreign bank entails two types of effects. On the one hand, it increases competition in the market place, benefiting consumers. Social welfare rises.

On the other hand, some of the profits of the new entrant are obtained by diversion of profits from other (domestic and foreign) banks present in the market. This means a transfer of domestic profits to foreign hands, which counts negatively in terms of domestic social welfare. Therefore, foreign *de novo* entry has both positive and negative effects. And one more foreign *de novo* entry may well be detrimental to welfare. Foreign entry by acquisition, since there is a price paid by the foreign firm, cannot be welfare decreasing (in this simple view of market equilibrium responses).

Since welfare implications of *de novo* entry and of entry by acquisition can differ, these types of entry may require distinct regulatory responses.

Box 2.3 Competition and market power in banking

The role of competition in the banking industry has always been controversial. The benefits of perfect competition for resource allocation and productive efficiency are well established. It must be noted, however, that in general competition is not perfect, and in this respect banking is no exception. Thus, the presence of imperfections may limit or even reverse the benefits of competition. Sources of frictions in retail banking are entry barriers and switching costs, and in corporate banking established relationships and asymmetric information between borrowers and lenders. Also, asymmetric information between depositors, lenders and regulators plays an important role in forcing discipline on banks. The result is that there is room to exercise market power (Vives, 1991, 2001a) in both the lending and retail markets.

The banking industry has some specific characteristics, however, that set it apart from other industries. Crucial are the important weight of debt in banks' capital structure and the wide dispersion of this debt, that is, deposits among individual investors. The large amount of debt increases the risk of failure (or insolvency) while the dispersion among small investors limits their ability to monitor the activities of the bank. Further, the social cost of a bank's failure is perceived to be large. Banks finance a large part of the productive activity of an economy by being a critical provider of capital to small and medium-sized firms. Thus, the social cost of bank failure includes the costs of financial and economic distress to a bank's depositors and borrowers. In summary, the possibility of failure in banking is important, with a potentially severe moral hazard problem and large social cost of systemic failure.

How does the specificity of the banking business affect the desirability of competition in the sector? Perhaps the most important aspect is that market power, at least up to some level, has benefits. This can easily be seen from models of competition in the deposit and credit markets (see, e.g., Matutes and Vives, 1996, 2000; Caminal and Matutes, 1997a, b). The intuition is that a bank that enjoys market power (and thus a high charter value) becomes more conservative because its opportunity cost of going bankrupt is large. Indeed, the decline of charter values due to deregulation and liberalization has been blamed for the increase in failures in the banking sector from the 1980s onwards (Keeley, 1990; Boot *et al.*, 1993; and Hellmann *et al.*, 2000).

More competition in lending markets may also turn against potential borrowers. This may happen because the presence of more potential lenders allows borrowers more opportunities to shop around for loans. This opportunity is particularly valuable for low quality borrowers, who have a greater probability of being turned down for a loan. Thus banks, recognizing the adverse impact of competition on the average quality of the pool of their potential borrowers, will react by raising average lending rates. This may result in higher lending rates in more competitive markets (see, e.g., Broecker, 1990; Riordan, 1993; Petersen and Rajan, 1994, 1995, 2000).

Overall, however, competition is perceived to be good for efficiency. (The importance of X-inefficiency in explaining deadweight losses in banking does not seem to be less than in other industries, and may dominate scale and product mix efficiency; Berger and Humphrey, 1992.) Furthermore, a healthy degree of rivalry is perceived to be necessary to keep a vigorous pace of innovation in an industry (dynamic efficiency). This view is probably the basis of the trend towards introducing more competition and liberalization in the banking sector all over the world. An effective market enlargement typically accompanies liberalization, be it because of possibilities of access to international markets and market integration or because of an increase in internal demand for financial services once 'financial repression' is eliminated.

Progress in information technology and globalization have also worked in the direction of market expansion and have occurred concurrently with market liberalization. (See Besanko and Thakor, 1993, for the distributional implications of liberalization in a spatial banking model and Cordella and Yeyati, 2002, 2003, for the effects of financial opening...

Box 2.3 continued

...in the presence of deposit insurance and disclosure requirements.) Market enlargement increases the diversification possibilities of financial institutions. A typical example is the repeal in the United States of restrictions on interstate branching. It is clear that interstate expansion increases competition and the diversification possibilities of banks. A similar phenomenon may be developing in Europe with the possibility of cross-country expansion. Liberalization may therefore increase at the same time as competition and diversification possibilities.

The increase in competition resulting from market integration, liberalization and/or deregulation may in turn induce banks to take too much risk (e.g. in emerging markets), increasing their chance of failure. This added risk may more than offset the potential benefits due to increased diversification opportunities, resulting in an increased overall riskiness of the banking sector.

2.5 Conclusions

This chapter assesses the extent to which the single market programme and the euro have contributed to the construction of an integrated EU banking system, and analyses the implications for the structure of national banking systems. The analysis is carried out at the level of banking institutions, since a more detailed study by lines of business is undertaken in the following chapters.

The EU banking integration process combines powerful policy tools: the mutual recognition principle, a common currency for almost all EU15 members and harmonized prudential regulations. The general picture that emerges, however, is one of uneven integration: almost non-existent in retail markets but quite substantial at the wholesale level, particularly in the interbank market. Of course, the increased integration of wholesale financial markets may yield indirectly some of the benefits of an enlarged EU financial market, as retail customers get access to foreign financial investments and funds through their local institutions.

The integration programme has had a profound impact on the structure of EU banking markets. Integration has advanced through increased cross-border flows and not much through cross-border expansion. It has been accompanied by a process of corporate restructuring which has, to a large degree, focused on domestic deals.

This domestic restructuring wave has led to an increase in the average size of banks in all markets, and promoted the convergence of market structures, with large increases in bank size and concentration ratios in the more fragmented markets. This broad trend of integration, however, has not eliminated national differences in banking systems, which are rooted in specific country characteristics. It has allowed, though, the rationalization of the industry, eliminating excess capacity, increasing the liens of business of banks and achieving efficiency gains through these channels, rather than through the exploitation of scale economies linked to EU expansion.

The restructuring process has not involved cross-border deals in significant number. This may be so because bankers perceive that no significant gains may be achieved from EU-wide growth, but could also be the result of political protection by Member States. The experience of rapid cross-border consolidation in the

United States after the repeal of legislation that prevented interstate banking would point towards these political variables as an explanation of the insufficient development of cross-border M&A.

If that is the case, the political obstacles to cross-border deals could be undermining the welfare gains that the EU could achieve through increased financial integration. Arguments about ownership, however, may not be only political. There might be sound economic reasons that justify domestic control of large local banks, and if that is the case, it may not be surprising that few cross-border deals are observed. In fact, if wholesale integration of financial markets allows Europeans to tap indirectly into the wider EU financial market, the fact that foreign banks have a small presence in local retail markets may not be that important, and could guarantee the stability of the payment systems and the continuation of long-term relationship banking. Nevertheless, this explanation for limited pan-European M&A should be examined with care. In particular, it is important to ensure that there are no policy measures that, pretending to achieve domestic social objectives, imply discrimination on the basis of nationality of ownership.

3 Retail Markets

3.1 Introduction

This chapter looks at retail banking. The main difference between retail and wholesale banking (and other banking services, such as asset management, related to capital markets) is the relative importance of geography. Retail, unlike wholesale, customers are scattered spatially and have little mobility, enhancing the importance of the branch network as a key competitive asset. Another important characteristic of retail banking is the high variable costs of activity, especially staff costs.

Retail banking is the field in which the possibilities for exploiting contact with the customer for the provision of many other – not necessarily banking – services (such as insurance services) seems greatest. This may explain why the consolidation process within the financial industry, when it has involved not only banks, has very often focused on retail services (Padoa-Schioppa, 2000).

Retail banks face competition from equity and debt markets in both corporate and personal segments. The development of capital markets created alternatives for investment and financing. In particular the corporate sector has been making a gradual move away from traditional bank-based financing towards an increasingly market-based approach to raising capital. This has implications in Europe, where bank lending has been the main source of firm financing. If the US financial markets are regarded as integrated then the completion of European integration will imply that European corporations will in future rely more heavily on market debt. Also households' use of financial instruments is changing. Savings are diverted from deposits to equity and other investment products (see London Economics, 2002, for further details). These will generate more competition in the loan segment of the financial intermediation market and consequently a reduction in prices.

Retail banks face competition not only from other banks and organized markets, but also from players originating in other industries (insurance companies, supermarket chains and car dealers, for example). Overall, competition has been increasing in bank retailing. The deregulation and integration measures promoted by the EU build upon this trend. We now address the extent to which they have achieved market integration.

3.2 Market integration

A cornerstone of the development of a single European banking market is the convergence of regulatory regimes. Several barriers to cross-border activity have

been dismantled within the EU since the 1990s. Despite actions taken to date, mainly concentrated in solvency supervision issues and entry liberalization, the differences in regulations of banking activities are still a barrier to the expansion of cross-border activities. A main issue is whether the single market programme and the euro have created market integration in retail banking.

The main features of the regulatory changes proposed by the European Commission are the principle of mutual recognition, the control by the home country for prudential purposes, and some minimal harmonization of prudential rules. Mutual recognition (the European passport) implies that a single authorization is needed for a bank to operate in each and every country of the EU. Once a bank is operating in a market, the legal barriers to enter in a different EU Member State are relatively small.¹

While the single market programme has been successful in goods, in financial services there remain regulatory, tax and legal barriers to a truly single market. For instance, firms still face difficulties in raising equity on a pan-European basis as differences in taxation cause distortions in both investments and savings allocation. In the retail field, the lack of harmonization of customer information² and the absence of efficient procedures for resolving cross-border disputes have created difficulties for integration under the FSAP (Cabral *et al.*, 2002).

Although legal entry barriers related to prudential supervision have been removed in the EU, informal barriers remain (Blandón, 2000). The more important are the use of different languages across the EU and home-bias preferences of customers. The first implies that documentation has to be translated into several languages, creating significant costs for the development of new products.

There are also political barriers. Despite the 'European passport', national governments can intervene for the 'general good'. The grounds for such interventions are ambiguous, giving national authorities considerable discretion to intervene.³ The 'general good' clause limits the extent of integration in European banking.

Views expressed at the time of the Cecchini report (CEC, 1998) were in retrospect quite naïve in thinking that the single market measures would lead to a seamless market where the law of one price would prevail. Reality has shown that many structural factors that segment financial markets, and in particular retail banking, are enduring. Examples of such factors are the institutional and legal (commercial law and taxation) differences across countries, the existence of network externalities and switching costs and the nature of the incentive problems faced by financial intermediaries as a result of information asymmetries. In the end, information and trust advantages stemming from proximity still profoundly influence the market structure of retail banking in Europe. Researchers provided early warning (e.g. Vives, 1991) that retail banking is inherently imperfectly competitive and that the market is naturally segmented with switching costs, information asymmetries and reputation effects that are all conducive to discrimination.

Despite deregulation and the introduction of the euro the retail banking industry in Europe remains fragmented. It is an industry that requires heavy investment in brand names, branch networks and relationships with customers (Gual, 1999), as well as country-specific legal expertise (Cecchetti, 1999).

As discussed in Chapter 2, there is no single measure of market integration widely accepted and ready to be applied to banking markets. Instead our assessment of the degree of market integration must rely on a set of different characteristics of the European banking sector.

We can focus on the evolution of bank characteristics and price indicators, or we can look at a quantity indicator, such as cross-border flows or, in the case of

direct investment, the market share of foreign entities. Price convergence implies that price differentials for the same financial service should be eliminated over time, or at least greatly reduced, down to the level justified by the existence of significant arbitrage or transportation costs.

As for quantities, it should be stressed that this is a complementary indicator. Indeed, the absence of cross-border flows (or the small market share of foreign competitors) need not be incompatible with a substantial degree of integration, provided that the threat of foreign entry/competition keeps the markets integrated – with price differences which do not exceed the costs of arbitrage.

3.2.1 Price evidence: interest rate differentials

A simple measure of market integration is how close are the interest rates of different countries. This chapter focuses on interest-rate differentials for retail products, particularly those targeting households, since corporate lending is discussed in more detail in Chapter 4. In this respect, the available evidence shows a mixed picture. In a fully integrated financial market, interest-rate dispersion should be zero.⁴ This is only observable in wholesale markets such as the inter-bank euro market after the euro launch, although non-euro countries also present strong convergence after 1999, reflecting the fact that EMU had consequences for the countries that did not join. Other wholesale markets such as government bonds markets show a high degree of convergence but to a smaller extent than the interbank market, and the degree of convergence diminishes as we move into the corporate bonds market. This is explored in detail in the next chapter.

This picture of integration after the introduction of the euro is not observed to the same extent in the retail loans markets (consumer, including mortgages, and corporate). There was limited convergence after 1999 and there are still large differences between countries, especially for corporate loans. Consumer loans, in particular home loans, still show considerable dispersion in rates across countries.⁵

Financial products that are more differentiated and cannot be traded across borders easily (mortgage and corporate loans) exhibit a higher dispersion and a lower rate of convergence. Nominal interest rate convergence, for the period 1993 to 2001, is bigger in more standardized products (time deposits and mortgage loans to households) and smaller in more differentiated products, such as consumer loans and short- and long-term loans to enterprises (Guevara *et al.*, 2004).

Convergence is slower in smaller countries. Interestingly, Guevara *et al.* (2004) did not find significant differences between the countries of the euro area and the countries of the EU. One possible implication is that barriers to integration in retail markets have not been significantly reduced with the emergence of the euro zone. The analysis of banking margins shows a decline in absolute margins but an increase in relative margins (Lerner index).⁶ They also found that investment banks and specialized banks display greater convergence and smaller margins than those that are more orientated towards deposit and loan markets (universal banks, that include a retail business, and pure retail banks).⁷

This evidence hints at the potential role played by local knowledge as a barrier to market integration. It also points to the limited role that pan-European banks may have in the future of banking in Europe, relative to what was previously expected. As statistical techniques based on cointegration do not unveil the detailed factors behind the distinct degrees of convergence (market integration), other indicators have to be used to complement the analysis.

3.2.2 Cost of cross-border transactions

An important piece of evidence on the integration of retail banking services is the cost of cross-border transactions (for example, payments), which have been for a long time more expensive than comparable domestic transactions.

The reports on bank charges in Europe (ECB, 2000, 2001) find only slight reductions over time and enduring barriers to cross-border transactions. For a similar banking product – a 100 euro cross-border bank credit transfer – euro area banks have charged different prices, showing that the Law of One Price did not hold (see Table 3.1).

With EU integration, it is expected that competition increases translate into price convergence in homogeneous products. However, Table 3.2 does not confirm this intuition. Despite the small decline in standard deviation (one possible indicator of integration) we can see an increase in most banks' charges in the euro area. This examination is even more striking if we take into account that the euro introduction facilitates cross-country comparisons.

As from January 2002, cross-border payments that do not exceed 12,500 euros do not need to be reported for balance-of-payments statistics, and the justification

Table 3.1 Average cost of a 100 euro cross-border bank credit transfer

	<i>Average cost (euro)</i>		
	<i>1999</i>	<i>2001</i>	<i>% change</i>
Austria	10.61	17.40	6.79
Belgium	13.37	11.87	-1.50
France	16.88	18.06	1.18
Germany	13.78	11.93	-1.85
Ireland	25.98	25.04	-0.94
Italy	18.28	19.74	1.46
Luxembourg	8.91	9.58	0.67
Netherlands	10.00	11.45	1.45
Portugal	29.68	31.04	1.36
Spain	20.50	20.56	0.06
Mean	17.10	17.37	0.27
Std. Dev.	6.66	6.53	-0.13

Source: Pagano *et al.* (2002).

Table 3.2 Evolution of banking costs

<i>As % of gross income</i>	<i>1990</i>	<i>1995</i>	<i>1999</i>
<i>Staff costs</i>			
Average EU	36.05	35.98	33.08
Std. Dev.	8.04	5.73	6.13
Max/Min	2.52	1.87	1.97
<i>Operating expenses</i>			
Average EU	64.54	67.35	64.30
Std. Dev.	12.15	14.43	9.34
Max/Min	2.18	2.41	1.87

Notes: Figures exclude Ireland. For each country, all banks; for Luxembourg, Portugal and Sweden, commercial banks; and for Denmark, commercial and savings banks. The 1999 values for Austria and Finland refer to 1998.

Source: OECD, Bank Profitability: Financial Statements of Banks (2001).

Box 3.1 Universal banking

Countries have developed over time different attitudes towards universal banking. Some countries, such as Germany, the United Kingdom and Switzerland, have traditionally allowed concentration of broad banking activities in universal banks. Other countries, such as the United States, Japan and Italy, have instead separated banking and commerce as a way of promoting the stability of the commercial banking sector. In the United States, for example, as a reaction to the banking crises of the 1930s the Glass–Steagall Act of 1933 ended a long period of universal banking. It is only recently, with the Gramm–Leach–Bliley Financial Services Modernization Act of 1999, that the United States repealed the Glass–Steagall Act, opening the door to universal banks in US financial markets. It is interesting to note that one of the rationales for the repeal of the Glass–Steagall Act was the belief that US banks, operating under the constraints of the Act, were not able to compete effectively and efficiently with foreign competitors that were not subject to similar constraints.

These trends raise several important issues: are financial systems that are dominated by universal banks inherently riskier than those with separate commercial and investment banks? Can banks (either commercial or investment banks) whose activities are constrained by the mandated separation of banking and commerce compete effectively with universal banks? Are banks' customers, whether corporate clients or consumers, better off in a universal banking system?

Banking theory has examined these issues with mixed results. One important advantage of universal banks is that they allow the exploitation of economies of scope between commercial and investment banking. Economies of scope may be particularly beneficial in information-intensive activities such as banking. For example, information collected by commercial banks during their normal lending activities may prove useful for their investment bank arm when underwriting equity or debt offering. These economies of scope are present in all market segments. A small private firm, borrowing from a commercial bank in a system with separation of banking and commerce, may shy away from public equity markets because of the costs involved in hiring a reputable underwriter. In a financial system with universal banks, instead, banks may offer firms one-stop, single-provider capabilities that may facilitate firms' capital acquisition processes in differentiated markets. Similarly, a large firm may benefit from building a relationship with a single provider that caters to all its financial and advising needs: lending, underwriting of debt and equity, M&A advising, etc. Furthermore, the value of such relationships will be greater in markets characterized by severe informational asymmetries between firms and outside investors, and will be lower in market segments where transaction-based financing, such as securitization, is more common.

An added benefit of universal banks is that, by allowing a single investor to hold both debt and equity, it can reduce the potential conflict between shareholders and bondholders and facilitate financial restructuring and the resolution of financial distress (Mitchell and Saunders, 1996). The resulting reduction of the related agency and financial distress costs allows firms to increase leverage, lower their cost of capital and thus become more competitive. Similarly, the presence of banks' representatives on the board of directors may improve corporate governance and, again, make firms more efficient and competitive.

Universal banks, however, do not have a Midas touch. The benefits of universal banking are also disputed. For example, Saunders and Walter (1994), when comparing the performance of specialized banks in the United States and Japan with the European universal banks, find evidence of economies of scale in the former and of diseconomies of scope between investment and commercial banking. Boot and Thakor (1997) in a theoretical model, find that financial innovation in a universal banking system is less intense (in a stochastic sense) than in a financial system in which commercial and investment banks are...

Box 3.1 continued

...functionally separated. The information advantage enjoyed by universal banks may also be detrimental to both client firms and investors. The information advantage obtained by a universal bank may translate into an information monopoly that may allow the bank to extract rents from its client firms. A system separating industry and commerce may instead offer firms financial alternatives serviced by competing institutions and may result in more favourable financial arrangements. Kanatas and Qi (2003) suggest that universal banks, because of their information advantage, fear less competition from commercial banks, and may be induced to expend less effort in their underwriting activities than a specialized investment banker would instead provide.

A second potential problem of universal banks is the conflict of interest between their commercial bank arm and the interests of the investors' clientele of their underwriting arm. The privileged information obtained by the commercial banking arm may be used strategically by the underwriting arm when pricing and distributing securities issued by troubled firms. Also, capital infusions obtained by underwriting and placing securities issued by troubled firms may reduce the existing financial exposure on the lending side with a particular firm. (The recent events at Parmalat provide an example of such difficulties.) Thus, universal banking may exacerbate the conflict of interest and the adverse effect of informational asymmetries in financial markets.

What is the potential effect of such conflict of interest on universal banks' underwriting abilities? By looking at the pre-Glass-Steagall Act securities underwriting by commercial banks, Kroszner and Rajan (1994, 1997) suggest that investors anticipated the potential conflict of interest implicit in universal banks, and correspondingly charged a 'lemon premium' to such issues.

