

FOSS
(51)

Tobias C. Hoschka

**Cross-Border Entry
in
European
Retail Financial Services**

**Determinants, Regulation
and the Impact on Competition**

Thesis submitted for assessment with a view to
obtaining the Degree of
Doctor of the European University Institute

Florence, October 1992

LIB
332
.1094
HOS

European University Institute



30001006356895

51
R

LIB
332.1094
HOS



Tobias C. Hoschka

Cross-Border Entry in European Retail Financial Services

**Determinants, Regulation
and the Impact on Competition**

Thesis submitted for assessment with a view to
obtaining the Degree of
Doctor of the European University Institute

Florence, October 1992

3321094

*To my parents for their
guidance and support
over so many years*

Acknowledgements

Undertaking research for a doctoral thesis is never done without the help of others. Above all, I would like to thank my supervisor Professor Stephen Martin for his guidance and many helpful comments. I am also grateful to Professor John Vickers of the University of Oxford and the members of my defence committee, Dr. Paolo Clarotti, Professor Marcello de Cecco, Professor Charles Jacklin and Professor David Llewellyn for many helpful comments. I would like to thank Professor Philippe Schmitter, the Director of the Center for European Studies at Stanford University, who provided me with the opportunity to spend time as a visiting research scholar at Stanford. I am also grateful to Professor Don Harris of Oxford University who made it possible for me to spend two years as a research associate at Oxford.

I am grateful for financial support to the Foreign and Commonwealth Office of the United Kingdom, the UK Economic and Social Research Council, the German Marshall Fund of the United States and to the Commission of the European Communities.

Finally, this thesis could not have been written without the opportunity to discuss the topics with many practitioners. The almost forty interviews in seven EC countries form the backbone of the study both for the theoretical sections where the insights gained in the interviews were incorporated in an informal way, and also in the empirical section where the evidence is analysed in a more systematic fashion. I am therefore very grateful to the following individuals who provided time and effort by granting access to invaluable data sources and for being willing to take part in interviews which sometimes lasted for up to three hours. Without their help this thesis could not have been written in the present form.

- Mr. Udo-Olaf Bader, Secretary of the Banking Advisory Committee, Commission of the EC, DG15
- Mr. Chris Bagguley, Marketing Director International, Eagle Star Assurance Plc
- Miss Christine Baird, Senior Manager, International Banking, National Westminster Bank
- Mr. Joe Barraclough, Country Manager, Holland and Italy, Prudential Assurance Plc
- Mr. Hermann Bierer, Senior Engagement Manager, Financial Institutions, McKinsey & Company
- Mr. Christian Bockrath, Director of Public Relations, Colonia AG
- Dr. Luciano Ciampi, Chief Economist, Banca d'America e d'Italia, Milano
- Dr. Matthias Danne, Director, Rheinische Hypothekenbank AG
- Mr. Ernst Deeg, Director of International Banking, Dresdner Bank AG
- Miss Yoko Dochi, International Officer, Capital Markets Division, Bank of Tokyo

- Mr. Paul Earnest, Group Manager Europe, Commercial Union Plc
- Dott. Franca Forster, Marketing Officer, Banca d'America e d'Italia, Milano
- Miss Sophia Fowler, Manager, European Retail Services, Barclays Bank
- Mr. Heiko Glander, Senior Associate, Banking Practise, McKinsey
- Mr. Marcel Gonner, Commission of the EC, DG4 A-3
- Mr. Martin Green, Group Manager Marketing, International Division, Sun Life
- Mr. Michael Hörr, Manager for France, Allianz Holding Company Munich
- Mr. Heinz Michael Horst, Director of Public Relations, Citibank Germany,
- Mr. Ulrich Krause-Heiber, Commission of the EC, DG4
- Dr. Joachim Liese, Corporate Planning Department, Deutsche Bank
- Mr. Hartwig Loh, Director of Marketing, Equity & Law Life Insurance, Germany
- Mr. Eberhard von Löhneysen, Principal, Financial Institutions, McKinsey & Company
- Dr. Paolo Ponzanelli, Condirettore, Banca d'America e d'Italia, Milano
- Mr. Jürgen Rindermann, Manager for Italy, Allianz Holding Company Munich
- Mr. Claas Romer, Head of Personal Life Insurance, Delta Lloyd Netherlands
- Mr. Robert Selander, Vice-President, Europe Consumer Services Group, Citibank
- Dr. Hans-Joachim Schmidt-Gersbach, Director, International Banking, Dresdner Bank AG
- Dr. Ivano Scalabrelli, Procuratore, Banca Toscana, Firenze
- Mrs. Heike Schmitz, Planning Group for European Strategy, Commerzbank AG
- Mr. Satish Shah, Research Department, Equity and Law Life Assurance Plc, London
- Mr. Iwan de la Sota, Southern Europe Steering Group, Allianz Holding
- Dr. Klaus-Dieter Stadler, Commission of the EC, DG4
- Mr. Walter Stewart, Assistant General Manager Europe, Royal Bank of Scotland
- Dr. Christine Volkmann, Corporate Planning Department, Deutsche Bank AG
- Mr. Tim Ward, Head of European Retail Banking, Barclays Bank
- Dr. Gert Wünsche, Deputy Director of Strategy, Commerzbank AG
- Mr. Heijn Zijlstra, Senior Manager, Non-Life Sector, Delta Lloyd Netherlands

Table of Contents

List of Tables

List of Figures

Introduction..... 14

Chapter One: Cross-Border Penetration of Financial Services in the EC: Definitions and Evolution

1. Basic definitions	9
1.1. An industry definition of financial services.....	9
1.1.1. Intra-industry dynamics: decompartmentalisation in the financial services sector: the case of banking.....	9
1.1.2. Inter-industry dynamics: increasing cross-industry penetration in retail financial services	12
1.2. Financial services markets	14
1.3. Vehicles of cross-border entry in financial services	16
2. The evolution of cross-border penetration in EC financial services.....	19
2.1. Banking.....	19
2.2. Insurance	26
3. Conclusions	29

Chapter Two: The Regulatory Environment of Cross-Border Entry in EC Retail Financial Services

1. Public regulation of retail financial services as a response to market failures	32
1.1. The basic problem: agency conflicts between owners, managers and customers.....	33
1.2. Informational asymmetries	36
1.3. Negative externalities resulting from insolvencies.....	37
2. The changing regulatory approach to financial services in the EC	40
2.1. Liberalisation of capital movements	40
2.1.1. The impact of liberalising capital flows on financial services competition: theoretical considerations.....	41
2.1.2. Abolishing UK exchange controls in 1979: an application of the theory.....	43
2.2. The EC Services Directives: minimum harmonisation and the home- country principle.....	45
3. Free capital flows and the EC Directives: scope for strategic deregulation?	51
3.1. Financial services regulation in an international setting: game- theoretic considerations.....	53
3.2. Competitive strategic deregulation in the EC: an application of the model to banking	60

3.2.1. Minimum reserve requirements.....	60
3.2.2. Deposit rate regulation	63
3.2.3. Taxation of interest rate earnings	65
3.2.4. Universal banking versus separation.....	67
3.3. Competitive deregulation in the EC insurance sector.....	69
3.3.1. The regulation of life insurance.....	69
3.3.2. The regulation of motor insurance.....	72
4. Conclusions	74

**Chapter Three:
An Eclectic Theory of Cross-Border Entry
in Retail Financial Services**

1. A first approach: trade theory.....	77
1.1. A brief overview of trade theory in services.....	78
1.2. The applicability of trade theory to financial services	80
2. A firm-level approach to the theory of cross-border entry	82
2.1. Direct financing versus financial intermediation: a contractual theory of the economic function of banks	82
2.2. Diversification and risk pooling: the economic function of insurance firms	87
2.3. An application to the theory of cross-border entry: inherent cost advantages of foreign financial services firms	89
2.4. Follow and lead the customer	92
2.5. Intangible assets	93
3. Locational factors: the relation between host- and home-country characteristics.....	95
4. Market imperfections and transaction costs: factors determining the mode of cross-border entry.....	97
4.1. Exporting versus FDI: the decision between cross-border provision of services and multinationalisation	98
4.2. Cross-border majority acquisitions versus de novo entry	100
4.3. Joint ventures	103
4.4. Strategic alliances and cooperation agreements	105
5. Conclusions	107

**Chapter Four:
Barriers to Cross-Border Entry
in European Retail Financial Services**

1. Regulatory barriers to cross-border entry.....	110
1.1. Entry by other EC institutions.....	110
1.2. Entry by non-EC financial services firms.....	114
1.3. Cross-border acquisitions and the lack of a market for corporate control in European financial services	115
1.4. Public ownership of financial services firms.....	119
2. Market-inherent barriers to cross-border entry	120
2.1. Economies of size	120
2.1.1. Scale economies	120
2.1.2. Scope economies	125
2.1.3. Some evidence on the size/profitability relation for European banks.....	128
2.2. Reputation and switching costs	130
2.3. Strategic entry deterrence of domestic incumbents	136

2.3.1. Domestic consolidation as a means of deterring foreign entry.....	136
2.3.2. The example of ATM networks.....	144
2.3.4. Branch proliferation.....	148
2.4. Retail financial services: a contestable market?.....	151
3. Conclusions	153

**Chapter Five:
The Potential Impact of Foreign Entry on Domestic Competition**

1. Competition in retail banking with cross-border entry: theoretical concepts	155
1.1. Cross-border entry can increase price competition: the example of the deposit market	155
1.2. Cross-border entry can reduce X-inefficiency	160
1.3. Cross-border entry can spoil collusive domestic equilibria.....	161
1.4. Cross-border entry can increase quality and variety of services	163
2. The potential impact of cross-border entry: empirical data.....	164
2.1. The Price Waterhouse study on financial services: a critical assessment	164
2.2. Price and margin differences in retail banking: new international data for the EC.....	167
2.2.1. Methodology.....	167
2.2.2. The data.....	170
2.2.3. Possible reasons for international price differences	172
2.2.4. Do higher prices lead to greater profits?	173
Table 5.5 Operating results of non-life insurers in five EC countries over 1985 to 1989 time period.....	175
2.3. Differing efficiency levels in European financial services: the example of labour productivity	175
2.4. Collusive equilibria in banking: the example of deposit interest rates	176
2.5. Quality levels in retail banking	177
3. Conclusions	178

**Chapter Six:
The Scale of Cross-Border Entry
in EC Financial Services:
an Aggregate Analysis**

1. The extent of cross-border entry in EC financial services: intra-EC activities	180
1.1. International trade in financial services.....	181
1.2. Cross-border acquisitions	184
1.3. Joint Ventures.....	194
1.4. Strategic alliances and cooperations	196
1.5. De novo entry	198
2. Cross-Border entry activities into the EC by non-EC firms	199
2.1. Entry into the EC by US financial services firms.....	199
2.2. Entry into the EC by Japanese financial services firms	201
2.3. Entry into the EC by other non-EC financial services firms.....	203
3. Conclusions	203

**Chapter Seven:
Cross-Border Entry in
European Retail Banking:
Interview Evidence and Case Studies**

1. Cross-border entry in the EC: evidence from focus interviews	207
1.1. A note on research methodology.....	207
1.2. Interview results: summary and analysis	210
2. Case studies of cross-border majority acquisitions	212
2.1. Deutsche Bank's acquisitions in Italy and Spain.....	213
2.1.1. Deutsche Bank's European strategy.....	213
2.1.2. Banco Comercial Transatlantico	215
2.1.3. Banca d'America e d'Italia	217
2.2. Barclays Bank's European retail strategy.....	222
2.3. National Westminster's European retail strategy.....	227
2.3.1. Nat West's approach to expansion in European retail banking	227
2.3.2. The strategy in Spanish retail banking since 1985.....	229
2.4. The strategy of a non-European bank: the example of Citibank.....	230
2.4.1. Citibank's European retail strategy.....	230
2.4.2. Citibank's European acquisitions: the example of KKB Bank.....	233
3. Case studies of cross-border strategic alliances	237
3.1. Banco Santander and Royal Bank of Scotland.....	237
3.1.1. Background and strategic objectives of the alliance	237
3.1.2. A joint venture in Germany: the example of CC-Bank.....	240
3.2. Commerzbank and Banco Hispano Americano	241
4. Conclusions	243

**Chapter Eight:
Cross-Border Entry
in European Insurance:
Survey Evidence and Case Studies**

1. Results from the questionnaire survey	245
1.1. A note on research methodology.....	245
1.2. Results from questionnaire	247
2. Case studies of cross-border entry strategies.....	250
2.1. Allianz' European acquisitions.....	250
2.1.1. Allianz' strategy of international expansion in Europe: a historical overview	250
2.1.2. Allianz' strategy in Spain.....	254
2.1.3. Allianz' strategy in the French market	258
2.2. Equity & Law Life Insurance	260
2.2.1. Equity & Law's de novo entry strategy in Germany.....	260
2.3. Commercial Union's European strategy	263
2.3.1. CU's entry strategy on the Continent	263
2.3.2. Significant market share in the Netherlands: Delta-Lloyd	264
2.4. UAP's and Liberty Life's acquisition of Sun Life.....	267
2.5. Victoire's acquisition of Colonia.....	268
2.6. Prudential's strategy in Italy and the Netherlands	269
2.7. Eagle Star in Spain, Portugal and the Netherlands	270
3. Conclusions	271

**Chapter Nine:
The Liberalisation of
Inter-State Entry in US Banking:
a comparative analysis**

1. The evolution of interstate banking: gradual lifting of restrictions in the 1980s	275
2. Regulatory competition between state regulators: the examples of South Dakota and Delaware	278
3. The impact of lifting interstate banking restrictions on intrastate competition	285
4. Conclusions	288

**Chapter Ten:
Cross-Border Entry
in Retail Financial Services:
Policy Implications**

1. Competition policy and cross-border transactions	291
2. Financial services regulation in the Internal Market.....	293
2.1. EC deposit insurance schemes in an international context	293
2.1.1. Deposit insurance in the EC.....	294
2.1.2. The implications of increasing internationalisation on deposit insurance	296
2.1.3. The proposed EC Directive on deposit insurance.....	298
2.2. Lender of last resort in an international context	301
2.2.1. The lender of last resort: theoretical considerations	301
2.2.2. The LLR for multinational banks: home-country or host-country responsibility?.....	303
3. Conclusions	305

Conclusions.....	306
-------------------------	------------

List of Tables

- Table 1.1
Number of banks in EC countries in December 1990; 10
- Table 1.2
Number of foreign banks in ten EC countries from 1960 to 1986; 20
- Table 1.3
Number of foreign branches and subsidiaries of domestic banks from 1960 to 1986; 21
- Table 1.4
Countries of origin of foreign banks in Germany in 1990; 23
- Table 1.5
Market share in 1991 of foreign banks in Germany for selected banking segments; 24
- Table 1.6
Number of foreign insurers in ten EC countries from 1968 to 1989; 25
- Table 1.7
Countries of origin and market shares of foreign insurers in Germany in 1989; 27
- Table 2.1
Reserve requirements in the EC in 1988; 60
- Table 2.2
Opportunity costs of EC reserve requirements per unit of deposit; 61
- Table 2.3
Regulations concerning interest rate income in 1991; 65
- Table 2.4
Comparative summary of life insurance regulation in six EC countries; 69
- Table 2.5
Regulations concerning motor insurance in 12 EC countries; 72
- Table 4.1
Ownership, size and performance of largest 162 EC banks in 1988; 117
- Table 4.2
Size/profitability correlation for largest 173 EC banks; 127
- Table 4.3
R-firm concentration ratios for banking and insurance in 1988/89; 137
- Table 4.4
Number of Branches in 8 EC countries from 1960 to 1991; 147
- Table 5.1
Typical product bundle and prices surveyed for personal customers; 166
- Table 5.2
Price differences in German retail banking; 168
- Table 5.3
Comparison of price and margin differences in retail banking for six EC countries; 169
- Table 5.4
Return on assets for EC commercial banks from 1986 to 1989; 171
- Table 5.5
Operating results of non-life insurers in five EC countries over 1985 to 1989 time period; 172
- Table 5.6
Wage levels and productivity in banking in 10 EC countries; 173
- Table 5.7
Average margins for demand and savings deposits in 1991; 174
- Table 5.8
Opening hours of retail branches in eight EC countries in 1992; 175
- Table 6.1
Intra-EC trade in financial services; 178

- Table 6.2
Extra-EC trade in financial services; 179
- Table 6.3
Trade in banking services in 1990; 180
- Table 6.4 The biggest intra-EC cross-border majority acquisitions
between 1986 and 1992; 186
- Table 6.5
Member banks of European co-operation groups; 193
- Table 7.1
Analysis of BancoTrans financial statements; 214
- Table 7.2
Analysis of BAI's pricing strategy; 216
- Table 7.3
Analysis of Banca d'America's financial statements; 218
- Table 7.4
International banking activities of BAI since 1987; 218
- Table 7.5
Analysis of Barclays' pricing strategy in France; 223
- Table 7.6
Analysis of Citibank's pricing strategy in Germany; 233
- Table 7.7
Analysis of KKB's financial statements from 1986 to 1990; 234
- Table 8.1
Number of firms and response rates for individual EC countries for survey; 243
- Table 8.2
Insurance growth rates in Spain from 1985 to 1989 compared to EC average; 252
- Table 8.3
Insurance growth rates in France from 1985 to 1989 compared to EC average; 256
- Table 8.4
Analysis of financial statements of Equity & Law Germany from 1987 to 1990; 259
- Table 8.5
Analysis of Delta-Lloyds financial statements from 1983 to 1991; 263
- Table 9.1
Interstate banking laws in the federal states in 1991
- Table 9.2
Compound annual growth rates at commercial banks in South Dakota and Delaware
between 1980 and 1989; 276
- Table 10.1
Deposit insurance schemes for commercial banks in the EC in 1991; 289
- Table 10.2
Coverage of multinational banking under domestic deposit insurance schemes in 1991;
292

List of Figures

- Figure 1.1
Means of cross-border entry in retail financial services; 16
- Figure 1.2
Foreign assets and liabilities of domestic commercial banks in 1990; 22
- Figure 1.3
Market share of foreign insurers in the EC countries in 1986; 26
- Figure 1.4
Development of market shares of foreign insurers in Germany from 1975 to 1989; 28
- Figure 2.1
Choice between risky asset management strategies; 34
- Figure 2.2
Flows of portfolio investment in the UK from 1975-85; 42
- Figure 2.3
Stocks of UK portfolio investment from 1975-85; 43
- Figure 2.4
Bank lending (in sterling) abroad; 44
- Figure 2.5
Two examples of regulators' hypothetical hyperplanes and social welfare; 54
- Figure 2.6
Real returns to policyholders of life insurers; 70
- Figure 4.1
Number of domestic acquisitions in financial services in the EC; 136
- Figure 4.2
Concentration ratios in retail banking in 1988; 138
- Figure 4.3
Number of ATMs in 6 EC countries, Japan and the US in 1990; 142
- Figure 4.4
Number of inhabitants per bank branch in 1989/90; 147
- Figure 5.1
Potential price reductions in financial services according to the PW study; 162
- Figure 6.1
Net trade of 9 EC countries with world in financial services in 1988; 180
- Figure 6.2
Number and value of cross-border majority acquisitions in European industries in 1989; 181
- Figure 6.3
Number of acquisitions in EC financial services from 1975 to 1991; 182
- Figure 6.4
Majority acquisitions in EC financial services; 184
- Figure 6.5
Minority acquisitions in EC financial services; 184
- Figure 6.6
Target countries by number and transaction value in EC banking majority acquisitions; 187
- Figure 6.7
Target countries by number in EC insurance majority acquisitions; 188
- Figure 6.8
Target countries in EC banking and insurance minority acquisitions; 189
- Figure 6.9
Target countries of majority and minority acquisitions in brokerage and investment banking; 190
- Figure 6.10

- Cross-border joint ventures in EC financial services from 1984 to 1991; 191
- Figure 6.11
Classification of joint ventures; 192
- Figure 6.12
Target countries of de novo entry activities of EC banks; 196
- Figure 8.1
Insurance densities in the twelve EC economies in 1989; 253
- Figure 8.2
Premiums as percentage of GDP in the twelve EC economies in 1989; 254
- Figure 9.1
Number of interstate acquisitions in the US from 1980 to 1989; 272
- Figure 9.2
Impact of banking legislation on banking employment in South Dakota and Delaware;
277
- Figure 9.3
Income tax revenue from banks in South Dakota and Delaware; 278

Introduction

Motivation and objectives of the thesis

Most retail financial services in the European Community (EC) have for a long time been characterised by a low degree of cross-border penetration and competition. This market fragmentation stemmed partly from government regulations obstructing free movement of capital, freedom of establishment and provision of services in the EC. Not surprisingly, therefore, the 1988 Cecchini-report concluded that in the European financial services sector "... market openness, competition and low cost-efficiency is often deliberately not assured".

This lack of cross-border market penetration is supposed to change with the advent of the European internal market in 1993 after the adoption of the Single European Act and various EC Directives concerning financial services. The implementation of these measures in the financial services sector is predicted to lead to overall price reductions by 10% and a rise in European GDP by 1.5 % over a five-year period which accounts for a third of the total projected effects of the 1992 programme.¹ In addition, the changes in the regulatory regime are expected to impact significantly the current structure, conduct and performance of the financial services industry. As the Banking Advisory Committee of the Commission of the EC (1988, p.13) comments, for example, the new Directives "will result in the banking system undergoing fundamental and perhaps dramatic changes". Similarly, for insurance services, a practitioner claims that "operators will face dramatic changes in the near future ... which can be summarized by just these two single words: increased competition" (Bebear, 1990, p.359). Other academic commentators predict that "whether the 1992 deadline is met or not, financial markets will dramatically change to the point of bearing little resemblance to what they used to be" (Huveneers and Steinherr, 1990, p.3). Are such predictions realistic or do they overestimate the potential impact of regulatory reform?

Consider the mechanism which is supposed to bring about the changes in European financial services. According to the Price Waterhouse study on financial services which is part of the 'Cecchini Report', the large-scale economic study on the costs of market barriers between the EC countries, price differences across Member States will be gradually eliminated as the EC moves closer to financial integration. The report envisages two prerequisites for attaining greater price convergence: first, a "legislative {EC} programme

¹ See Cecchini-Report, *European Economy*, 35, 1988, p. 86.

which is aimed at stimulating cross-border trade and encouraging investment and establishment in foreign territories". Secondly, an "intensified interest in Pan-European acquisition and merger opportunities" (Price Waterhouse, 1988, p.2).

The main vehicle to establish a more unified market in financial services is therefore the elimination of barriers to cross-border entry which is supposed to lead to increased international competition between firms, due to the resulting threat of potential or actual entry. Thus, whether or not the significant projected welfare effects in the financial services sector will obtain depends crucially on the extent, scope and effects on competition of cross-border entry.

Increased cross-border entry has so far been assumed rather than systematically analysed, however, in most studies of European financial services integration (e.g. Neven, 1990; Vives, 1991).² As Gardener noted only most recently (1992, p.121):

"Although the general mechanism and broad direction of change for financial sectors hypothesised by Cecchini are generally accepted, there has been practically no research to date on the process and respective time period for financial prices to converge".

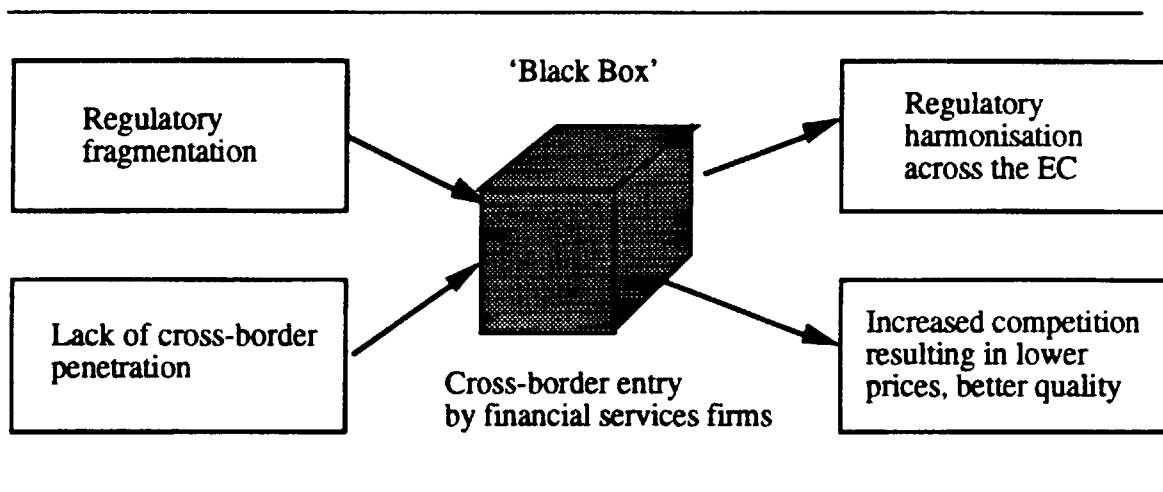
It is exactly in this area of analysing the actual cross-border entry process where this thesis shall make a contribution to the literature. It is thus intended to fill the 'black box' of the cross-border entry mechanism which was not subjected to analytical scrutiny in existing related studies.