Finally, universal banks may also exacerbate the conflict between financial institutions and regulatory agencies. Universal banks, by expanding the asset class of their portfolios and the scope of their activities, have more opportunities to increase the average riskiness of their asset structure, with a potential destabilizing effect on the solvency of the overall financial system. The shift towards universal banking has required a general overhaul of the existing regulatory framework in Europe as well as worldwide.

for high fees of cross-border payments relative to domestic ones disappears. The banking industry has resisted these attempts to make small cross-border transactions cheaper.⁸ It was not uncommon to find costs being charged to both parties to a transfer even when one party expects to bear all the costs. In fact, this has led to the enactment of Regulation EC 2560/2001, which imposes charges for cross-border payments in euros that are equal to the ones within a Member State. The regulation came into effect on 1 July 2002.⁹

As for the equalization of cross-border and within-country transfer charges for amounts up to 12,500 euros,¹⁰ the regulation entered into force on 1 July 2003. Only euro zone countries are obliged to comply with this regulation. Cross-border transfers represent on average only 1% of total transfers in the euro zone. As a consequence, instead of a decline in profits banks may gain because of an increase in cross-border activity.

3.2.3 Pass-through of money market rates to retail rates

A further implication of integration is a common response to exogenous shocks. That is, changes in interest rates should converge over time. A possible approach to detecting market integration is assessing the cointegration of credit interest rates across countries. The available evidence points to convergence of interest

rates in the second half of the 1990s for four markets: interbank loans, government bonds, mortgage loans and corporate loans. All markets present interest rate convergence but to a different degree in each market (Kleimeier and Sander, 2002; Pagano *et al.*, 2002).

Another way to examine the reaction of different markets to common shocks is to assess differences in pass-through of national money market rates to bank credit and deposit rates. Under an integrated market, one should observe a convergence both in money market rates and in pass-through. The available evidence shows that countries differed in pass-through rates, but have become closer in recent years.

In this respect, Mojon (2000) shows that the pass-through has been different both across countries and across markets. For example, short-term credit rates typically respond faster and have a higher level of pass-through than mortgages or deposit rates.¹¹ Hence, the financial structure of the economy might be important for the monetary transmission mechanism. More significantly, the speed of the pass-through increased both with deregulation and with monetary union.

Overall, price-related indicators suggest that market integration occurred to some extent. It has been deeper in markets where local information plays a smaller role as a profitability determinant.

3.3 The impact on competition and market structure

The single market programme was designed to create not only a unified market-place but also a more competitive one. Even if market integration has stopped short of expectations in some segments of the retail banking industry, significant discipline may be exerted by entry or the threat of entry. Over the last decade, however, the number of banking institutions operating in the EU has declined. That, together with the M&A trend discussed in Chapter 2, has led to substantial increases in market concentration.

The Cecchini report (CEC, 1988) on the impact of the single market programme predicted convergence of prices to the lowest cost, driven by cross-border competition. After ten years of the single market programme, the impact seems to have been much smaller than expected. Although the Cecchini report mentions price equalization as the outcome of liberalization and market integration, while markets remains imperfectly integrated we should expect prices to be in line with marginal costs and not necessarily to be equal across countries. To the extent that money markets converge, so too will the opportunity cost of funds and we should see declining variations in interest rates as competition increases.

The general view is that increased market competition in Europe (Molyneux, 1999), has led to lower intermediation margins and forced banks to look for alternative sources of revenues and profits, like fees and commissions. But the introduction of the euro also implied a loss of revenues from foreign-exchange transactions. If banks enjoy some oligopoly power they may be able to increase both prices (intermediation margins and commissions). Thus, under the latter interpretation, a positive association between changes in the intermediation margin and changes in commissions would result from industry cartelization. Under the former view, a negative association would be an indication of increased competition. The available evidence on the issue is far from conclusive. Neither of the two possibilities can be excluded.

3.3.1 Intermediation margins

The evolution of intermediation margins provides a key indicator of competition. An expected result of market integration is stiffer competition among banks. Consequently, intermediation margins should reflect the increase in competition. Table 3.3 reports intermediation margins over the 1990s. It should be noted, however, that the margins observed are also the result of differences in the efficiency of the financial institutions/markets and differences in risk. Moreover, over the period under consideration, some countries, such as Spain and Finland in Table 3.3, experienced a dramatic drop in interest rates, and this affects the assessment of changes in the margins.

Intermediation margins show no common pattern, in the 1990s, across banking products. For savings deposits, a highly visible product from consumers' eyes, we see a decline in margin levels and dispersion. This could be the result of increased competition between banks and other financial firms (investment funds are close substitutes for this type of deposit), but could also reflect the low levels of interest rates, which create a natural ceiling for possible values of the savings-deposits interest rate. This is a likely event, as the margins at the start of the 1990s were quite high.

On the other hand, corporate loans and consumer loans have experienced constant, if not increasing, margins. While in the case of corporate loans, the relatively low margins already prevailing in 1990 did not allow for much of a reduction (and in fact a considerable increase has occurred in Germany during the 1990s), on the consumer loans side that was not the case and margins were quite high. Here banks have been able to sustain the previous margins, and in some cases even increase them.

Thus, competition forces have not had the same impact across products. In accordance with theory, lower margins have materialized in the more homogeneous products. Differentiation (i.e. information advantages) in consumer loans has probably allowed banks to retain high margins. Not surprisingly, competition and the degree of integration go hand in hand in terms of their impact across the product space. Integrated and more competitive markets are easier to achieve in the case of homogeneous products.

Table 3.3 Intermediation margins (%), (1990–2000)

	<i>Saving deposits</i>			<i>Consumer loans</i>		
	<i>1990</i>	<i>1995</i>	<i>2000</i>	<i>1990</i>	<i>1995</i>	<i>2000</i>
Belgium	4.9	0.72	0.75	n.a.	6.92	3.63
Netherlands	5.63	3.13	1.84	3.62	2.32	2.91
Finland	11.55	3.85	1.84	-0.45	4.09	2.75
France	5.6	0.66	0.92	5.4	3.03	4.85
Denmark	2.08	1.37	1.31	4.32	8.18	6.84
Spain	11.58	5.58	2.37	3.18	5.62	4.67
Average	6.89	2.55	1.51	3.21	5.03	4.28
Std. Dev.	3.51	1.80	0.57	1.98	2.08	1.39

Notes: Margin on savings deposits = Treasury bill rate less rate paid on savings deposits. Margin on consumer/corporate loans = rate charged on loans less Treasury bill rate. Simple average.

Sources: Dermine (2002), adapted; own calculations.

3.3.2 Concentration and profitability

Even if the evolution of prices appears to indicate that competition has increased for certain products, the concern about competition levels in European banking markets stems from the fact that concentration has been increasing in almost all markets, as banks consolidate (see Table 3.4 and the discussion in Chapter 2). Still, as argued above, this may be compatible with more competition due to an enlargement of the relevant geographic market.

The available evidence is ambiguous on this matter. Cerasi *et al.* (2001) find that deregulation has increased competition in European banking, namely in interest rates, though national markets remain segmented. This finding is not universal, as the analysis of Corvoisier and Gropp (2001) suggests that increased bank concentration in the EU over the period 1993–99 resulted in less competitive pricing in demand deposits and loans. The picture is different in the case of savings and time deposits, which in fact seem to have become a more competitive market. Molyneux (1999), on the other hand, found for the 1990s that, despite an increase in concentration, competition has become more intensive. Moreover, the benefits from a reduction in interest margins have been shared by both corporate and household sectors.

On the issue of profitability and concentration, the usual presumption of higher concentration being positively associated with higher profitability does not seem to hold, in general, in European banking.¹² A higher degree of rivalry may induce exit and thus consolidation need not entail a deterioration of competition. Thus, an increase in concentration at the country level may well be consistent with no change in profitability.

There is not much evidence on the relationship between concentration, efficiency and profitability. Recent studies (Molyneux, 2003; Jansen and de Haan, 2003) suggest that increased concentration in European banking has not so far

Table 3.4 Banking Market Concentration

	<i>Number of credit institutions</i>			<i>Assets of five largest credit institutions as % of total local banking assets (CR5)</i>		
	<i>1990</i>	<i>1995</i>	<i>2001</i>	<i>1990</i>	<i>1995</i>	<i>2001</i>
Belgium	157	145	112	48	54	78
Germany	4,720	3,785	2,526	14	17	20
Greece	39	53	61	83	76	66
Spain	696	506	367	35	46	53
France	2,027	1,469	1,050	42	41	47
Ireland	48	56	88	44	44	43
Italy	1,156	970	843	19	26	29
Luxembourg	177	220	194	n.a.	21	28
The Netherlands	111	102	561	73	76	82
Austria	1,210	1,041	836	35	39	45
Portugal	260	233	212	58	74	60
Finland	529	381	369	53	69	80
Euro area	11,130	8,961	7,219	46	49	53
Denmark	124	122	203	76	74	68
Sweden	704	249	149*	70	86	88
UK	624	564	452	n.a.	27	30
EU	12,582	9,896	8,023	50	51	52

Note: * 2000.

Source: Cabral *et al.* (2002).

raised profitability. Interestingly, Molyneux (2003) argues that the competitive pressure on the market leader is strongly exerted by the second-largest bank in each country. Moreover, M&A tended to preserve the relative size of the two largest banks in European countries.

As discussed previously, the integration movement has increased concentration mostly at the country level. Consolidation seems to have resulted in some efficiency gains, basically through rationalization. On the cost savings side, it is fair to say that during the 1990s European banks were able to increase their efficiency, though with very substantial variation across banks.¹³ A possible interpretation of why these efficiency gains did not translate into higher bank profitability is that they have been passed through to consumers as a result of the market competition that integration has fostered.

These works concentrate on broad definitions of banking activities. Thus, they are consistent with the findings of deeper market integration and significant increases in competition in wholesale and corporate finance activities, but weak integration and even a possible reduction in competition in some segments of retail banking. The link from further market integration to more competition in retail banking to consumers' benefits and banks' efficiency is still not clearly established for European banking.

3.3.3 Pass-through and competition

The issue of pass-through of market interest rates to retail rates is interesting both in a monetary policy perspective and from a competition point of view. The

Box 3.2 Size advantages and market concentration: a natural banking oligopoly?

In addition to expanding diversification possibilities, with obvious beneficial effects on a bank's stability, size also provides other important advantages. First of all, size offers the possibility of exploiting scale economies, especially in overheads expenses ranging from administrative and back-office operations, to information technology and investment banking operations (for example, information gathering and fund management). Second, size may help a bank in realizing scope economies origination from combining different product lines (for example, it increases the relationship value to clients and decreases average marketing costs). Another possibility is that there are scope economies between commercial and investment banking (as explained in Box 3.1). Finally, a large bank may be too big to fail (TBTF) and has a larger capacity to influence regulation. The disadvantages of size come from diseconomies of management and agency problems. Larger organizations may be more difficult to manage, may require multiple layers of middle managers, exacerbating internal agency conflicts and therefore the costs for managing and controlling such conflicts. (See Daltung and Cerasi, 2000.)

Consolidation may deliver the advantages of size eliminating excess capacity in the branch network (when the networks of the merging banks overlap) and improving diversification, particularly if the banks operate in regions with non-synchronized cycles. Furthermore, consolidation may provide a way to cut excess labour in rigid labour markets (as in Europe) and to access the mass retail market in a foreign country. At the same time consolidation may be an instrument to relax price competition and increase market power, to fulfil the empire-building ambitions and private benefits of managers and to avoid being taken over.

We have argued that liberalization usually entails market enlargement. What happens to the equilibrium concentration level in a market when the market size expands?...

Box 3.2 continued

...We know that in an industry characterized by the presence of a sunk cost of entry, concentration decreases as the ratio of the market size to the sunk cost of entry increases. An implication of these standard entry models is that an increase in market size (induced, for example, by market integration and liberalization) will decrease the number of banks, but concentration in the enlarged market (say at the European level) will be lower than the starting level in the individual countries.

Banking is being transformed towards a service industry in which sunk costs are determined by banks' investments in, say, communication networks, information technology, or specialized human capital, aimed at reducing costs or improving the quality of services offered. In this case an increase in market size need not lower concentration (Sutton, 1991). This result may happen for the following reason. Consider a three-stage process. First, banks make an entry decision, which requires them to incur a fixed cost. Second, banks make an investment decision (such as expenditures in cost-reducing information technology and/or fixed investment in information acquisition). Finally, banks compete in the marketplace. In such a setting there are circumstances where increasing the size of the market does not generate more entry in equilibrium. In fact, it may in some cases even generate exit. This happens when the initial fixed expenditure is large in relation to the variable expenditures at the production and market stage, and when market shares are sufficiently sensitive to investments. In these cases, increasing the size of the market promotes an increase in expenditures by a few firms in the second investment stage, typically leading to an upper limit on the number of active firms that can coexist in equilibrium. (See Sutton, 1991; Schmalensee, 1992.)

The extent to which sunk costs in banking are endogenous in the sense described above is obviously an empirical question. It seems plausible to suggest, however, that the increased importance of investments in information technology and information acquisition in general has increased the degree of endogeneity of banking sunk costs, and that market shares are now more sensitive to such investment expenditures. If this is the case, then in the new global marketplace there will be room for only a few global players, even in a greatly expanded market. This would apply particularly to wholesale and investment banking activities, like underwriting, trading, brokerage, rating and M&A, in the top tier of multinational corporations as well as in medium-sized firms with international operations.

latter perspective is the one we emphasize here. Since market power tends to be used to smooth prices over time, a fast and complete interest rate pass-through can be seen as an indication of a close-to-competitive market environment.

During the 1990s several researchers looked at a variety of specifications of the pass-through model. Two of the most recent papers have looked at the EU retail markets precisely over the period that witnessed the process of liberalization and integration.¹⁴ Mojon (2000) provides an analysis of the magnitude of the pass-through effect and assesses whether it went down with the opening up of the markets in the 1990s. Corvoisier and Gropp (2001) go beyond this assessment and consider whether the trend of increased concentration that we have observed in many EU countries has offset the forces that led to increased competition as a result of the process of EU integration.

Mojon finds that deposit markets are stickier than credit markets on average. The most competitive markets appear to be those corresponding to short-term credit to firms. At the country level, Spain, Belgium and the Netherlands show the least flexibility. Most interesting for our purposes is the analysis of how the level of the pass-through changes within the sample period, which comprises 1979–98. The author divides the sample into two periods, 1979–88 and 1988–98, and shows

that stickiness goes down for several countries and markets, as predicted in the presence of increased competition. However, this is certainly not the case in all instances.

Mojon goes on to analyse the determinants of differences in the pass-through across countries and time. The results are revealing. He shows that a variable capturing the extent of deregulation through the adoption of the single banking market directives is an important contributor to explaining the magnitude of the pass-through as well as its asymmetry.

Corvoisier and Gropp (2001) do not look directly at the pass-through. Rather, starting from a Klein-Monti model of banking competition, they specify a regression model where the loan mark-up is a function of several structural variables and, in particular, measures of the degree of concentration in the market. They try to ascertain the extent to which the magnitude of the mark-up can be explained by measures of concentration. They find that for loans and demand deposits, the trend towards increased concentration has limited the reduction of the mark-up. This is not the case, however, in markets for savings and time deposits.

One explanation of these results is that markets for loans and demand deposits have poorer substitutes. With the development of UCITS (undertakings for the collective investment of transferable securities) and other investment vehicles, substitution away from deposits that are not needed for transactions has become easier. By contrast, the only substitute for loan financing is direct financing and demand deposits are used for transactions, with very few alternatives available.

3.4 Investment funds

European investment funds have displayed enormous growth over the last 15 years. The asset management industry can be defined in different ways. One definition is to include 'all forms of collective (institutionalized) and individual (discretionary) investment of savings by financial institutions for third parties in money and capital markets' (CEPS, 2003, p. 5). A narrower definition includes only 'investment services which utilise sophisticated portfolio management techniques by financial institutions for third parties' (Heinemann *et al.*, 2003). Whatever the exact definition, the asset management market comprises a large number of sub-markets and products. We can divide it in two large segments: retail clients and institutional clients. What characterizes each segment is the degree of product standardization, with it being higher for retail clients. This type of customer has access to highly regulated collective services (e.g. UCITS).

The most important segment of the investment fund industry is high-net-worth individuals, with a market share of 79% in 2000. The segment is associated with largely unregulated and often individualized services. The market is well integrated; customers have a global perspective, financial literacy and less home bias (Heinemann *et al.*, 2003).

The first European Regulation on UCITS (Directive 85/611/EEC) was enacted in 1985 and established the basic framework for funds activity. This Directive also allowed funds meeting its requirements to be marketed in any Member State without having to go through an approval process in each country – the 'European passport' approach. European legislation has facilitated the creation, marketing and distribution of pan-European investment funds.¹⁵

Market growth has been supported by demography and macroeconomic factors (Ernst & Young, 2002): the baby boomers entering middle age; the unsustainable welfare state pension funds combined with rising markets; booming stock

markets; lower interest rates on savings deposits; cheaper and widespread access to financial information; and intense market campaigns contributing to an increase in the number of persons investing in financial products.

Financial resources have been transferred from bank accounts to investment funds. Households were the main driving force of investment fund growth rate, increasingly substituting investment fund shares for traditional savings and deposits until the end of 2000.¹⁶

Although the introduction of the euro was a beneficial factor for cross-border investment, diversification needs require investors to hold assets outside the euro zone. Total equity flows into the euro area were negative between 1998 and 2000. However, they turned positive in 2001 (144.3 billion euros) and mid-2002 (10.7 billion euros) (Adjaouté and Danthine, 2003).

The increase in competition, associated with new entry, forced market players to take measures like cost control, technological improvements, product development and diversification, new marketing strategies and a more European perspective of the market. Technological development provides transparency and security to customers, on the one hand, and cost economies to financial firms, on the other. These are important factors in the integration of the European investment fund industry and its cross-border expansion.

Between 1991 and 2000, European UCITS assets displayed an increase of more than 500%. Still, in 2001, the European investment fund market remained less than half of the US market. The growth rate of the investment fund industry has been declining in the very recent past for cyclical reasons. Nonetheless, the level of assets under management is still high.

The geographic breakdown of UCITS assets across Member States reveals that these products have not been introduced uniformly across the EU. Luxembourg, France, Italy, UK and Germany represent about 80% of the market even if these countries represent about 70% of the EU population (Figure 3.1). These figures show that the European market is not fully integrated yet. Since mid-1990 the Nordic countries have been catching up (see Figure 3.2). Portugal and Spain have had lower growth in their UCITS markets due to a less favourable performance of equity funds.

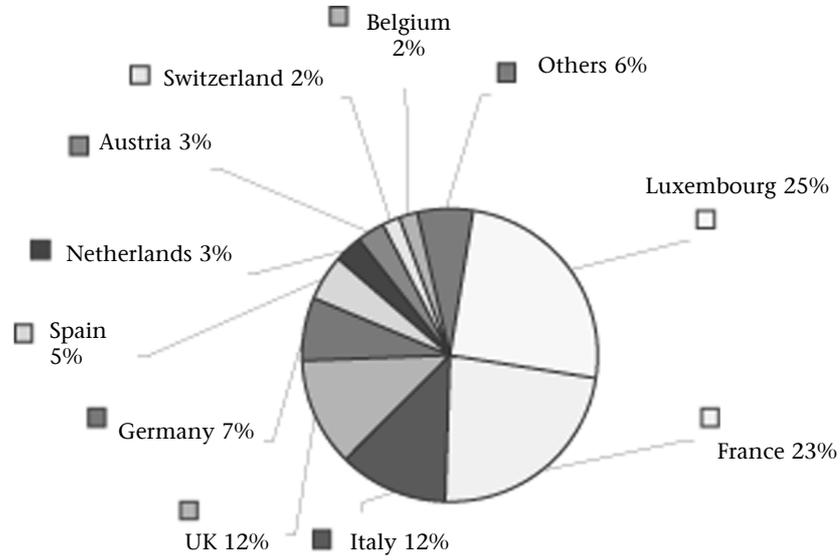
The number of foreign funds registered in national markets has increased over the last ten years. The real importance of these numbers differs from market to market. Moreover, although being cross-border in a formal sense, many of these companies are designed for a particular national market and the choice of the domicile is driven by tax reasons. One must be careful of its use as a market integration indicator.

The overall trend until end-2000 was a rise in balanced and equity funds in relation to bonds funds. The funds distribution according to its type is different across euro area members, with equity funds being more important in Benelux countries and Finland (European Central Bank, Euro Area Investment Funds Statistics, <http://www.ecb.int/press/pr/stats/if/html/index.en.html>).

The structure of funds is also quite distinct from one country to another. Larger markets are naturally more attractive, and tend to have higher market shares of foreign companies. Smaller markets are still dominated by domestic-based funds (Heinemann and Jopp, 2002).