Financial services are frequently divided into three different categories: insurance, banking and securities. Accordingly, the vast majority of industry studies analyse these three sectors separately. In contrast to these studies, this thesis follows an integrated approach to the analysis of retail financial services. This seems preferable for two major reasons: first, industrial logic is such that banks, insurers and securities firms have increasingly entered each other's traditional territories in the retail financial services market. Thus, a single industry study would miss out on the industry dynamics in this market. Second, the juxtaposition of the cross-border penetration process in the different sectors allows a comparative analysis of the fundamental similarities and differences. The focus of this study is on retail financial services which are broadly defined as including personal customers as well as small and medium-sized enterprises. Cross-border entry in wholesale and

² This is not just true for the banking industry: most academic analyses of European industrial integration assume increased cross-border penetration, but do not subject the penetration process *per se* to analytical scrutiny.

investment banking as well as reinsurance is not examined in this study, since competition in these markets is internationalised already with few expected changes after 1992.

The thesis focuses on the two sets of issues relevant to a social welfare analysis of cross-border entry in retail financial services: first, regulatory factors in the EC need to be analysed, since increasing cross-border penetration has implications both for regulatory convergence across the EC countries and raises questions of attaining the original objectives of regulation. Second, the impact of foreign entry on domestic competition in retail financial services requires scrutiny, since the major benefits of financial integration are expected to result from the welfare-enhancing effects stemming from increased competition of foreign firms in the domestic market. The following figure illustrates schematically the 'black box' which is the catalyst in bringing about both regulatory convergence as well as increased competition in an integrated EC market.



When breaking up this 'black box' we can distinguish between the regulatory and the competition issues. Consider first the regulatory issues: the Second EC Banking Directive taking effect in January 1993 and the Third EC Non-Life and Life Insurance Directives fundamentally change the rules governing cross-border entry of EC financial services firms: a 'single financial services passport' is established which allows any EC institution to enter other EC countries without the need to apply for a separate licence in the host country. In addition, supervision is mostly undertaken by the firm's home country regulators. Thus, entering foreign firms are regulated under a different regime than domestic competitors which may result in competitive distortions unless national regulatory environments start converging. Does cross-border entry therefore lead to 'strategic deregulation' among national EC regulators and does such a process jeopardise the underlying economic objectives of financial services regulation? Or is the home country rule an ingenious mechanism to ensure speedy harmonisation of EC financial services regulations by avoiding lengthy negotiations between Member

States? In addition, is the existing regulatory framework sufficient to guarantee financial stability and attain the original objectives of financial services regulation, as cross-border entry activities result in increased internationalisation of domestic markets?³

Consider next the impact of cross-border entry on domestic competition which is the second main area analysed in this study. The rationale for European economic integration rests on one of the fundamental theorems of industrial and, indeed, welfare economics: increased competition through new entry improves the resource allocation by shifting production to the most efficient suppliers and benefits consumers through lower prices and/or better quality of services.

In order to adapt this proposition to the case of cross-border entry in retail financial services, two theoretical questions need to be addressed. First, in order to assess the significance and causes of increased foreign penetration a theory of cross-border entry is required. While there have been attempts to apply the theory of multinational enterprises to the financial services sector, no convincing theory exists which is able to explain why firms enter foreign markets particularly in the retail sector. Specifically, what competitive advantage may compensate a foreign firm for operating in an unfamiliar environment and still having to establish a reputation among domestic customers? And what factors determine the choice of the entry vehicle, once a firm has decided to enter a foreign market?

We find that the most likely form of cross-border entry in retail financial services is through acquisition. While domestic acquisitions have been the subject of substantial academic analysis, little research has been undertaken on cross-border transactions, and so their economic determinants, effects, and consequences in terms of social welfare remain largely unexplored. Moreover, acquisitions in service industries may differ significantly in their motivation and welfare effects from industrial combinations. Yet, they have received comparatively little attention in the literature.⁴

³ Bryan (1990, p.121) claims that "Pan-European liberalisation of rules is taking place without fundamental reform of national safety-and soundness regulation". King (1990, p.577) notes the "urgent practical necessity to construct a new regulatory regime for financial services in the context of not only '1992' but also a global market with highly mobile capital".

⁴ As noted by Hannan and Rhoades (1987, p.67), for example: "rather surprisingly, (the rationale for mergers) has been studied fairly extensively by economists in connection with mergers in the industrial sector, but has received little attention in banking". Similarly, for the insurance sector, Schroath (1988, p.363) observes "an absence in the literature of empirical studies of international operations of service firms and international insurance firms in particular."

The second requirement to analyse the actual or potential impact of cross-border entry on domestic prices and quality is to develop elements of a theory of domestic competition in retail financial services with cross-border entry. Entry of foreign firms may impact the domestic industry via two channels: first, cross-border entry may change the market structure, increasing the level of competition by breaking up (tacitly) collusive behaviour among domestic incumbents. Second, foreign firms may introduce new products or services and bring special expertise to the market. This may make an already competitive market more efficient. The impact on domestic social welfare of such foreign entry may not be unambiguous, however: the increase in consumer surplus due to lower prices could be more than outweighed by reductions in producer surplus, as domestic firms lose market share to foreign entrants. Does such a situation require delegation of regulatory control to the EC authorities, as domestic regulators (tacitly) discriminate against foreign entrants to protect domestic firms?

The general approach chosen in this study to address these questions is heavily influenced by the theory of industrial organisation (IO) and thus attempts to bridge a gap between the financial services literature and that of IO which is mostly concerned with the structure, conduct and performance of manufacturing rather than service industries.⁵ Rather than developing one 'grand' model of the retail financial services industry, however, it is attempted to apply the insights from several IO models to the specific case of this industry. While most of industrial organisation has recently become highly theoretical,⁶ this approach has the merit of indicating the areas where the recent theoretical developments can make significant contributions to understanding and elucidating the functioning of one particular industry. It is thereby able to highlight the strengths and weaknesses of particular models.

In order to address the area of cross-border entry from an empirical perspective, three complementary approaches are selected: first, an original database on EC cross-border entry activities in financial services from 1986 until 1992 is developed to perform aggregate and time-series analyses. Second, detailed case study analyses are undertaken to inquire into the

⁵ In the third edition of their almost classic introductory textbook on industrial organisation, Scherer and Ross (1990, p.1) state that they have "little to say about ... banking, insurance and other financial intermediary industries, which are the province of money and banking specialists".

⁶ Tirole (1988, p.3), for example, emphasises that the "theoretical evolution has been very healthy" to the field of IO, but also observes an imbalance between theory and empirical research in a field "in which theoretical models are often lacking in generality and in which practical implications are so crucial".

motives and strategies of cross-border entry activities.⁷ Third, a comparative analysis with the United States is undertaken to juxtapose the deregulatory process with respect to inter-state entry in the US and cross-border entry in the EC and to assess whether conclusions can be drawn for the integration of the European retail financial services market.⁸

Structure of the study

The *first chapter* starts by introducing the fundamental definitions for the study and gives a brief account of the historical development and current state of cross-border penetration of retail financial services in the EC.

The *second chapter* presents a brief overview of the theory of financial services regulation and analyses possible market failures which may necessitate public regulation. These theoretical insights are then applied to the case of regulatory reform in retail financial services on the EC level, analysing the impact of capital liberalisation and the EC Banking and Insurance Directives. Rather than providing a full-fledged account of financial services regulation, this chapter concentrates on the interaction of regulation and cross-border entry. The focus of the analysis is therefore placed on the issue of 'strategic deregulation'. This refers to the process of competitive interaction between national regulators which may be forced to abandon regulations which place domestic firms at a disadvantage compared to foreign entrants. Alternatively, domestic regulators may attempt to provide a permissive regulatory regime either to attract foreign entrants or to convey a regulatory advantage on domestic institutions which enter foreign EC markets under the home-country regime. A simple model is developed to analyse the likelihood and conditions of such strategic deregulation which is then applied to selected areas of financial services regulation.

A *third chapter* develops a theory of cross-border entry in retail financial services. It thereby synthesises concepts from industrial organisation, transaction cost economics and the theory of multinational enterprises. While the theory of cross-border entry is fairly well-developed in the context of manufacturing firms, it is not clear which qualifications, if any, are required to apply it to a service industry, such as the retail financial services sector. The starting point for the theoretical analysis is the question which competitive advantage may compensate a foreign firm for the cost

⁷ Tirole (1988, p.4) notes that "industrial organisation theorists have often felt more comfortable with case studies than with statistical analysis - perhaps because it may be easier to recover the industry's basic conditions and behavior from rich case studies than from selective statistics ...".

⁸ Neven (1990, p.175), for example, notes that "the United States could be a laboratory experiment for European deregulation".

disadvantages resulting from operating at a distance and in a foreign environment. A second stage in the theory then looks at the firm's choice of the mode of entry: a firm may decide between provision of services across national borders (i.e. 'exporting'), establishing a new branch or subsidiary, co-operation with a firm in the host market through a strategic alliance, setting up a joint venture with a domestic or another foreign firm or acquiring a firm in the host country. It is analysed which factors influence the choice of the entry vehicle in the retail financial services sector.

Chapter four analyses various barriers to cross-border entry in European retail financial services which may pose significant impediments to increased cross-border penetration. Such barriers include 'public' entry barriers such as explicit or implicit regulatory restrictions, public ownership of banks and insurers or the lack of a level playing field for cross-border acquisitions, and industry or market-inherent barriers which include size economies, reputational barriers and switching costs.

A fifth chapter scrutinises the possible effect of cross-border entry on domestic retail financial services competition. Four key areas are identified where cross-border entry can impact domestic competition: foreign entrants can increase price competition, spoil domestic collusive equilibria, force incumbents to reduce X-inefficiency and introduce new products or services with greater quality levels. These four mechanisms are analysed both from a theoretical and an empirical perspective.

In the *sixth chapter* statistical data on the extent of actual entry through cross-border provision of services, (majority or minority) acquisitions, strategic alliances, joint ventures and de novo entry are presented. For this purpose a new database needed to be developed which includes cross-border entry activities of the largest EC banks and insurers, as well as EC entry of the largest American, Japanese and other non-European firms for the time period from 1986 until 1992. This database allows an analysis of cross-border entry activities both over time and across different EC countries. It therefore addresses the questions of which EC countries are the main targets of cross-border entry and whether there have been significant changes of entry activities over time. In addition, the database permits a comparative analysis of entry vehicles chosen and therefore puts the theoretical predictions of the third chapter on the choice of the entry vehicle to an empirical test.

The aggregate analysis of chapter six encounters clear limits, however, when testing the theory of why cross-border entry activities take place and what impact they may have on competition. To further inquire into these questions, *chapters seven* and *eight* present individual case-study analyses for the banking and insurance sectors respectively. Publicly available background data are collected on individual transactions and these are supplemented by interviews at the firm level to gain an insight into the underlying strategies of entering firms. Particular focus is placed on the

questions of post-entry strategies in relation to domestic incumbents concerning pricing, quality of services offered and marketing strategies to scrutinise how foreign firms attempt to cope with entry difficulties such as establishing a reputation and overcoming customer switching costs. In addition, the results of a questionnaire survey are reported which was sent out to more than 300 European banks and insurers.

The *ninth chapter* offers a comparative perspective by analysing inter-state entry in the US. It focuses on the question whether conclusions and predictions can be drawn from the US experience in the past decade for the derestriction of cross-border entry in the EC after 1992. While there are a number of differences between the US and European systems, such as the functional separation imposed by the 1933 Glass-Steagall Act, interesting analogies exist. These include in particular the restrictions on inter-state banking, both in terms of branching and acquisitions, as imposed by the 1927 McFadden Act and the 1956 Douglas amendment. Most of these restrictions were gradually softened since the beginning of the 1980s, giving rise to a number of inter-state entry activities. This allows an analysis of both regulatory competition between state regulators and the impact of out-of-state entry on structure, conduct and performance of US banking and thus to draw up a comparative perspective to the EC process.

The *tenth chapter* presents some public policy implications which can be derived from the preceding theoretical and empirical analysis. These concern in particular the application of competition policy to EC cross-border transactions in retail financial services and the public policy means to maintain financial stability in an integrated European market increasingly characterised by cross-border penetration of financial services. *

A summary concludes the study.

Chapter One: Cross-Border Penetration of Financial Services in the EC: Definitions and Evolution

This first chapter introduces the fundamental definitions for the study and presents an overview of the evolution and current state of cross-border penetration of retail financial services markets in the European Community. Section 1 discusses possible industry and market definitions of European financial services and introduces our definitions of the different vehicles of cross-border entry. Section 2 then analyses the evolution of cross-border penetration in European financial services.

1. Basic definitions

1.1. An industry definition of financial services

When defining the European financial services industry, we can distinguish two recent trends: first, there is an increase of traditionally non-competing firms from the *same* industry to enter each other's lines of business. This process is termed decompartmentalisation and is discussed in the next section for the case of banking. Secondly, there has been a dramatic trend towards *inter*-industry penetration especially in the retail banking and insurance sectors. This process is discussed in the second section.

1.1.1. Intra-industry dynamics: decompartmentalisation in the financial services sector: the case of banking

First, consider possible definitions of the banking industry. The term 'banking' is used to cover a wide range of financial services, and definitions vary from fairly narrow to very broad. According to Article 1 of the first EC Directive on banking,¹ a "credit institution" is defined as taking deposits and investing or lending these funds.² The appendix of the Second Banking Directive³ includes

¹ OJL, 780, 1977.

² The 1986 French Banking Act adopted this definition but additionally includes the issue of means of payment as a third characterising criterion. In contrast, Article 1 of the German Banking Act subsumes a much wider range of activities under its banking definition.

a range of financial services offered by banks including not only 'traditional' banking activities such as deposit-taking and lending but also trading and brokerage activities, mortgage business, leasing, money broking, portfolio management and consulting services.

Consider next the 'institutional' classification of banks. Traditionally, three main institutional groups of banks are distinguished in the EC whose numbers are published annually by the Commission of the EC:

- *commercial* or universal banks engaging in the full range of banking activities, extending from mass retail services over all types of corporate services to international investment banking;
- *savings* and *co-operative* banks whose main funding base are deposits from personal customers. They frequently have a regional focus and their lending activities are more restricted than those of commercial banks. In their activities they accord most closely with the first EC Directive's definition of banks;
- *specialised* banks which focus on a subset of banking activities. This group includes mortgage banks and building societies, as well as finance companies and investment banks. These institutions are characterised by engaging only in a limited range of activities.

Table 1.1 reports the number of credit institutions in the EC countries according to such an institutional classification.

³ OJL 386, 30.12. 1989.

Table 1.1: Number of banks in EC countries in December 1990

	Com- mercial Banks	Savings/ Mutual Banks	Cooper- ative Banks	Special- ised Banks	Total number of banks	Inhabi- tants per bank
Germany	312	595	3030	80	4,017	15,683
France	407	207	173	1078	1,865	30,027
Italy	259	84	716	96	1,155	49,922
UK	544	0	0	112	656	86,890
Spain	152	67	107	442	768	50,781
Denmark	77	131	34	22	264	19,469
Luxemb.	172	0	48	23	243	1,563
Netherl.	97	53	1	29	180	83,666
Belgium	84	428	0	41	553	17,793
Ireland	33	2	0	11	46	76,521
Greece	37	0	0	2	39	259,487
Portugal	22	1	0	3	26	379,615
EC Total	2,196	1,568	4,109	1,939	9,812	32,000

Source: EC Commission.

While such a differentiation of the industry according to types of institutions reflects its historical development, many formerly non-competing banks have been moving into each others' territories, as their traditional customer base offered continuously less growth potential. This trend towards diversification and 'decompartmentalisation' (OECD, 1989, p.60) has resulted in increased market overlap between banks which have traditionally operated in separate markets.⁴

⁴ Two examples illustrate this blurring of demarcation lines: first, the decision of British building societies to actively enter retail personal customer services by offering interest-bearing current accounts with close to money market rates after the 1986 Building Society Act cleared the way for an expansion of activities. The success of the building societies' entry strategy prompted the large clearing banks to offer similar accounts to defend their market share in the strategically important personal customer market. Building Societies in Britain now offer very similar services in the retail financial services market as commercial banks and new legislation introduced in 1992 further extends their permitted scope of activities. The second example are the regional savings and co-operative banks which have cut into the market share of commercial banks by forming alliances and organising on a national level. France's Credit Agricole, for example, is not only the largest European co-operative bank but according to size of capital also the biggest commercial bank in Europe. While savings banks in Germany have traditionally had a regional focus, they have been actively expanding their international business through cooperating in the regional or interregional "Girozentralen" to become more competitive in the market of medium-sized and larger corporates. In most EC countries the business activities of savings and cooperative banks are now virtually indistinguishable from those of traditional commercial banks (see, for example, Denning (1990) on the reform movements of savings banks in the EC since 1972).

In face of these recent strategies to enter new lines of business, Hawawini and Rajera (1990, p.11) conclude that "instead of 10,000 European banks with broad traditional categories of specialisation, we are currently observing 10,000 banks all more or less beginning to engage in similar activities". The next chapter analyses this trend towards universal banking in the EC, while the impact of such decompartmentalisation on competition is discussed in chapter four.

1.1.2. Inter-industry dynamics: increasing cross-industry penetration in retail financial services

When defining the retail financial services industry, one has to take account of the trend towards *bancassurance* or *Allfinanz*, i.e. unifying the whole range of financial services under one roof. In particular, banks have entered the insurance sector by distributing insurance products.⁵ At the same time, insurance companies progressively move into traditional bank business. This trend has been particularly pronounced in the life insurance sector where products constitute close substitutes to traditional banking products such as fund management, pension products and long-term savings plans. Since such cross-industry penetration plays a significant role also in cross-border transactions, we proceed to discuss these moves in greater detail.

In contrast to Japan and the US, there have been few to no regulatory restrictions on the crossing of market and product lines between banks and insurers in the EC.⁶ Probably the first European bank which actively entered the insurance business as early as 1967 was the UK Trustee Savings Bank (TSB), the amalgamation of the UK national savings banks. Today, TSB sells and through a subsidiary also underwrites life insurance through a specialised sales force of 450 employees who get referrals from the branches, as well as general insurance such as fire, travel and household coverage through its branch network. TSB Life, the life insurance subsidiary now contributes more than a quarter of group profits which demonstrates the success of TSB's venture into the insurance sector. Encouraged by its success in insurance products, TSB has entered a joint venture with Cariplo, the largest Italian bank, and French Caisse National de Prevoyance which aims at establishing an insurance sales force in the Italian market drawing on Cariplo's massive retail base.

TSB's success in the insurance sector encouraged the other major UK banks to emulate its strategic move. The five large clearing banks all chose different entry routes into insurance, however: while National Westminster decided to remain an independent insurance broker rather than entering the underwriting business itself or striking an exclusive alliance with one

⁵ See Salomon Brothers (1990) for a comprehensive account of the moves of European banks into the insurance sector on which part of our account is based.

⁶ Existing restrictions in the Netherlands were phased out in January 1990.

insurer, Barclays has been selling unit-trust linked life insurance for as long as twenty years with a sales force of now almost 1,000 employees and plans to expand services significantly. Midland Bank decided to enter a joint venture with Commercial Union (CU), the fifth-largest UK life insurer to form Midland Life in which Midland owns 60 percent with the aim of establishing a sales force drawing on CU's insurance know-how and Midland's retail customer base. Lloyds Bank decided to engage in a merger with Abbey Life in 1988, the country's tenth-largest life insurer, which created the country's first financial services conglomerate. Finally, Royal Bank of Scotland (RBS) has set up a life insurance joint venture with Scottish Equitable and also pursued de novo entry by setting up a new direct sales auto insurance subsidiary, Direct Line, which has achieved significant growth rates since its inception.⁷

In Germany, the trend towards *Allfinanz* has been a fairly recent phenomenon. Some banks perceived the need to enter the life insurance business, since their share of total savings had steadily decreased with the proportion of total savings invested in life insurance increasing from 15.8 percent in 1970 to 21.5 percent in 1988. The first move towards *Allfinanz* was undertaken by Germany's fifth-largest insurer, the A&M Group, which acquired the troubled BfG Bank in 1987, the country's tenth-largest bank, to form the first financial services group.⁸ Deutsche Bank, Germany's largest bank followed A&M's move by founding a de novo life subsidiary in 1989 after a long period of cooperation with Allianz, Europe's largest insurer. Allianz attempted to prevent this invasion of its traditional main line of business by threatening to withdraw its substantial fund management business from Deutsche.⁹ It finally settled with an exclusive distribution agreement with Deutsche's main rival, Germany's second-largest Dresdner Bank, culminating in the acquisition of a 24 percent stake in 1991.¹⁰

In France the process of cross-industry penetration has been even more pronounced with Credit Agricole, the giant cooperative banking group with almost 10,000 retail branches being the most prominent example. Only three years after founding a new life insurance subsidiary in 1986, it obtained an 11 percent market share, making it the second-largest life insurer in France with plans to expand into the non-life business as well. BNP, the second-largest

⁷ UK insurance firms have also explored new outlets for their products, mainly striking distribution alliances with building societies and acquiring estate agencies. For example, the largest non-life insurer General Accident uses the Chelsea Building Society, third-largest Royal Insurance uses Leeds & Holbeck, while fourth-largest Sun Alliance has an agreement with the Woolwich.

⁸ With limited success, however, as A&M may be selling off BfG to Credit Lyonnais. Recently, French AGF acquired a 25 percent stake in A&M and will establish contacts to Credit Lyonnais.

⁹ Allianz has an approximate investment portfolio of \$66 billion.

¹⁰ In April 1992 Allianz was under scrutiny by the German Federal Cartel Office for having accumulated a majority stake in Dresdner Bank .

French bank has its own life insurance subsidiary, while cooperating with UAP in the distribution of non-life products.

Very similar developments to those in the UK, Germany and France have taken place in other European countries. The symbiosis between banking and insurance has been most complete in Spain where almost all the major insurers are owned by the large domestic banks. The only major insurer not majority-owned by a bank, the mutual Mapfre group, in turn entered the retail banking field. In the Netherlands banks account for around 20 percent of the distribution of insurance products.

In summary, it becomes evident that banks and insurers increasingly become direct competitors in the retail financial services sector. It appears that banks have so far made more successful inroads into the insurance sector than vice versa, largely because the distribution channels of insurance firms are more difficult to adapt to frequent-interaction bank products. Banks, however, have adopted some of the sales force methods of insurance firms with bank employees visiting customers outside branch opening hours. In addition, banks may have important reputational advantages over insurance firms.

Finally, an industry definition of retail financial services would be incomplete without including the recent inroads by non-financial services firms such as automobile companies,¹¹ department stores¹² or retailers¹³ into traditional banking and insurance activities. These firms increasingly provide traditional financial services such as credit cards, life and non-life insurance, payment services, and even consumer loans or real estate financing. While these moves of non-financial services firms are still in the beginning stages in Europe, the success of US firms such as the retailer Sears or the auto producer Ford indicates that non-financial services firms may also become a significant force in European retail financial services.

1.2. Financial services markets

Concerning possible market definitions it is useful to identify particular sub-markets in the market for financial services. Such a market-led approach is

¹¹ Volkswagen calls itself 'Europe's largest non-bank financial services company'. It offers a current account with credit cards at low cost, loan financing as well as travel and car insurance. It maintains contact with its customers through free telephone banking. Customers who buy a car or bring in their cars for repair are offered this range of financial products.

¹² For example, the German department store Hertie offers the Barclaycard.

¹³ The German mail order company Quelle constitutes such an example with its banking subsidiaries Norisbank and Quelle Bank. Its main competitive advantage is thereby its customer database consisting of over 19 million addresses with information about spending habits and even income levels.

preferable to an institutional classification, as firms belonging to similar institutional groups may operate in different markets and competition occurs in various sub-markets rather than along institutional lines.

Most current market definitions in financial services follow functional or institutional criteria, however. A typical differentiation of banking markets, for example, is given by the OECD definition (1989, p.107)¹⁴ which distinguishes between the following markets:

- retail financial services
- corporate financial services
- securities and brokerage business
- interbank services
- international services.

Such a functional classification is too broad for our purposes, however. Securities and brokerage business, for example, covers a wide range of products and services from the small transaction of a retail customer to the Eurobond issue of a large multinational. In addition, most banks are increasingly organised according to customer groups rather than functional lines. Both Barclays Bank and Deutsche Bank, for example, have recently undergone a complete internal reorganisation process to adapt a customer-focused organisational structure. Similarly, insurance firms increasingly adopt a customer-orientated organisation structure (Farny, 1990). Considering these trends, it is useful to further differentiate functional sectors by customer groups. We therefore differentiate the following segments:

1. *Mass retail services*: standardised products which do not require significant specific tailoring towards the needs of individual customers and are mostly distributed through a local branch or agent network. They include the vast majority of personal banking and insurance services and those financial services for small enterprises which are largely standardised with local specialists serving the clientele.
2. *High net worth individuals*: financial services for wealthy individuals which need to be tailored towards individual needs and require higher service skills than in mass retail, such as portfolio and tax management techniques or specialised investment advice.
3. *Medium-sized enterprises*: require mostly tailor-made solutions, frequently served by regional firm headquarters rather than local branches or agents, aided by centralised specialist departments, such as international services, tax and corporate finance.
4. *Large corporates, financial institutions and public agencies*: served exclusively by specialised firms such as merchant banks or by specific

¹⁴ OECD, Paris, 1989, *Competition in Banking*.

departments in national headquarters of large commercial banks. Insurance firms are served by reinsurance companies.

In this study, the focus is placed upon the competitive effects of cross-border entry in the first three markets. For the purpose of this study, I define the first three markets as the 'retail' financial services market which is a somewhat broader definition than the conventional definition which usually just includes the mass market. I intentionally neglect the 'wholesale' market for large corporates, financial institutions and government agencies, as this market is largely internationalised already. In the wholesale market characterised by low margins and large transactions, competition is on a European or even a global scale with few national restrictions remaining even before further European integration and therefore the effects of additional cross-border entry are expected to be comparatively small.^{15 16}

1.3. Vehicles of cross-border entry in financial services

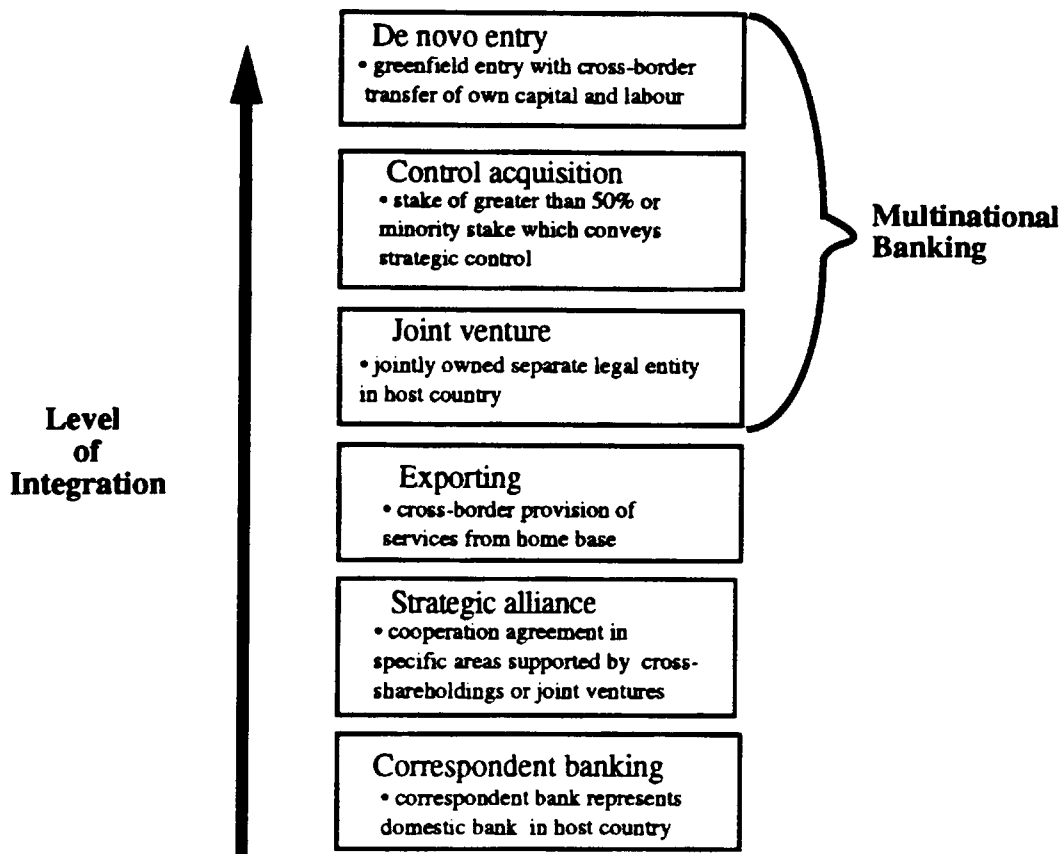
A multinational financial services corporation (MNSC) is defined as a firm which owns branches or subsidiaries in at least one country other than that of its main legal incorporation. There is some doubt about whether a firm which merely owns representative offices in another country may be called 'multinational' and I choose not to include such facilities in our definition, since representative offices merely serve a liaison function for the parent firm but cannot actively operate in the host market.

Cross-border *entry* is defined as a dynamic rather than a static concept where a firm follows the strategic objective of transacting with economic agents in the host country. Cross-border entry therefore has a wider scope than just aiming to become a MNSC, as it is not limited to acquiring or setting up a branch or subsidiary. A firm may choose other vehicles to enter a foreign market such as cross-border provision of services or a joint venture or strategic alliance with a firm in the host market or another foreign firm, aimed at entering or increasing the presence in the host market. Figure 1.1 summarises the whole range of tools available to a firm wishing to undertake cross-border entry.

¹⁵ Large firms maintain several banking relationships with both domestic and foreign banks in addition to internalising many financial services in in-house banks. Therefore, financial officers in the large corporates have the ability to switch immediately to the bank which offers the best price (see also the discussion of switching costs in chapter 5). As one banker explained in a personal interview, "multinational and large firms calculate with every penny and are able to shift huge amounts from one bank to another just by pushing a few buttons. This market is therefore very international, highly competitive and offers minimal margins".

¹⁶ Reinsurance is a highly international market with few regulatory restrictions. In the EC reinsurance was deregulated as early as 1964 by the EC Reinsurance Directive (64/225/EEC).

Figure 1.1: Means of cross-border entry in retail financial services



I now give more detailed definitions of the different forms of cross-border entry. *De novo entry* is defined as setting up a branch or subsidiary in a foreign country from scratch. It involves a transfer of capital from the home to the host country.

A *majority acquisition* is characterised by the purchase of more than fifty percent of outstanding share capital which leads to a change in control in the acquired firm. Such a transaction has a cross-border dimension whenever the acquiring firm has its main headquarters incorporated in a different country than those of the acquisition target. Concerning such acquisitions, the definition of a “concentration” of the EC merger control regulation is followed.¹⁷ According to Article 3 (1), a majority acquisition may take two forms:

- a “legal merger” where the acquired company is dissolved and its assets and liabilities are fully transferred to the purchasing party or,

¹⁷ Council Regulation (EEC) No 4064/89 of 21 December 1989 on the control of concentrations between undertakings.

alternatively, the two or more merging companies dissolve to form a single new company;

- a “takeover” where one party gains “direct or indirect control of the whole or parts of one or more other undertakings” through any kind of suitable means such as share or asset purchase, but the acquired company remains in existence.¹⁸

Legal mergers on a cross-border basis are not yet possible, however, as all cross-border transactions must be carried out under one or the other national company law due to the lack of a European cross-border merger option in EC company law (see Jacquemin, 1989, p.14-15).¹⁹ As a result of this, cross-border majority acquisitions always take the form of a takeover of a domestic firm by a foreign institution rather than a transaction between equal partners which leads to potential problems of arousing national or political resentment.^{20 21}

A *joint venture (JV)* is defined as a legally independent entity owned by two or more parent companies which actively influence the corporate policy of the JV. Such a JV can be between two or more foreign banks which set up a company in the target country or between foreign and local firms.

A *strategic alliance* shall be defined as an explicit agreement between at least two banks to co-operate in a range of activities in a foreign host country. Such an agreement may be supported by mutual shareholdings.

Finally, *exporting* refers to cross-border provision of services from the home country rather than serving the customers through a local branch.

¹⁸ For the distinction between a legal merger and a takeover, see also paragraphs 4 and 6 of the explanatory memorandum of the proposed EC directive on takeovers, COM (88) 823; OJ 1989 C64/8.

¹⁹ The merger between the Dutch and Belgium insurance firms AMEV and Groupe Assurances to form Fortis constitutes the only cross-border transaction in financial services so far which could be called a *de facto* though not a legal cross-border merger.

²⁰ An interesting example of the failure of a proposed cross-border merger is that between Belgian Generale Bank and the Dutch Amro Bank. The two banks agreed in February 1988 that they want to create “an indissoluble banking combination with one group management and one strategy/corporate policy” by 1991. In September 1989 these plans were abandoned in favour of a strategic alliance. One of the main reasons for the failure of the cross-border merger was that neither bank was willing to be ‘acquired’ and thus forced to change nationality. In addition, the lack of a European company statute was cited as creating considerable tax and legal problems.

²¹ This problem has led the EC Commission to propose a Directive on cross-border mergers (the Tenth Company Law Directive, COM (84) 727; OJ 1985 C23/11) which aims to establish common rules for cross-border mergers and, in conjunction with the European Company Statute (COM (89)268; OJ 1989 C263/41 and C263/69), is to provide a legal means for setting up a European company under EC law rather than (possibly conflicting) national company laws. Both directives are still pending before the Council of Ministers, however, as there are differing opinions on the degree of worker participation.

2. The evolution of cross-border penetration in EC financial services

Since the process of cross-industry penetration of the insurance and banking sectors is a fairly recent phenomenon, we follow the traditional differentiation of the financial services industry into banking and insurance when discussing the historical evolution of cross-border penetration of European financial services in this section.

2.1. Banking

Foreign penetration of banking in Europe is a comparatively recent phenomenon. While international banking activities can be traced back to the Florentine banking houses in the fourteenth and fifteenth centuries (see Davis and Lewis, 1987, p.216), it was only in the nineteenth century that British banks began to penetrate overseas market on a systematic scale, followed by other European banks.²² The British overseas banks provided a range of banking services in their host countries but focused especially on retail services. Although some of these banks set up branches in international financial centres such as Frankfurt and Paris, their main focus were countries outside Europe, and in particular developing economies and the colonies. Of the 1,286 foreign branches of British banks in 1913, for example, only 21 were established in Europe thus accounting for only 1.6 percent of the total.²³ As Jones (1990a, p.3) notes "foreign penetration of the domestic banking systems of Britain {and} continental Europe ... was virtually non-existent" at the beginning of this century and this situation remained essentially unchanged until the beginning of the 1960s when the first wave of internationalisation of European markets started.

At the beginning of the 1960s, American commercial banks expanded into overseas markets and European banks responded by entering the US market in turn but also by increasing their presence in other European countries. Among the most prominent US entrants were the biggest commercial banks which mostly concentrated their European efforts on wholesale activities. Some banks such as Citicorp, Chase Manhattan or Chemical Bank even entered European retail banking through greenfield establishments and acquisitions. With the exception of Citibank, however, all banks withdrew only a few years later, as they incurred heavy losses in these markets. The move of expanding in Europe was part of a wider trend towards the multinationalisation of US banking. The number of foreign branches and

²² For a more detailed account of the history of multinational banking, see the contributions in Jones (1990a).

²³ See Jones (1990b, p.31). For British institutions the same author notes that they "never made more than a marginal impact in North America, continental Europe or Japan" (1990, p. 36).

subsidiaries of US banks increased from 133 in 1960 to 1,759 in 1986 (Huertas, 1990, p.253). Foreign assets accounted for 14 percent of total US bank assets in 1986, while they stood at only one percent in 1960. The most international of the US commercial banks, Citicorp, had only 70 foreign branches in 1960. This number had increased to 2,135 foreign offices at the end of 1988 with foreign activities accounting for almost half of total revenues and pre-tax earnings.

At the same time, European banks responded to the invasion of US banks by entering the US market, but also by increasing their cross-border entry activities in Europe. The development of European cross-border banking can be exemplified for the case of France: in 1914 domestic banks had around forty foreign offices in Europe (Michalet and Sauviat, 1981). Only ten new offices were added between the wars and an additional eighty-three new foreign offices were newly founded until 1968 worldwide. This fairly slow growth significantly increased in the succeeding decade. In the period from 1968 to 1973 alone, eighty-seven new offices were established and European offices accounted for ten new representative offices, eight new branches and thirteen new subsidiaries (Statistical Releases of the Association Francaise des Banques). Over the next five-year period, the growth rate of foreign offices rose even more dramatically: worldwide, 192 new foreign offices were established, more than twice the number between 1945 and 1968.

British banks took longer to recognise the importance of multinational banking in the industrial countries. With their traditional focus on the former colonies, they had neglected the industrialised countries and were forced to shift attention to these markets in the 1970s. As Jones (1990b, p.54) notes "it was only in the early and mid-1970s ... that British multinational bankers began to recognize that over the last thirty years not only had three major economic powers blocs emerged - the United States, continental Europe and Japan - but that they scarcely owned a single branch in any of them". In the second half of the 1970s and the beginning of the 1980s British banks therefore actively entered these markets to make up for previous neglect.

The most recent entrants into the European markets were the Japanese banks which have continuously increased their presence over the past fifteen years. The late entry of the Japanese banks resulted from restrictions which the Japanese Ministry of Finance imposed on domestic banks where only the Bank of Tokyo was allowed to operate internationally. With the lifting of these restrictions at the beginning of the 1970s, Japanese banks began to enter European markets focusing almost exclusively on wholesale and investment banking. Between 1975 and 1987 the number of branches in Europe increased by 30 percent, while subsidiaries rose tenfold (Dueser, 1990, p.110). By the end of the 1980s, Japanese banks had established a leading position in some areas of international banking such as the Euromarkets.²⁴

²⁴ The cross-border entry activities entry of European, American and Japanese banks are discussed in greater detail in chapter six.

An aggregate picture of multinational banking in the EC is conveyed by the number of foreign banks in different EC countries. These are listed in table 1.2 which illustrates the development over time from 1960 to 1986. Not surprisingly, the UK leads the ranking with London being Europe's main financial centre and thus attracting the highest number of foreign institutions. Foreign-owned banks in the UK account for over sixty percent of total bank assets and they are mostly involved in investment banking and capital market activities. Germany is a close second as Europe's largest economy and the position of foreign banks in Germany is examined below in greater detail. Luxembourg's strong position stems from its special status as a financial centre, due to its favourable tax and bank secrecy regulations. Spain and Italy appear to be underbanked in terms of presence of foreign institutions due to former regulatory restrictions on cross-border entry. Of the 53 foreign institutions in Spain, thirteen had full access to the retail market in 1990.

Table 1.2: Number of foreign banks in ten EC countries from 1960 to 1986

	1960	1970	1980	1986
UK	51	95	214	293
Germany	24	77	213	283
France	33	58	122	152
Luxemb.	3	23	99	110
Belgium	14	26	51	57
Spain	4	4	25	49
Netherl.	1	23	39	42
Italy	1	4	25	36
Greece	2	3	18	19
Denmark	0	0	5	8

Source: OECD (1989, p.147).

Table 1.3 illustrates the dramatic growth of foreign branches and subsidiaries of domestic banks. While in 1960 very few banks possessed an international network, there was a rapid increase in the 1970s and again since 1980. In contrast to the constant or even decreasing number of domestic branches, the number of foreign branches and subsidiaries was still increasing between 1980 and 1986. In some countries international operations account for a substantial proportion of total business activities. In France, for example, activities of foreign branches and subsidiaries accounted for 41.5 percent of total business volume in 1984 (Metais, 1990. p.142).

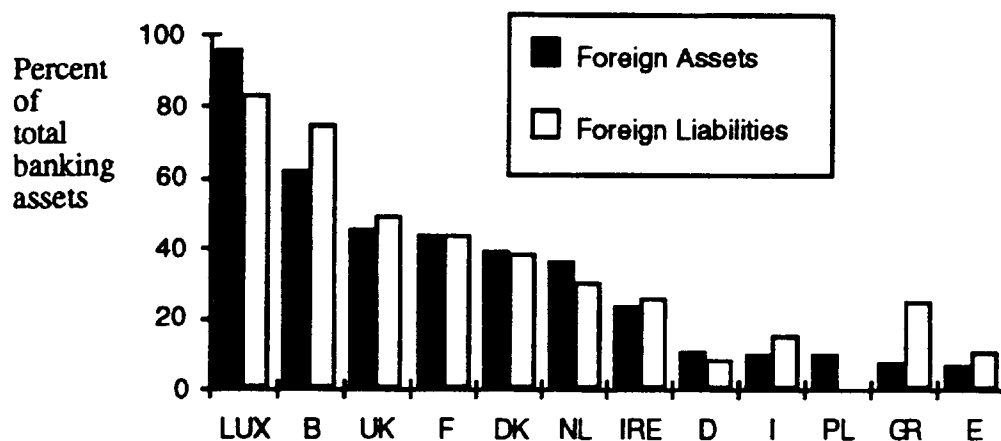
Table 1.3: Number of foreign branches and subsidiaries of domestic banks from 1960 to 1986

	1960	1970	1980	1986
France	n.a.	133	304	455
Ireland	60	84	224	276
Germany	3	8	126	230
Netherl.	3	55	145	170
Spain	5	25	82	136
Italy	17	22	44	75
Denmark	0	0	18	56
Belgium	5	6	14	27

Source: OECD (1989, p.148); Deutsche Bundesbank; France 1968, 1980: Association Francaise des Banques, Statistical Releases.

Figure 1.2 shows aggregate foreign assets and liabilities of commercial banks in the twelve EC countries in 1990. These are expressed as a percentage of total domestic banking assets as recorded by the International Monetary Fund Financial Statistics. Foreign assets and liabilities of domestic banks (including subsidiaries but not branches of foreign banks) provide an indicator of the degree of internationalisation of the country's banking system. It is therefore not surprising that those countries with (former) capital controls, i.e. Spain, Portugal, Greece and Italy have the lowest foreign assets, as domestic banks and residents were not able to freely lend abroad and engage in international banking activities. Germany which has had no capital restrictions is also characterised by a low degree of internationalisation which appears surprising considering the significant export activities in industrial sectors. The most internationalised banking systems are Luxembourg with its large number of subsidiaries of foreign banks, Belgium and the UK with London as the world's most international financial centre.

Figure 1.2: Foreign assets and liabilities of domestic commercial banks in 1990



Data for Italy, France and Belgium are for 1988

Source: own calculation from IMF International Financial Statistics 1991.

We see that there has been a significant multinationalisation process in European banking since the beginning of the 1960s. Intentionally, this was referred to as the 'first' wave of internationalisation which was characterised by cross-border entry activities almost exclusively targeted at wholesale and investment banking activities. Currently, we may be witnessing the second wave of internationalisation in European banking with cross-border entry activities being targeted at new banking markets and in particular the retail market, as broadly defined above. Data on cross-border entry activities in this area since 1986 will be presented in chapter six.

The best statistics on foreign bank representation in any EC country are available for Germany, as provided by the Bundesbank. An analysis of the countries of origin of branches of foreign banks in table 1.4 reveals that the US accounts for the largest number of foreign branches and subsidiaries in 1990, with Japan being a close second. Japanese banks still operate largely through branches, whereas banks from most other countries have established subsidiaries. It is interesting to note that the three countries which are most strongly represented and account for 58 percent of business volume are non-EC members. The largest EC country in terms of business volume is the UK which only accounts for 9 percent of business volume, however.

Table 1.4: Countries of origin of foreign banks in Germany in 1990

Parent country	Number of branches of foreign banks	Business volume (DM billions)	Number of subsidiaries of foreign banks	Business volume (DM billion)
US	18	8.1	18	32.3
Japan	14	25.3	14	5.7
France	2	0.5	8	12.7
UK	6	2.9	5	11.3
Switzerl.	0	0	8	16.4
Netherlands	2	0.3	7	6.8
Italy	7	8.2	2	1.0
other EC countries	14	2.3	7	3.1
rest of the world	31	2.9	12	12.7
Total	94	50.5	81	102.0

Source: own calculations from data in *Die Bank* 7/90.

Of the foreign banks which are represented in Germany in 1990 only two were engaged in retail banking with more than ten branches: these were KKB Bank owned by Citibank with around 300 retail branches and CC-Bank owned jointly by Royal Bank of Scotland and Banco Santander with 36 branches. These will be discussed as case studies in chapter seven. Other foreign banks which offered retail business were mainly aimed at foreign workers in Germany such as the Turkish and Greek banks or were in areas close to the national borders such as French Societe Generale. Three British-owned banks and the subsidiaries of Swiss banks were involved in private banking for high-net wealth customers. None of these banks had more than ten retail branches, however, and are therefore unlikely to have much of an impact on domestic retail banking.

Table 1.5 reports market share data of foreign banks in Germany in 1991 for selected banking segments. Branches of foreign banks account for 1.5 percent of total bank assets and subsidiaries of foreign banks account for 2.6 percent, amounting to a 4.1 percent share of foreign banks in Germany. The market share data show that the overall impact of foreign banks in these aggregate markets has been minimal. A time-series analysis reveals that the market share of foreign banks has not increased for the past five years, but has remained largely constant and even decreased in some areas.

Table 1.5: Market share in 1991 of foreign banks in Germany for selected banking segments

	Branches of foreign banks	Subsidiaries of foreign banks	Total market share of foreign banks
Loans to firms	0.7%	1.8%	2.5%
Loans to personal customers	0.04%	1.6%	1.64%
Loans to public authorities	0.4%	0.6%	1.0%
Loans to other banks	0.7%	1.6%	2.3%
Deposits from firms	0.4%	1.8%	2.2%
Deposits from personal customers	0.02%	1.1%	1.12%
Deposits from public authorities	0.04%	0.3%	0.34%
Deposits from other banks	1.7%	3.4%	5.1%
Securities accounts	0.02%	3.1%	3.12%
Interest rate/currency swaps	2.7%	4.0%	6.7%

Source: Own calculation from monthly report of the Deutsche Bundesbank, August 1991; Statistical Supplement to monthly reports, series 1, no.8; data are for June 1991.

It becomes apparent that foreign banks have a minimal market share in the most typical retail banking areas such as taking domestic deposits or lending to personal customers.²⁵

These data clearly suggest that even fairly disaggregated market share data need to be interpreted cautiously, as they do not necessarily convey a true picture of the relevant market. At any rate, this example underlines the earlier discussed need to differentiate carefully the markets in which banks compete. Aggregate data are unlikely to provide much insight into the actual significance and impact of foreign banks in particular markets.²⁶

²⁵ Foreign banks have the greatest market share with the largest 500 firms. In this market a single firm maintains on average 19 banking relationships and 43 percent of the largest German firms had a banking relationship with a foreign bank in 1990 (Greenwich Associates, 1990). 31 percent included a foreign bank as one of their five "main banks", whereas 14 percent even had a foreign "Hausbank".

²⁶ For example, the "market share" data of Steinherr and Gilibert (1989) which are frequently re-quoted (e.g. Neven, 1990; Hawawini and Rajera, 1990) provide little insight into actual market shares of foreign banks. This results from the fact that their data are calculated as the percentage of foreign banks' assets of total industry assets and thus differentiate neither between retail and wholesale markets, nor between domestic and international activities (such as the Euromarkets). Not surprisingly therefore, foreign banks have a particularly high market share in Luxembourg and the UK which host significant international banking centres which may have little to do with domestic markets. Thus, a typical retail bank customer in the UK may notice little of the fact that 60 percent of total UK banking assets are owned by foreign banks.

2.2. Insurance

Internationalisation in insurance has seen an equally dramatic expansion as in banking. It is interesting to note the differences between the multinationalisation processes between the two sectors, however: whereas cross-border activities in banking were for a long time targeted almost exclusively at the non-retail sector, insurers have expanded also into the retail sector in foreign countries. Some of the largest European insurers have been active in other European countries since the beginning of the century.