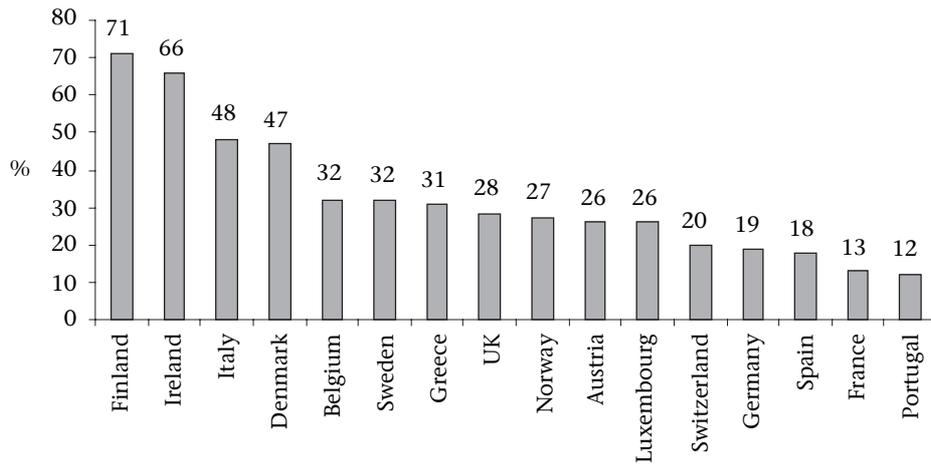
One important characteristic of cross-border fund sales in Europe is the significance of Ireland and Luxembourg¹⁷ as cross-border platforms. Round-trip type funds play an important role in cross-border transactions. They are also a way to access the EU market by non-EU states (mainly Switzerland and the US). The weight of round-trip funds has been decreasing, however, suggesting an increase of 'real' cross-border transactions.

Figure 3.1 Geographical breakdown of European UCITS assets (2001)



Source: FEFSI – Fédération Européenne des Fonds et Sociétés d’Investissement, Statistical Release, June 2001 (<http://www.fefsi.org>)

Figure 3.2 Growth in the UCITS market (2000/1995)



Source: FEFSI – Fédération Européenne des Fonds et Sociétés d’Investissement, Statistical Release, June 2001 (<http://www.fefsi.org>)

A fund can be distributed via both internal and external channels. External distribution networks are the preferred ones due to lower costs.¹⁸ Financial companies are adopting a 'large retailer' strategy for the distribution of funds, deciding to distribute the products of competitors and trying to generate income on the basis of distribution fees rather than on management fees.

Banks and insurance companies are the dominant distributors in most European countries (other distributors are independent financial advisers, discount brokers, savings supermarkets and commercial retailers). The increasing use of e-channels generates opportunities for small distributors providing easy and cost-efficient tools, introducing more competition in the market (Ernst & Young, 2002).

Banks typically prefer to sell in-house products. Given their dominance over distribution channels, the large share of in-house funds comes as no surprise. The move towards third-party investment funds, promoted by an 'open architecture', is seen as a positive factor to cross-border products promotion and European integration.

The growth rate may have been slowed down by the downturn of the market since 2000, but in the long run a different approach, more competitive and quality demanding, will be expected from fund distributors. Of course, the outcome also hinges on the relative profitability of selling third-party funds *vis-à-vis* own funds.

Another important measure of integration is the unregulated products' market share in third-party funds.¹⁹ This share differs considerably between EU countries. Despite the evolution towards financial integration within the EU there are barriers to cross-border business: fiscal discrimination (taxes and subsidies) against foreign investment; tax and regulatory constraints for the merger of funds, especially cross-border.

In addition, the extensive regulation of UCITS in EU Directives limits cross-border marketing of innovative products. The absence of pan-European standard information on funds' performance, charges and fees makes it hard for the consumer to compare cross-country. The lack of consumer protection, complaint networks, compensation schemes and codes of conducts, together with legislative and regulatory (tax) issues, may constrain the emergence of a truly European market. It is not uncommon to find disguised protectionism in consumer protection regulations. Due to high entrance costs, small countries are often ignored in internationalization strategies because their small market potential makes them unprofitable locations.

No evidence has been presented on the magnitude of cost savings arising from larger average sizes and on the rate of pass-through of these gains to consumers. On cross-border M&A, the points raised in Danthine *et al.* (2000) are still valid. In short, whenever the aim is to obtain expertise, we should observe cross-border merger activity.

The investment managers interviewed by Heinemann *et al.* (2002) expect an expansion of the market in the future. In relation to distribution channels, insurance and fund supermarkets are expected to increase in importance. Fund supermarkets are a useful way to enter the market for small intermediaries (small banks and independent financial advisers). With electronic trading platforms and internet penetration among private households, infrastructure costs are smaller.

Overall, despite the fact that Europeanization of investment funds is a way to integrate markets, and the euro provides a way to diversify without exchange-rate risk, the lifting of restrictions on foreign holdings has not led to a fully integrated market. A major issue of debate is tax competition within Europe to capture investment funds. The role of banks is ambiguous. The use of bank branches as a major distribution channel creates a barrier to entry (the deployment

of a distribution network). The importance of it depends on the distribution and manufacturing policies of banks. If they move to the creation of new products and, at the same time, deliver products of other institutions, the importance of the network relative to the rate of product innovation decreases. On the other hand, for the proliferation of products to be successful, it may be crucial to be close to customers.

3.5 Conclusion

The main finding from this chapter is that integration in retail banking has been slow and it is lower than in corporate finance, described in the next chapter. In particular, loans to residential consumers are still markets where presence and nationality do matter. A natural reference point to assess retail banking integration is the cost of cross-border transactions. On this measure there are still barriers.²⁰ The amounts traded are small, and bank charges have shown little change over time.

Danthine *et al.* (1999) suggested that even if competition had increased somewhat during the 1990s, there was room for further competition in the banking market. We argue that the same conclusion holds after the introduction of the euro and the more recent deregulation measures in the banking sector: the increase in competition has been relatively small. A main issue is how much is still left, given that market characteristics (namely, the local nature of retailing activities) work as a powerful force against integration and pan-European competition.

The surprising feature of Europe's liberalization and deregulation in banking is not that the integration of markets is incomplete. After all, cultural factors, like consumers' habits and language, should allow for some differentiation to remain across markets. The surprise is that market integration in some areas falls so short of expectations. Country-specific forces are stronger than initially anticipated; in particular economic forces, like the importance of long-term relationships, have been underestimated.

Analysis of retail banking markets needs to identify the main obstacles to market integration. The analysis of Barros (1999), with data from Portugal, a small EU country, suggests that local market characteristics, and not market power, seem to be behind high margins. Also, the results from Fuentelsaz and Gomez (2001) indicate protection of local home markets in the Spanish banking market.

The implication is that just enacting legislation forcing the opening of entry in banking markets may not be enough to achieve a fully integrated market. The local market nature of banking competition makes it harder for legislative moves to reach a high level of market integration in some retail banking activities. Of course, artificial obstacles or lack of harmonization in other areas (consumer protection, contract law, settlement regulations, collateral) must also be removed. Overall, the experience in the EU, even after the creation of the euro area, reveals that market integration has progressed very slowly.

A main unresolved issue is what lies behind the barriers to further market integration in retail banking. The easy and immediate answer is proximity to customers, advantages from local information and relationship business. However, the several unsuccessful cases of entry attempts into foreign retail banking markets, namely in the smaller European markets, suggests that other factors may be at play as well.²¹ The mere deployment of branch networks does not guarantee the success of cross-border expansion.

4 Corporate Banking

4.1 Introduction

This chapter examines issues in the corporate finance aspects of bank integration. By corporate finance we mean both commercial banking services (for example, lending and money transmission) and investment banking services (for example, underwriting of seasoned and initial public offerings (IPOs), bond issues and M&A), as well as private equity and venture capital. We will draw on the extensive literature that exists on measuring and monitoring European financial integration in banking.

The main question that we address in this chapter is the extent to which there has been integration across the different components of corporate finance banking, whether the degrees of integration have been uniform or very different in the various segments, what contributes to levels of integration and the way in which this might affect the ability of the corporate sector to undertake its activities.

A report by Greenwich Associates¹ suggests that European corporations currently enjoy easier access to credit markets than their counterparts in the United States. This reflects the more fragmented nature of the European market, giving corporations a wide choice among alternative suppliers of credit. As international banks gain a larger market share, however, then they will expect to link the provision of credit to other more profitable products and services. European corporate lending is therefore likely to adopt features of the US market.

The main conclusion to which this chapter comes is that the degree of integration in corporate banking markets has been variable and uneven. There has been extensive integration in certain areas of banking, in particular in investment banking and the provision of banking services to large firms. There is a high degree of competition with substantial penetration by foreign banks in securities issuance and transaction-based activities such as M&A. It has been more limited in more traditional bank lending activities, however, in particular in lending to SMEs.

Integration has taken the form of a growing presence of US banks in corporate bond and equity issuance markets. Integration of corporate banking at the large end of the market has been associated with the adoption of US investment banking techniques. There has been a much less significant penetration by US banks in lending to small and medium-sized firms.

Size of firm is therefore an important determinant of the degree to which corporations have access to international banking markets. This is consistent with theories of banks that emphasize asymmetries of information in the provision of, in particular, loans to high-risk firms. The proximity of lenders to borrowers might be expected to be a determinant of the degree to which information problems and other capital market imperfections can be overcome. Unless they

can establish extensive branch networks, foreign banks are therefore at a drawback in the provision of loans to high-risk borrowers.

Although size of borrower may be an important consideration, it does not appear to be the dominant one. There is much less evidence of integration in syndicated bank lending, primarily to larger corporations, than in bond markets. In addition, there has been a substantial increase in the degree of international flows to venture capital firms that are primarily engaged in investing in small, sometimes very small, firms. Size of firm does not therefore appear to be either a necessary or sufficient condition for financial market integration. One of the issues that this chapter will address is why integration is so much more in evidence in some than other corporate markets.

This has an important bearing on the direction in which European corporate banking is likely to develop and the issues raised by the Greenwich Associates report. It suggests that the fragmentation that has been associated with diversity of alternative sources of finance may persist at least in relation to some types of corporate lending, even though US style practices will prevail elsewhere. A critical question that Europe needs to address is the extent to which it will wish to maintain or even promote diversity in bank lending practices across countries.

A second critical question raised in the introductory chapter is the relevance of ownership to corporate banking. Is the dominance of US banks in investment banking activities a cause of concern or should it be welcomed? Since it is concentrated at the transaction rather than the relationship end of the market, this chapter suggests that the increased levels of competition with which it is associated are in all probability beneficial.

The chapter in turn discusses the various markets in which banks are involved. It is divided into debt and equity finance and each of these are subdivided into public and private markets. Section 4.2 begins with public debt, that is, corporate bond, markets; Section 4.3 is concerned with private debt, that is, bank lending to small, medium-sized and larger firms; Section 4.4 with public equity markets (underwriting of equity issues and mergers and acquisitions); and Section 4.5 with private equity markets. Section 4.6 concludes the chapter by arguing that the categorization by type of finance and the nature of the markets provide valuable insights into the nature of banking integration in Europe and some policy lessons for where efforts in promoting integration can most usefully be concentrated.

4.2 Corporate bond markets

Corporate bond markets in Europe have traditionally been small by the standards of those in North America and Japan. They have been largely confined to high-grade borrowers, frequently financial institutions. There has, however, been an approximate 280% growth in the outstanding value of corporate bonds over the five years between 1998 and 2003, from around 180 billion euros to 680 billion euros. This growth has been particularly striking at the low-grade end of the market. In 1998 there was virtually no BBB rated lending in Europe; by 2003 it had risen to over 180 billion euros, representing over a quarter of outstanding bonds (Baele *et al.*, 2004a).²

Much of the growth in bond issuance has been associated with non-financial corporations. In 1998, financial institutions accounted for approximately 85% of outstanding corporate bonds, and industrials for around 7%; by 2003 the share of industrials had increased to around 38% and the share of financial institutions

had declined to 54% (Baele *et al.*, 2004a). Nevertheless, the corporate bond market in Europe remains small in relation to that in the United States and Japan, 8% of GDP in the euro area in 2001 compared with 29% and 25% in the United States and Japan respectively, according to Hartmann *et al.* (2003).

One of the factors promoting the growth in European bond markets has been the effect of the euro on relaxing currency restrictions on the holdings of institutions. These restrictions include currency matching requirements that put a ceiling (typically 20%) on the mismatch between the currency of assets and liabilities, and restrictions on allocations of portfolios to foreign securities. For example, foreign-currency holdings have been limited to 3% of pension fund bonds in France, 2% in Germany and 12% in the Netherlands. Similarly the euro relaxed 'prudent man' rules on pension fund portfolios that also encouraged domestic currency holdings.

According to Baele *et al.* (2004a), there has been a marked increase in bond market funds with a European-wide investment strategy. The share of European-wide managed bond funds increased from 17% in 1998 to 60% in 2002. This is much faster than the overall growth of global bond funds over the same period.

Baele *et al.* (2004a) have undertaken an analysis of the spreads on 1,256 corporate bonds issued in Austria, France, Germany, Ireland, the Netherlands and Spain over the period April 1998 to May 2003. Cross-sectional regressions, undertaken monthly on corporate bond spreads relative to a zero-coupon German government bond, are regressed on the bond's coupon, liquidity, time to maturity a set of dummy proxies or ratings, sector and country. The rating effect explained about one-quarter of the cross-sectional variation and country proxies only account for a small percentage of premia. This points to a fairly high degree of integration of the corporate bond market in Europe.

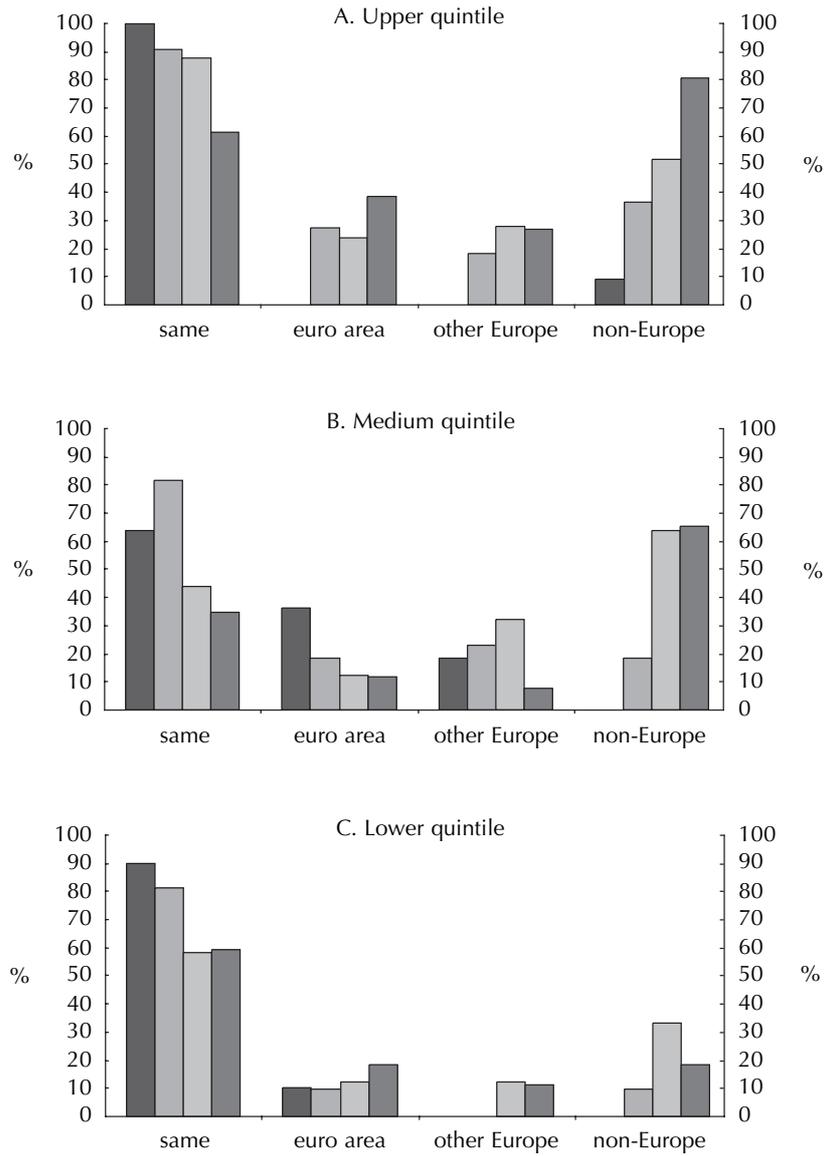
One of the key functions performed by banks in relation to bonds is to underwrite their issues. The emergence of the euro area increased the size of the market into which bonds could be sold. This may have encouraged greater reliance on local banks if they possessed informational advantages over other banks or less reliance if the international marketing of bonds became more important. Santos and Tsatsaronis (2003) report a sharp drop in the average fees charged by bookrunners on underwriting issues in euros over the period 1994–2001. This drop was much more appreciable than that observed in the US-dollar segment of the market over the same period. This result was confirmed in a regression of bond underwriting fees in a sample of 3,110 issues: controlling for bond and issuer characteristics, there was a much larger decline in euro- than dollar-denominated underwriting fees.

More striking evidence for the integration of the underwriting market came from an examination of the nationality of bankers involved. While US investment bankers tripled their share of business originated by US borrowers from pre- to post-EMU, European bankers' share of euro bonds declined after EMU. The existence of a business relationship with a borrower therefore appears to have played a limited role in the choice of underwriter. The main winners in the euro zone underwriting market have been the US banks. Pre-EMU US bankers only underwrote 3.6% of issues; post-EMU this rose to around 25%.

Figure 4.1 shows the proportion of bookrunners of euro area firms' bond issues that came from the same country as the issuer, somewhere else in the euro area, somewhere else in Europe and outside Europe in 1995, 1998, 1999 and 2000. The three graphs refer to different sizes of issues – the upper quintile, median quintile and lower quintile respectively. The figure shows a dramatic decline in the proportion of bookrunners coming from the same country as the issuer, a slight

Figure 4.1 Bookrunners of euro area firms' bond issues

1995
 1998
 1999
 2000



Note: % share in all transactions

Source: Dealogic.

Table 4.1 Top bookrunners in all eurobonds

	1/1/02-31/12/02			1/1/03-31/12/03			1/1/04-31/12/04		
	Total \$m	Share	No. of issues	Total \$m	Share	No. of issues	Total \$m	Share	No. of issues
Deutsche Bank	64,028.7	9.0	207	80,424.7	8.3	272	80,355.5	7.8	303
Citigroup/SSB	48,608.6	6.8	126	65,408.5	6.8	213	71,184.4	6.9	223
Morgan Stanley	42,320.8	6.0	138	53,846.6	5.6	170	63,508.8	6.2	214
JP Morgan	40,130.8	5.7	123	53,048.5	5.5	221	62,921.8	6.1	255
DrKW	38,624.2	5.4	131	51,072.9	5.3	197	60,324.6	5.9	178
ABN AMRO	37,717.4	5.3	121	50,275.1	5.2	196	59,039.2	5.8	212
SG	34,829.1	4.9	114	49,763.7	5.2	191	58,343.3	5.7	221
Barclays Capital	34,559.2	4.9	113	47,399.9	4.9	180	50,747.7	5.0	234
BNP Paribas	34,385.2	4.8	106	45,885.1	4.8	145	49,762.4	4.9	252
Merrill Lynch	29,735.0	4.2	109	42,185.1	4.4	147	44,038.4	4.3	155
Top 10 total	404,938.4	57.0	1,288	539,310.1	56.0	1,932	600,226.1	58.6	2,247
Industry totals	710,654.2	100.0	1,599	964,888.9	100.0	2,229	1,025,579.6	100.0	2,529
				Top 10 total			Top 10 total		
				Industry totals			Industry totals		

Source: Thomson Financial.

increase in the proportion coming from elsewhere in Europe and a dramatic increase in the proportion coming from outside Europe, particularly among the largest quintile of issues.

This penetration of bond markets by US issuers can be seen from Table 4.1, which shows the top ten banks involved in all eurobond issues in 2002, 2003 and 2004. It shows US banks in general occupying 40% of the top positions.

The marked reduction in underwriting fees in the euro area was therefore associated with greater contestability of the investment banking business and the rapid penetration of the market by US investment banks. This suggests that the ability to place issues into large markets is of more significance in gaining competitive advantage than relationships arising from geographical proximity.

In summary, evidence on both pricing and quantities suggests that the rapidly expanding European corporate bond market has witnessed a high degree of cross-border integration with particularly significant penetration by US banks.