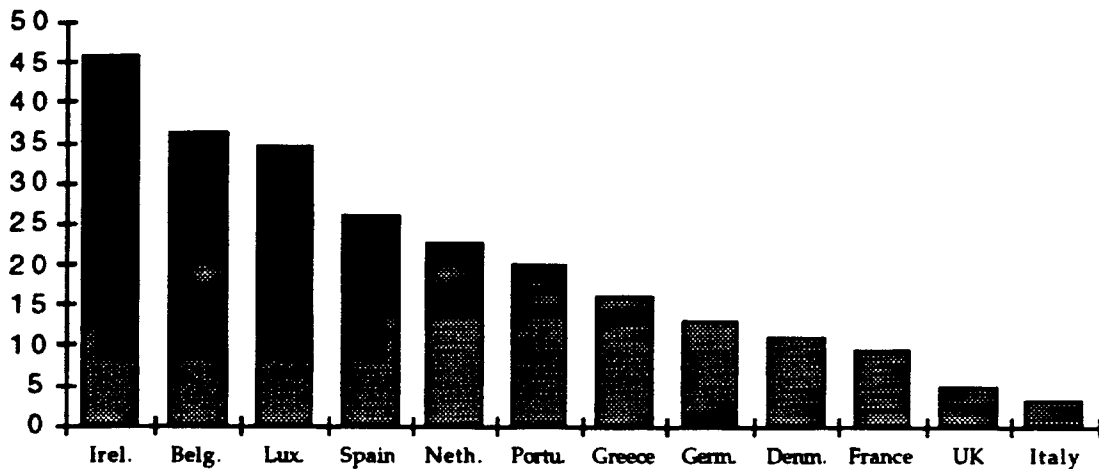
Figure 1. 7 illustrates that the number of foreign insurers has increased in some but not all EC countries in the period from 1968 to 1989.

Table 1. 6: Number of foreign insurers in ten EC countries from 1968 to 1989

	1968	1982	1989
UK	134	170	143
France	206	168	147
Germany	47	116	145
Italy	48	49	n.a.
Netherl.	302	157	152
Denmark	71	65	n.a.
Belgium	304	147	n.a.
Greece	65	83	n.a.

Source: based on direct contacts with Swiss Re, several national sources.

Figure 1.3 presents the market shares of foreign insurers in the EC countries in 1986. These are calculated as the proportion of total domestic premium income accounted for by foreign insurers. Market share of foreign insurers is greatest in Ireland, where a number of companies are owned by British insurers. It is interesting to note that the UK which has the most open and unregulated insurance sector also has the second-lowest market share of foreign firms. This shows that the extent of foreign penetration does not alone depend on regulatory barriers to cross-border entry.

Figure 1.3: Market share of foreign insurers in the EC countries in 1986

Source: Sigma, 2/1989; OECD, Statistics on Insurance, 1988; own calculations.

Some of the largest EC insurers are also the most internationalised: Italy's Generali, for example, derives more than 60 percent of its premium income from foreign operations, whereas AXA receives one third of its income from abroad. Half of UAP's assets are based abroad of which 90 percent are in Europe. Similarly, Allianz by now has almost half of its assets based outside Germany. Unlike in the banking sector, all of these insurers have the majority of their foreign activities in the retail sector rather than in the large corporate market. As an example of the internationalisation process in insurance over time, I discuss the development of Allianz' cross-border entry activities in chapter eight.

Furthermore, also unlike in the banking sector there have been several large-scale cross-border acquisitions in the insurance industry which were targeted at some of the largest domestic institutions. These include, for example, the 1989 acquisition of Germany's second-largest non-life insurer, Colonia, by the French Groupe Victoire. In the Netherlands, UK's Commercial Union acquired Delta Lloyd as early as 1973, the third-largest insurer. Similarly, in Italy the second-largest insurer RAS was acquired by Germany's Allianz. In most EC countries we find at least a few foreign insurers among the largest 15 national insurance firms. This contrasts with the banking sector where there are virtually no foreign banks among the largest domestic institutions. Thus, even though foreign firms in insurance still play a limited role compared to some other service and manufacturing industries, they account for a significantly greater market share in retail financial services than foreign banks which have so far focused mainly on wholesale activities in their international expansion strategies. I will discuss reasons for this difference in the third and fourth chapters, where a theory of cross-border entry is developed and possible barriers to cross-border entry will

be discussed. In chapter seven and eight individual case studies of cross-border entry activities are analysed.

Similarly to the banking sector, the best statistics on the significance and market share of foreign insurers in a domestic market are available for Germany as provided by the Supervisory Office for Insurance. Table 1.9 provides an analysis of the countries of origin and the respective market shares of foreign insurers which operated in Germany in 1989.

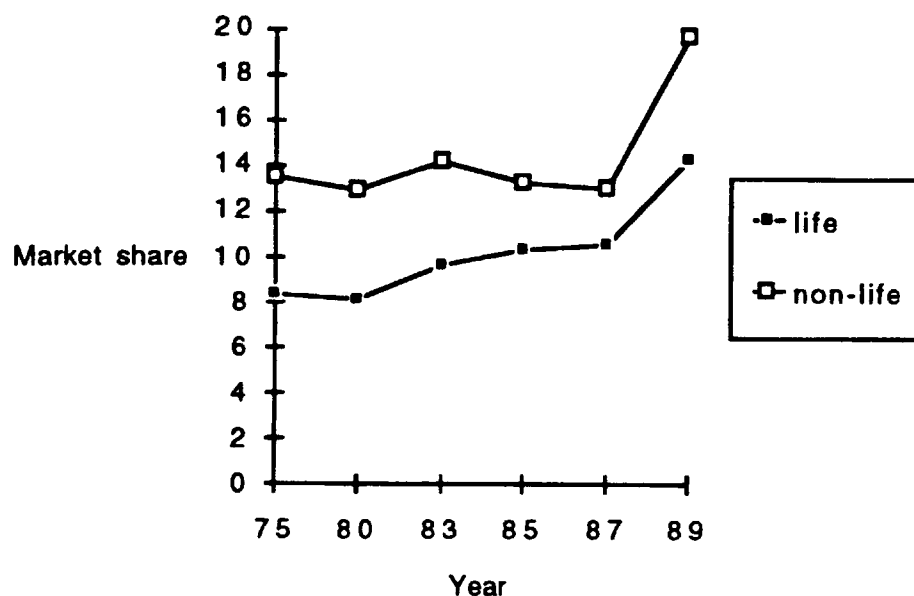
Table 1.7: Countries of origin and market shares of foreign insurers in Germany in 1989

Parent country	Number of foreign firms in life	Market share	Number of foreign firms in non-life	Market share	Total number of foreign firms	Total market share
UK	4	1.3	35	2.8	39	1.9
Switzerland	12	7.7	26	7.9	38	8.7
France	3	0.1	19	0.5	22	0.3
Netherl.	4	4.6	8	6.6	12	5.1
US	2	0.1	8	0.5	10	0.3
Italy	2	0.5	5	0.1	7	0.2
other EC countries	0	0	7	2.3	7	2.3
rest of the world	0	0	7	2.9	7	2.9
Total	27	14.4	115	19.8	142	17.3

Source: German Supervisory Office for Insurance, Annual Report 1990.

Figure 1.3 shows the development of market shares of foreign insurers from 1975 to 1989. It becomes obvious that foreign firms in both life and non-life have substantially increased their stakes in the German market, especially since 1987. In particular, in comparison to the banking sector foreign insurers in Germany have a significantly higher market share. This is despite the fact that regulatory barriers in the German insurance market are probably highest in the EC, while there are no official barriers to foreign entry in the banking sector. This shows that entry depends not just on the lack of regulatory entry barriers.

Figure 1.4: Development of market shares of foreign insurers in Germany from 1975 to 1989



Source: German Supervisory Office for Insurance, Annual Report 1990.

Unfortunately, similarly detailed data about the market share of foreign insurers are not available for the other EC countries. It appears, however, that foreign insurers have a significantly greater market share in the retail financial services than foreign banks.

3. Conclusions

This first chapter has introduced the basic definitions of the financial services industry and markets. Concerning a possible industry definition, it was noted that due to increasing decompartmentalisation an institutional classification no longer provides a sufficient basis for evaluating financial services competition in the retail sector. It was therefore decided to follow a market-oriented definition where retail financial services are broadly defined as comprising the mass personal and small business market, high net worth individuals and mid-sized corporates. Multinational financial services corporations are defined as firms operating in at least one country other than that of their main legal incorporation through means of branches or subsidiaries. Finally, cross-border entry is viewed as a dynamic concept in this study where a firm follows the strategic objective of expanding operations to foreign markets through a range of possible entry vehicles ranging from de novo entry over acquisitions, strategic alliances, joint ventures or exporting.

A brief overview of the historical evolution of cross-border banking in Europe has shown that significant foreign penetration started only around the beginning of the 1960s and was predominantly in the area of wholesale and investment banking. It remains to be seen whether the second wave of internationalisation in European banking which focuses on retail banking markets will be of equal significance.

In insurance services there has been an equally significant multinationalisation process. In contrast to the banking sector, however, this has also concerned the retail financial services sector. Although data are scarce, foreign insurers seem to have a significantly greater market share in retail financial services than foreign banks.

I develop a theory of cross-border entry in chapter three to explain such differences in the significance of foreign financial services firms and analyse barriers to cross-border entry in chapter four. Before proceeding to these topics, the next chapter analyses the changes in the regulatory framework of cross-border entry in the EC.

Chapter Two: The Regulatory Environment of Cross-Border Entry in EC Retail Financial Services

Financial markets in the EC were for a long time separated by restrictions on cross-border capital movements as well as rigid regulations which frequently had the effect of protecting the domestic industry from foreign competition. Regulatory entry barriers were erected with the legitimation of protecting depositors or policyholders and preserving monetary and financial stability. This linkage between entry barriers and regulatory objectives was recognised in the Cecchini-report which states that:¹

“A common feature of the financial ... service branches is that the regulatory functions of government, while aiming primarily at prudential or safety objectives, also often tend to limit entry into the market as a side effect ... the general objective of European market integration ... is, therefore, to separate out far more clearly the setting and supervision of prudential and safety standards from the issue of market entry”

Due to the comparatively high degree of protection of the domestic financial services industries, it comes as no surprise that this sector has been singled out as a prime target for liberalisation in the context of the 1992 programme. In fact, increasing competition due to cross-border entry in financial services is predicted to yield one third of the total projected increase in annual European GDP of 4.5%.² This estimate underlines the significance of the financial services sector relative to other industries in the internal market programme.

Since many issues surrounding cross-border entry are related to regulation, it is indispensable to start from first principles and analyse the economic rationale for financial services regulation. The next section analyses financial services regulation as a response to market failures and critically assesses the resulting need for public intervention. Rather than giving a comprehensive account of all the issues involved, however, it provides an analysis of the questions most relevant to regulatory changes in the context of the internal market programme and their relationship to cross-

¹ See Cecchini-Report, *European Economy*, 35, 1988, p. 86.

² *ibid.* (p. 161).

border entry.³ In the second section, recent regulatory changes on the EC level are analysed, focusing on the liberalisation of capital movements and the implications of the recent EC Banking and Insurance Directives. Finally, the third section analyses the question whether increased cross-border entry will lead to competitive deregulation between European regulators.

1. Public regulation of retail financial services as a response to market failures

Financial services are usually subjected to a much higher degree of public regulation than any other service industry, even though the 1980s have witnessed a series of deregulatory moves in most Western countries⁴ and the internal European market programme for financial services has been described as a gigantic exercise in deregulation. Yet, despite these deregulatory moves there is widespread agreement in the economic and legal literature that some form of public regulation must be retained in order to achieve a smooth and efficient functioning of the financial services sector. For example, while industrial firm failures are usually considered the result of a natural selection process in a market economy which do not require public intervention, financial services firm failures are usually publicly regulated.⁵ What then is the economic rationale for public intervention in the financial services market and what is 'special' about financial services firms that requires a different regulatory regime from other industries?

Two forms of 'market failures' are usually identified to justify the special regulatory attention given to financial institutions: firstly, informational asymmetries between financial services firms and customers necessitating measures to ensure consumer protection, and secondly, the possibility of systemic runs or 'contagion' in the case of individual firm failures inflicting negative external effects on the economy.⁶ Before discussing this

³ For a more complete discussion of the general issues involved in banking regulation see, for example, Goodhart (1989, chapters 8 and 9) or Baltensperger and Dermine (1987). For a discussion of regulatory issues in insurance, see, for example, McDowell (1989).

⁴ See, for example, Mayer (1990) for an analysis of the deregulatory moves in the UK, Vives (1990) for the case of Spain, Melitz (1990) for France, or Santomero (1990) for the US.

⁵ As the recent failure of the Bank of New England or the crisis of the Savings and Loan Associations in the US illustrate, public authorities prefer to 'bail out' failing institutions rather than subjecting them to bankruptcy procedures like in other industries. See White (1989) and Kane (1989) for an analysis of the recent crisis in S & Ls.

⁶ Both arguments are microeconomic in perspective. There have also been macroeconomic considerations put forward to justify banking regulation such as the need for a minimum reserve ratio to effectively pursue monetary policy. In their survey of such macroeconomic considerations Baltensperger and Dermine (1987, p. 70) conclude, however, that "regulatory decisions should be based not on macroeconomic stability considerations ... but rather on microeconomic efficiency grounds".

'conventional' justification of financial services regulation, we address the agency problems which arise between customers, owners and management and which lie at the heart of market failures in financial services.

1.1. The basic problem: agency conflicts between owners, managers and customers

Whenever there is separation of ownership and control in financial services or industrial firms, agency problems may arise due to different maximands and asymmetric information.⁷ In the parlance of principal-agent theory,⁸ the principals (owners) engage in a contract with the agent (management), delegating to them the right to lead day-to-day activities of the firm.

In the case of financial intermediaries, however, managers act not only as agents for the ultimate owners (i.e. shareholders or government), but concurrently as agents for depositors or policyholders (called 'customers' henceforth). Thus, they are engaged in two separate agency relationships with two principals and associated problems of incentive incompatibility.

It may happen, therefore, that the underlying preference orderings of owners, customers and managers diverge due to different degrees of risk-aversion, for example. Owners and customers both want to induce the agent to adopt their preferences (maximising the value of the firm or following a prudent portfolio strategy), by setting up an appropriate incentive and monitoring system. Accordingly, two types of failures may arise: first, it may be impossible to design an optimal incentive scheme to ensure that the agent acts in the principals' interest due to goal incompatibilities between customers, owners and managers.⁹ Second, complete monitoring may be

⁷ In his *Wealth of Nations* Adam Smith may have been the first observant of these agency problems: "the directors ... being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own ... negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company" (1776, p.700). The modern literature of this problem dates back at least to the seminal book by Berle and Means (1932).

⁸ For the 'classic' application of positive principal-agent theory to the theory of the firm, see Jensen and Meckling (1976).

⁹ In particular, there is a problem of asymmetric information between principals and agents: Holmstrom and Tirole (1989, p.89) note that "the presence of private information (on the part of managers) ... prevents inexpensive contractual solutions and provides a potential opportunity for the manager to pursue his own objectives rather than the owner's". Such asymmetric information exists also between managers and depositors. This is a problem of *adverse selection*.

prohibitively costly and asymmetric information between principals and agents may prevent fully effective monitoring altogether.¹⁰

Goal incompatibilities may be a result of differences in risk attitudes of agents and principals: portfolio theory illustrates the advantages of diversifying a portfolio of risky assets. The Capital Asset Pricing Model (CAPM), for instance, derives the return of any single risky asset as the sum of a firm-specific component and a 'systematic' or non-diversifiable component associated with general market conditions. Once shareholders have diversified their portfolios, they are largely immune against firm-specific risk and therefore risk-neutral with respect to any particular firm. Managers, however, are unable to diversify their employment and are therefore overinvested in the firm they serve.¹¹ A similar situation applies to customers who are unlikely to diversify their deposits or policies over a range of institutions due to increasing transaction costs which outweigh the benefit of lower risk of insolvency of the financial services firm.¹² One may therefore hypothesise that shareholders are least and depositors or policy-holders most risk-averse with managers somewhere inbetween, but more likely to be risk-averse.¹³

To illustrate these different attitudes towards risk consider the choice between three asset management strategies as illustrated in Figure 2.1. Suppose $h(X)$ is the distribution function of a low-risk strategy (e.g. a mutual

¹⁰ When ordinary share capital is widely dispersed, there is a large number of depositors and management control is costly, monitoring may become a public good: if a single shareholder or depositor decided to monitor management she would incur the full costs but receive only a fraction of the pay-off of her activity. Since other shareholders and depositors cannot be excluded from the benefit of the resulting higher share price or lower probability of insolvency, they are able to free-ride and therefore no individual principal has an incentive to monitor. Similarly for a *coalition* of principals: if such a coalition is sufficiently large, the expected benefits of monitoring may exceed expected costs. However, the coalition is likely to be inherently unstable because it again faces a free-rider problem: if it is believed that the coalition will continue to monitor management, it is individually rational to exit the coalition, thereby avoiding the costs but continuing to enjoy the benefits. As a result, monitoring by principals will be sub-optimally low due to this moral hazard problem.

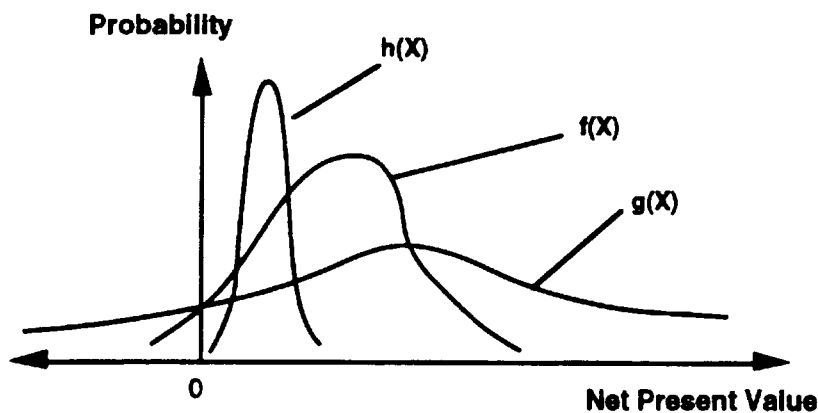
¹¹ In particular, managers' mobility may be limited due to development of *firm-specific human capital* (Williamson, 1984). In addition, stock option schemes intended to align managers' with shareholders' incentives (Demsetz, 1983) tend to exacerbate the overinvestment in the firm.

¹² The effect of 'institutional diversification' on risk reduction is likely to be marginal, since the probability of any individual firm failure is fairly small. Furthermore, in the presence of deposit insurance or lender-of-last resort facilities the incentive to diversify is non-existent (see below). Transaction costs of maintaining several bank relationships, on the other hand, may be substantial.

¹³ Still, bank managers may be considerably less risk-averse than depositors would like them to be, as is illustrated in the recent S & L crisis in the US. Moral hazard problems increased considerably due to the existence of a comprehensive deposit insurance scheme.

fund) with X being the net present value, $f(X)$ is a higher return but also higher risk alternative (such as loans to an enterprise), whereas $g(X)$ is the strategy with the highest risk but also the highest return (e.g. real estate, junk bonds). Thus, we have $E\{g(X)\} > E\{f(X)\} > E\{h(X)\}$ and $var\{g(x)\} > var\{f(x)\} > var\{h(x)\}$ with $E\{.\}$ being the expectation operator and $var\{.\}$ the variance.

Figure 2.1: Choice between risky asset management strategies



Suppose that managers, shareholders and customers all have different degrees of risk aversion. A risk-averse management may easily prefer $f(x)$ over distribution $g(x)$ because it has a lower probability of a negative net present value, even though the expected net present value is lower. Customers may be even more risk-averse and prefer the most conservative asset management strategy $h(X)$, since it has the lowest probability of default. Well-diversified shareholders being risk-neutral, however, would prefer management to choose $g(X)$ as it maximises the value of the firm.

In summary, therefore, financial services firm managers, in particular when performing a fiduciary function for depositors, have the difficult task of reconciling possibly incompatible objectives of customers and shareholders with respect to risk management, while at the same time maximising their own objective function. This is the most significant characteristic which distinguishes the financial services sector from most other industries.

Both 'conventional' economic justifications for financial services regulation can be stated in this agency perspective: the next section analyses the issue of asymmetric information which lies at the heart of the monitoring problem between customers and managers.¹⁴ Section 1.3 then analyses possible negative externalities which may result if management has pursued an overly risky strategy which resulted in insolvency.

¹⁴ The monitoring problem between *shareholders* and management is discussed in greater detail in chapter four in the section on the corporate control market.

1.2. Informational asymmetries

Informational asymmetries result from financial services being mostly 'experience' goods where quality can only be determined after purchase (Shapiro, 1983) or even 'credence' goods where quality may never be determinable even *ex post* (see Nelson, 1970; Darby and Karni, 1973). Informational asymmetries are of two kinds: first, depositors and policyholders have incomplete information on the asset quality of the firm. Second, financial services products may be so complex that retail customers are unable to assess the quality of the particular service offered. Each of these is discussed in turn.

As financial services firms hold private information on the quality and riskiness of their assets, it is difficult for depositors and insured to assess whether it manages its funds in a prudent way.¹⁵ Full disclosure of all private information which the firm holds would eliminate asymmetric information, but is not feasible both for competitive reasons, as well as on grounds of protecting inside information given to the firm by its loan applicants. Asymmetric information also results from customers being unable *ex ante* to assess the quality of the services provided by the firm, since this would require specialised information. For example, in insurance services claims processing efficiency is unlikely to be known before actual liabilities arise. The possibility of 'repeat purchases', which usually constitutes a natural incentive for firms not to provide inferior services,¹⁶ may be insufficient protection in the case of single large financial transactions such as life insurance or mortgages. Leland (1979) presents a model of a market with asymmetric information where equilibrium obtains at sub-optimal quality standards due to the 'lemon-problem'. In such a case, it may be welfare-enhancing to improve on the market outcome through public regulation, such as setting minimum quality standards through the licensing of banks and insurers and monitoring activities.

Informational asymmetries concerning the quality of firm assets may be alleviated by private rating agencies which assess the prudence and risk of firms' asset management strategies.¹⁷ Compared to private depositors, such

¹⁵ Such informational asymmetries are aggravated by the recent increase in the use of off-balance sheet activities such as options, swaps or credit lines which do not appear in published accounts and are therefore difficult to monitor for outside observers.

¹⁶ Repeat purchases reduce moral hazard problems if they induce firms to establish a reputation for providing high-quality services (see, for example, Milgrom and Roberts, 1982, 1986). As building up a reputation requires time, however, customers may be unable to discriminate between high and low-quality providers in the first periods (Diamond, 1989).

¹⁷ Such as Moody's and Standard and Poor's ratings of firms' bond issues ranging from AAA (Aaa for Moody's) for the least risky firms over C-rated bonds which are in the junk-bond category to D-ratings for firms which experience serious financial difficulties. The rating has significant implications for a firm's funding costs: those institutions which have lower ratings,

agencies enjoy economies of scale in assessing firms' risks and solvency, but still face incomplete information about the firm's business policies. Thus, while these agencies reduce informational asymmetries they do not eliminate the problem and one may therefore argue that public intervention is required to lay down rules to ensure prudent asset management strategies.

The second main source of informational asymmetries stems from the complexity of the financial product which may be such that it requires expert know-how in order to assess the quality and type of the product. This applies especially to insurance products where as McDowell (1989, p.41) notes "policies have become so technical, so long, and so complex that only insurance specialists can understand them". This complexity of insurance contracts may justify regulatory intervention to standardise the contract format at least to some extent in order to ensure comparability of products and services.

Let us note at this stage that neither type of informational asymmetry is unique to financial services, but applies equally to other services such as the medical, legal or accounting professions. It is therefore not evident that the regulation of financial services should be any different from that of other services where public regulation is often complemented and even substituted by self-regulation.¹⁸ One could argue that in the presence of informational asymmetries, service providers have a natural incentive to engage in self-regulation through formation of 'clubs' setting minimum quality levels and penalising 'black sheep' who want to free-ride on the good reputation thus established. At the same time, however, clubs may set up anti-competitive practises such as erecting entry barriers unjustifiable on prudential grounds or collusive behaviour on prices (see Shaked and Sutton, 1981, 1982). In Leland's model (1979), for example, self-regulation may lead to quality standards being set too high. Mayer and Neven (1991) show that self-regulation is less effective for small clubs of firms whose reputation is not (yet) well-established. Thus, under these circumstances it may be preferable to have statutory rather than self-regulation.