4.3 Lending to SMEs and syndicated bank lending

The degree of integration in lending to SMEs is appreciably less than in bond markets. Baele *et al.* (2004a) examines the degree of convergence in lending rates by banks to enterprises across countries. They report that there is more evidence of convergence of medium- and long-term interest rates than of short-term rates. Part of this arises from convergence in market rates of interest brought about by the introduction of the euro. To abstract from this, it is necessary to examine spreads of lending rates above market interest rates. When this is done then there is still some but less convergence in margins. Cabral *et al.* (2002) report that the average standard deviation in corporate lending rates in euro countries was 3.50% over the period May 1998 to May 1999 and 1.34% over the period May 2001 to May 2002, while the average standard deviation of lending margins relative to market rates declined from 1.67% to 1.34% over the same period. Baele *et al.* (2004a) record that the convergence of margins is also more pronounced in medium- and long-term than short-term interest rates. They also report some but not a dramatic increase in cross-border lending. In contrast to bond markets, bank-lending remains fragmented with significant discrepancies in lending rates remaining.

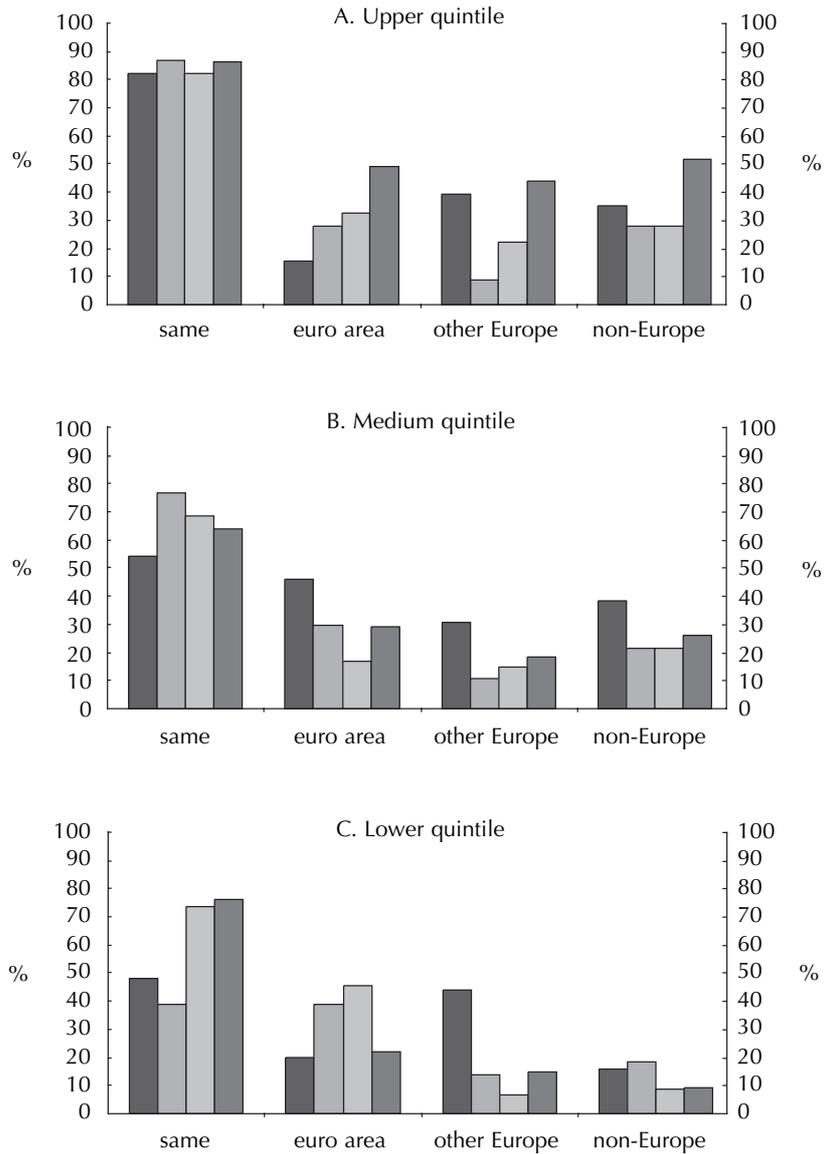
The limited degree of integration in lending may reflect the importance of information and relations between banks and borrowers. Local banks may be at an informational advantage relative to foreign banks in evaluating and monitoring borrowers. Branch networks may therefore be a necessary requirement for banks to be able to service geographically dispersed SMEs and this may discourage foreign bank competition if the establishment of such networks is difficult or expensive.

One strand of the literature suggests that internationalization of bank lending might be expected if relationships between the headquarters of firms and banks are particularly important. In that case, as firms expand their activities internationally they might seek similar global diversification by their banks to service the activities of their foreign subsidiaries. A number of papers (Brealey and Kaplanis, 1996; Goldberg and Saunders, 1981; Grosse and Goldberg, 1991; Ter Wengel, 1995) report such 'follow-your-customer' strategies.

On the other hand, the knowledge and contacts of local banks may be particularly significant for foreign affiliates, in which case they will seek the services of

Figure 4.2 Arrangers of euro area firms' syndicated loans, (% share in all transactions)

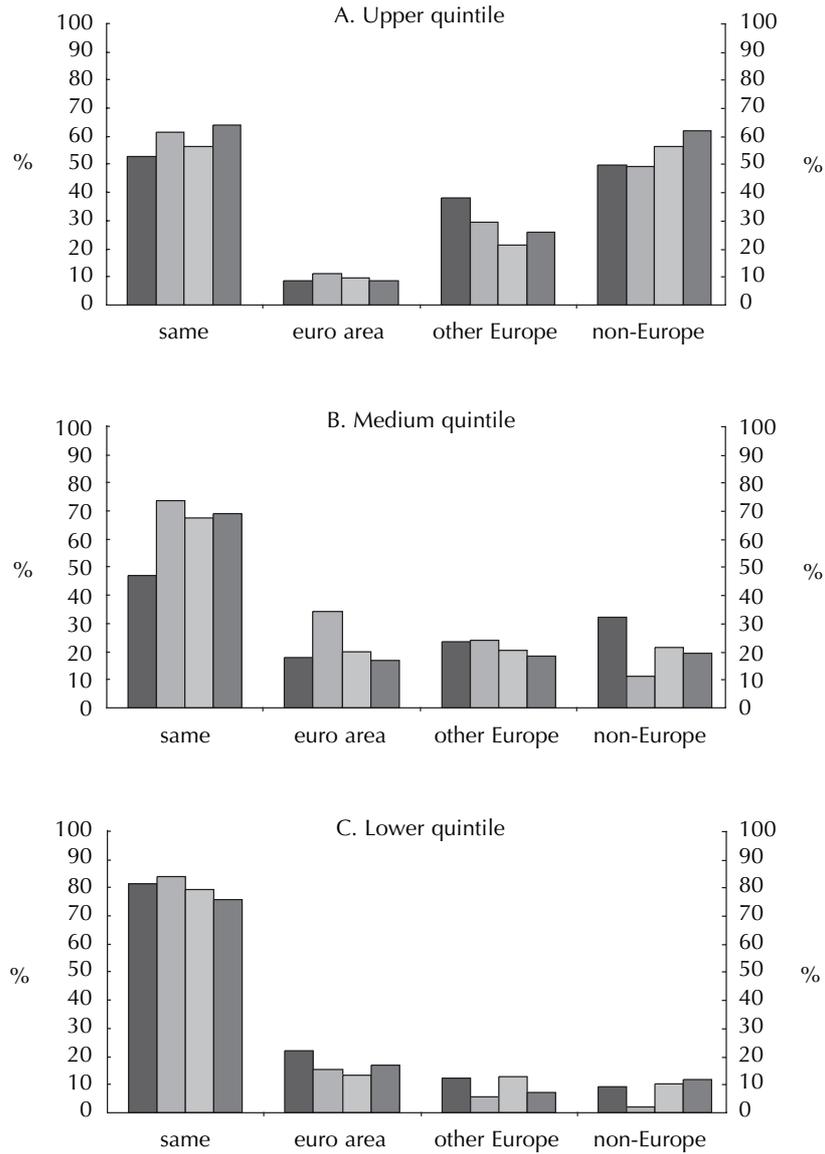
1995
 1998
 1999
 2000



Note: % share in all transactions
 Source: Dealogic.

Figure 4.3 Bookrunners of euro area firms' equity issues, (% share in all transactions)

1995 1998
 1999 2000



Note: % share in all transactions
 Source: Dealogic.

Table 4.2 Distribution of top 20 bookrunners in equities in euro (or legacy currencies) issued by euro area resident firms and group, according to bookrunner's nationality

(% of total)		1995	2000	2001
Euro area		64.2	41.1	45.6
of which	DE	14.5	20.1	15.8
	FR	20.7	6.3	12.4
	NL	9.5	6.1	7.9
Other europe		20.3	10.6	15.1
of which	UK	0.0	0.0	0.0
	CH	20.3	10.6	14.0
Rest of world		11.5	35.7	36.6
of which	US	10.8	35.7	36.6
	JP	0.7	0.0	0.0
Total top 20		96.0	87.7	97.3

Source: Dealogic.

local rather than multinational banks. Recent work (for example, Seth *et al.*, 1998, and Stanley *et al.*, 1993) find that foreign-owned banks tend to lend to borrowers other than their home country customers and have a high proportion of assets invested in domestic not foreign firms. This suggests that the globalization of banking is not primarily motivated by 'follow-your-customer' considerations.

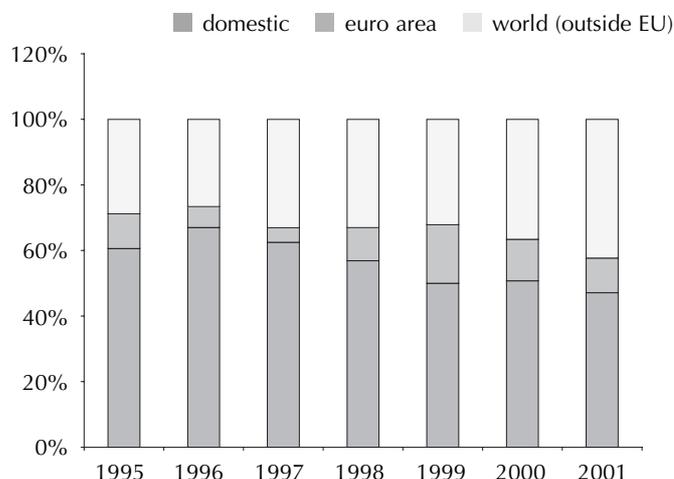
Consistent with the informational problem theory, Berger *et al.* (2001) report that foreign-owned banks have problems lending to small businesses. In a particularly interesting analysis, Berger *et al.* (2002) examine the choice of firms in Europe of banks supplying cash management, including lending services. They observe in a sample of more than 2,000 firms that those that use host banks are more likely to employ local or regional banks more frequently than global banks, and firms that use home banks are more likely to use global banks as they expand. However, two-thirds of firms choose a bank headquartered in the host nation. This is consistently observed for affiliates situated in different European countries, though affiliates of US firms in Europe tend to use host banks less frequently and US banks more frequently than affiliates of European firms. This use of host bank suggests that there is a strong reliance of foreign affiliates on the local knowledge that host banks can provide. Given the association of host with local or regional banks, this in turn points to the difficulty that global banks face of penetrating lending markets and suggests that the extent of globalization may remain limited as many corporations continue to rely on the knowledge of local or regional banks.

The limited degree of integration of bank lending is not restricted to SMEs. It is also a feature of syndicated bank lending. In marked contrast to bond markets, Cabral *et al.* (2002) record a very uneven movement in gross fees on syndicated loans in euros taken up by euro area residents. On the upper quintile of size transactions there was some decline between 1995 and 2000, but on the median quintile of transactions gross fees actually increased over the period. In addition, as Figure 4.2 shows, there has been little penetration of overseas banks of domestic syndicated bank lending markets. There has been no marked decline in the proportion of banks coming from the same country as the borrower over the period 1995-2000. In relation to the lower quintile of loans there has actually been an increase. In particular, US banks have not penetrated the syndicated bank lending market to the same extent as the corporate bond market.

Table 4.3 Top financial advisers in European takeovers (all completed European targets)

	1/1/02-31/12/02			1/1/03-31/12/03			1/1/04-30/6/04				
	Value (\$m)	Deals	Share (%)	Value (\$m)	Deals	Share (%)	Value (\$m)	Deals	Share (%)		
Deutsche Bank	109,127.7	97	10.6	Goldman Sachs	126,497.7	67	12.9	Goldman Sachs	52,600.2	25	13.4
Goldman Sachs	103,420.5	90	10.0	Lazard	100,730.7	95	10.3	Morgan Stanley	42,635.0	29	10.9
Merril Lynch	100,942.7	65	9.8	Citigroup	98,439.7	65	10.1	Lazard	37,733.4	35	9.6
Morgan Stanley	90,532.7	111	8.8	JP Morgan Chase	96,425.0	92	9.9	JP Morgan Chase	35,970.5	49	9.2
Rothschild	87,764.4	109	8.5	Morgan Stanley	83,163.0	73	8.5	Rothschild	34,575.7	72	8.8
JP Morgan Chase	80,368.4	95	7.8	Merril Lynch	80,863.0	53	8.3	Deutsche Bank	28,080.0	38	7.2
CSFB	78,691.0	92	7.6	UBS	75,172.6	85	7.7	BNP Paribas	22,867.8	23	5.8
Citigroup	76,581.2	77	7.4	Rothschild	73,512.8	137	7.5	Merril Lynch	22,263.4	23	5.7
UBS	76,146.4	79	7.4	Deutsche Bank	57,380.5	83	5.9	UBS	20,443.6	34	5.2
Lehman Brothers	68,961.9	74	6.7	CSFB	45,775.4	70	4.7	Citigroup	20,306.0	27	5.2
Lazard	64,203.5	103	6.2	Lehman Brothers	33,492.3	42	3.4	HSBC Holdings	18,280.6	9	4.7
BNP Paribas	45,247.3	59	4.4	BNP Paribas	31,225.4	49	3.2	ABN Amro	15,884.1	28	4.0
Mediobanca	19,069.0	23	1.8	Mediobanca	28,792.7	31	2.9	CSFB	13,942.5	38	3.6
CréditAgricole -				CréditAgricole -				Société Générale	13,771.5	21	3.5
CréditLyonnais	18,753.5	49	1.8	CréditLyonnais	27856.8	46	2.8	Cazenove	13,301.7	7	3.4
Société Générale	12,988.0	29	1.3	Société Générale	19297.9	46	2.0				

Source: *Investment Dealers Digest*, volume 70, issue 28; volume 70, issue 70, issue 3.

Figure 4.4 Geographical location of M&A deals among credit institutions

Note: The domestic deals involve institutions in the same country, while the euro area deals concern banks situated in two different countries of the euro area. The world M&A deals involve one institution located in the euro area and another located outside.

Source: SDC Thomson Financial. From: P. Hartmann, A. Maddaloni and S. Manganelli (2003), 'The Euro-Area Financial System: Structure, Integration and Policy Initiatives', *Oxford Review of Economic Policy*, 19, pp.180–213.

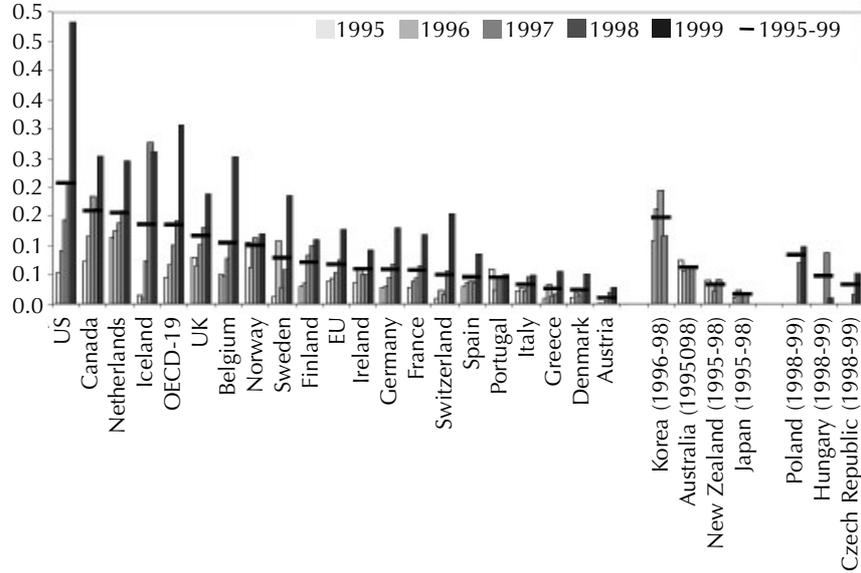
In summary, there is a marked distinction between the bond and bank lending market. There has been a high degree of integration in the European bond markets, as reflected both in terms of pricing behaviour and the presence of foreign banks. There has been only modest convergence of interest rates, fees and margins in bank lending and little penetration by foreign banks. The distinction appears to have more to do with the nature of intermediation than with the size of borrowers. Syndicated bank lending to large companies shows markedly fewer signs of convergence and integration than bond finance.

4.4 Public equity markets

Some of the trends that emerged in the market for bond underwriting are also found in equity underwriting, albeit to a lesser degree. Gross underwriting fees have declined in the euro area zone, dropping from an average of 2.8% in 1995 to 2.4% in 2000 for the top quintile transactions, and from 3.8% to 3.0% in the same period for the median quintile transactions (Cabral *et al.*, 2002). This decline in underwriting fees may reflect heightened competitive pressure among investment banks in the euro area zone. The decline in fees, however, is less pronounced than the one experienced in the corporate bond market during the same period, and may reflect a lower degree of integration in this market segment.

The different behaviour observed in the bond and equity markets may be due to the greater importance of local factors in equity than in bond underwriting, and the greater difficulty of competing when incumbent banks have an information advantage. The presence of asymmetries of information between issuers and

Figure 4.5 Venture capital investment ('country of management' approach) in early stages and expansion as a percentage of GDP



Source: EVCA, various yearbooks; NVCA, various annual reports; Canadian Venture Capital Association (CVCA); *Asian Venture Capital Journal*; *The 2000 Guide to Venture Capital in Asia*.

investors, and the knowledge acquired by a bank during past transactions with a firm, give incumbent banks an information advantage that it is difficult for a potential competitor to overcome.³ This produces a lower degree of competition and financial integration in an information-sensitive market segment such as equity underwriting.

This possibility is confirmed in Figure 4.3. The figure shows, for euro zone firms, the composition of bookrunner teams broken down by domestic banks, and banks from another euro area country, a European country outside the euro area, or from outside Europe. The figure shows that in contrast to what is observed in the bond markets, domestic banks still command a strong presence in domestic equity underwriting. The predominant position of domestic banks is particularly strong in transactions in the smallest-size class of firms, that is, those in the lowest quintile. Since information asymmetries are presumably more severe for smaller firms, these data are consistent with the hypothesis that the incumbents' information advantage hinders competition and thus cross-border activities. Figure 4.3 also documents an increased importance of non-European banks in equity underwriting. Not surprisingly, the presence of non-European banks has been stronger for transactions in the upper quintile, where incumbents are less protected by their information advantage and thus more open to competition.

Overall, equity markets appear to have become somewhat more competitive. The market share of the top three banks has decreased from approximately 45% in 1995 to less than 30% in 2000, while the market share of the top ten banks in the same period remained stable at approximately 70% (Cabral *et al.*, 2002).

It is interesting to note that non-European banks, especially US banks, seem to have taken advantage of the window of opportunity offered by the increased

Figure 4.6 Fraction of funds managed by domestic venture capital funds originated from another European country (IMPORT), and fraction of funds managed by domestic venture capital funds employed to finance firms located in another European country (EXPORT)

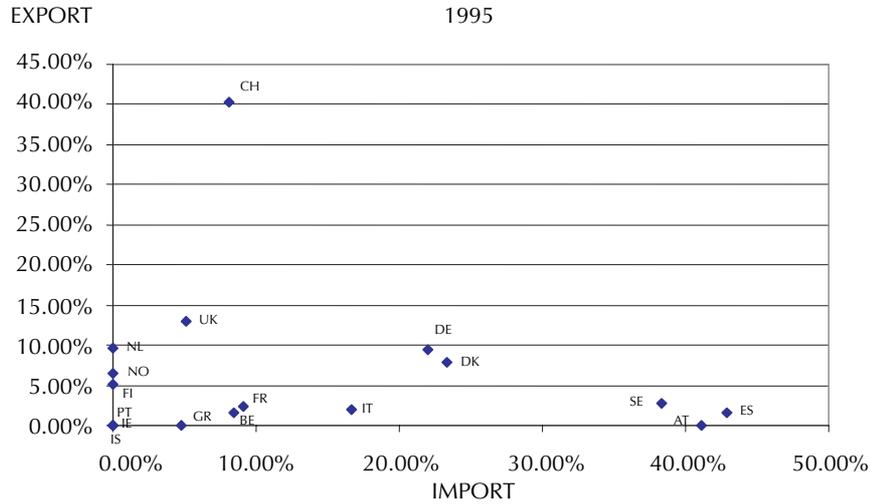
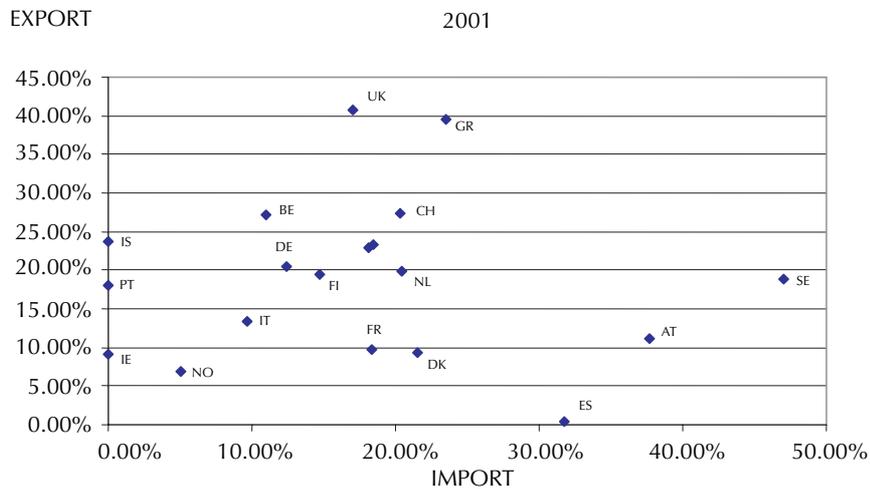


Figure 4.7 Fraction of funds managed by domestic venture capital funds originated from another European country (IMPORT), and fraction of funds managed by domestic venture capital funds employed to finance firms located in another European country (EXPORT)



Key: AT: Austria; BE: Belgium; CH: Switzerland; DE: Germany; DK: Denmark; ES: Spain; FI: Finland; FR: France; GR: Greece; IE: Ireland; IS: Iceland IT: Italy; NL: The Netherlands; NO: Norway; PT: Portugal; SE: Sweden; UK: United Kingdom.

Sources: EVCA; own calculations.

competitive pressures experienced in this period. While euro area banks have maintained their small presence in the upper quintile segment (at less than 10%), the presence of other non-euro-area European banks has declined to the advantage of non-European banks. The increased importance of non-European banks is due almost exclusively to the increased presence of US banks, which increased their overall market share from 10.8% in 1995 to 36.6% in 2001 (see Table 4.2).

This is particularly evident in the involvement of US banks in advising on takeover deals of European target firms. Table 4.3 shows the top financial advisers in completed European takeovers in 2002, 2003 and the first six months of 2004. US banks occupied around half of the top ten positions and most of the top five positions. Figure 4.4 shows that there has been a progressive decline in the proportion of M&A deals handled by domestic banks since the mid-1990s, with the main growth coming from outside Europe (presumably the US) rather than other euro area countries.

This increased importance of US banks in large transactions may be due to the greater reputation and better worldwide distribution capabilities of US banks. Thus, these data are consistent with theories suggesting that the reputation of investment banks in equity underwriting increases their value to issuers, providing US banks with a competitive advantage over less reputable competitors.⁴

In sum, equity markets have displayed a significant degree of integration, though not on the scale of that observed in bond markets. Cross-border activity has been particularly in evidence in large firm transactions with US banks capturing a substantial fraction of the market.

4.5 Private equity markets and venture capital

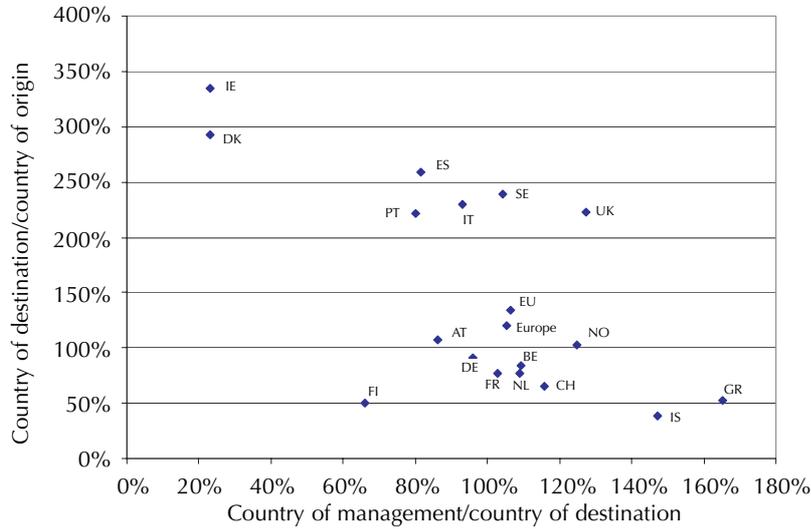
In comparison with those in the United States, European private equity and venture capital have traditionally been relatively undeveloped, especially as a vehicle to finance small enterprises. While the 1990s have witnessed a dramatic increase in the importance of private equity in both North America and Europe, especially in continental Europe, the gap has in fact widened.

From 1995 to 1999 private equity and venture capital increased nearly tenfold in the United States, while during the same period they increased a bit less than four times in the EU. Private equity and venture capital in the United States rose from 0.07% of GNP in 1995 to 0.27% in 1999, while in the same period they increased from 0.08% of GNP to 0.16% in the EU. The rate of growth of venture capital has also been rather uneven in the EU during this period, less than doubling in Norway while increasing 95 times in Austria.⁵

The difference in importance of venture capital and private equity in the United States and the EU is accentuated by the fact that venture capital in Europe includes leveraged buyout (LBO) activity, while it is excluded from the US figures. Restricting the analysis to venture capital directed toward small enterprises in their early stages and expansion financing, the gap between the United States and the EU has widened still further. In 1995, the amount of investments in early stages and expansion, as a percentage of GDP, was roughly equal in the United States and the EU in 1999; since then it has grown five times in the United States and only doubled in the EU (see Figure 4.5).

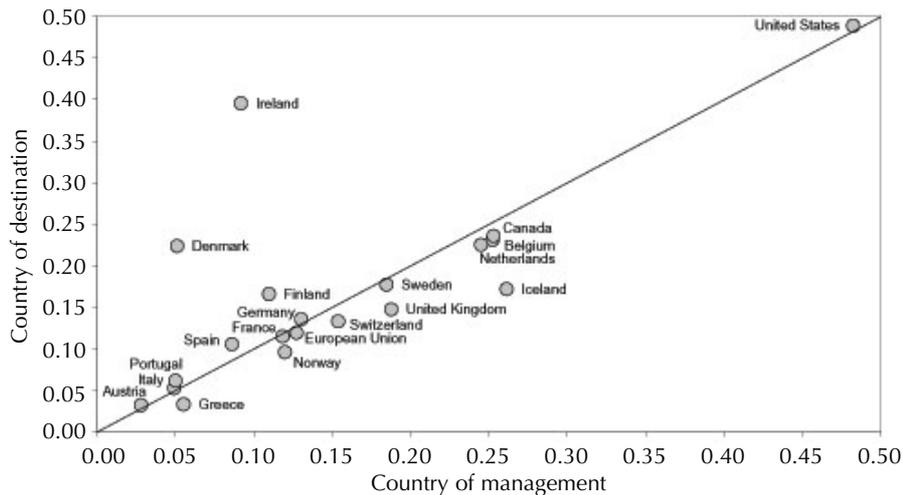
The sources of venture capital funds also suggest another important difference between the United States and the EU. In North America, pension funds are the most important source of private equity (50% during 1995–99), followed by

Figure 4.8 Ratio of funds of venture capital funds managed domestically with respect to funds invested domestically (horizontal axis), and ratio of funds invested domestically with respect to funds originating domestically (vertical axis)



Key: AT: Austria; BE: Belgium; CH: Switzerland; DE: Germany; DK: Denmark; ES: Spain; FI: Finland; FR: France; GR: Greece; IE: Ireland; IS: Iceland IT: Italy; NL: The Netherlands; NO: Norway; PT: Portugal; SE: Sweden; UK: United Kingdom.
 Source: Own calculations based on data reported in Baygan and Freudenberg (2000).

Figure 4.9 Investment in early stages and expansion: 'country of management' vs. 'country of destination' approach, 1999 (% of GDP)



Sources: EVCA; NVCA; Canadian Venture Capital Association (CVCA).

corporations (15%) and individuals and families (11%). Over the same period, banks are the main source of funds in Europe (28%), followed by pension funds (23%) and insurance companies (13%).⁶

The European market for venture capital integrated at a rapid pace during the 1990s, with a progressive increase in the cross-border flows of venture capital finance. Cross-border flows of venture capital arise primarily for two reasons. Private equity funds are first raised from investors located in a certain country, the country of origin. These funds may be committed to a venture capital fund located domestically, or may instead migrate to another country to be managed by a venture capital fund located in this second country, the country of management. In addition, funds managed in a certain country may be invested domestically, that is, used to finance a local firm, or may again migrate to another country to be invested in a firm located in a foreign country, the country of destination. Thus, between fund raising and investing, finance may cross national borders twice: first, from the country of origin to the country of management, and then from the country of management to the country of destination.

One way to measure the degree of integration of the European venture capital markets is to focus on the country of management and observe the inflow and outflow of funds from that country's perspective. This is the so-called 'country of management approach'. Figures 4.6 and 4.7 document the fast process of integration that has characterized the European venture capital markets. The figures show for European countries the fraction of funds managed by a domestic venture capital fund firm that originated from another European country (IMPORT), and the fraction of funds managed by a domestic venture capital fund that is employed to finance a firm located in another European country (EXPORT).

These figures document the dramatic increase in cross-border activity among European countries: while in 1995 the fraction of import and export of funds was less than 15% for most European countries, six years later the same ratios were more than 15% in most countries. The European venture capital market shows clear signs of integration.

A further interesting feature emerging from Figures 4.6 and 4.7 is that for certain countries, located close to the 45% line, the import of funds by domestic venture capital firms balances their export of funds. These countries, such as the Netherlands and Switzerland, attract funds from abroad, which are managed by a domestic firm and then reinvested abroad. Thus, such countries export venture capital managerial expertise by acting as a source of venture capital funds for firms located in other European countries. In some countries, such as Austria, Denmark, Spain and Sweden, domestic venture capital firms consistently import more funds than they export. In these countries domestic venture capital firms import funds that are then invested domestically. Finally, in other countries, such as the United Kingdom, domestic venture capital firms consistently export more funds than they import, and thus act as net suppliers of both funds and managerial capabilities.

The foregoing discussion reveals that funds may cross borders either to be managed abroad or to reach their final destination abroad as an investment. Thus, a country may act as either a net supplier of investment funds, by generating domestically more funds than it employs domestically, or it may act as supplier of fund management capabilities, by attracting funds from abroad and re-exporting them, in the process managing domestically more funds than it invests domestically.

Figure 4.8 disentangles the two aspects of origination and management. For each country, the figure reports the ratio of funds managed domestically to those invested domestically, and the ratio of funds invested domestically to funds originating domestically. Countries in the NE quadrant invest more funds than they

generate, acting as net importers of funds, and manage domestically more funds than they invest domestically, acting thus as net exporters of fund management capabilities. Correspondingly, countries in the SE quadrant act as exporters of both funds and managerial capabilities, countries in the SW quadrant act as exporters of funds but importers of managerial capabilities, and finally countries in the NW quadrant import both funds and managerial capabilities.

Figure 4.8 reveals that cross-border activities are strong for both funds and fund management, with substantial differences across countries. For example, the UK is a net exporter of fund management capabilities (which is consistent with the findings reported in Figure 4.7), but also is a net importer of venture capital funds, by investing domestically more than it originated domestically. Interestingly, Ireland and Denmark are net importers of both funds and fund management capabilities. Spain, Italy and Portugal import funds that are then managed and invested locally. These features are confirmed in Figure 4.9, showing the proportion of funds managed and funds invested as a percentage of GDP for venture capital devoted to early stages and expansion. Thus, the main picture that we observe for the venture capital market in its entirety is also relevant in the segment of small firm financing.

In summary, while early stage financing in Europe is modest in comparison with that in the United States, the European venture capital industry displays a remarkable degree of integration and cross-border activity. Flows are large both between suppliers of finance and management firms and between the managers and the ultimate users of capital. Some countries are net exporters of finance and some of fund management; others are importers of one or both of these. As we will describe in the final section of this chapter, this raises some interesting questions about the relevance of theory and institutional factors to the integration process.

4.6 Conclusions

This chapter has documented an interesting and in some respects surprising picture of the corporate finance aspects of integration in European banking. Theories of corporate finance suggest that information problems are more serious in equity than debt finance as a consequence of the greater information sensitivity of equity finance. In addition, the participation of a large number of investors requires information to be more widely available in public securities than in private capital markets. We would therefore anticipate that in a ranking of financial integration it would be most in evidence in public debt markets, least in private equity markets and somewhere in between in private debt and public equity markets.

Some of the results in this chapter are consistent with this picture. We have observed the highest degree of integration in public bond markets – significantly more than in either private debt or public equity markets. We have reported some integration of equity markets but only modest integration in bank lending to corporations. The limited degree of integration in bank lending has been associated with information problems of evaluating the quality of borrowers, benefiting local banks with national branch networks. The difficulty that foreign banks encounter in establishing branch networks has restricted the degree of international penetration of bank lending markets.⁷

Somewhat more surprising is that this is not confined to lending to small and medium-sized firms, where information problems might be expected to be most acute. In relation to bond and equity issuance, integration has been most pronounced at the large end of the market. But in bank lending, to date there has been only modest integration of syndicated bank lending to relatively large firms.

Still more surprising is the observation of high degrees of integration in the market that would have been expected to be most prone to information problems, namely private equity. A local presence of well-informed investors might have been anticipated to be particularly important in the provision of private equity and integration to be least advanced in this field of corporate finance.

That is not the case and a possible explanation is important in understanding the factors influencing the integration process. The private equity market displays institutional characteristics that are different from those of other and in particular banking markets. The sources of finance from institutional and private investors are distinct and geographically separate from their management through venture capital firms. Cross-border flows are therefore observed between sources and managers of funds as well as between managers and the ultimate users of finance. Some countries act as net sources of venture capital finance and others as net importers; some countries are exporters of management expertise and some as importers. Section 4.5 reported a high level of cross-border flows in both finance and management.

This brings out an important aspect of trade in financial services that has received little attention to date. The financing of, in particular, firms in their early stages of development may require access to particular sources of finance and managerial expertise that may be available at lower cost internationally than domestically. Costs of finance are reduced if firms can be appropriately matched with both investors and fund managers.

The diversity in financing opportunities is particularly great in private equity markets where investors bear a high proportion of risks and there are marked variations in the characteristics of firms. In private debt markets, firm characteristics vary but investors only bear a modest amount of risk; in public equity markets, investors bear risks but only have a limited ongoing managerial involvement. The combination of financial and managerial flows are therefore particularly high in private equity and the separation of the two functions allows these to be observed in a very striking and informative way.

The process of financial integration in the corporate finance aspects of banking is more complex than finance theories might lead one to predict. It is not simply governed by whether finance takes the form of equity or debt, whether markets are private or public, or whether borrowing firms are large or small. There have been significant levels of integration in private-equity financing, where pronounced market failures might be expected to arise.

One of the implications of our analysis is that the attention that has been devoted to trying to stimulate integration in bank lending might have been misdirected. High degrees of integration might not be expected given the modest gains and the informational problems that have to be overcome. Provided that firms have access to international sources of private equity, then there may only be a limited requirement for integration in banking. There may in fact be advantages to a local presence in banking sustaining longer-term relations with firms.

A potentially more significant cause for concern is the limited growth in European private equity markets and their focus on later-stage finance and management buy-outs. The development of a vibrant SME sector in Europe, and

in particular a high-tech one, may be more dependent on stimulating the provision of private equity to firms in their early stages of development than the integration of bank lending. The potential impediments to this are, first, insufficient sources of finance and, secondly, inadequate managerial expertise and intermediation between the providers and ultimate users of finance.

While sources of funds might be the problem, this is unlikely: if the managerial expertise exists then finance is likely to be forthcoming from outside as well as within Europe. Instead, limited managerial experience is probably a more serious deficiency of European private equity markets. Europe has less experience than the United States of creating a cadre of individuals with a combination of scientific, technical, managerial and entrepreneurial experience from either the corporate or the university sectors. Further development and integration of private equity markets may hinge more critically on the emergence of such a class of individuals than on regulation to promote greater cross-border flows in finance.

In relation to investment banking activities, integration has occurred largely on the back of penetration of European markets by US banks. While other chapters in the report suggest that there may be causes for concern about high levels of foreign penetration of domestic banking activities where local bank-firm relations prevail, this is unlikely to be the case in relation to transaction-based activities for large corporations. US banks have injected a greater degree of competition and efficiency in the new issue process, to the benefit of European corporations.

5 Integrating New European Banks

5.1 Introduction

Eight Central and East European countries joined the EU on 1 May 2004. It was an important step in a still ongoing accession process, spanning so far more than a decade of remarkable institutional development and gradual economic and political integration with the rest of the EU. An important aspect of this development and integration is financial. The financial systems of the new Member States have developed from the institutions associated with central planning. From more or less complete insulation they have become more and more integrated into the rest of the national financial systems of the old EU members and the emerging European financial system described in previous chapters.

But the processes of development and integration have still to be completed. Most institutions associated with a modern developed market economy remain in place, but implementation and enforcement are sometimes lacking. Risk levels are still higher for those investing in the new Member States. The fact that the process is not yet complete, however, also means that there are still considerable gains to be captured from deepening institutional development. The challenge is to reach these goals in an environment where membership of the EU no longer serves as a strong anchor for the reform process.

Most of the gains from real integration have already come through general trade liberalization and specific trade agreements signed earlier between the EU and the new Member States. The entry of foreign banks reinforced the ailing banking systems of many countries in a phase of financial fragility, and transformed outmoded banks, most of them previously state-owned. Many of these institutions are now growing rapidly with very high profitability. The expansion of retail banking and small business loans is particularly striking.

But there are still large potential gains from further improvements in the operations of the foreign-controlled banks and their institutional integration into their parent institutions. At the same time concerns are also being raised that the financial systems of the new Member States have exposed themselves to new threats to their stability. Some observers even argue that the local banking systems have lost their capacity to support the development of their domestic industries, in particular small and medium-sized firms where local knowledge often is perceived as critical.

In this chapter we want to understand how well integrated the financial systems of central and eastern Europe are in those of the rest of the EU and what the impediments are to further integration. The chapter starts by describing the emerging financial systems and identifying their institutional strengths and weaknesses. We then look specifically at banking transition and its outcome in

terms of structure and performance. Financial development and banking transition in particular have contributed to, and been affected by, real and financial integration. In the next section we examine the process of real and financial convergence and point to variations across countries and sectors in terms of speed of convergence. The chapter concludes by drawing some conclusions and policy implications.

5.2 Emerging financial systems

The countries of Central and Eastern Europe, including the Baltic states, have fundamentally reformed their financial systems over the last decade. While they shared the legacy of central planning and authoritarian rule, there were also differences in starting points. Some countries, in particular Hungary, had implemented significant early reforms and had a sizeable private sector (as did Poland). The manifestation of central planning also differed across countries, with the Czech Republic and East Germany often portrayed as more central and more planned than the others. In addition, the legacy in terms of macroeconomic imbalances varied considerably from country to country. Poland, for example, had a huge debt overhang with a large foreign debt, while other countries could start with more of a clean slate.

The countries adopted very different policies for dealing with the problems inherited from the past and the new challenges they faced in their transition to market economies. Poland defaulted on its foreign creditors, whereas Hungary honoured its debts. Some countries, like the Czech Republic, created special 'hospital banks' for the bad debts inherited from central planning, whereas others did not. Hungary put in place an automatic bankruptcy trigger which forced a large number of firms into court-led restructuring. In sharp contrast Poland instead announced a moratorium on bankruptcies to allow banks and firms to restructure their contracts in informal workouts.

In addition, privatization strategies differed markedly, both for banks and non-financial companies. Poland early on opted to privatize banks through IPOs, but after some less successful attempts sales to strategic investors became the predominant mode of privatization. Hungary also sold most of its banks to foreign banks. The Czech Republic hesitated long before privatizing through sales to foreign banks, and Slovenia only contemplated its first bank privatization, to a foreign bank, in 2004. Similarly, the privatization schemes for firms varied greatly from one country to another. Hungary and Estonia opted for sales, whereas the Czech Republic used mass privatization through vouchers. Poland announced a mass-privatization scheme, but political inertia slowed down the process and eventually most privatization took place through managerial buy-outs and liquidations.

The countries also followed different trajectories. All countries had banking crises early on, often followed by generalized, repeated bail-outs, but after the initial turbulence most countries in Central and Eastern Europe experienced a relatively stable institutional development. The establishment of hard budget constraints and the reduction of subsidies and direct credits helped promote improvements in institutional quality. Estonia, Poland and Slovenia showed a positive correlation between financial development (measured as the ratio of domestic credit to the private sector to GDP) and economic growth (Berglöf and Bolton, 2002). The Czech Republic and Slovakia started out with very high levels

of credit to the private sector, but this was largely an artifact of mass privatization and poor accounting of non-performing loans. With more accurate measures these two countries would probably also exhibit a similar correlation. Bulgaria, on the other hand, had initial financial expansion with little growth and then contraction with some economic growth.