1.3. Negative externalities resulting from insolvencies

A second argument for public regulation of financial services is that insolvencies may inflict significant negative externalities on agents. In addition, firm failures may spark off a crisis of confidence in the financial

such as the American banks, suffer a serious competitive disadvantage, as their funding costs in the capital market increase proportionately.

¹⁸ Only in the UK do we currently find some degree of self-regulation in particular in investment services.

system and lead to a contagious run of depositors or policyholders.¹⁹ I discuss each of these arguments in turn.

In contrast to the industrial sector where bankruptcy is seen to be the result of a natural process of weeding out weak and badly managed companies, failures in the financial services sector are usually considered to require public intervention. This stems from the fact that outright failures in the financial services sector affect not only owners, creditors and employees as in the industrial sector but also depositors and policyholders. Thus, if a bank or a life insurer become insolvent depositors and policyholders may lose part of their lifetime savings. Similarly, if a general insurer fails both first-party and third-party claimants may face significant financial calamities.²⁰ Outright bankruptcy is therefore considered to be undesirable from an equity point of view.

Next consider the problem of contagious runs which may inflict losses not only on depositors and policyholders who are 'last in the queue', but also on the productive efficiency of the economy, as financial services firms are forced to call in long-term loans, forcing the firms to which they have lent to sell possibly illiquid assets at a loss, disrupting otherwise profitable production. While runs have so far been exclusively modelled in the banking context, they may also occur in the life insurance sector.²¹ This is due to the fact that the fundamental issues of runs are similar for banks and life insurers.

The possibility of runs in the banking context was formalised by Diamond and Dybvig (1983) who construct a three-period model in which banks transform illiquid assets into liquid liabilities. They show that bank runs can emerge as 'sun spot' equilibria if, for example, agents believe that a bank's assets do not cover its deposits.²² This is due to the fact that demand deposits are not 'earmarked', but are paid back according to a sequential

¹⁹ Bank runs were common during the Great Depression; see Bernanke (1983, esp. p.258-61) and Kindleberger (1989) who also gives a broad account of other financial crises.

²⁰ See Wenk (1987) for an analysis of the causes, effects and regulatory approaches to insurer insolvency.

²¹ As the recent example of two life insurers in California illustrates: a run by policyholders of the First Capital Life Insurance Company of California set in, induced by the failure of Executive Life of California. This example has the typical characteristic of a contagious run: First Capital Life, although technically solvent at the time, had an equally high proportion of assets invested in junk bonds as Executive Life. After the deterioration of the junk bond market policyholders concluded that First Capital Life may soon be in similar problems as the failed Executive Life.

²² Jacklin and Bhattacharya (1988) construct a model where 'information-based' bank runs can emerge due to private information about bank returns on the part of depositors. Postlewaite and Vives (1987) scrutinise strategic expectations about behaviour of other depositors as a possible trigger of runs.

distribution rule. Hence, those 'last in the queue' have every reason to expect that their deposits will not be repaid if the initial assumption of insufficient total bank assets turns out to be correct.

As Diamond and Dybvig's model contains only one bank, however, it is unable to explain contagion, i.e. the spreading of massive deposit withdrawals from one particular institution to other banks or life insurers, as doubts about these other firm's solvency situation spreads among depositors or policyholders. Contagion may occur as a result of irrational 'panic', as depositors are affected by a general decline of confidence in the solvency of the financial services institutions. The failure of a bank or an insurer with a high risk exposure in a particular market such as real estate or junk bonds, for example, may therefore be interpreted as a signal of difficulties looming ahead for other firms also active in the market concerned.²³

As the value of the firm's assets plunges, possibly to a level insufficient to cover all liabilities, it may be a rational strategy for depositors and policyholders to transfer their funds from threatened institutions to firms with a less risky asset portfolio. This is the 'flight towards safety' which can frequently be observed in times of increased firm failures.²⁴ While such asset transfers do not jeopardise the entire financial system, they may still inflict real costs on the economy, as firms which are affected by a run have to call in loans and these may not be immediately replaced by loans on similar terms from other financial institutions due to transaction costs. In addition, those depositors and policyholders who are last in the queue may suffer significant financial losses.

Moreover, as Bernanke (1983) notes, the reduced efficiency of financial intermediation during a time of runs may lead to a credit crunch, with its associated contractionary effects on output. Without the provision of credit by banks, an economy is likely to contract. Bank lending conveys significant positive external effects on the economy which are not captured by either the borrower or the lender. Runs may therefore inflict substantial negative externalities on the economy spreading far beyond the financial sector and therefore constitute a main economic rationale for public regulatory intervention which aims at preventing such runs.

²³ Thus, the failure of the Bank of New England, for example, which had a substantial stake in the troubled real estate market in the north-east of the United States, may be interpreted as a signal of solvency problems ahead for banks with a similar involvement in that market.

²⁴ Kaufman (1988) argues that this threat of transferring funds from high-risk to lower-risk firms serves as a disciplining device on financial services managers to pursue prudent asset portfolio strategies. However, informational asymmetries between managers and depositors or policyholders make this constraint less binding.

2. The changing regulatory approach to financial services in the EC

2.1. Liberalisation of capital movements

The abolition of remaining restrictions on the free movement of capital is an obvious prerequisite for an internal market in financial services, since agents must have free choice to transfer capital internationally. The legal concept of 'movement of capital' hereby refers to the transfer of financial assets across national borders or between citizens of different nationalities, *without* an accompanying exchange of a good or service.²⁵ Liberalisation of capital movements was already envisaged in Article 67(1) of the Treaty of Rome, which also included 'safeguard clauses' such as Articles 73(2), 108 and 109, however, enabling Member States to restrict full liberalisation in the case of capital market or balance of payments difficulties. These clauses constituted a frequently used escape from the 1960 and 1962 EC Directives²⁶ aimed at implementing the provisions of the Treaty.²⁷ Thus, progress on the liberalisation of capital movements had been slow up to 1985 when only Germany, Belgium, Luxembourg, the Netherlands and the UK had a completely open capital market.

Further liberalisation measures concerning the free movement of capital were therefore targeted in the Commission's White Paper with the major legislative measure being the Directive on 'Complete Liberalisation of Capital Movements'²⁸ which aims to abolish most remaining exchange controls by 1992.²⁹ Such complete liberalisation of capital flows has obvious macroeconomic implications for the effectiveness of domestic monetary and fiscal policies.³⁰ I focus here on the microeconomic impact, in particular concerning financial services.

²⁵ Capital movements which accompany such exchanges are referred to as 'payments' in the sense of Article 106(1) of the Treaty of Rome. Current payments related to the movement of capital, e.g. concerning interest or dividend, are captured by Article 67(2) which fully derestricts these transactions.

²⁶ OJL, 12.7. 1960 and OJL, 22.1. 1963.

²⁷ In particular, they enabled countries like France, Italy, or Belgium to maintain exchange controls (such controls were abolished in 1979 in the UK).

²⁸ OJL 178, 8.7. 1988.

²⁹ Greece, Ireland, Portugal and Spain are given until 1992 or 1995 to implement the directive.

³⁰ See, for example, Padoa-Schioppa (1987), p. 72-80.

2.1.1. The impact of liberalising capital flows on financial services competition: theoretical considerations

With free capital flows both personal and corporate customers have an increased choice when diversifying their portfolio internationally or purchasing foreign financial services products. In particular, customers who were previously confined to deposit their assets within national boundaries now have the possibility to invest in other countries, for example by opening savings and fund management accounts³¹ or purchasing life insurance abroad.

Suppose free capital flows are introduced in a country which was previously characterised by restrictions on capital outflows. Investors are then given the opportunity to move capital abroad if they wish.

Consider first the implications in terms of international portfolio diversification which can be modelled in the Markowitz (1959) mean-variance framework: agents assess risks and returns of investment opportunities abroad and maximise expected utility.³² It follows from one of the basic principles of portfolio theory that international diversification will be more effective the less correlated are risks and returns of assets. Two characteristics distinguish international diversification from a standard portfolio problem: first, agents have to form expectations about the rate of change in exchange rates. The variability of exchange rates is reduced, however, through the European exchange rate mechanism (ERM) which sets upper and lower limits on the maximum exchange rate fluctuations (2.5% and 6% respectively). Second, international investment may involve higher transaction costs than domestic investment (e.g. monitoring and communication costs). Such transaction costs may be a significant deterrent to investing abroad, reducing the expected return. They include in particular higher search and communication expenses and limited accessibility if the foreign firm has no domestic presence. Such transaction costs are continuously lowered by technological advances, however, facilitating cross-border communication and accessibility. In addition, market opportunities open up for brokerage firms specialised in international investment, performing the role of financial intermediaries in reducing transaction costs. Thus, while exchange rate fluctuations and transaction costs may reduce the

³¹ This was prohibited in countries such as France, Italy, or Spain where residents were not allowed to open accounts abroad.

³² The benefits of international portfolio diversification for reducing risk at a constant return were first demonstrated by Levy and Sarnat (1970). Hawawini and Jacquillat (1990) examine the benefits of diversification for the case of European equities, calculating correlation coefficients for European stock markets, explicitly taking into account foreign-exchange risk. As the correlation between European markets on the one hand, and share price movements and exchange rates on the other hand is fairly low, they conclude that diversification across European equity markets results in a reduction of risk at constant returns.

expected return of international assets, they are unlikely to absorb completely the benefit of risk reduction through international diversification.

In addition to being able to reduce portfolio risk, agents will be able to invest in assets and products abroad which may not be available in the same form in their home country (e.g. mutual funds, unit-linked life insurance) either due to regulatory restrictions or lack of competition between domestic financial services firms. Domestic agents may also be able to circumvent tax regulations by investing abroad.

With free capital flows, private and corporate customers will seek loans where capital costs are lowest. Banks from countries with former capital restrictions may therefore be able to expand their international lending activities. Similarly, insurers will be able to expand activities and invest in foreign assets.

As domestic residents are given the opportunity to expand their portfolios to include foreign assets, domestic financial services firms are forced to expand their coverage of international markets to provide intermediation services and reduce transaction costs for customers who invest internationally. In addition, as banks are given the opportunity to lend to firms and residents in foreign countries, new market opportunities open up abroad.

At the same time, foreign financial services firms from countries which have had free capital flows for some time may gain domestic market share in the country which just abolished capital flow restrictions. This may result from a competitive advantage over domestic firms due to greater experience in international portfolio management and lending, resulting from accumulated know-how and learning effects,³³ an established reputation among customers and a greater international network.³⁴

Thus, while domestic financial services firms become more international in their coverage by entering foreign markets, foreign firms are likely to enter the domestic market. Free capital flows are therefore the *conditio sine qua non* for this mutual cross-border penetration process in European financial services industries.

³³ The first economic analysis of learning effects is that by Arrow (1962). The impact of learning by doing on strategic competition is analysed by Spence (1981), Fudenberg and Tirole (1983) and Stokey (1986). Dasgupta and Stiglitz (1988) show that the concept goes back to Aristotle.

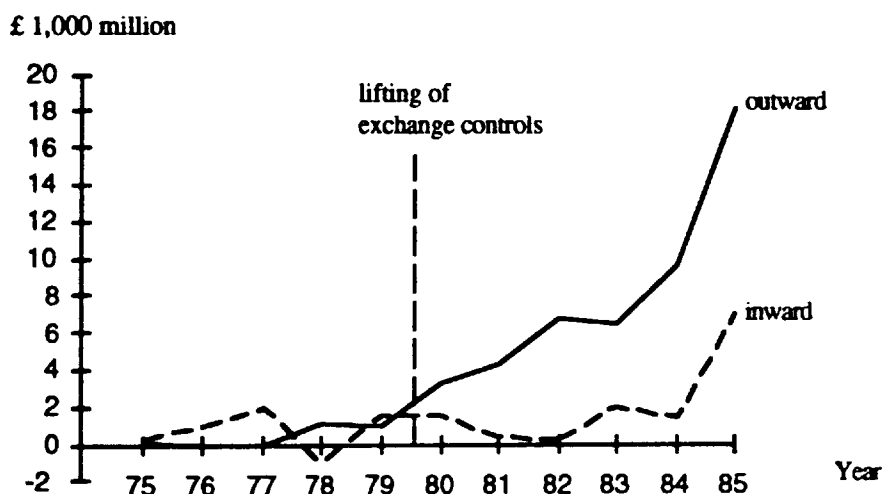
³⁴ Indeed, as was discussed in chapter one, banks from countries with former capital flow restrictions such as Italy and Spain have a smaller international network than banks from countries with free capital flows.

2.1.2. Abolishing UK exchange controls in 1979: an application of the theory

What are the actual effects of lifting capital flow restrictions on cross-border movements of deposits and loans? This question is analysed for the case of the UK where exchange controls were progressively abolished from June to October 1979.³⁵ The controls applied to direct and portfolio foreign investment, as well as imposing restrictions on residents to hold foreign currency deposits and prohibiting financial services firms to undertake overseas sterling lending unrelated to UK trade.³⁶

With respect to portfolio investment, the controls prohibited residents to acquire foreign exchange for international investment purposes, except when investing proceeds from the sale of foreign securities or borrowing from overseas. Figure 2.2 illustrates the impact of lifting these controls on portfolio investment flows.

Figure 2.2: Flows of portfolio investment in the UK from 1975-85



Source: UK Central Statistical Office, Balance of Payments Pink Book 1986.

Outward flows increased significantly leading to a large net outflow, as inward investment rose only slightly. In 1979 outward flows were £0.9 billion with a net inflow of capital of £0.6 billion. In 1985 these figures had changed significantly: outward portfolio investment stood at £18.2 billion leading to

³⁵ This case study focuses on the effects of the abolition of controls on portfolio investment and bank lending. For a more complete coverage of the macroeconomic issues involved, see in particular Bank of England (1981) and Artis (1988) on which part of our account is based.

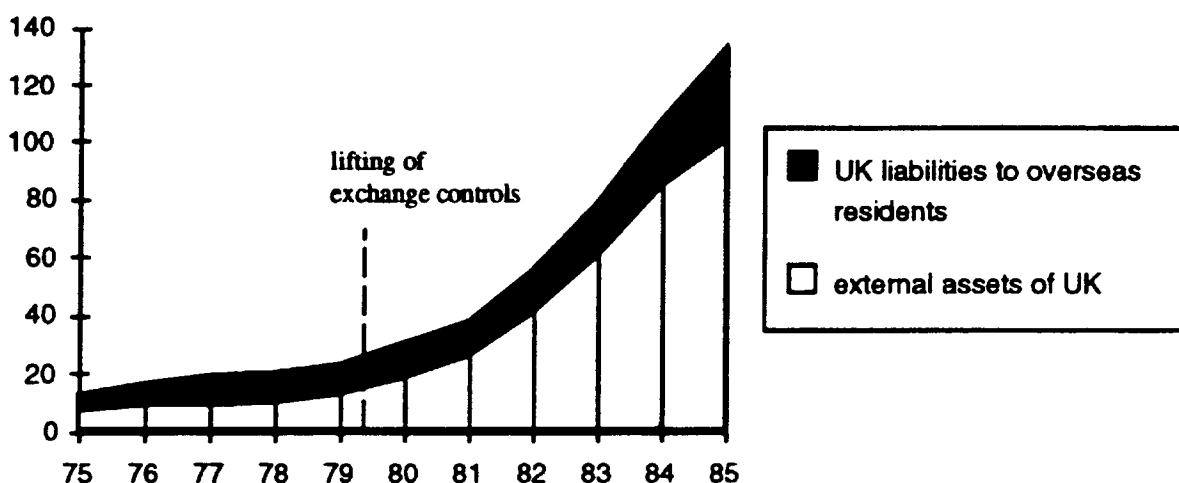
³⁶ See Bank of England (1977).

net capital outflows of £11.2 billion. This illustrates the significant impact which liberalisation of capital flows had on portfolio investment.

The impact on stocks of portfolio investment of UK residents was equally significant. UK liabilities to overseas residents increased from £9.7 billion in 1978 to £32.1 billion in 1985, while total external assets rose even more dramatically from £10.3 billion to £100.6 billion. This rise is illustrated in Figure 2.3 which shows the large increase in external assets held by UK residents.

Figure 2.3 Stocks of UK portfolio investment from 1975-85

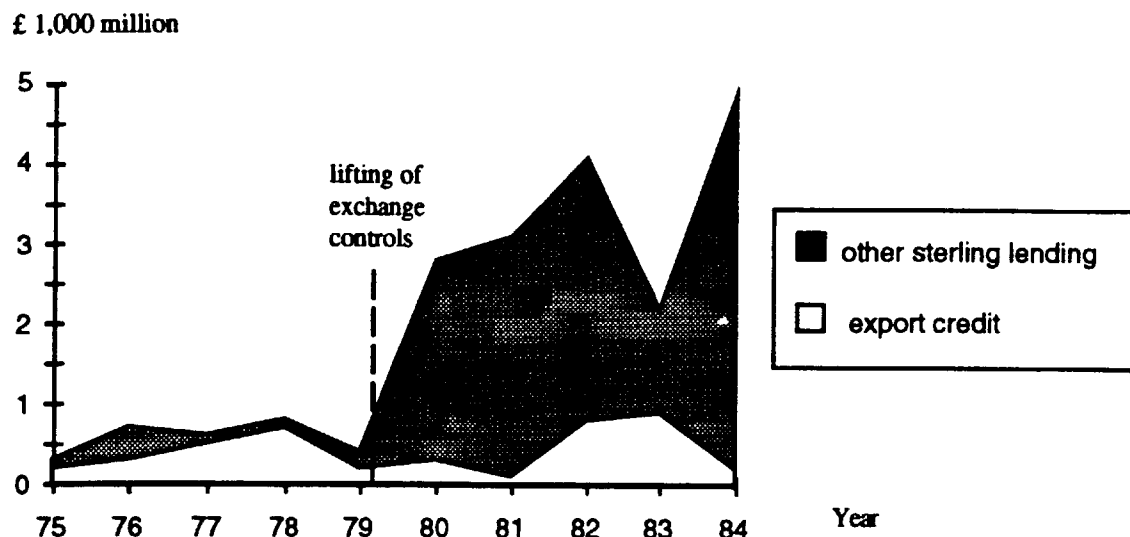
£ 1,000 million



Source: UK Central Statistical Office, Balance of Payments Pink Book 1986.

How did the lifting of exchange controls affect direct bank lending abroad? Figure 2.4 shows two categories of bank lending: that related to export financing which was largely unrestricted under exchange controls and a second category which subsumes all other forms of overseas bank lending. Not surprisingly, export-related lending did not change significantly after the abolition of controls. Other bank lending, however, experienced a significant rise from £100 million to £4.7 billion in 1984.

Figure 2.4: Bank lending (in sterling) abroad



Source: UK Central Statistical Office, Balance of Payments Pink Book 1986; table 8.4.

As is demonstrated by this example, domestic banks may be able to significantly expand their international lending activity after the abolition of exchange controls. This shows that entry barriers concerning transaction and switching costs can be successfully overcome.

2.2. The EC Services Directives: minimum harmonisation and the home-country principle

Freedom of establishment and provision of services in the EC were already enshrined in the 1957 Treaty of Rome, with Article 61 stating that "the liberalisation of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalisation of movement of capital". While freedom of establishment was largely achieved by the First Banking and Insurance Directives,³⁷ harmonisation of financial services regulations, widely perceived as a necessary prerequisite for opening up domestic markets, made slow progress. In particular, cross-border provision of financial services was seriously hampered by exchange controls and regulatory restrictions.³⁸

³⁷ The First 1973 Non-Life and 1979 Life Directives established the right for any authorised EC insurer to set up a branch or subsidiary in any other EC country after having gone through an authorisation procedure which was harmonised across all EC countries. In banking, freedom of establishment for EC banks has been secured in all EC countries.

³⁸ In legal terms, "cross-border provision of services" in the sense of Articles 59 to 66 of the Treaty of Rome refers to the 'exporting' of a service, i.e. a cross-border transaction of a performance of tasks for remuneration where the provider resides in a different Member State

Does freedom of services play a significant role in financial services, however? For the insurance sector, Farny (1990, p.380) implies that freedom of services is unlikely to have much of an effect when creating the internal market. More specifically, he questions

“whether the enormous efforts involved in introducing de jure and de facto steps to create freedom of services within the EC are not perhaps a great waste, considering the meagre results which are to be expected in direct insurance business.”

This author takes a too narrow view of the concept of freedom of services, however. The concept does not only involve uninhibited cross-border provision of services which is indeed unlikely to play a significant role in retail financial services. More importantly, the principle of host-country control erected significant barriers to entry, as the entering firm until 1993 had to comply with the regulations in the host country. This implies that a firm which opened a branch in another EC country had to adhere to the foreign regulatory regime. In insurance, for example, foreign firms wishing to enter the German market had to submit detailed business plans. If such a business plan included products which were not allowed in Germany it was not authorised by the German authorities. This practise may have provided a significant disincentive to seek authorisation in another EC country.

With the adoption of the Single European Act which was based on the comprehensive “White Paper on the Completion of the Internal Market” presented by the EC Commission in June 1985, a new concept was introduced in order to achieve a truly internal market: Apart from establishing qualified majority voting in major areas of Community decision-making, this new approach is based on the following four principles:

- i.) *minimum harmonisation* of essential regulations such as solvency and liquidity ratios, capital requirements or forms and contents of published accounts;³⁹

than the recipient. The concept of “freedom of establishment” refers to the right of setting up a permanent branch or subsidiary in the market of another Member State.

³⁹ The First Insurance Directives laid down common principles concerning technical reserves, solvency requirements and a minimum guarantee fund. In addition, a separation between life and non-life business was imposed for newly authorised companies. In banking, the Own Funds Directive (OJL 124, 5.5.1989) and the Solvency Ratio Directive (OJL 386, 30.12.1989) established common rules for capital adequacy. The Directive on ‘Annual Accounts of Banks’ (OJL 372, 31.12.1986) sets a common format for published accounts of EC financial institutions. The analogous Directive for insurance company accounts (COM89 474) is to take effect only in 1995. Directives on the winding-up procedures are proposed for the banking and insurance sectors which ensure equal treatment of creditors and customers across the EC.

ii.) *mutual recognition* of the regulatory regimes in other EC countries, concerning authorisation and prudential supervision systems;⁴⁰

iii.) *home country control*, i.e. prudential supervision, monitoring of financial soundness and solvency of financial services firms operating in other EC markets is undertaken by the home country's authorities;

iv.) *host country supervision* of rules of conduct in the Member State.⁴¹

Mutual recognition and home country control result in the so-called 'financial services passport' which allows firms authorised in one Member State to establish branches or export services to other EC countries, without requiring a separate licence from the host country's authorities.

Minimum harmonisation is required to ensure that players in the market follow at least a basic common set of rules and to avoid too stark competitive distortions.⁴²

In the banking sector the Second Banking Directive establishes the 'single banking passport' which enables all EC-authorized banks to operate under the home-country rule starting in January 1993. Concerning capital adequacy, the basic principles of the BIS-guidelines (BIS, 1987) were taken up in the EC Solvency Directive. The main difference between the Basle rules and the EC Directive is that the former are only applicable to a few internationally operating banks in the G-10 countries, whereas the EC Directive is binding for all EC credit institutions. Thus, those five EC countries which are not members of the G-10 group are affected as well.⁴³ The

⁴⁰ This principle was first legally evaluated by the European Court of Justice in its *Cassis de Dijon* decision (ECJ, 1979, 649) which forms the basis for its application in all areas of mutual recognition (see Paragraph 58 of the White Book for the Completion of the European Internal Market, Commission of the EC, 14.5. 1985).

⁴¹ Host country supervision of rules of conduct is not formally recognised like the first three principles. However, it will be a constituent part at least for the first phase of the "Financial Services Passport".

⁴² The need for minimum harmonisation is also emphasised in judgements by the European Court of Justice: for example, in Case 205/1984 the Court stressed the need for further harmonisation measures in insurance legislation.

⁴³ The imposition of capital requirements is not costless in practise: if the Miller-Modigliani theorem held, then requiring banks to hold higher capital reserves, i.e. "core" capital, equity, or long-term bonds, as opposed to non-capital liabilities, such as deposits or CD's, would not impose higher funding costs on the bank. For this result to hold, however, there must be complete information and tax neutrality. In practise, non-capital financing tools appear to be cheaper than raising capital and so increasing capital requirements leads to higher funding costs which in turn translates into higher prices for financial products, reducing consumer welfare. Regulators therefore face a trade-off when raising capital requirements: while the risk of firm failures is reduced, prices for financial products may rise. The optimal level of capital requirements therefore obtains where the marginal social benefit of fewer bank failures is just equal to the marginal social cost of higher product prices.