Despite different starting points, very different policies and varying development trajectories, these countries now share many characteristics. Financial intermediation is strongly dominated by banks, with a few exceptions controlled by foreign interests. These banks are oriented towards funding government deficits, while corporate finance is still limited. Firms so far rely strongly on internal finance and foreign direct investment. Retail banking is growing, but is not yet at Western European levels of importance. Equity markets are still weak, in some countries even declining. Stock market capitalization, another common measure, fluctuates greatly over time, but at the end of 2003 the Tallinn Stock Exchange, now owned and controlled by the Swedish OM-HEX Group, had the largest market relative to the domestic economy (amounting to 34% of the Estonian GDP). In absolute terms Warsaw is the largest exchange in Central and Eastern Europe. The corresponding figure for the other countries in the region ranges between 4.3% (Bulgaria) and 21% (Czech Republic).

Patterns of ownership and control in the corporate sector are also converging. While the extent of remaining government ownership differs from one country to another, private ownership dominates everywhere. Ownership and control of individual corporations are becoming increasingly concentrated, with the emergence of corporate groupings and significant foreign owners in most countries, substituting for the weaknesses in the domestic financial system. As firms grow in size, ownership and control are separated, primarily using pyramids, raising corporate governance concerns. Most firms in Central and Eastern Europe are still owner-managed, but even as firms with professional managers become more common, controlling shareholders still play a critical role.

Despite sharing these general characteristics, there are also important variations across countries (Table 5.1). The traditional measures of financial development are inherently unreliable in transition countries, but the most common such measure shows Slovenia as being most developed financially (domestic credit to the private sector amounts to 41% of GDP). Hungary, Latvia and Estonia are in a middle

Table 5.1 Key financial sector development indicators for 2003

	<i>Number of banks (foreign-owned)</i>	<i>Asset share of state-owned banks (%)</i>	<i>Domestic credit to private sector (% of GDP)</i>	<i>Stock market capitalisation (% of GDP)</i>	<i>EBRD index of banking-sector reform*</i>	<i>EBRD index of non-bank financial institutions*</i>
Czech Republic	35 (26)	3.0	17.9	17.9	3.7	3.0
Estonia	7 (4)	0.0	33.7	41.5	3.7	3.3
Hungary	38 (29)	7.4	42.3	18.7	4.0	3.7
Latvia	23 (10)	4.1	38.8	9.6	3.7	3.0
Poland	58 (46)	25.7	17.8	17.3	3.3	3.7
Slovak Republic	21 (16)	1.5	25.0	7.6	3.3	2.7
Slovenia	22 (6)	12.8	43.3	17.1	3.3	2.7
Bulgaria	35 (12)	0.4	25.8	7.9	3.3	2.3
Romania	30 (21)	40.6	9.5	9.6	2.7	2.0

Note: *The transition indicator scores range from 1 to 4 with 0.3 decimal points added or subtracted for + and – ratings.

Source: EBRD, Transition Report (2004).

category with the ratio of domestic credit to GDP corresponding to 34%, 33%, and 30%, respectively. Lithuania (14%), Poland (15%) and Bulgaria (18%) are less developed according to the same measure. Romania comes out as having the least developed financial sector with domestic credits corresponding to a mere 8% of GDP.

The regulatory response has largely been conditioned by accession to the EU. Regulators have emulated existing institutions in current Member States and to some extent anticipated possible future regulation at the EU level. As a result, the Central and East European countries have adopted regulations that on paper are often stricter than in most other EU countries. Weaknesses are still apparent in implementation of existing regulation, however, and key supervisory institutions often lack the necessary political backing. The general enforcement environment still does not match that of Western Europe (see Figures 5.1–5.4 for four measures of institutional quality in selected countries).

The reforms in the financial sector have progressed far, at least in the banking sector (the countries left outside the first Eastern enlargement, Bulgaria and in particular Romania, are still lagging). Non-bank financial institutions still require more reform in all countries, and there are reasons to be concerned about the scope for such reforms. The EU accession process has so far imposed discipline on legislators and regulators in the acceding countries, but the enforcement capacity of the EU is much weaker once these countries have become members. The process of accession to the EMU is focused on meeting certain macro criteria, rather than specific institutional requirements.

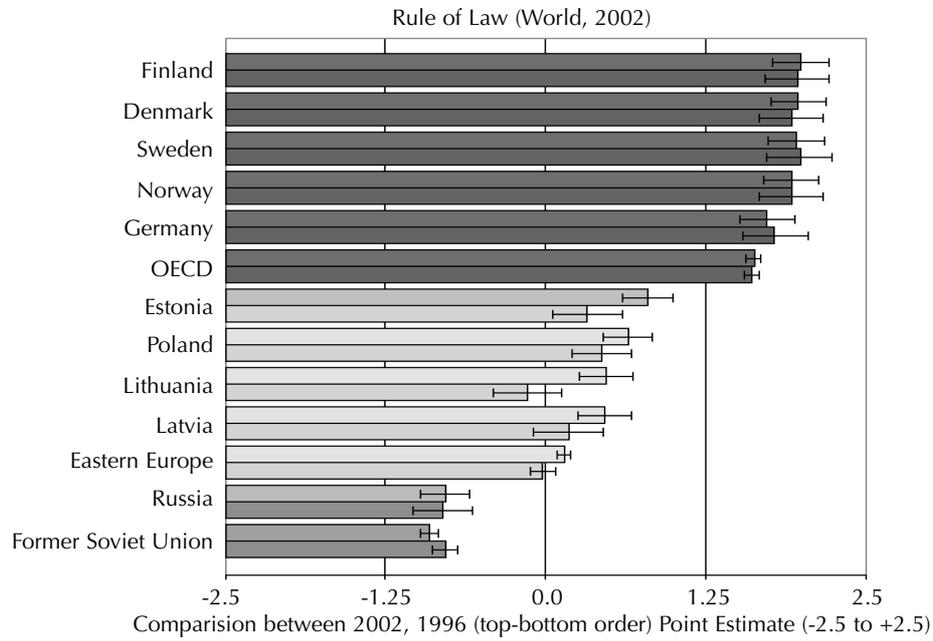
The new Central and East European Member States generally have an impressive record of maintaining macroeconomic stability, but some countries were adversely affected by the Russian crisis in 1998. Evidence suggests that the quality of domestic institutions, as measured by investor protection and rule of law, strongly influenced the strength of impact from this crisis. Bulgaria, of course, went through a dramatic financial crisis essentially of its own making and opted to establish a currency board. Over the last couple of years macroeconomic imbalances have re-emerged in most Central and East European countries and, most recently, in the Baltic states. Mid-2004, only Slovenia unequivocally met the entry requirements of the EMU.

The ten countries have opted for a variety of exchange rate and monetary policy regimes. Broadly speaking, pre-accession economies have four main alternatives for exchange rate regimes before entering ERM-II and the euro area: hard pegs in the form of currency boards and euroization; soft pegs with announced band width; managed floats without announced bands; and full float. While some countries (Estonia, Lithuania and Bulgaria) have chosen to implicitly participate in the euro area via currency boards, countries such as Poland and the Czech Republic have opted for a full float. Other countries have some intermediate arrangement.

5.3 Banking transition

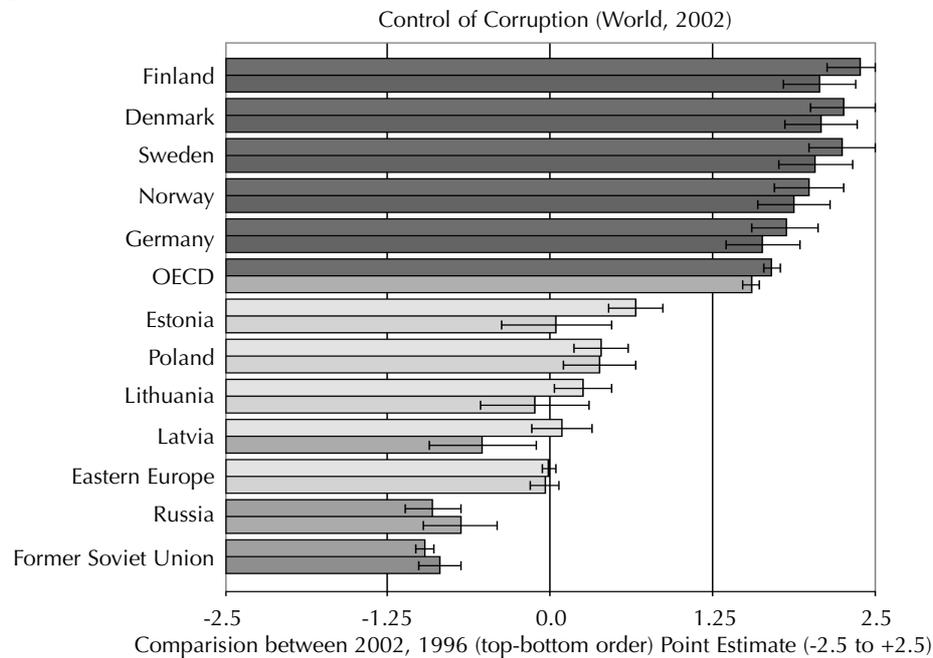
All banking systems in transition economies have evolved from a single institution, the monobank, which was responsible for both monetary policy and commercial banking. The monobank essentially ensured the financial resources necessary to meet production plans. Very little attention was paid to credit-worthiness. The bank did not really screen, monitor projects, or enforce repayment of loans, rather it was the channel for funds allocated by the plan. Moreover,

Figure 5.1 Measures of institutional quality: rule of law (world, 2002)



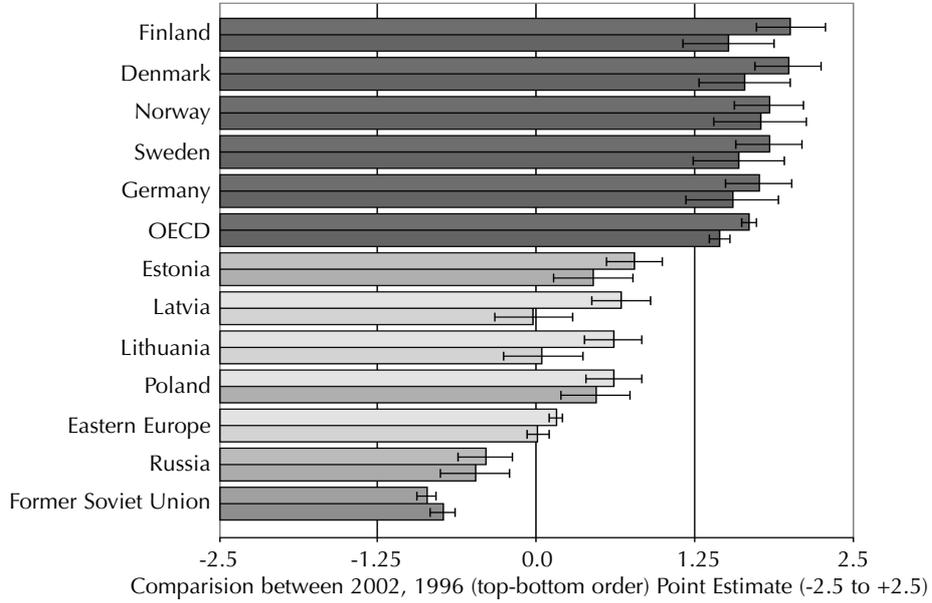
Source: Kaufmann *et al.* (2003), 'Governance Matter III: Governance Indicators for 1996-2002' (<http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>)

Figure 5.2 Measures of institutional quality: control of corruption (world, 2002)



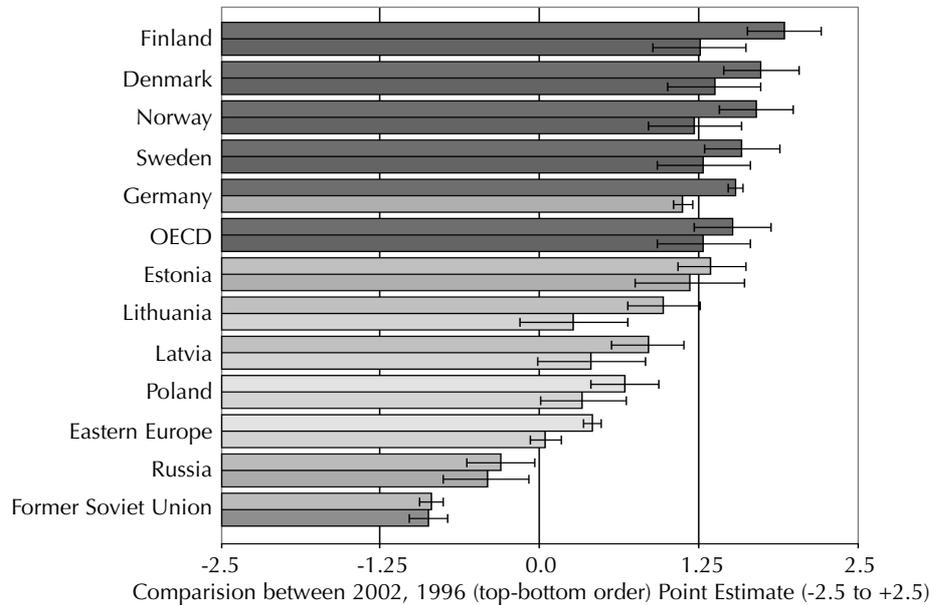
Source: Kaufmann *et al.* (2003), 'Governance Matter III: Governance Indicators for 1996-2002' (<http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>)

Figure 5.3 Measures of institutional quality: government effectiveness (world, 2002)
Government Effectiveness (World, 2002)



Source: Kaufmann *et al.* (2003), 'Governance Matter III: Governance Indicators for 1996-2002' (<http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>)

Figure 5.4 Measures of institutional quality: regulatory quality (world, 2002)
Regulatory Quality (World, 2002)



Source: Kaufmann *et al.* (2003), 'Governance Matter III: Governance Indicators for 1996-2002' (<http://www.worldbank.org/wbi/governance/pubs/govmatters3.html>)

since the planned economy repressed or hid inflation and nominally guaranteed jobs for all, the standard countercyclical tasks of central banking were not especially relevant.

The financial sectors transition from a planned economy to a market-oriented economy involved transforming the monobank into a decentralized financial system supporting a market economy. Most Soviet-bloc countries started this process by implementing more or less the same measures: separating the central and commercial banking activities of the monobank, and breaking up the commercial banking activities into multiple smaller units. As with general policies, however, countries adopted very different policies in reforming the banking sector and the sectors immediately depending on it.

All countries have allowed for entry of new banks, but the thresholds have been very different. Poland strongly encouraged new entry, whereas the Czech Republic took a very restrictive view towards potential entrants. Similarly, countries have pursued very different bank privatization strategies. In all countries governments have played an important role in cleaning up and recapitalizing the troubled banking institutions from the early stages of transition (Bonin *et al.*, 2004). To date, privatization is most advanced in Estonia and Lithuania with fully privatized banking sectors (see Table 5.1). Likewise, the Czech Republic, Latvia and Slovakia have privatized extensively, and the remaining share of state assets in the banking sector ranges between 3% and 5%. Privatization is least advanced in Slovenia and Romania, where the largest banks are state-owned and account for 50 and 44% of the market, respectively.

The attitude to foreign ownership also varies across countries. Poland opened up early to foreign investors and then took a more restrictive stand. Others, like the Czech Republic, waited until very late, after several serious bank failures, to invite strategic investors from outside. Slovenia is only now about to let foreign strategic ownership into one of its major banks. Some countries, like Poland, proceeded gradually and one of its main banks still remains under state control, while Hungary sold off the bulk of its banking system more or less overnight, after a series of once-and-for-all general bail-outs. With the exception of Slovenia, more than half of the banking sectors in the new Member States are now foreign-owned.

Regarding the structure of the banking sector, large differences exist between the countries. Central European countries such as Poland, the Czech Republic and Hungary still have largely fragmented banking sectors with most banks controlled by foreign interests. In the Baltic states consolidation is essentially in the hands of three Scandinavian banks. The banking universe of Central and Eastern Europe today essentially consists of three types of institutions – the privatized, previously state-owned banks, the *de novo* banks (primarily foreign greenfield investments) and the remaining state-owned banks.

The spreads between loan and deposit rates have decreased dramatically in most countries over the last decades and in several countries, like Estonia and Latvia, levels are now on a par with those in Western Europe. But in some countries spreads have increased again in recent years in response to macroeconomic uncertainty. Poland, for example, saw an increase from 4.5% in 1997 to 8.5% in 2002.

As the risk premium in the corporate sector is coming down in most countries, a trend reinforced by EU accession, banks will be increasingly tempted to engage in long-term corporate finance. There is a potential role for commercial banks in exercising corporate governance in non-financial companies. With strongly concentrated ownership and control of most companies, hostile takeovers and proxy

fighters are largely ineffective as disciplining devices, and boards of directors cannot be expected to play an independent role. If banks are to become more involved in corporate governance, supervision must improve.

A recent study of banks in six countries shows some interesting patterns in terms of strategic orientation and performance across different types of banks (Bonin *et al.*, 2004). The banks in which foreign banks have acquired control have done very well in terms of financial performance, even better than greenfield investments and definitely better than state-owned banks. Their success is primarily due to a rapid expansion in fee-based business where they have been able to exploit a combination of superior technologies (provided by the foreign bank) and inherited local networks.

The foreign-controlled privatized banks have managed to sustain levels of profitability comparable with greenfield investments, despite higher overall costs and non-interest expenditures. The picture is less encouraging when it comes to investment finance. Bonin *et al.* find no evidence of increased lending by the privatized institutions. In fact, neither the foreign-controlled banks, whether greenfield or acquired, nor state-owned banks extend more loans to the corporate sector. This is troubling since these large banks collect a substantial portion of the primary deposits in these countries. These deposits have primarily been channelled into the financing of government budget deficits.

Banking transition has not ended yet, and there is still considerable uncertainty as to the ultimate shape and function of the banking institutions in Central and Eastern Europe. What role will these banks play in the global strategies of their parent banks? Also, it is not clear to what system these countries are transitioning. The global (and European) financial system is very much a 'moving target'. In parallel with the economic and political transition in Central and Eastern Europe, the international banking system has been dramatically restructured, with strong US dominance and cross-border activity on the increase.

5.4 Integration with Western Europe

Broad economic convergence of the Central and East European accession countries towards the current EU members has been a key objective of enlargement. But the criteria for EU membership, originally adopted by the Copenhagen summit in 1992, focused on institutional convergence. Remarkable achievements have been made in this respect in all new Member States, but considerable gaps still remain (see Figures 5.1–5.4 for development of institutional quality between 1996 and 2002). Significant improvements were made in the quality of the regulatory framework and in government effectiveness, whereas the measures of rule of law and corruption do not show the same overall progress. Individual countries, in particular the Baltic states, have dramatically raised the quality of their institutions over the time period. In terms of regulatory quality, broadly speaking 'laws-on-the-book', the leading countries are on par with the EU average. It is also interesting to note that for most measures the variance in perception of institutional quality (the thin lines at the top of each bar) have come down in virtually all Central and East European countries for all measures. There also seems to be a better understanding, or at least an emerging consensus, of the institutional weaknesses in these countries.

Even though the bulk of the remaining difference in the risk premium between old and new Member States has institutional origins, it is natural that after EU

membership has been achieved and the populations in accession countries *de facto* have voted in favour of membership in the EMU, interest shifts to the Maastricht criteria emphasizing monetary and real convergence. In the rest of this section we look at some measures of such convergence (see Chapter 2 for a discussion of the different types of measures).

The traditional measure of monetary integration estimates the extent to which interest rates converge across countries. Unfortunately, the empirical evidence on interest-rate convergence between Central and Eastern Europe, on the one hand, and the EU, on the other, is scattered and partial, often only providing partial coverage of the Central and East European countries and short time series. Table 5.2 shows a simple exercise using updated (January 1997–August 2003) descriptive statistics for all the Central and East European countries of deviations from key parity relationships, with Germany as the benchmark (Jurevica and Sepping, 2004). In general, Slovenia, Estonia and Latvia show the smallest, and Romania by far the largest, mean deviation and variance for the sample period. (The Bulgarian data are problematic, and some extreme observations in early 1997 have been eliminated, explaining the surprisingly low variance and mean.)

The short-run persistence in the deviations suggests that the convergence process is ongoing, that is, the countries are still in the process of catching up (see Table 5.3).¹ The different speeds of convergence for different parities point to a higher speed of financial, as compared with real, integration during the period (Table 5.4 displays the magnitude of the negative trend coefficient, a measure of the relative speed of convergence).² Poland, Slovakia, Hungary and Czech Republic appear to converge faster both financially and in real terms. Slovenia and Latvia show the slowest pace of convergence for all parities, and Slovakia and Lithuania exhibit slow convergence in the deviations from purchasing power parities. These differences, however, are largely a reflection of the different starting points. Poland, Slovakia, Hungary and Czech Republic started out with higher segmentation with respect to Germany, leaving more room for improvement (Slovenia, Latvia, Slovakia and Lithuania have the smallest mean deviations from the respective parities).

The degree of financial integration depends on the integration of the goods markets, but financial integration is lagging behind real integration, most clearly in Slovakia, Slovenia, Poland and Romania. Variability of exchange-rate fluctuations contributes little to deviations from purchasing power parity (PPP), while changes in relative prices add much more, implying high domestic inflationary pressures.³ For the majority of countries, inflation convergence lags behind real convergence. The evidence suggests ultimate long-term convergence in both real and nominal terms in most, but not all, countries.⁴

In sum, real convergence is relatively strong in all countries, with the exception of Bulgaria and Latvia. Fluctuations of exchange rates are low for the majority of countries. The higher differentials of nominal interest rates may indicate that unsustainable domestic exchange-rate policies, lack of monetary integration and/or lack of capital mobility. Taken together, central and eastern Europe follows the general pattern of emerging markets of an overall risk premium reflecting country, exchange-rate and asset-specific risks.

Table 5.2 Descriptive statistics of deviations from parity relationships, Germany against each country variable

	Czech Rep.	Hungary	Latvia	Lithuania	Germany/ Slovenia	Slovakia	Poland	Estonia	Romania	Bulgaria
<i>Real interest differentials</i>										
Mean	0.017	0.011	0.004	0.033	-0.003	0.032	0.063	-0.013	0.176	0.001
Median	0.011	0.011	0.001	0.025	-0.010	0.015	0.057	-0.017	0.059	0.000
Maximum	0.233	0.044	0.055	0.163	0.050	0.325	0.106	0.109	1.370	0.050
Minimum	-0.023	-0.024	-0.030	-0.34	-0.032	-0.103	0.033	-0.076	-0.060	-0.040
Range	0.256	0.068	0.085	0.197	0.082	0.428	0.073	0.185	1.430	0.090
Variance	0.0014	0.0003	0.0003	0.0013	0.0004	0.0075	0.0004	0.0011	0.0857	0.0003
Skewness	4.036	-0.087	0.629	1.571	1.091	0.929	0.510	1.412	2.359	-0.122
Kurtosis	22.672	2.346	3.059	6.484	3.075	3.532	2.044	6.542	8.290	3.914
<i>Uncovered interest differentials</i>										
Mean	0.047	0.099	0.021	0.041	0.057	0.096	0.124	0.029	0.511	-0.054
Median	0.030	0.090	0.020	0.040	0.050	0.070	0.130	0.010	0.425	-0.037
Maximum	0.250	0.190	0.090	0.190	0.110	0.380	0.250	0.150	1.720	0.037
Minimum	-0.040	0.000	-0.050	-0.040	0.020	0.020	0.000	0.000	0.130	-0.312
Range	0.290	0.190	0.140	0.230	0.090	0.360	0.250	0.150	1.590	0.349
Variance	0.0033	0.0021	0.0008	0.0021	0.0006	0.0055	0.0042	0.0014	0.1176	0.0038
Skewness	1.221	0.104	0.063	0.762	0.894	1.175	-0.210	1.809	1.348	-1.716
Kurtosis	4.271	2.024	2.972	3.464	2.839	4.237	2.076	5.352	4.572	7.203
<i>Deviations from relative purchasing power parity</i>										
Mean	0.030	0.088	0.017	0.008	0.060	0.063	0.062	0.042	0.335	0.056
Median	0.020	0.084	0.019	0.007	0.060	0.055	0.069	0.032	0.370	0.046
Maximum	0.148	0.171	0.070	0.090	0.089	0.165	0.165	0.108	0.640	0.297
Minimum	-0.040	-0.031	-0.049	-0.060	0.029	-0.016	-0.059	-0.009	0.096	-0.034
Range	0.188	0.202	0.119	0.150	0.060	0.181	0.224	0.117	0.544	0.331
Variance	0.0018	0.0019	0.0006	0.0010	0.0001	0.0016	0.0031	0.0009	0.0182	0.0034
Skewness	1.003	0.050	-0.308	0.157	-0.489	0.950	-0.247	0.810	-0.078	1.627
Kurtosis	3.548	2.559	2.944	2.706	3.453	3.668	2.159	2.542	2.070	7.206

Table 5.3 Short-run persistence of deviations from parity relationships, Germany against each country variable

	Czech Rep.	Hungary	Latvia	Lithuania	Slovenia/ Germany/	Slovakia	Poland	Estonia	Romania	Bulgaria
<i>Real interest differentials</i>										
AR(1)	1.013***	0.933***	1.065***	1.125***	0.420***	0.901***	0.907***	1.362***	1.164***	1.169***
<i>t</i>	(9.201)	(20.738)	(8.978)	(9.678)	(3.861)	(18.547)	(19.124)	(13.809)	(9.385)	(10.246)
AR(2)	-0.589***	-	-0.311***	-0.287**	0.354***	-	-	-0.483***	-0.264**	-0.234
<i>t</i>	(-4.020)	-	(-2.650)	(-2.526)	(3.087)	-	-	(-5.003)	(-2.174)	(-1.461)
AR(3)	0.333***	-	-	-	0.098	-	-	-	-	-0.105
<i>t</i>	(3.030)	-	-	-	(0.941)	-	-	-	-	(-1.137)
<i>Uncovered interest differentials</i>										
AR(1)	0.864***	0.901***	0.698***	0.810***	0.647***	0.880***	0.880***	1.437***	0.916***	-0.040
<i>t</i>	(15.156)	(20.823)	(7.967)	(11.421)	(6.136)	(16.502)	(16.126)	(14.781)	(19.876)	(-0.325)
AR(2)	-	-	-	-	0.253**	-	-	-0.529***	-	-
<i>t</i>	-	-	-	-	(0.0193)	-	-	(-5.427)	-	-
<i>Deviations from Relative Purchasing Power Parity</i>										
AR(1)	0.858***	0.901***	0.632***	0.648***	0.685***	0.835***	0.842***	0.958***	1.146***	0.500***
<i>t</i>	(4.426)	(19.762)	(6.922)	(7.105)	8.039	(13.383)	(14.454)	(33.563)	(9.385)	(4.172)
AR(2)	-	-	-	-	-	-	-	-	-0.264**	2.554***
<i>t</i>	-	-	-	-	-	-	-	-	(-2.174)	(-0.263)

Table 5.4 Magnitude of annual absolute deviation for individual countries and panel of variables (pool without Bulgaria and Romania), Germany against each country variable

	Czech Rep.	Hungary	Latvia	Lithuania/ Germany/	Slovenia	Slovakia	Poland	Estonia
<i>Real interest rate parity</i>								
Individual	-0.008**	0.000	-0.004	-0.008**	-0.005*	-0.022***	-0.004	-0.006*
<i>p-value</i>	(0.025)	(0.974)	(0.389)	(0.044)	(0.099)	(0.000)	(0.246)	(0.069)
Common	-	-	-	-0.007***	-	-	-	-
<i>p-value</i>	-	-	-	(0.000)	-	-	-	-
<i>Uncovered interest rate parity</i>								
Individual	-0.021***	-0.021***	-0.006	-0.019***	-0.007*	-0.029***	-0.027***	-0.011**
<i>p-value</i>	(0.000)	(0.000)	(0.262)	(0.002)	(0.094)	(0.000)	(0.000)	(0.014)
Common	-	-	-	-0.018***	-	-	-	-
<i>p-value</i>	-	-	-	(0.000)	-	-	-	-
<i>Purchasing power parity</i>								
Individual	-0.010***	-0.019***	-0.004	-0.004	-0.002	-0.0008	-0.017***	-0.012***
<i>p-value</i>	(0.0004)	(0.000)	(0.332)	(0.414)	(0.593)	(0.805)	(0.000)	(0.001)
Common	-	-	-	-0.009***	-	-	-	-
<i>p-value</i>	-	-	-	(0.000)	-	-	-	-

Note: *, ** and *** denote significance level at 10%, 5% and 1% respectively.

5.5 Integration at the level of individual banks

The higher degree of measured financial integration among the old EU members as compared with the integration between Western Europe and Central and Eastern Europe contrasts with the strong ownership links between banks in the two regions. Ownership integration evidently does not equate with financial integration. Unfortunately, data on the extent of integration within individual banking organizations are not easily accessible, but casual evidence suggests that the extent of integration between parent banks and local banks varies considerably across institutions.

A comparison of the Scandinavian banks in the Baltic countries provides an interesting illustration. The two banks with the strongest presence, SEB and Swedbank, have adopted very different strategies *vis-à-vis* integration. SEB is pursuing a careful but determined integration ('many countries, one bank' is the slogan used), whereas Swedbank is giving its local bank, Hansabank, more or less free rein. Even the form of incorporation differs across banks, with most institutions choosing to work through subsidiaries but some establishing branches. Nordea, the third Scandinavian bank with a significant presence in the Baltic countries, is pursuing a greenfield strategy with fully integrated branch offices.

A series of interviews with banks active in the rest of Central and Eastern Europe indicates that most banks are pursuing a significant degree of integration. The predominant pattern appears to be to first restructure the banks and then integrate them. The evidence reported earlier from Bonin *et al.* (2004) showing strong profitability in the foreign-controlled, previously state-owned banks suggests that the first phase has been largely successful. Despite the variations across institutions in strategies pursued, we should expect extensive further institutional integration of Central and East European banks with their foreign parent banks. Moreover, the narrow product range of these banks should be expected to gradually expand.

Table 5.5 Magnitude of annual absolute deviations for individual countries and panel of variables (Pool No. 2 with Bulgaria and Romania), Germany against each country variable

	Germany/	
	Bulgaria	Romania
<i>Uncovered interest rate parity</i>		
Individual	-0.003	-0.167***
<i>p-value</i>	(0.878)	(0.000)
Common	-0.066**	
<i>p-value</i>	(0.043)	
<i>Real interest rate parity</i>		
Individual	-1.184**	-0.031
<i>p-value</i>	(0.028)	(0.948)
Common	-0.607	
<i>p-value</i>	(0.117)	
<i>Purchasing power parity</i>		
Individual	-1.339**	-0.018
<i>p-value</i>	(0.029)	(0.973)
Common	-0.679	
<i>p-value</i>	(0.123)	

Figure 5.5a Variance contribution to annual average absolute deviations from PPP: variability of change in exchange rate (Δs) versus variability of change in inflation rate ($\Delta p - \Delta p^*$), in % contribution

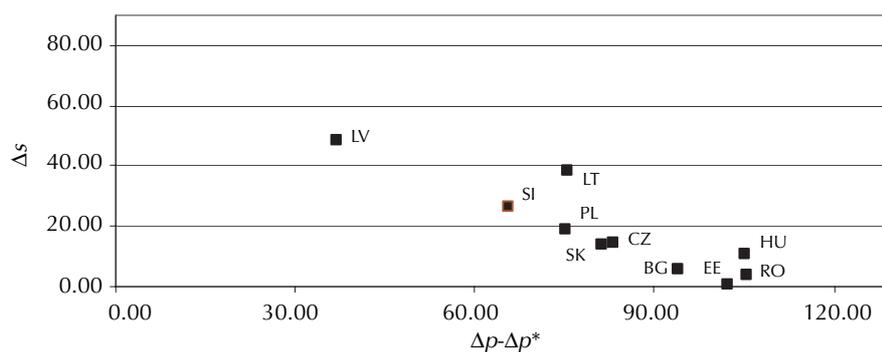
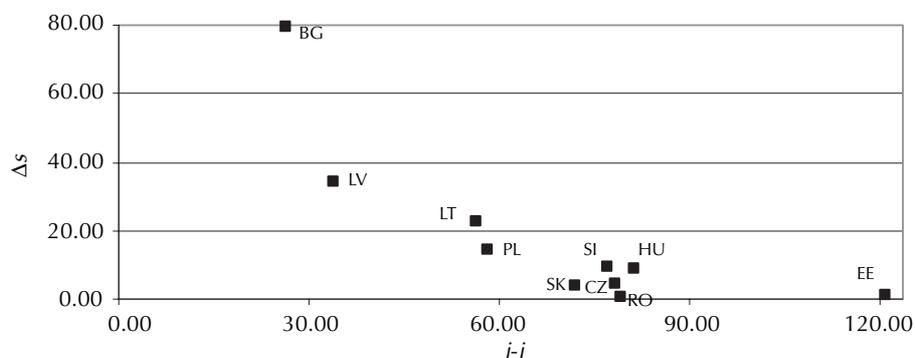


Figure 5.5b Variance contribution to annual average absolute deviations from UIP: variability of change in exchange rate (Δs) versus variability of change in nominal interest rates ($i - i^*$), in % contribution



Key: BG: Bulgaria; CZ: Czech Rep.; EE: Estonia; HU: Hungary; LT: Lithuania; LV: Latvia; PL: Poland; RO: Romania; SI: Slovenia; SK: Slovakia.

Table 5.6 Stationary tests of parities (using ADF-GLS unit root test), Germany against each country variable

	Czech Rep.	Hungary	Latvia	Lithuania	Slovenia	Slovakia	Poland	Estonia	Romania	Bulgaria
<i>Real interest parity</i>										
ADF- τ	-3.257**[2]	-	-	-	-2.174[2]	-2.850*[1]	-	-	-2.690***[1]	-
GLS μ	-	-1.772*[1]	-2.309**[1]	-1.782*[1]	-	-	-1.468[1]	-1.907*[1]	-	-0.507[3]
<i>Purchasing power parity</i>										
ADF- τ	-3.047**[2]	-4.692***[1]	-4.190***[1]	-5.009***[1]	-	-	-4.306***[1]	-1.588[1]	-2.161**[1]	-
GLS μ	-	-	-	-	-3.423**[1]	-2.008**[1]	-	-	-	-2.262**[1]
<i>Uncovered interest parity</i>										
ADF- τ	-3.988**[1]	-3.942**[1]	-4.947***[1]	-2.96**[1]	-2.383[2]	-3.548***[1]	-	-2.941**[1]	-2.866***[1]	-
GLS μ	-	-	-	-	-	-	-1.534[1]	-	-	-1.357[2]

Note: τ stands for series that have linear trend ($\alpha = 1 + c/T$, where $c = -13$); μ for series without trend ($\alpha = 1 + c/T$, where $c = -7$); *, ** and *** denote rejecting hypothesis of unit root at 10%, 5% and 1% significance level respectively.

Table 5.7 Variance decomposition of deviations from separate parity relationships, Germany against each variable

	Czech Rep.	Hungary	Latvia	Lithuania	Slovenia	Slovakia	Poland	Estonia	Romania	Bulgaria
<i>Real interest rate parity differentials</i>										
Var (RIP) %	0.14	0.03	0.03	0.14	0.04	0.75	0.04	0.11	8.56	0.07
% Var (UIP)	216.70	577.00	228.89	146.92	83.57	72.75	808.15	123.94	144.62	41.74
% Var (PPP)	119.69	514.29	158.13	81.05	35.91	21.15	598.13	80.30	22.38	86.58
% -2Cox	-236.39	-991.30	-287.01	-127.96	-19.48	6.09	-1,306.28	-104.24	-67.00	-28.32
<i>Uncovered interest differentials</i>										
Var (UIP) %	0.33	0.21	0.08	0.21	0.04	0.55	0.42	0.14	11.76	0.38
% Var (i-i*)	108.57	103.04	45.11	75.13	96.24	104.70	77.70	161.46	105.67	35.33
% Var (Δ s)	8.95	9.28	34.04	22.76	4.10	4.46	14.14	0.99	0.62	79.52
% -2Cox	-17.52	-12.32	20.85	2.11	-0.34	-9.16	8.15	-62.45	-6.29	-14.85
<i>Relative purchasing power parity differentials</i>										
Var(PPP) %	0.18	0.19	0.06	0.12	0.01	0.16	0.31	0.09	1.82	0.34
% Var(Δ p- Δ p*)	83.18	105.14	36.93	75.40	65.78	81.22	75.07	102.23	105.47	94.05
% Var (Δ s)	14.29	10.60	48.33	38.36	26.70	13.99	19.15	0.92	4.05	5.72
% -2Cox	2.45	-15.32	14.02	-15.12	8.75	5.73	6.15	3.17	-9.06	0.18

Table 5.8 Short-run persistence of deviations from parity relationships

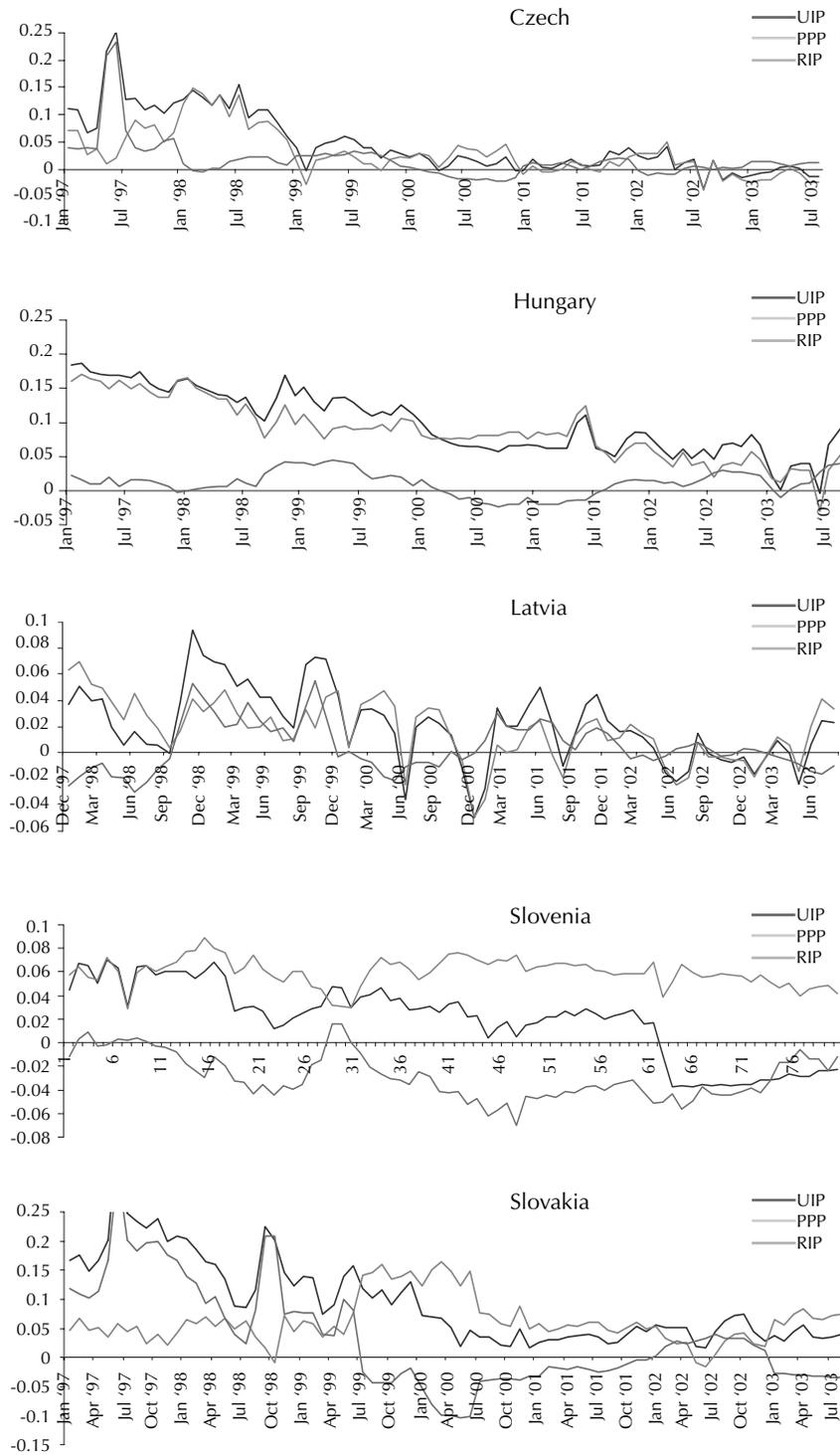
<i>Real interest differentials</i>	BG	CZ	EE	HU	LV	LT	PL	RO	SK	SLO
Direct investments	Free	S	S	S	Free (3)	S1	S1	S	S2	S,Q
Investments in real estate	L	L	L	L	L	S/P	L	L	L (2)	L
Stock market operations	Free (4)	S	L	L	Free (1)	Free (1)	L	Free (1, 2)	Free	L
Security and money market operations	Free	Free	Free	P	Free (1)	Free (1)	P	P	Free	Free
Operations in current and deposit accounts	Free (1)	Free	Free	Free	Free	Free (1)	Q, P	P	Free (1)	Free (1)
Credits related to commercial transactions	Free	Free	Free	Free	Free	Free	Free	P	Free	Free
Financial loans	R	Free	Free	Free	Free	Free	Free (5)	P	Free	Free
Personal capital movements	R	Free	Free (1)	Free	Free	Free	P, Q	P	Free	Free