Second Banking Directive further establishes in Article 4 (1) minimum capital requirements of ECU 5 million⁴⁴ and abolishes the previous requirements of holding separate 'earmarked' capital for foreign branches. Thus, entry requirements are kept to a regulatory minimum and include only the most basic safety requirements.

While in the banking sector the EC Commission proceeded directly from the establishment directive to a 'single banking passport', it deemed it necessary to introduce an intermediate step in insurance services in the form of the Second Insurance Directives before proceeding to the 'single insurance passport' Directives. The Second Non-Life Insurance Directive which came into force in seven Member States in June 1990⁴⁵ only establishes the passport rule for so-called "large risks" which includes mainly transactions with large commercial firms.⁴⁶ Retail financial services are excluded from the freedom of services provision, however. The Second Life Insurance Directive to be implemented by May 1993⁴⁷ only establishes the home-country rule if the customer on her *own initiative* seeks an insurance policy from a company in another Member State (Art. 13 para.1). Further, by May 1996 the consumer must have the right to be able to contact a broker who will be able to distribute products from foreign life insurers which are not licensed in the domestic country (Art. 27 para.2). The Directive also allows for direct advertising of foreign life insurers in the domestic market, though not allowing personal solicitations. Most importantly, however, the Directive does not introduce the home-country rule of supervision as yet.

The need to differentiate between transactions with retail customers and large commercial clients in the form of the Second Insurance Directives is mainly a result of the 1986 *Commission v. Germany* decision by the European Court of Justice. In this case the Court decided that insurance services are characterised by a high degree of asymmetric information which necessitates special measures to ensure consumer protection in the retail area though not necessarily in the commercial sector. Thus, until further harmonisation of insurance regulation on the EC level is obtained, detailed

⁴⁴ Art. 4 (2) provides for exceptions where the minimum capital must not be less than one million ECU and which need to be notified by the Member State to the Commission.

⁴⁵ OJL, 88, 357, EEC. Longer implementation periods were granted to Ireland, Spain, Portugal and Greece.

⁴⁶ More specifically, it includes all marine, aviation, transport, commercial credit and surety ship risks and to all transactions where the insured is a substantial commercial undertaking which is defined as firm which fulfills at least two of the following criteria: balance-sheet total of 12.4 million ECU, net turnover of 24 million ECU or at least 500 employees. These thresholds are to be halved by the beginning of 1993.

⁴⁷ OJ 1990 L 330/50. Spain is given until the end of 1995, Greece and Portugal are given until the end of 1998 to implement the Directive.

authorisation requirements by individual Member States are compatible with the freedom of services provisions of the EC treaty.⁴⁸

To complete the internal market in insurance services the proposed Third Insurance Directives which the Commission hopes to have passed by the Council in 1992 establish a single licence also in the mass risk non-life sector as well as allowing life companies to actively solicit business across borders without requiring an additional licence from the host country's authorities and being regulated under the home country's regime. In the non-life sector the Third Directive which was passed by the Council in June 1992 and is to be implemented by July 1994⁴⁹ and the proposed Third Life Directive introduce the single insurance passport which is identical to the single banking passport. The Directives includes a range of harmonisation measures concerning licensing, technical reserves, the calculation of solvency ratios and the monitoring of insurance undertakings by the home country regulator, while not containing specific guidelines on the calculation of premiums. The degree of harmonisation goes further in insurance than in the banking sector which is a direct result of the requirements laid down by the European Court of Justice in its insurance decision.

By establishing a single financial services licence in the EC, the problem of large-scale harmonisation is circumvented, but only at the cost of regulatory ambiguities during a transitional period of adaption: some degree of host-country regulation remains, as foreign institutions have to obey the same conduct of business rules as domestic institutions. This may imply that financial services firms continue to have to deal with twelve different sets of rules. Thus, foreign firms offering consumer credit or investment services in the UK, for example, have to adhere to the rules of conduct of the Consumer Credit or Financial Services Acts respectively, even though the licensing requirement does not apply. This combination of home country supervision with host country rules of conduct may therefore lead to clashes between possibly incompatible regulations, as the borderline between supervision and conduct is not clearly defined in the Directives. These ambiguities shall be discussed for the banking sector, as the legislation concerning retail financial services has progressed more than in the insurance sector where the Third Directives have not been finalised as yet.

Article 21(2) of the Second Banking Directive states that the public authorities of the host country can enforce domestic regulations if they find that

“an institution having a branch or providing services within its territory is not complying with the legal provisions adopted in that State

⁴⁸ For a more detailed interpretation of the Court decision see, for example, Pool (1990, p.42-45).

⁴⁹ Spain is given until the end of 1996, while Greece and Portugal have until the end of 1998 to implement the Directive.

pursuant to the provisions of this Directive involving powers of the host Member State ...”.

What exactly constitutes these legal provisions, however, is subject to interpretation. Article 21(5) only specifies that authorities of the host country have the power

“... to take appropriate measures to prevent or punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interest of the public good.”

From the articles of the Directive it is not clear, however, which provisions do lie “in the interest of the public good”. This lack of clarity was already noted by the Banking Advisory Committee of the Commission of the EC (1988) which consists of top-level representatives of the Member States’ central banks. The Committee commented that “the Directive should state more clearly the coverage of ‘public interest’ with regard to national rules of good conduct of financial services business (appropriate accounting rules, investor protection, advertising rules) and how far the competent authorities of the host Member State could continue to apply those rules in future in respect of branches of credit institutions from other Member States”.

For example, paying interest on current account deposits is prohibited in France, while in Belgium variable-rate mortgage loans are outlawed; both activities are standard practice in other EC countries, however, and foreign banks operating in the two countries can therefore offer such services. According to officials at the Commission, both examples would not be captured by the rules of conduct provision of Article 21 and it therefore seems reasonable to predict that domestic firms will place pressure on home regulators to scrap such restrictions which put them at a competitive disadvantage compared to foreign firms.

In personal interviews at the Directorate-General 15 of the Commission of the EC which is responsible for EC financial services regulation, an official confirmed that the public interest criterion will be subjected to a narrow interpretation. It will only apply in circumstances where there is a well-defined case for subjecting foreign institutions to national rules of conduct. Legitimate reasons may include the preservation of financial stability to prevent negative externalities or reasons of depositor protection which result from asymmetric information. The danger of a too general application of the rules of conduct provision by the Member countries is recognised at the Commission.⁵⁰ As the official at DG15 noted: “We need to be on the guard

⁵⁰ The Director General of DG 15 notes that “the division between home and host country is a cause of some concern to us. There is clearly a risk that host country regulation of the conduct of business or even the marketing and advertising can lead to the creation of serious obstacles to cross-frontier trade ... it is clear that further litigation before the European Court and perhaps also some further harmonisation may be necessary to remove “host country” rules which constitute serious obstacles” (Fitchew, 1990b, p.36-37).

that the home-country principle of the Directives is not made ineffective through a broad interpretation of the rules of conduct clause by Member States".

Some degree of inconsistency exists concerning the relation between mutual recognition and host country financial services contract law. While in the banking sector an institution offering services abroad may choose whether it does so under the contract law of the home country or the host country (Williams, 1986),⁵¹ in the insurance sector the Second Life Insurance Directive stipulates in Art. 4(4) that a Member State may require domestic contract law to be applied to all insurance contracts where domestic residents are involved. This, in effect, implies that countries can establish the host-country rule for insurance contracts.

To summarise, despite regulatory ambiguities concerning rules of conduct clauses and contract law, the Second Banking Directive and the Second and proposed Third Insurance Directives establish a significant step towards reducing regulatory entry barriers. In particular, they establish that foreign institutions no longer have to deal with twelve different supervisory regimes but can operate according to the familiar home-country regime in other EC countries. This not only lowers barriers to cross-border entry but may also have significant effects for the shape of domestic regulatory regimes. The latter aspect is now analysed in greater detail in the following section.

3. Free capital flows and the EC Directives: scope for strategic deregulation?

It has been predicted that the Second Banking and Second and Third Insurance Directives will lead to a process of 'strategic deregulation' among European regulators, each attempting to provide the best starting position for domestic institutions when entering other EC markets.⁵² Whether such a process leads to an improvement in social welfare is not clear *a priori*., however. Two opposing views of strategic deregulation can be formulated: on the one hand, 'competitive disequilibria' may be the fastest route to a level playing field in the EC without requiring large-scale harmonisation. The perceived need for such harmonisation had been the main obstacle to financial market integration with negotiations dead-locked over minor details for years. With increased cross-border entry of foreign FS firms regulated by their home-country authorities, domestic regulators are forced to

⁵¹ This rule was established in the 1980 Rome Convention concerning contract law which does not apply to the insurance sector.

⁵² The EC Commission is expressly following a *laissez-faire* policy in this respect. The Director-General of DG15 stated that "the motto (the EC Commission has) adopted ... is *solvitur ambulando*; in other words, to wait until the problems are thrown up and hopefully solved by the market itself." (Fitchew, 1990, p.12).

abandon restrictions which other countries consider superfluous, thus reducing regulatory differences. One could therefore argue that since national regulators all pursue similar objectives, the main one being the preservation of financial stability, harmonisation of regulations does not jeopardise these objectives.

In contrast, most academic commentators have argued that strategic deregulation bears the danger that the original purposes of financial regulation are sacrificed, as market forces lead to a level of European regulation at the lowest common denominator. Vives (1991, p.25/26) warns that:

“The application of the home country principle to solvency and to the approval of banking services, coupled with the application of the host country principle for deposit insurance schemes, gives incentives for national authorities to be very liberal in setting standards to provide national banks a competitive advantage abroad. If disaster happens, foreign taxpayers will foot the bill”

While solvency requirements were harmonised by the Solvency and Own Funds Directive (see above) and the jeopardy of “competitive deregulation” was thus reduced, for deposit insurance schemes the host country principle will be established (see chapter ten). Thus, it is the domestic rather than the foreign taxpayer who “will foot the bill”.

In a similar spirit, Masera (1990, p. 337), notes that:

“the solution of these fundamental problems {of achieving a stable integrated environment in financial services} should not be left to competition between regulatory systems; competitive deregulation cannot be the answer to the problems posed by those ‘market-failure’ instances which require regulation in the first place.”

In a similar spirit, Mayer (1988, p.346) observes that:

“Competition between regulators may act to diminish the effectiveness of regulation. The major concern that has been expressed about the effects of international competition between regulators has been that it has a levelling down effect ... This is not the right basis on which to make policy decisions regarding the operation of markets. In sectors in which externalities provide the rationale for the imposition of regulation, there can be no presumption that competition between regulators will be welfare-enhancing”.

According to this view, competitive deregulation may result in ‘regulatory arbitrage’ with financial institutions locating in those countries with the least rigid regulations, as they have “freedom ... to ‘vote with their

feet' for the regulatory jurisdiction of their choice" (Hirshleifer, 1976). Such arbitrage opportunities may therefore induce regulators to provide a permissive and lax regulatory environment to attract foreign firms and provide domestic institutions with a regulatory advantage when entering other EC markets. Thus, it is argued that the financial services directives could lead to the *de facto* imposition of the most permissive regulations and this may cause concern over attaining the original objectives of financial regulation.

This view of competitive deregulation holds that in the absence of significant transaction costs of relocation the market for regulation is to some extent contestable: national regulators cannot impose restrictions which raise the 'price' of regulation imposed on institutions operating in the country to a level significantly above that in other EC States, as there would be immediate exit from the market with institutions relocating to those countries which charge lower 'regulatory prices'. Thus, in the presence of competing national regulators the continuous interaction of regulators and regulatees responding to shifts in the regulatory environment, leads to a market-determined long-run equilibrium level of international regulation. However, it is by no means evident *per se* that this long-run equilibrium reached by market forces is optimal in terms of addressing the objective of alleviating market failures in financial markets.

The next section develops theoretical considerations on competitive regulation in an international setting, while sections 3.2 and 3.3 apply the model to selected areas of EC financial services regulation.

3.1. Financial services regulation in an international setting: game-theoretic considerations

I develop a model of strategic interdependence where regulators and regulatees continuously respond to each others' actions. This implies that domestic regulators are in constant competition with other national regulators in determining and responding to shifts in the environment.⁵³ Regulatees, on the other hand, respond to shifts in the 'net regulatory burden' (NRB) which is the difference between the benefits of regulation (e.g. greater financial stability) and the costs of regulation imposed on the institution (e.g. interest foregone on holding reserves).⁵⁴ Thus, the NRB concept incorporates the notion that regulations not only impose costs on regulatees but also benefits.

⁵³ Even though Article 7 of the Second Banking Directive postulates that supervisory authorities should cooperate on regulatory matters, in practice one finds ample examples of regulatory competition rather than cooperation (see below).

⁵⁴ This concept was introduced by Kane (1987).

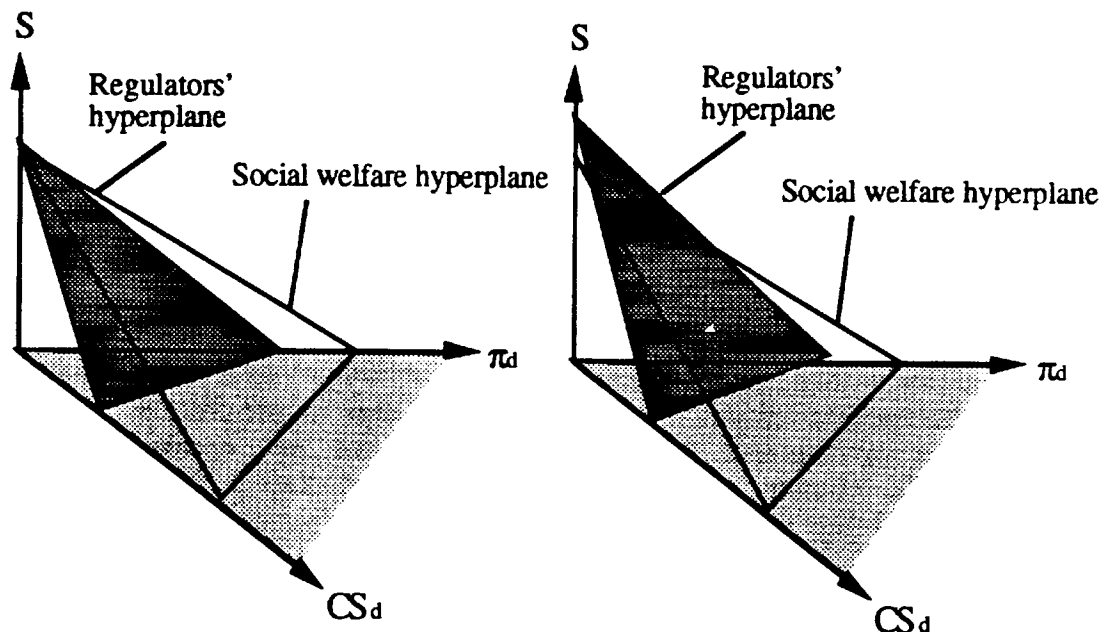
Consider a simple two-country model, each country with one national regulator and m FS firms, so that there are $2(m + 1)$ players. Regulators control a vector of $x = (x_1, \dots, x_n)$ regulatory measures. Let $\sum c_i = c_1(x_1) + \dots + c_n(x_n)$ be the sum of costs and $\sum b_i = b_1(x_1) + \dots + b_n(x_n)$ be the benefits of the n possible regulations to the firm and define the net regulatory burden as a continuous function $f(c, b) = \sum c_i - \sum b_i$. FS firms minimise a cost function $C(Q, L, f(c, b))$ where Q is output and L are relocation costs of moving part of the business to another country. Domestic industry profit is assumed to be a decreasing function of the net regulatory burden, i.e. we have $\pi_d(f(c, b))$ with $\pi'_d(\cdot) < 0$.

Regulators, on the other hand, maximise an objective function $R(\pi_d, CS_d, S)$, where π_d is domestic industry profits, CS_d is domestic consumer surplus and S is financial stability. Regulatory agencies are required by statutory law to preserve domestic (and international) financial stability and are thus unlikely to deregulate infinitely. In addition, both π_d and CS_d depend to a certain degree on S such that regulators place particular weight on preserving financial stability. This argument of the objective function therefore sets a lower bound on the possible regulatory outcome, consisting of 'core' regulations necessary to preserve an orderly function of the financial system. Which measures constitute this core, however, is unknown *ex ante* and national regulators may disagree on the scope of the regulations. Let the regulatory vector which maximises the regulator's objective function be given by x_r^* .

I assume that regulators place different weights on the arguments of their objective function such that $\partial R / \partial S > \partial R / \partial \pi_d > \partial R / \partial CS_d$. Thus, regulators are most concerned about preserving financial stability and more concerned about domestic industry profits than consumer surplus.⁵⁵ The latter assumption can be explained by two arguments: first, regulators may be 'captured' by FS firms (Stigler, 1971). Second, as higher profits lead to a lower probability of bank insolvency, they contribute indirectly to greater financial stability. Higher consumer surplus, on the other hand, has no comparable beneficial effect on financial stability and is therefore valued less highly by regulators. The regulators' choice when maximising their objective function is illustrated in figure 2.5. The first case illustrates an example where regulators place most, but not too much weight on preserving financial stability. The second example refers to a case where regulators actually place too much weight on preserving financial stability.

⁵⁵ 'Consumer' surplus in this framework refers not only to actual consumers but to all users of domestic financial services including firms.

Figure 2.5: Two examples of regulators' hypothetical hyperplanes and social welfare



It is obvious that regulators have a set of possible regulatory vectors to choose from, as indicated by the darkly shaded hyperplane. Which point actually maximises the regulators' objective function depends on the relative weights they attach to the welfare arguments.

Notice further that the regulator's objective function is not necessarily identical to the domestic social welfare function $W_d = W_d(\pi_d + CS_d, S)$ which places equal weights on industry profits and consumer surplus such that $\partial R / \partial \pi_d = \partial R / \partial CS_d$.⁵⁶ Thus, we may have $x_r^* \neq x_{SW}^*$ where x_{SW}^* is the regulatory vector which maximises social welfare.

If the two functions were identical, i.e. the two hyperplanes would coincide, then regulatory competition could only lead to a decrease in social welfare after allowing FS firms to re-allocate. This results from the simple fact that in the absence of the relocation threat, regulators pursue unconstrained maximisation of domestic social welfare. Introducing the relocation constraint through regulatory competition can therefore not improve on the pre-competitive equilibrium which already constitutes the social optimum. Social welfare in the competitive world will therefore be less than or equal to the pre-competitive outcome. This simple reasoning establishes our first

⁵⁶ This results from the assumption that through appropriate redistributions the desired wealth allocation can be obtained.

proposition: suppose that regulatory competition is introduced in period n . Thus, we have:

$$\text{Proposition 1: } \{ R^{n-i}(\cdot) = W_d(\cdot) \} \Rightarrow \{ W_d^n \leq W_d^{n-i} \}$$

This simple proposition sheds some light on the diametrically opposed views about the impact of regulatory competition which were described above. Those who believe that regulatory competition is unlikely to improve social welfare implicitly assume that domestic regulators already maximise social welfare. Those, however, who welcome regulatory competition as doing away with unnecessarily strict regulations may assume that regulators have so far placed too much emphasis on preserving financial stability by keeping industry profits high to the detriment of consumers.

National regulators choose between three principal strategies when determining the regulatory vector: first, they may aim to provide the best starting position for domestic FS firms moving abroad, by decreasing the NRB for domestic FS firms for those activities which they pursue in the foreign country, as this raises π_d and does not impact CS_d or S . This is the strategy to which critics of regulatory competition commonly refer. However, it is not clear that reducing the NRB for domestic FS firms is at all necessary for providing an edge to domestic FS firms. For those activities where FS firms are able to open a subsidiary abroad, they can escape the (possibly stricter) domestic regulatory regime anyway.

Second, regulators may want to eliminate a possible competitive disadvantage of domestic FS firms if these are governed by more stringent rules than actual or potential foreign entrants. This primarily ensures that π_d does not fall as a result of declining market shares of domestic institutions. The impact on CS_d and S is ambiguous and depends on the type of regulation under consideration. CS_d is most likely to be unaffected or rise if the regulation being relaxed contributed to higher prices for financial services (such as the prohibition to pay interest on current accounts, for example). The NRB for domestic FS firms is thus reduced for those activities where foreign FS firms can effectively compete in the domestic country.

Third, regulators may want to attract foreign entry by creating a regulatory regime conducive to foreign entry and thus boosting the country's position as an international financial centre. Such a strategy entails providing a regulatory regime which offers a low NRB to both domestic and foreign FS firms. It has an ambiguous effect on domestic profits: on the one hand, it raises π_d as the presence of many international institutions conveys positive externalities on domestic firms which increase their business. On the other hand, domestic institutions may lose market share to foreign entrants. In general, the first effect is likely to over-compensate the second effect if the domestic financial services industry is small and the entry of foreign FS firms is substantial. In addition, CS_d rises as competition is fostered with its associated beneficial effects on prices, quality and variety of services. Finally,

there may also be significant tax and employment effects as foreign FS firms create a substantial number of jobs in the domestic economy as well as being a source of tax revenue.⁵⁷

FS firms are the second major players in this regulatory game. FS firms' objective function is to minimise the net regulatory burden subject to relocation costs. The latter are likely to be low as entry solely for regulatory purposes is near-contestable. We assume that with freedom of entry and exit, FS firms will open subsidiaries for particular lines of business in those countries where the NRB is lowest.⁵⁸ The costs of setting up a subsidiary only for regulatory purposes are minimal and not sunk, as they are largely recoverable. This is demonstrated by the 'brassplate'-institutions located in offshore tax havens which sometimes consist of little more than small offices with minimal staff. A conceivable strategic response by FS firms to the home-country rule is therefore for parent companies to select the regulatory regime in that country with the lowest NRB for any particular line of business (e.g. credit cards, mortgages) and open a subsidiary. Through cross-border branching they are then able to impose this regulatory regime on the whole of their European operations. Thus, it is not necessary for a bank to completely relocate its headquarters, a threat which may not be credible, but merely to establish a subsidiary in another country which carries with it much lower relocation costs and is therefore a more feasible strategy.

Consider first a situation where both countries start out from different regulatory regimes, i.e. $x \neq x_f$ in period 1 where the subscript f denotes the foreign country. The model structure is that of an infinitely repeated game where each period consists of two stages: in stage 1 regulators determine the NRB and in stage 2 FS firms decide on their strategies. Suppose first that regulators cannot cooperate (e.g. due to the prohibitive complexity of reaching a cooperative outcome) and thus pursue a non-cooperative strategy taking the actions of the other country as given (Nash regulation game). The

⁵⁷ An example where domestic regulators successfully tried to create an attractive regulatory environment for foreign banks is described by Grubel (1989, p.70) who cites the case of Singapore where the government asked international banks to "prepare a wish-list of regulatory and tax concessions" which would make the city state an attractive location as an international financial centre. A similar story can be told of Luxembourg where every fifth employee depends on the financial services industry and which has consistently and successfully tried to create a regulatory and tax environment which would attract foreign banks. As these two examples illustrate, it is most likely to be smaller countries where national regulators pursue such a strategy of providing a favourable regulatory environment.

⁵⁸ Capie and Wood (1990, p.308) assume that "trans-European banks would be likely to develop substantial branching networks. If, for example, France were an attractive country from the point of view of regulation and banks made their headquarters there, they would do that with a view to establishing themselves in other countries also." Such an assumption appears very unrealistic, however, as it is hard to imagine that Barclays or Deutsche Bank move their headquarters to Paris. We therefore assume that banks do not move headquarters but only subsidiaries and lines of business (e.g. credit cards).

following proposition constitutes the conventional wisdom in such a regulation game:

Proposition 2: After n repetitions of the game, we have $NRB - C_{re} = NRB_f$.

where C_{re} are relocation costs of domestic FS firms. The reasoning for this result to obtain runs along the following lines: suppose that in period 1 the domestic NRB is substantially above the foreign NRB. At the beginning of period 2 the possibility of relocation is introduced. A forward-looking domestic regulator anticipates that FS firms will respond in stage 2 of the game by relocating at least part of their business and will therefore reduce the domestic NRB in stage 1 of period two. The response of FS firms then largely depends on the success of the regulator's attempt to reduce the NRB. After a few repetitions of the game, a long-run equilibrium obtains where the NRB has equalised across countries except for differences persisting due to relocation costs. This is the process of competitive deregulation which is referred to in many recent writings on European regulatory integration (e.g. Joerges, 1991).

This result, however, is too simplistic considering the arguments of the objective function and the complexity of strategies available to regulators. Consider a domestic regulator who 'sticks to his principles' by not participating in competitive deregulation through continuous reductions in the NRB. Instead, the regulator keeps the NRB persistently above that of the foreign country. This has the effect of inducing domestic FS firms to open a subsidiary in the foreign country and pursue cross-border branching into the domestic country. Since the earnings of foreign subsidiaries are usually consolidated, the reduction in π_d is likely to be negligible. CS_d is likely to increase, since the costs of offering services decrease due to the lower regulatory burden. Finally, S is not detrimentally affected as it would be in the case of competitive deregulation, since regulations are kept at a level ensuring financial stability. By pursuing such a strategy of not participating in the competitive race, the domestic regulator effectively free-rides on the benefits provided by the permissive regulatory regime in the other country without jeopardising financial stability in his own country.

Consider next the possibility of coordination between the two national regulators. Recognising their strategic interdependence, the two regulators could maximise a joint regulatory objective function rather than individual functions. In contrast to collusion between firms, explicit cooperation between regulators is not prohibited but actually commonplace. In a static model with costless collusion, regulators will do at least as well as in the non-cooperative outcome, since the latter is always a possible equilibrium in the game with coordination. However, there may be significant obstacles to reaching an explicit cooperative agreement due to negotiation costs,

uncertainty about FS firms' responses and heterogenous regulations on whose practical effects regulators may disagree.⁵⁹

Consider, for example, a situation where $x = x^*$ in period 1. In such a case, regulators may have an incentive to differentiate their regimes to avoid head-to-head competition and attract foreign FS firms.⁶⁰ It is conceivable, for instance, that regulators tacitly or explicitly 'divide' the market in a way that each country is able to specialise in a certain area. For example, if the domestic country has a comparative advantage in stock market activities due to accumulated reputation and know-how, the foreign country may 'concede' this area in return for specialisation in another area. Both regulators would be better off by cooperating and agreeing to specialise. However, there is an incentive to invade the other regulator's market to gain additional market share. This is the classical Prisoners' Dilemma where regulators end up in the non-cooperative equilibrium both in the static formulation as well as the finitely repeated version (by backward induction). In an infinitely repeated game, however, collusion may be sustainable.

Such a collusive equilibrium in an infinitely repeated supergame suffers from the inherent threat of cheating, however (see, for example, Rubinstein, 1979, 1980). A regulator will cheat if she expects the discounted benefit of deviating from the collusive agreement to be greater than the potential future loss of non-cooperative behaviour. It can be shown that for high values of the discount factor, regulators will stick to the tacitly collusive equilibrium, as long-term losses from reverting to non-cooperative strategies are valued greater than short-term benefits from cheating (e.g. Aumann, 1959; Friedman, 1971).

A regulator may expect to gain significantly if expecting that the other player retaliates only with a lagged response due to administrative sluggishness, for example. Due to the publicity requirements of public regulation, however, any move to engage in strategic regulation by deviating from the cooperative solution would be instantly detected. Regulators can therefore threaten to punish cheating by engaging in a 'regulation war'. Such a threat to retaliate would be credible if the welfare loss of sticking to the cooperative solution is large. Since this is likely to be the case for regulations which may draw away business from the country which sticks to an unfavourable agreement, the threat of retaliation is likely to be more credible the greater the adverse impact on domestic profits and consumer surplus. Thus, the instant detection of chiseling as well as the credibility of the retaliation threat tend to increase the stability of a cooperative equilibrium.

⁵⁹ Supervisors in the EC have started to cooperate by reaching a "memorandum of understanding" to avoid regulatory arbitrage. The concrete impact of such a cooperative solution has yet to be seen.

⁶⁰ Compare the incentives of firms to differentiate their products to avoid Bertrand competition.

What emerges from this analysis is that competitive deregulation is a far more complicated process than most commentators assume. It is clearly not the case that regulators will simply engage in lax supervision and provide as permissive a regulatory regime as possible under the home-country rule. Instead, there are equally plausible scenarios where a regulator intentionally maintains a high regulatory burden or where national regulators cooperate to set a high level of regulation. In the next two sections I look at areas where competitive deregulation *may* play a role.

3.2. Competitive strategic deregulation in the EC: an application of the model to banking

Applying this game-theoretic framework to competitive deregulation in the EC has interesting implications. I look at four areas of regulation which may come under intense scrutiny as the Second Banking Directive comes into effect. The methodology of the analysis is as follows: as suggested by the preceding theoretical considerations, we first have to examine the costs and benefits of particular regulations to the bank. Thereafter, the credibility of the relocation threat needs to be determined by analysing the costs and benefits of moving location and/or business abroad in order to reduce the NRB.

3.2.1. *Minimum reserve requirements*

The first area which may be affected by strategic deregulation are minimum reserve regulations. These require the bank to hold a particular proportion of demand deposits at the central bank. Table 2.1 reports the level of reserve requirements in the EC countries in 1988.

Table 2.1: Reserve requirements in the EC in 1988

Italy	25%*
Spain	18.5%*
Portugal	15%
Ireland	10%
Germany	4.15 - 12.1%
Greece	7.5%*
France	2.5 - 5%
UK	0.5%
Belgium	0
Luxembourg	0
Netherlands	0**
Denmark	0

* reserves remunerated to some degree

** A small, variable and remunerated reserve requirement was introduced in 1988

Source: Morgan Guaranty Trust, World Financial Markets, No.5, 1988

It is obvious that there are distinct differences between the EC countries concerning the required level of reserves. Let us first analyse the NRB. The cost of reserve requirements is given by the difference between the remuneration rate (where existent) and the return which the bank would receive if it could freely lend or invest the funds. To understand the implicit cost of reserve requirements consider the following simple example. A bank in Luxembourg obtains the Franc equivalent of a 100 ECU deposit on which it pays a 10 percent interest rate. It keeps a liquid reserve of 10 ECU, lends out 90 ECU at an interest rate of 12 percent and so makes a gross margin of 0.8 ECU. Now consider a bank in Ireland which also obtains the equivalent of a 100 ECU deposit but has to keep 10 ECU with the Irish Central Bank. Keeping the same liquidity margin of 10 ECU, it can only lend out 80 ECU.⁶¹ Suppose the deposit and lending rates in the two countries happen to be identical. In this case the Irish bank has a negative margin of -0.4 ECU! As can easily be calculated, the deposit/lending margin has to be greater by 75 percent for the Irish bank to earn a similar gross operating margin as the Luxembourg bank. Thus, different reserve requirements may lead to significant competitive distortions between the EC countries and such differences need also to be taken into account when assessing differences in deposit/lending margins.

Empirically, a conservative approximation for the return which a bank could earn if it freely invested the funds which it currently needs to keep with the central bank is given by the rate on short-term government bonds, as listed in IMF Financial Statistics, for example. Let this be denoted as r_g . Data were obtained for the period 1985 to 1990 and averaged out for this five-year

⁶¹ Only if one considers reserve requirements and liquidity margins to be substitutes are the costs of keeping reserve requirements lower.

period. These data were then employed to calculate the opportunity cost of reserve requirements as shown in Table 2.2. These costs are computed as $M(r_g - r_d)$ where M is the reserve coefficient and r_d denotes the remuneration of deposits held with the central bank (where existent).

Table 2.2: Opportunity costs of EC reserve requirements per unit of deposit

Italy	2.4%
Portugal	2.4%
Spain	1.4%
Ireland	1%
Greece	0.8%
Germany	0.4%
France	0.3%
UK	0.05%
Belgium	0
Luxembourg	0
Netherlands	0
Denmark	0

Source: own calculation from Table 2.1 and average interest rates on short-term government bonds (treasury bills) from 1985-89 as listed in row 6c of IMF Financial Statistics.

The table shows that there are significant differences in the opportunity costs of reserve requirements. Italy and Portugal stand out with the highest opportunity cost and this may constitute a significant competitive disadvantage in international operations. The benefits of reserve requirements are not clear. While they are mostly regarded as a monetary policy instrument, countries are able to pursue effective monetary policy by other means, as the examples of the Netherlands or Belgium illustrate. Primarily, reserve requirements constitute an important source of revenue for the government and thus replace other forms of taxes (Romer, 1985). This implicit tax conveys no direct benefits on banks, however. The NRB for reserve requirements therefore depends largely on costs, as benefits are fairly insignificant.

So far, reserve requirements have been considered a monetary policy instrument by the EC Commission and are therefore exempt from the home-country rule. Nevertheless, international capital mobility may lead to a situation where banks from a system with high reserve requirements are disadvantaged due to higher funding costs. This is likely to lead to pressure on the domestic central bank to relax reserve requirements and rely on other policy means to pursue monetary and fiscal policy which have more neutral effects on financial services competition.⁶² Alternatively, banks could place

⁶² Such a process could already be observed in France where minimum reserve requirements were reduced in May 1992 from 4.1 percent on current accounts to 1 percent and from 2 percent on savings accounts to 1 percent. A similar development has taken place in Spain where reserve requirements were reduced in March 1990.

pressure on the central bank to introduce a more competitive remuneration rate for the deposits held at the bank in order to reduce the implicit cost of reserve requirements and the competitive distortions which result as banks from countries with different reserve requirements start competing.

An interesting example of the effects of competitive deregulation is given by the recent plans in Germany to allow the introduction of money market funds by the end of 1992. These funds were so far legally prohibited because they do not underlie any reserve requirements. The Bundesbank claimed that these funds therefore make it more difficult to pursue effective monetary policy. Possibly even more importantly, the Bundesbank feared increasing funding costs for banks if there are large shifts from inexpensive savings deposits into more costly money market funds. Such an increase in funding costs is supposed to lead to a higher probability of insolvencies, as competition increases. It is interesting to note that the Bundesbank apparently places greater emphasis on financial stability than on consumer surplus which clearly increases, since money market funds pay significantly higher interest rates than banks currently pay on savings accounts which still constitute the majority of savings in Germany.⁶³ Banks for a long time joined the Bundesbank in its opposition to money market funds, as the funds obviously increase refinancing costs for the banks. After January 1993, however, foreign financial services firms will be able to offer money market funds in the German market under the home-country rule. German banks fearing the competition of foreign institutions finally placed pressure on the German regulators to abolish the restrictions on money market funds in order to be able to compete with foreign firms.

3.2.2. Deposit rate regulation

Deposit rate regulation is an example where the NRB appears to be negative. Banks reap substantial benefits from the prohibition of paying market rates on demand and saving deposits, as margins on sight deposits are the largest single contributor to banks' profits averaging up to 80%.⁶⁴ There are therefore enormous benefits but few costs resulting from deposit rate regulation for the financial services sector which makes the net regulatory burden negative. This situation is likely to change dramatically, however, with the implementation of free capital flows and the home-country rule. First, with free capital movements domestic residents will be able to move their funds to countries which pay interest on their deposits (see above). Second, the home-country rule may be applicable if entering banks will be allowed to offer

⁶³ Money market funds at the beginning of 1992 pay around 9 percent compared to an average of 2.5 percent on savings accounts.

⁶⁴ See chapter five.

interest-rate bearing accounts.⁶⁵ These mechanisms are likely to make the net regulatory burden positive and induce banks to circumvent domestic restrictions to reduce the NRB.

In France, for example, paying interest on current accounts is prohibited by the 1967 regulation concerning interest rates on bank deposits. This regulation further specifies that interest rates on savings deposits are subject to government control.⁶⁶ The intention of such public intervention is to avoid 'excessive competition' jeopardising margins, profitability, capital ratios and thus financial stability. Such reasoning appears flawed, however, as it introduces cross-subsidisation which may have distortionary effects. In addition, rate regulation reduces (though not eliminates) price competition and may force banks to compete and possibly over-invest in quality such as the number of branches.⁶⁷

In practise, government restrictions on interest rates can be circumvented up to a certain degree. In France, for example, the development of UCITS (undertakings for collective investment in transferable securities), the MATIF (*marché à terme international de France*) and cash management techniques constitute close substitutes for demand deposits which pay market interest rates. Nevertheless, despite these financial innovations purely designed to circumvent public regulations, a substantial degree of cross-subsidisation still remains in the French market: a significant proportion of payment-related services such as cheques, for example, are distributed free of charge or substantially below costs (such as credit cards which have among the lowest fees in the world). This leads to an estimated annual loss of FF40 billion in the area of payment services (Henrot and Levy-Lang, 1990). This loss is cross-subsidised by the significant profits made on current accounts resulting from the suppression of competition in this area due to government prohibition of paying market rates of interest. Attempts by the banking industry to introduce charges on cheques, for example, to establish a more cost-oriented pricing structure, failed due to resistance from consumer organisations. Under the home-country rule, foreign banks will be able to

⁶⁵ An EC Commission official noted that the prohibition of remunerating sight deposits may be motivated by monetary policy considerations and would therefore not fall under the home country principle.

⁶⁶ Since May 1986 interest rates on time deposits with a maturing of more than three months have been deregulated which now closely follow money-market rates. In Belgium the interest rate on current accounts was fixed by interbank agreement (at 0.5%) but this practice was discontinued due to the prohibition of interbank agreements in the Treaty of Rome.

⁶⁷ For the case of Spain, for example, Caminal, Gual and Vives (1990, p.268) note that "after the liberalisation of branching in 1974 there was a large geographic expansion of banks competing through proximity to the customer and service instead of prices, which were regulated". In fact, the number of branches actually doubled in only two years after deregulation. A similar though less dramatic development occurred in France after branch banking was deregulated in 1967/68 (see de Boissieu, 1990).

offer interest-bearing accounts, however, and therefore these prohibitive regulations are likely to come under substantial pressure by domestic banks.

Government regulation is not solely responsible for the national differences in current account interest rates, however. No restrictions on such activities exist in Germany, the UK and since March 1987 in Spain. But while competitive forces have led to the introduction of interest-bearing current accounts in both the UK and Spain, no interest is paid on demand deposits in Germany. I will discuss possible reasons for this in chapter five.

3.2.3. Taxation of interest rate earnings

Another area which is likely to be affected by the possibility to freely transfer capital across borders to foreign banks or subsidiaries of domestic banks is that of taxation of interest rate earnings. Taxation practise currently varies widely with some countries relying exclusively on the honesty of the resident to declare her interest rate income in the annual income tax declaration. Generally, the domestic government has two principal options to tax interest rate income. First, it may place a withholding tax on the income which is subtracted 'at source' from the interest payment. Such a tax may or may not be 'definite' meaning that the taxpayer does not have to declare that income in the annual income tax declaration. Second, the regulator may require banks to submit 'control messages' to the tax authorities about the interest rate income of depositors. These may be on a sample basis to constitute a sufficient deterrent to tax evasion or cover all interest payments. Table 2.3 illustrates the different practises in eight EC countries as well as the EFTA-countries Austria and Switzerland which need to be considered due to their potential status as a 'tax haven'.

Table 2.3: Regulations concerning interest rate income in 1991

Country	Residents	Non-residents
Germany	25 percent withholding tax	-
UK	25 percent withholding tax	no tax
France	control messages or source tax (18.1%) depending on type of investment	25 percent tax on bonds, 46 percent on deposits
Italy	12.5 percent on bonds, 30 percent on deposits, definite tax	30 percent on both bonds and deposits, some exemptions
Spain	25 percent tax and control messages for bonds	25 percent tax
Denmark	control messages	-
Luxembourg	-	-
Ireland	35 percent source tax on bonds/deposits	35 percent on bonds, no tax on deposits
Netherlands	control messages	-
Belgium	10 percent withholding tax, definite tax	10 percent tax
Switzerland	35 percent withholding tax,	35 percent withholding tax; no tax for bonds of foreign issuers
Austria	10 percent withholding tax	10 percent withholding tax; exemptions for deposits/ bonds

Source: own compilation from several national sources.

Table 2.3 illustrates that there are significant differences in the way interest rate income is subjected to taxation. Luxembourg is the only EC country which has neither a withholding tax nor control messages.

Depositors may be highly sensitive to differences in taxation principles. In Germany the introduction of a withholding tax of 25 percent in 1988 resulted in a capital flight of more than DM 70 billion, forcing the German government to quickly abandon this tax. This example illustrates that economic agents respond quickly to differences in taxation. A significant proportion of the capital was transferred to Luxembourg where domestic and German banks offered special investment funds which were regulated under Luxembourg law and thus exempt from the German withholding tax. While investors were quick to respond to the change in the regulatory regime, they were much slower to disinvest after the tax was abolished: it is estimated that eighty percent of the capital transferred to Luxembourg remained there.⁶⁸

The economic analysis of taxation of interest rates can also be framed in terms of the NRB. The stricter the principles concerning interest rate taxation, the greater the incentive for agents to invest at least part of their wealth abroad. Thus, the higher the interest rate burden, the more difficult it is for

⁶⁸ See Capital 8/1991, p.71.

domestic banks to refinance themselves through deposits, as these are more likely to flow abroad. The NRB is therefore likely to be positively related to the enforced interest rate burden.

Capital transfers will lead to pressure on governments to harmonise taxation principles.⁶⁹ In particular, other EC governments will place pressure on tax-lenient EC countries such as Luxembourg to introduce some form of taxation. It is likely that plans for a common withholding tax on the EC level will re-surface. Nevertheless, Luxembourg has so far successfully resisted with the argument that the introduction of a tax in the EC will only lead to a capital flight to non-EC countries such as Switzerland or Austria and off-shore centres such as the Channel Islands. With the accession of the EFTA countries, however, which will be obliged to implement the EC Directives such concerns may have lost in force.

3.2.4. Universal banking versus separation

One form of prudential regulation is the restriction of admissible lines of business which a bank may enter. There are significant imbalances across the EC countries in the type of services which regulators permit banks to engage in: these range from the all-encompassing 'universal bank' system in Germany or Spain to a much more restricted range of permitted services in Italy, for example.

Universal banking systems can be divided into different categories: first, a banking system such as in the UK may be *de facto* universal where banks are allowed to engage in brokerage services only through subsidiaries. Such 'fire walls' are supposed to reduce possible conflicts of interest inside the organisation. Second, in a banking system such as in the Netherlands banks are allowed to engage in all investment and brokerage services but are not permitted to hold significant equity stakes in industrial firms. Finally, the third category is characterised by no such restrictions on industry equity participations. Examples are the universal banking systems in Germany, Spain and Greece.

To assess the NRB of restrictions on the permitted range of activities we need to assess both costs and benefits of these restrictions. The costs of such restrictions consist mainly of not being able to attain potential economies of scope. Such economies may arise due to pooling of information collection if several services are offered to the same customer, since a customer creditworthiness evaluation needs to be undertaken only once.⁷⁰ In addition,

⁶⁹ On the issue of tax harmonisation in the EC see, for example, Giovannini and Hines (1991). They report a tendency of EC corporate income tax rates to converge which may be the result of a similar process as that for withholding taxes.

⁷⁰ The empirical studies in the US on economies of scope reviewed in chapter 4 cannot capture information collection advantages due to the lack of a universal banking system in the US.

allowing bank officials to be represented in the supervisory boards of non-bank firms may establish a closer working relationship between bank and firm, further reducing costs of information collection. Finally, diversification advantages resulting from a broader range of activities may contribute to achieving the same bank return at lower risk.

What are the social costs of allowing unrestricted universal banking? Permitting banks to hold equity participations in non-bank firms may lead to higher risk of bank failure as bankruptcy of the firm may induce solvency problems of the participating bank. Second, possible conflicts of interest may occur if a bank acts as underwriter and broker at the same time.⁷¹

Due to the complexity of the effects of restrictions on permissible lines of business it seems difficult to determine the NRB.⁷² However, casual observation of banks in countries where restrictions on full universal banking exist, shows that through 'creative' organisational forms such as holding companies banks attempt to circumvent official restrictions. This seems to suggest that banks perceive the NRB of line of business restrictions to be positive. Even for a holding company structure, there may be significant transaction costs of administering such a firm structure, since organisational complexity rises compared to an unrestricted universal bank form. In addition, economies of scope between different lines of services may be foregone if communication between the legally separated subsidiaries is prohibited through 'firewall' provisions.

How credible is the threat of relocation in the case of line of business regulation? First, note that it is possible for a bank from a country with a universal bank system to operate its full range of activities in a host country in which there may be substantial restrictions on permitted activities. Entry by the universal bank would be based on Article 18(1) of the Second Banking Directive which requires that any activity listed in the annex to the Directive may be carried out by authorised institutions in any Member State. Banking activities included cover the whole range of services typically carried out by universal banks, including securities trading, underwriting, brokerage services and consultancy.

Second, in addition to operating the full range of banking services with no need to maintain separate subsidiaries, the Directive contains no principal preclusion of banks participating in other non-bank firms and non-bank firms acquiring stakes in banks. Thus, existing restrictions on industry participations in Member States do not apply to foreign banks where such restrictions do not exist in their home countries. However, Article 12 (4)

⁷¹ For an account of possible conflict of interest situations which typically arise in universal banks, see OECD (1989, p.228-229).

⁷² See Huveneers and Steinherr (1990), however, for such an attempt.

determines that such non-bank participations may not exceed 15 percent of the bank's equity capital.

Thus, domestic banks may react by calling on home regulators to ease hampering restrictions which put them at a competitive disadvantage in countries where a stricter separation of commercial and investment banking is in place. Secondly, domestic banks may threaten to open a subsidiary in a country with no restrictions and make domestic branches a legal part of this foreign subsidiary. In this case, it would be possible to operate under the universal bank principle and circumvent existing domestic restrictions.

3.3. Competitive deregulation in the EC insurance sector

Currently, two different approaches to regulating insurance services in the EC can be distinguished: the "maritime" model (Albert, 1987) which is predominant in the UK, Netherlands, Ireland and Denmark where regulators grant a license and monitor the solvency of insurers but abstain from direct premium or profit regulation. The second model is the "Alpine" model where regulators interfere directly in the product and pricing structures of the insurance sector. The most extreme example of such a material control system is Germany where new products need to be approved by the supervisory authorities, a process which has taken up to six years in some cases. In addition, premiums are determined and monitored by the regulators with detailed rules on how to distribute excess profits to the insured.

Under the passport rules it will be possible for a UK insurer, for example, to offer according to its own regulatory regime in the German market. The draft proposals for the Third EC Insurance Directives therefore include provisions which require Member States to give up any prior approval of premiums and products and instead to ensure the solvency of the insurer. Thus, the Directives basically follow the "maritime" model rather than the "Alpine" model. The Directives are therefore likely to lead to a process of strategic deregulation as those countries which have followed the material control approach are forced to abandon their strict premium and product controls. This process shall be discussed for the examples of the life and motor insurance sectors in the next two sections.

3.3.1. The regulation of life insurance

Table 2.4 provides an overview of the different approaches to regulating life insurance in the largest six EC economies which together constitute 95 percent of the total life insurance business in the EC. It becomes apparent that the regulatory approach differs in some main respects in the EC countries. In particular, as was mentioned above products and premiums are subject to prior regulatory approval by the supervisory authority in Germany, France and Italy, while in Spain premiums and conditions need to be communicated

to the regulator. No such ex ante approval is required in the UK and the Netherlands.