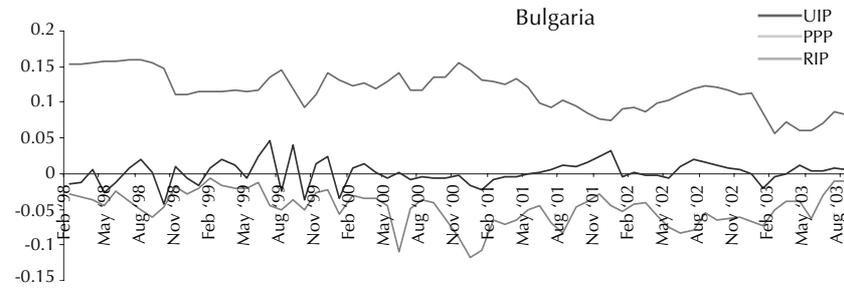
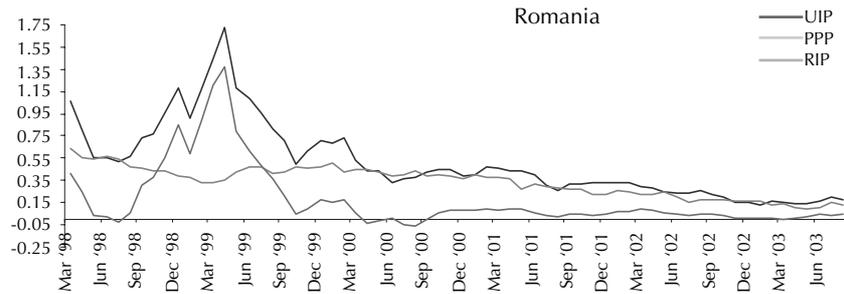
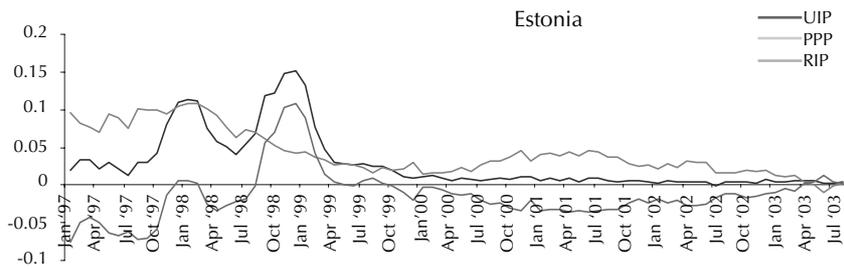
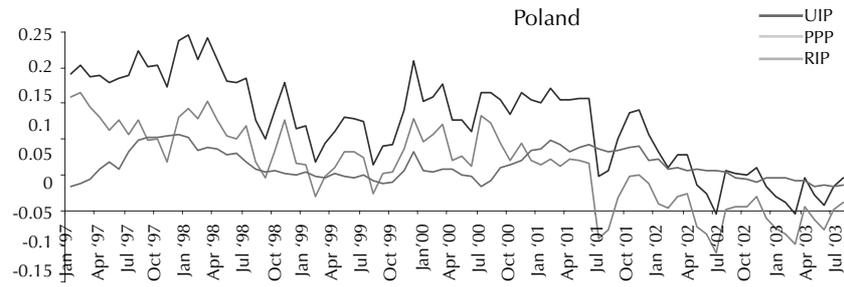
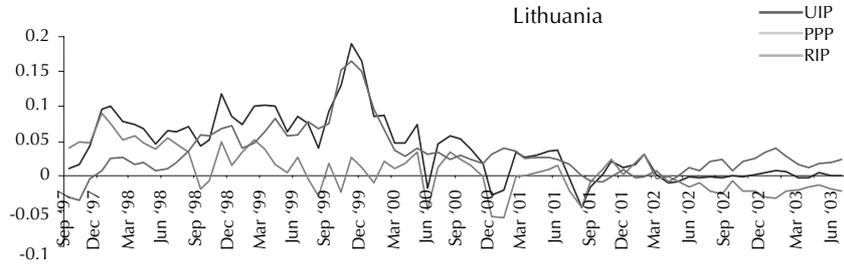
Note: The table is largely based on Begg *et al.* (2002).

Free: No limitations; L: Limited; P: Permission required; Q: Quantitative restrictions apply; R: Registration required; S: Free except for certain sectoral restrictions; (1): Some restrictions/requirements on outward operations; (2): Outward investments are free to OECD or EEA members; (3): Certain requirements on citizenship and language proficiency; (4): Acquisition of foreign items; R; (5): Short-term investments: P.

Key: BG: Bulgaria; CZ: Czech Rep.; EE: Estonia; HU: Hungary; LT: Lithuania; LV: Latvia; PL: Poland; RO: Romania; SI: Slovenia; SK: Slovakia.
Source: European Commission.

Figure 5.6 UIP, PPP and RIP series for the sample countries





The prospect of closer integration and more risky activities has provoked some interest among regulators and supervisors in Central and Eastern Europe. Foreign banks earlier offered a valuable opportunity for many governments attempting to break cycles of financial crises and subsequent bail-outs. The foreign institutions had much more solid balance sheets reducing the risk of runs. Moreover, the temptation to bail out failing institutions is less when they are foreign-owned. Judging from international experience, however, foreign ownership is not a guarantee against bank failure. Parent banks do not necessarily come to the rescue when their local institutions have problems. When local banks are incorporated as branches balance sheets are not separated, but subsidiaries can be, and sometimes are, effectively cut off from their parents, leaving the host government with the decision as whether to bail out.

A more serious, and perhaps more real, risk arises from the control of the foreign bank over the local bank's assets. Problems in the parent bank may lead to very rapid withdrawal of liquidity, jeopardizing the entire banking system in the host country. When some large European banks withdrew funds in response to fragility in their consolidated balance sheets in 2002–03, the central bank of at least one Central European financial system expressed serious concerns. While these threats appear weaker today, there is still a worry in some quarters that as institutional integration deepens such transfers of liquidity become easier. Limiting foreign ownership is too broad-brush a response to these concerns, and the alternative of restricting capital flows is difficult to implement. Careful monitoring and continued development of domestic institutions will hopefully give more advance warning and better capacity to counter fluctuations in liquidity.

In the absence of functioning regulation and supervision at the EU level, jurisdictional issues are also problematic. Most regulators in the region appear to apply double regulatory standards to the foreign-controlled banks, but who should have the ultimate responsibility? To some extent the answer to this question also depends on the answer to the question regarding what role the Central and East European banks will play in the global strategies of their parent banks. These strategic decisions will shape the national financial systems and their degree of integration into the rest of the world. A related question is what role the foreign banks should and will play in building the financial architecture and the broader investment climate of Central and Eastern Europe. The individual banks clearly have an interest in further improvements in the functioning of local institutions, allowing them to offer a broader range of products. In the Baltic states where the Scandinavian banks dominate, the incentives to support such broader development efforts may be sufficiently strong, but in the larger Central and East European markets no single institution is large enough to motivate such investments.

5.6 Conclusions

The pattern of variable and uneven financial integration is reinforced when the analysis is extended to the eight new Central and East European members of the EU (and the two countries still outside, Bulgaria and Romania). The banking systems of these countries have gone through a remarkable institutional development and integration of ownership, with West European banks controlling most of the important institutions in the new Member States. Old institutions have been transformed, and new ones created. The privatization process has created viable competitive banks with most of them now under foreign control.

A comprehensive regulatory structure is in place in virtually all the countries, but enforcement is sometimes lagging. Moreover, equity markets are struggling to stay independent, with stagnating numbers of listed companies and most stocks illiquid. Corporate bond markets are virtually non-existent. In particular, markets and banks have not provided much investment finance to the enterprise sector. The lack of institutions supporting finance to small and medium-sized firms, particularly those in high-risk segments, which is a feature of Western Europe, is even more apparent in Central and Eastern Europe.

The integration project is also incomplete. Real integration has proceeded quite far in response to the liberalization of trade, but financial integration is far from complete, as evidenced in the much higher spreads between lending and deposit rates in Central and Eastern Europe than in Western Europe. But spreads between lending and deposit rates differ markedly across the region. In some countries, in particular the Baltic states, these differences have come down dramatically over the last couple of years, while in others, like Poland, they remain high and sometimes have even increased. A closer analysis using cointegration reveals that both the path of convergence and the current levels differ among countries. Bulgaria and Romania are distinctly less integrated, in both real and financial terms.

Our analysis suggests that real and nominal convergence is ongoing in Central and Eastern Europe as part of a broader catch-up process. The countries with the strongest initial segmentation have converged more rapidly than those with less room for further convergence. In most, but not all, countries financial convergence lags behind real convergence, reflecting the very strong initial trade reorientation and slower development of the financial systems.

Another theme in previous chapters has been the relevance of ownership of financial institutions. The countries in Central and Eastern Europe have experienced a dramatic change in ownership from central planning to foreign ownership, sometimes via private domestic ownership. Despite the extensive ownership and control by West European banks, functional integration within individual bank organizations, that is, between the parent banks and their newly acquired or established institutions in Central and Eastern Europe, is still limited. On closer inspection we find substantial variation across banks in terms of the extent of integration, but most banks appear to pursue policies aimed at significantly stronger integration once the initial restructuring phase is completed.

The foreign control over domestic banks, once hailed as the solution to the distressed financial systems of Central and Eastern Europe in the mid-1990s, is now viewed with trepidation by some regulators. One important concern is that parent banks with increasing institutional integration can rapidly move large amounts of capital, thus jeopardizing the liquidity of the domestic financial systems. Another frequently raised issue is that foreign banks would not be interested in supplying, or not have sufficient knowledge to supply, local firms with investment finance.

The financial architects and builders in Central and Eastern Europe can point to remarkable achievements over the last 15 years, but they are still faced with numerous difficult challenges. In the medium term they have to correct macroeconomic imbalances and implement and enforce existing laws and regulation. In a world of increasing capital mobility and a breakup of domestic financing patterns, these financial systems have to compete for international savings. Domestic pension systems have to be reformed in the face of a deteriorating demographic crisis. These reforms will have a major impact on the structure and functioning of the financial systems.

In the medium term, before the countries of Central and Eastern Europe have joined the EMU, they are vulnerable to exchange rate fluctuations and other

macroeconomic shocks. This vulnerability reinforces concerns over the increasing integration of Central and East European banks into their parent banks. It will be understandable if local regulators contemplate introducing restrictions on the speed with which funds can be moved across borders, but international experience of such restrictions is not encouraging.

In the longer term the overriding concern is how to ensure that investment funds are channelled to domestic firms. The evidence strongly suggests a lack of investment finance in Central and Eastern Europe, in particular for small and medium-sized firms. Ample international evidence shows that such finance will have to come through informed finance, typically in a combination of large controlling owners, conglomerates with internal capital markets and banks. The new EU members have already seen a rapid increase in concentration of ownership and the emergence of conglomerates. Commercial banks have an important role to play in monitoring controlling owners and managers, but transparency and enforcement of corporate governance in both banks and firms are critical to prevent collusion.

Some observers have blamed the lack of investment finance on the strong presence of foreign banks, but there is little evidence that foreign-controlled banks are less apt at providing such finance than banks controlled by domestic interests. On the other hand, judging from the data, foreign banks are not better at it either. The problem does not appear to be in the banks themselves, but rather in the general investment climate in which they operate. Risk levels are still too high to allow a strong expansion into this segment of the market. The policy focus should be on bringing down risk levels rather than, as suggested by some observers, introducing new semi-public financial institutions. Such development banks tend to be vulnerable to political influence and softening budget constraints.

Endnotes

CHAPTER 1: INTRODUCTION

- 1 *The Future of European Banking: Monitoring European Integration 9*, Centre for Economic Policy Research, London, 1999.
- 2 The 2004 Review of the FSAP by an independent expert group concludes, as does this report, that integration has advanced substantially, although with varying degrees across industry segments. The experts argue that the Plan has been successful at passing legislation and the next critical stage is the implementation and enforcement of legislation in individual countries. The report assumes that this implementation will be achieved through the 'peer pressure' mechanisms embedded in the Lamfalussy approach. Apart from this, the report advocates the use of self-regulation and the introduction of new EU harmonization initiatives only on a very limited basis. On the other hand, not all Directives relevant for financial markets have to be implemented through the Lamfalussy procedure, and the normal co-decision procedure may also be used.
- 3 There has also been limited harmonization of regulation in telecommunications. The approach that is currently being taken is decentralized with coordination through a central body (in this case the Commission) that sets guidelines and prevents undue departures from the guidelines.
- 4 The pressure for host-country regulation comes at least in part from politicians who know that in the event of failure it is to them that their electorate will turn for remedies.
- 5 See Hull (2002) for a discussion of the implications for financial stability of the dependence of banking in New Zealand on the presence of Australian banks.
- 6 By distinguishing between distance and borders, Degryse and Ongena (2004a, b) provide an elegant description of why some banking markets remain nationally segmented.

CHAPTER 2: REGULATORY CHANGES AND THE STRUCTURE OF EUROPEAN BANKING

- 1 The Group of Ten (2001) and Dermine (2002) provide recent surveys of the analytical work, and the descriptive data (covering the period 1990–97) have been analysed by the ECB reports (ECB, 1999a, b; 2004).
- 2 See for example European Commission (2001).
- 3 Directive 73/183, EEC.
- 4 Directive 89/646/EEC.
- 5 See Gual (2004), pp. 128-35 for details.
- 6 For instance at the end of 1998 cooperative and saving banks' market share (as a percentage of total deposits) in France, Germany, Spain and Italy was

- respectively: 60.1%, 50.2%, 48.1% and 15.7% (Belaisch *et al.*, 2001 – Central Bank bulletins).
- 7 This first impression is reinforced by computation of b-convergence in this indicator. The exercise is purely illustrative, due to the limited data sample and to the absence of other controls.
 - 8 The recent work by Manna (2004) develops 'quantity indicators' that corroborate the main inferences from the analysis of pricing: a strong home bias in all markets, and a less integrated market in retail markets.
 - 9 There is also some evidence showing that foreign entrants tend to be less efficient than incumbent domestic banks (Berger *et al.*, 2000a).
 - 10 Between 1990 and 1995, the international assets (classified by nationality of ownership, Table 8 of the BIS International Banking Statistics, see BIS *Quarterly Review*) of EU15 banks that report to the BIS grew by 10.6% per year, and the rate was 12.7% between 1996 and 2001. Total assets for the same group of countries grew between 1997 and 2000 at an average rate of 6.9% (data from ECB, 2002b, Table 8).
 - 11 Cabral *et al.* (2002) also argued in favour of this assumption.
 - 12 The existence of Costa coffee inside branches of a major UK bank is one example. Whether this will spread to other banks and countries is not clear.
 - 13 The argument relies on the assumption that a characteristic of market integration is to decrease the entry costs into markets at a faster pace for *de novo* entry than for entry by acquisition.
 - 14 See also Berger *et al.* (1999).
 - 15 Still some caution is needed, as questions of adequate control for the business mix differential may arise. See Dermine (2002).
 - 16 Accounting data have certain shortcomings (e.g., international banks may manipulate transfer prices so as to minimise their world-wide tax liability).
 - 17 The value of assets of cross-border versus domestic mergers gives the same broad picture, if anything more biased towards domestic mergers. The more recent years (2000/04) have been fairly stable (ECB, 2004), and show lower aggregate activity in these years than in the second half of the 1990s.
 - 18 See also Berger *et al.* (1999) and Beitel and Shierek (2001).
 - 19 We use more recent data and include two more countries.
 - 20 This is based on the simple inspection of the mergers' data from Table 2.6 and the net margins of 1999 and 2001. A systematic analysis of this issue, however, could offer a different result.

CHAPTER 3: RETAIL MARKETS

- 1 For more details see the Second Banking Directive and the Investment Services Directive.
- 2 This is an area left to host-country control; see Gual (2004).
- 3 Gual (2004) analyses the 'general good' clause. Under this clause, host countries are allowed to control key aspects of the marketing and information provided for financial products. Sometimes these regulations are perceived by foreign banks to be restrictions that prevent the exploitation of pan-European scale economies. The key issue, though, is the extent to which they satisfy local preferences and are implemented in a non-discriminatory way.
- 4 On this see the discussion about measures of integration in Chapter 2. A distinction has to be drawn between the degree of dispersion and the rate of convergence of interest rate differentials.

- 5 For recent information on this, see European Commission (2004).
- 6 Price - marginal cost. The calculation of marginal cost is based on the usual specification of a translogarithmic cost function where as a measure of production they use total assets and three inputs prices (price of labour, capital and deposits) are computed.
- 7 The results should be viewed with care, as the cost function might not consider the information and supervision costs, idiosyncratic risks of the clients and of the operations. Hence, the reduction in competition and increase in market power implied in the previews analysis may not be reliable.
- 8 For an anecdotal account of how banks may attempt to circumvent this regulation see *The Economist* (2003), 'Mind your BICs and IBANs', 7 August, pp. 57-8.
- 9 Paper cheques are excluded due to processing costs.
- 10 From 1 January 2006 onwards cross-border transfers up to 50,000 euros also have to comply with the EC Regulation.
- 11 Mojon made estimations for the six biggest euro area economies (Belgium, France, Germany, Italy, the Netherlands and Spain) and used data from 1978 to 1998.
- 12 See Molyneux (2003) and Jansen & de Haan (2003), and the references therein.
- 13 See Altunbas *et al.* (1999), Schiure and Wagenvoost (1999), Sheldon (2001).
- 14 Another recent piece of work by Schüler and Heinemann (2002) looks at these issues using cointegration techniques. They find little integration for the consumer loans market and the savings-deposit market.
- 15 In December 2001 a new European Directive (UCITS III) expanded the range of products to be included in the European Passport.
- 16 Households increased their investment fund from 4,000 euros in 1995 to 11,600 euros in 2000 (*per capita* basis) (Heinemann and Jopp, 2002).
- 17 In these countries national investment groups are of minor importance. In 2002, their market share was 2.1% in Ireland and 1.4% in Luxembourg. Moreover, these values had declined since the mid-1990s.
- 18 There is a trade-off between lower distribution costs and higher risks for the fund's image and customer bases.
- 19 That is, have undergone the national registration procedure.
- 20 See also the previous chapter on these.
- 21 Examples are the NatWest experience in Spain, but also the experience of Spanish banks in the neighbouring market of Portugal.

CHAPTER 4: CORPORATE BANKING

- 1 'A Buyer's Market – For Now', Greenwich Associates, 16 March 2004.
- 2 See also Baele *et al.* (2004b).
- 3 See, for example Sharpe (1990), Rajan (1992) and James (1992).
- 4 See, for example, Chemmanur and Fulghieri (1994).
- 5 Baygan and Freudenberg (2000), Table 4.
- 6 Baygan and Freudenberg (2000), Table A1, and Mayer *et al.* (2005).
- 7 See Degryse and Ongena (2004a, b) for a theoretical description of this based on a distinction between distance and borders.

CHAPTER 5: INTEGRATING NEW EUROPEAN BANKS

- 1 Even when the two years with the most spillover effects from the emerging market crisis 1997 and 1998 are excluded, the deviations from parities persist in the period following the crisis.
- 2 The common trend coefficient of real interest rate parity (RIP), the measure of total financial integration across the whole sample of countries, is negative and significant. The corresponding coefficients for uncovered interest rate parity (UIP) and purchasing power parity (PPP) are also negative and highly significant, with the UIP common-trend coefficient being higher than the one for PPP, suggesting faster financial than real integration. When Bulgaria and Romania are included, annual absolute deviations reinforce this reasoning (since Bulgaria and Romania will not be entering the EU in the near term, they are analysed in a separate panel to avoid disturbances in the common coefficients of the panel of first-wave acceding countries). The common trend coefficients are much higher than in the previous panel, and the starting deviations of the Bulgaria and Romania series were the highest. The trend coefficient is negative, though not significant for RIP and PPP (which may be explained by the small number of observations in this data pool).
- 3 Decomposition of PPP (Figure 5.3) shows higher variability of changes in observed inflation rates.
- 4 Stationarity holds along all three differential series for Czech Republic, Hungary, Latvia, Lithuania, Slovakia and Romania, implying that these economies should converge with the euro area in the long run with respect to both real and financial (money market) integration. The RIP differential series do not exhibit stationarity in Slovenia, Poland and Bulgaria. Even though the PPP series for these countries are stationary, the lower degree of integration of money markets suggested by the non-stationarity of the UIP series' long-run convergence for real interest differentials is not assured in the long run.

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