Table 2.4: Comparative summary of life insurance regulation in six EC countries

	Official prescription of key actuarial parameters	Official rules for distribution of excess profits	Official rules for investing assets	Valuation principle of assets
Germany	yes	yes	yes	historical cost
UK	no	no	no	market value
France	yes	yes	yes	historical cost
Italy	no	no	yes	historical cost
Spain	no	no	no	market value
Netherl.	no	no	no	market value

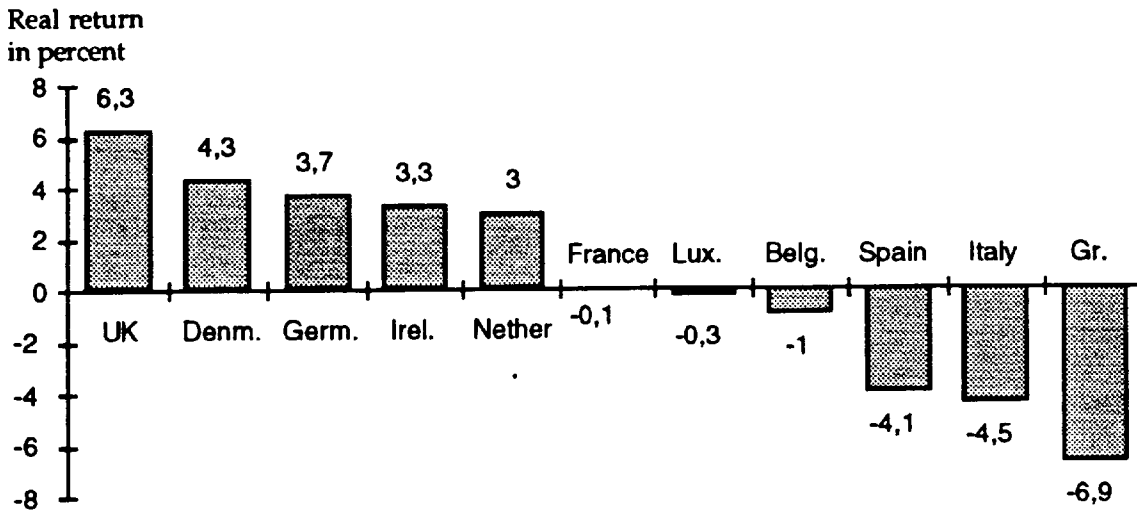
Source: own compilation from several national sources

In Germany and France key actuarial data required for calculating premiums are provided by the regulatory authorities. In France, for example, statistical data on mortality rates are prescribed by the regulator. The interest rate which is to be used to calculate the development of the value of the assets is officially determined to be 4.5 percent (3.5 percent for older contracts). Similarly, the cost component which the insurer is allowed to add to the actuarial premiums is officially determined. Thus, since the calculation of premiums is standardised, resulting premiums for life insurance are more or less identical for all insurers in the market. This leads to the virtual elimination of price competition in terms of premiums. As is apparent from table 2.4, however, both countries also have official rules for distributing excess profits which result from the conservative calculation of premiums. Thus, life insurers differ mainly in terms of the amount they are able to distribute to policyholders which in turn depends on their management of operating costs as well as the success of their asset management strategies.

Concerning these asset management strategies, Germany, France and Italy have explicit rules on the permitted composition of the asset portfolio. In France, for example, minimum and maximum percentage rates for specific assets such as government bonds or shares need to be obeyed. Similar rules in Germany and Italy are mainly targeted at preventing excessive investment of the funds of a life insurer in risky assets. These rules lead to a high proportion of investment in bonds of around 70 percent in Italy and 60 percent in France. Only 10 percent were invested in shares in Italy, while this figure was 20 percent in France. In contrast, in the UK where no rules on the composition of the asset portfolio of life insurers exist, more than 50 percent were invested in shares and only 20 percent in bonds. This indicates that in a less regulated market insurers invest to a greater extent in higher-risk, higher-return assets.

Restrictions concerning asset management strategies can also be viewed in terms of the NRB: at first glance, such restrictions provide only costs to the insurer, as life insurers cannot pursue an unconstrained portfolio management strategy but have to obey the official rules. Apart from administrative costs, conservative investment rules result in a lower expected return. Thus, by relocating to a country with less strict investment rules an insurer from a high-regulation country will be able to pursue a riskier strategy and thus is likely to be able to offer a higher return to the life policyholder. On the other hand, a high-risk strategy also results in a higher default risk with a life insurer facing a greater risk of not being able to cover its liabilities. Thus, a firm from a high regulation country will be able to build a reputation for offering low-risk policies. Thus, the balance of costs and benefits of asset investment rules are not clear. In figure 2.6 the real return to policyholders of life insurers for a ten-year policy in the twelve EC countries is shown.

Figure 2.6: Real returns to policyholders of life insurers



Source: Nonhoff (1991, p.262).

It becomes apparent that the real return is substantially higher in those countries which have established the 'maritime' regulatory approach, namely the UK, Denmark, Ireland and the Netherlands. In fact, in all other EC countries the real return to the life policyholder is negative. The only exception is Germany where returns were also positive. This is at least partly attributable to the low rate of inflation rather than to high nominal returns. In summary, there is therefore some evidence that a high regulatory intensity leads to lower returns and therefore to a positive net regulatory burden for insurers.

3.3.2. *The regulation of motor insurance*

The motor insurance sector constitutes by far the largest individual branch in premium terms of the non-life business in all EC countries. Due to the compulsory status of motor third-party liability insurance resulting from the specific policy objective of protecting third parties in automobile accidents, this sector was initially excluded from the Second Non-Life Directive.⁷³ Freedom of services for large risks (i.e. fleet policies) will be introduced by an amendment⁷⁴ to the First and Second Non-Life Directives, however, after the Third Motor Liability Insurance Directive passed in May 1990 has paved the way for such an approach.⁷⁵ Even more importantly, motor insurance will be included in the Third Non-Life Directive which introduces freedom of services at the end of 1994 also in the mass retail market.

Regulations concerning motor insurance currently differ significantly across the EC countries, as is illustrated in table 2.5. In particular, the setting of tariffs is free in seven EC countries, while being subject to government control or public authorisation in the other countries.

⁷³ See Pool (1990, p.69-82) for a detailed account of the development of EC legislation on motor insurance.

⁷⁴ OJL, 90, 618.

⁷⁵ OJL, 90/232.

Table 2. 5: Regulations concerning motor insurance in 12 EC countries

	Tariff Setting	Statutory minimum cover for cars (in ECU)		
		Personal Injury (per person)	property damage	per event
Germany	regulated	489,300	195,700	734,000
France	free	719,200	431,500	-
UK	free	unlimited	354,000	unlimited
Italy	regulated	454,600	194,800	974,100
Netherl.	free	-	-	867,400
Belgium	regulated	unlimited	unlimited	unlimited
Lux.	uniform	unlimited	unlimited	unlimited
Denm.	free	7,620,300	1,524,100	-
Irel.	free	unlimited	52,100	unlimited
Greece	uniform	69,800	14,000	-
Spain	free	61,400	16,900	unlimited
Portugal	free	65,900 (overall)		109,900
Second EC Directive (minimum coverage)	-	350,000	100,000 (per accident)	600,000 (personal injury & property damage)

Source: Swiss Re, Sigma 1/1991

Concerning statutory minimum cover for cars involved in accidents, there are still significant differences between the EC countries despite the harmonisation measures of the Second EC Motor Insurance Third-Liability Directive which establishes minimum amounts for liability coverage. Ireland, Greece, Spain and Portugal have until 1995, however, to establish the Directive. In addition, Member States are free to establish higher amounts for minimum coverage and frequently do so, as is apparent from the table. Regulatory competition may therefore also take place in the area of liability coverage. This stems from the fact that a Greek insurer, for example, which sells motor insurance in Germany according to home-country rules is able to offer substantially lower premiums due to significantly lower coverage in the case of an accident. It is not clear, however, whether German insurers therefore face a higher NRB, since high amounts for compulsory liability coverage also have benefits for insurers, as consumers may prefer higher rather than lower liability coverage. Thus, if consumers are willing to pay higher premiums for better coverage, such regulations do not lead to a higher NRB for those firms which are located in high coverage countries.

The impact of the EC Directives is likely to be most significant in the area of tariff setting in those countries in which tariffs were determined by the public authorities such as in Italy or are subject to authorisation such as in Germany or Belgium. In Germany, for example, premiums are based on the number of years of accident-free driving of the person seeking insurance, the county of residence, the horsepower of the car and the occupation of the

owner. Thus, an automobile owner has to look at only one tariff when comparing premiums for different insurers.⁷⁶

With the deregulation on the EC level, tariff and premium regulation will quickly disappear in those countries where it was formerly practised. In addition, the bonus/malus system which is currently uniform for all insurers in Germany is likely to be deregulated as soon as foreign insurers will be able to introduce different schemes which offer higher premium reductions for good risks.

In summary, in the motor insurance sector we expect the greatest changes in those countries which will be forced to abandon tariff and premium regulation, as foreign insurers will be able to offer unregulated rates which may be more advantageous to consumers.

4. Conclusions

In this chapter the regulatory environment of cross-border entry in retail financial services in the EC was analysed. It was argued that at the heart of market failures necessitating public regulation lie agency problems which arise between depositors or policyholders, managers and owners.

Two main market failures were identified which constitute the economic rationale for financial services regulation. First, informational asymmetries between customers and firms arise due to private information on the part of managers about the asset quality of their firm, as well as from the complex nature of many financial services products which prevents fully effective monitoring by customers. Secondly, negative externalities in the form of 'runs' on financial institutions may arise which have real effects on other sectors in the economy and may reduce the efficiency of financial intermediation.

Against this background, the changing regulatory approach of financial services regulation on the EC level was assessed. First, capital liberalisation provides the necessary prerequisite for increased cross-border penetration, as it allows both agents and firms to freely transfer funds across national boundaries and thus seek the optimal risk-return portfolio in the EC countries, as well as purchasing financial products in those countries which offer the best terms and conditions. Secondly, the Second EC Banking Directive and the Third EC Insurance Directives establish a regulatory regime

⁷⁶ This has led many insured to believe that there is also a uniform premium for the same tariffs which is not true, as there is indeed price competition between German insurers. Schulenburg (1989, p.10) reports the result of a survey which shows that 33 percent of German insured did not know that there is price competition between insurers and another significant proportion believed that they have inexpensive insurance even though they are actually with an expensive insurance company. He concludes that "insurance market regulation has not increased consumer information but has decreased it".

which allows cross-border provision of services and freedom of establishment under the home-country rule. While there are some ambiguities concerning the boundary between home country regulation and host country supervision of "rules of conduct", it seems certain that foreign financial services firms will be able to operate under home country regulatory rules for most of their activities and will therefore no longer have to deal with several different supervisory agencies when operating internationally.

A simple game-theoretic model was developed to analyse the process of 'strategic deregulation' where national regulators may aim to provide domestic financial institutions with competitive advantages abroad or attract foreign firms to the home country. It was shown, however, that once objective functions and strategies are fully specified, regulators have no interest in deregulating infinitely, since this would jeopardise financial stability in their home country. In addition, they are able to 'free-ride' on the deregulatory moves of other national regulators. It became clear that regulatory competition is a complicated process where regulators may choose from a variety of plausible strategies. In particular, it is by no means evident that regulatory competition results in lax supervision or leads to neglect of the original economic objectives of alleviating market failures, as predicted by some academic commentators.

Four areas which are likely to come under intense scrutiny in the banking sector after 1992 were identified, including minimum reserve requirements, deposit rate regulation, taxation of interest rate earnings and line of business restrictions. It appears likely that in these areas the dynamics of free capital flows and banks placing pressure on their home country regulator will lead to greater convergence on the EC level.

In the insurance sector even more significant changes will take place in those countries which have so far relied on a material control system of supervision with premium and profit regulation. This regulatory approach will quickly be replaced by a deregulated system of free price competition where regulators control only solvency and reserve requirements. This process of deregulation was discussed for the life and motor insurance sectors which are likely to be most affected by liberalisation.

Chapter Three: An Eclectic Theory of Cross-Border Entry in Retail Financial Services

The postwar multinationalisation process in manufacturing industries has been the subject of frequent theoretical and empirical scrutiny. Cross-border entry activities in financial services, however, which have undergone a similarly significant expansion process have attracted much less attention in the academic literature. Existing studies on financial services focus almost exclusively on cross-border entry in wholesale and investment banking and not on retail financial services. This chapter therefore develops an eclectic theory of cross-border entry in retail financial services and the focus of the analysis is thereby placed on three crucial questions:

- *Why* does a financial services firm enter a foreign market, i.e. what competitive advantage may compensate a foreign firm for operating at a distance and in a foreign environment?
- *Where* does a financial services firm enter a foreign market, i.e. what particular host and home country characteristics induce cross-border entry?
- *How* does the financial services firm enter, i.e. which environmental and strategic factors determine the choice of cross-border entry vehicles?

Following this research agenda, an eclectic theory of cross-border entry needs to comprise and analytically penetrate three fundamental aspects:

- *firm-level* conditions: possible sources of competitive advantages of foreign entrants giving them an edge over domestic financial services firms;
- *locational* conditions: characteristics of the target market in relation to the home market which makes cross-border entry attractive;
- *market-based* conditions: variables influencing the decision of whether to exploit firm-level and locational advantages by market transaction or internalisation.

While the first two conditions are each necessary for cross-border entry, it requires additional internalisation advantages resulting from market imperfections to make the financial services firm choose multinationalisation rather than other forms of cross-border entry such as exporting or a strategic alliance.

An eclectic model of multinational enterprises was developed by Dunning (1977, 1980)¹ and I use this paradigm as a structuring analytical framework to guide the analysis of cross-border entry in financial services. The analysis is more than a mere application of this eclectic model to the financial services industry, however, as I attempt to point out possible extensions and modifications of the eclectic framework.

The first section provides an overview of trade theory and its applicability to the financial services industry. The second section develops a firm-level approach to the theory of cross-border entry and looks at factors which may provide competitive advantages to foreign financial services, while the third section considers locational characteristics which may induce cross-border entry. Finally, a fourth section discusses the choice of the mode of entry into foreign markets.

1. A first approach: trade theory

The theories of international trade and foreign direct investment (FDI) have evolved rather separately. In fact, authors of the latter theory claim to start where trade theory supposedly ends.² The traditional separation of trade theory and the theory of FDI is sometimes explained by a different focus of analysis: while trade theory examines the question why countries trade with each other by means of exporting, the theory of FDI scrutinises why firms choose international production. Such a separation of issues does not seem to be warranted, however: in most industries the decision between exporting and FDI is not mutually exclusive.³ In practice, the distinction between exporting and FDI has become blurred: exporting activities are frequently supported by at least some form of foreign direct investment, such as opening a representative office, for example, to support distribution of the exported product. Exporting and FDI may even be chosen simultaneously by a firm such as in large-scale project finance or reinsurance which are frequently handled from headquarters, rather than being delegated to foreign branches. These considerations call for an integrated approach to the theory of trade

¹ Dunning's eclectic model is neatly summarised in his 1988 overview paper where he states that "it is ... the juxtaposition of the ownership-specific advantages of firms contemplating foreign production, or an increase in foreign production, the propensity to internalise the cross-border markets for these, and the attractions of a foreign location for production which is the gist of the eclectic paradigm of international production" (p.5).

² Dunning (1988, p.1), for example, states that "the point at which the Heckscher-Ohlin-Samuelson theory of trade fails is precisely that at which the modern paradigm of international production starts...".

³ This is stressed by Veugelers (1990, p.156) who notes that "whereas in the theoretical literature on the choice between exports and foreign direct investment both modes are taken as extreme opposites, ... it should nevertheless be stressed that the difference between exporting and local production is rather vague and in reality is more a question of degree."

and international production, rather than a separation of the issues into two distinct theories. Although such a 'general' theory is not developed in this chapter as our focus is on one particular industry, I hope to demonstrate the merits of such an eclectic approach when employing it to explain cross-border entry in the financial services industry.

The theory of international trade also underlies the methodology of the Cecchini report with many of its (implicit) assumptions and predictions originating in traditional trade theory.⁴ In the study on financial services, barriers to trade are considered to be a form of tariff: "the net effect {of barriers to trade} is as if there were a set of tariffs protecting the producers of financial services in the high price countries" (Price Waterhouse, 1988, p.19). Their removal is claimed to lead to welfare effects similar to those of a "move to free trade".

In the following section, I analyse whether the theory of international trade is suitable as an analytical framework for financial services.⁵

1.1. A brief overview of trade theory in services

Traditional trade theory started with Ricardo's *Principles of Political Economy and Taxation* (1817) in which he showed that countries can gain from trade if they have different production technologies resulting in differing opportunity costs of one country in the production of particular goods or services. Ricardo showed that trade can be beneficial even if one country has strictly lower marginal productivities in all factors of production, since specialisation allows exploitation of a comparative advantage in producing a good or service.

While Ricardo placed the focus on differing production technologies, Ohlin (1933) and Heckscher (1949) examined the consequences of differing factor endowments, assuming identical production technologies in a two country model with two goods or services and two production factors. Under a range of additional assumptions which basically assume away all differences between the two countries except factor endowments, they show that countries will export the good or service which requires a greater input of the factor in which the country has a greater endowment. In addition, free trade is a perfect substitute for international factor mobility, as it equalises input prices in the two countries.

⁴ See chapter 5 for a more detailed analysis of the Price Waterhouse study on financial services in the Cecchini-Report.

⁵ See, for example, Heffernan and Sinclair (1990) for a more comprehensive overview of modern trade theory.

Much of the succeeding theoretical developments in trade theory developed as a response to empirical evidence which seemed to be at odds with the Heckscher-Ohlin approach⁶ and also attempted to provide explanations of the increasing importance of *intra*-industry as distinct from *inter*-industry trade. The most interesting new developments in trade theory address economies of scale and imperfect competition (see Helpman and Krugman, 1985, for a review). Economies of scale are usually analysed in the context of monopolistic competition models where it can be shown that *intra*-industry trade occurs as a result of product differentiation and increasing returns. Models of imperfect competition in international trade have primarily addressed the impact of protective policy measures such as tariffs, export subsidies or import quotas (see Krugman, 1989).

Just like most of industrial organisation theory, international trade theory is almost exclusively addressed at manufacturing and extractive industries rather than the service sector. This has led Kierzkowski (1987, p.14) to observe a "general neglect of services by trade theorists". This neglect may partly be explained by the common notion that services are essentially 'non-tradeable', since they mostly require personal proximity between service provider and recipient. Thus, the few existing models on services in trade predominantly refer to trade in service factors where production and consumption of service products are inseparable (e.g. Melvin, 1989; Burgess, 1990).

We can distinguish two principal types of service transactions: the first category of services requires the transacting agents to be at the same location. Clearly, while physical proximity is required for some services (e.g. haircuts, medical examinations) which cannot be provided at a local distance, there is a wide range of services which can be provided across borders at an arms-length level, i.e. where service provider and recipient do not need to be in physical proximity. In particular, the recent advances in communication and information technology have shifted some services from the first into the second category. As will be discussed below, this is particularly true for financial services where particular products can now be provided or traded across borders. This implies that services which already account for a constantly increasing share of up to two thirds of the national product in some countries (see Enderwick, 1989, p.8) will also gain in significance in international trade. This rising importance is illustrated by the inclusion of services in the GATT Uruguay Round of Multilateral Trade Negotiations.

Are the theoretical models to explain international trade in goods also applicable to trade in services? Hindley and Smith (1984) argue that the theory of comparative advantage can be used to explain services trade. Sapir and Lutz (1981) apply the Heckscher-Ohlin paradigm to a range of services in

⁶ The best-known example being the Leontief 'paradox' (Leontief, 1953) which seemed to show that the United States imported capital-intensive goods and exported labour-intensive goods. See, however, Leamer (1980) for a critical evaluation of Leontief's methodological approach.

the developed and developing countries and find that factor endowments have some explanatory power but leave a significant degree of trade unexplained. Jones and Ruane (1990) build a simple Ricardian trade model for services and find that both factor and product trade unambiguously improve domestic social welfare over a situation of autarky. In the following section I analyse the applicability of trade theory for the case of financial services.

1.2. The applicability of trade theory to financial services

In a survey article on international financial services, Aliber (1984, p.663) sets the research agenda for a Ricardian comparative advantage approach to explaining trade in financial services: "In a competitive world economy, which countries produce bank deposits or financial intermediation services at the lowest possible cost?". In other words, for a comparative advantage explanation of international trade in services we need to search for factors which convey a relative cost advantage on financial services firms in one particular country. I discuss possible sources for such a comparative advantage for the example of banking.

Operating costs in financial services as in most other industries include labour (wages and salaries) and physical capital (e.g. buildings and equipment). In addition to these standard input factors, banks use funds to make loans to personal or commercial customers. Since funding costs constitute a crucial determinant of the firms' overall cost position, it is decided here to include them as an input factor.⁷ In particular, the variables in the bank's cost function are to some extent substitutable: a bank may have high labour and capital costs if it decides to gather loanable funds through a retail network. Alternatively, it may purchase funds in the interbank market and thus has higher interest rate costs but lower labour and capital costs. Cost of funds should therefore be included in the bank's cost function.

Access to cheaper funds may be the most important explanatory variable in the context of a comparative advantage explanation of international trade in banking services, as argued by Aliber (1976, 1984). While Aliber looks only at the cost of capital, however,⁸ one needs to include general funding costs of a bank including access to the interbank market and retail deposits. In particular, as funding costs vary between countries, those financial services firms which have access to cheaper funding sources at home are able to provide banking services abroad at lower costs. One may therefore expect

⁷ Therefore, the 'intermediation' approach to defining bank output is followed which includes interest expenses. The 'production' approach, in contrast, takes only operating costs, i.e. labour and physical capital into account (see Humphrey, 1984).

⁸ He only mentions the cost of equity finance: "The cost of capital is given to the firm by investors, who price the capital on the basis of the risk they associate with the firm and the returns available to them on other securities" (1984, p.669) .

those countries which have lower funding costs to be net exporters of banking services and especially international loans, the more so the greater the cost differential between the trading countries.

Funding costs of a bank are determined by a range of factors such as access to retail deposits including the interest rate which needs to be paid on demand and time deposits, access to the international and domestic interbank markets and the cost of equity finance determined by the risk which investors associate with the bank. Most importantly, however, the real rate of interest in a particular country determines a bank's funding costs, as it crucially influences the rates which the bank charges to borrowers and offers to depositors. Although the largest international financial services firms have the possibility to tap international capital markets and can therefore make themselves to some degree independent of the domestic interest rate level, other factors such as the domestic customer base impose the domestic interest rate on the bank. Thus, there is a correlation, though not a perfect one, between the national interest rate and the funding costs of the bank. As a result, banks from countries with lower real rates of interest can be expected to have a comparative advantage in offering particular services in international banking activities. In the European Community, however, continued economic and monetary integration will lead to smaller differences in real interest rates and therefore interest rate advantages will become less and less significant as a source of a comparative advantage.

In addition, a comparative advantage in terms of a lower national interest rate is not easily transferred to another country through international lending activities. Quite apart from country risk which has turned out to be significant in third world lending, there is still substantial currency risk even for stable economies and members of the EMS. Consider, for example, a German bank which sells a ten year fixed-rate mortgage to a Spanish customer for 6 million Pesetas at an annual interest rate of 12 percent. The mortgage is refinanced at a rate of 9 percent per annum in the German interbank market and Deutschmark are exchanged into Pesetas at an exchange rate of DM1.60 for 100 Pesetas. Now suppose that the Peseta depreciates to an exchange rate of DM 1.55/100 Pesetas after the first year and remains at this rate for the next nine years. As can easily be calculated, this leads to a total loss to the bank despite the initial handsome profit margin.

As this simple example demonstrates, an apparent comparative advantage stemming from lower funding costs cannot be translated quite that easily into a real funding advantage, once exchange rate factors are explicitly incorporated into the analysis. To determine the comparative advantage of a country in terms of funding costs it is therefore essential to determine the difference in cost of funds *and* the expected currency risk between two countries. In other words, to determine whether a comparative advantage exists it is necessary to undertake a detailed analysis of the economic differences between two countries.

It becomes clear from the preceding analysis that the theory of comparative advantage provides a useful starting point for analysing cross-border entry in financial services. However, it throws up as many new questions as it answers. In particular, a more thorough analysis of the roots of greater labour or capital productivity is needed. It is most useful to undertake such an analysis at the firm-level rather than at the aggregate macro-level.

2. A firm-level approach to the theory of cross-border entry

Cross-border entry may take a variety of organisational forms such as exporting, strategic alliances or multinationalisation. For any type of cross-border entry it is commonly argued that the entering firm needs to possess some competitive advantage to compensate for inherent cost disadvantages. Such cost disadvantages result purely from the fact that the entering firm is 'foreign' and yet unfamiliar with the host market. In the theory of FDI this argument was first formulated for manufacturing industries in Hymer's 1960 doctoral dissertation (published 1976).⁹ On a macro level this proposition is also implicit in much of traditional trade theory. In fact, as was discussed above, Ricardian trade theory is based on differences in production functions, while the Heckscher-Ohlin model cites differing access to production factors as the main rationale for trade. Both of these approaches can therefore be reinterpreted as exploring competitive advantages of firms involved in international trade or production which thus provides a micro foundation of the macro theory of trade. Before discussing the possible sources of such competitive advantages for the case of the retail financial services industry, I first analyse possible reasons for inherent cost disadvantages of foreign entrants.

It is essential for the understanding of the role and functions of multinational financial services firms to analyse why financial services firms exist and why intermediation replaces market transactions. The next section therefore develops a theory of the economic function of banks in an economy with transaction costs. In section 2.2 the economic role of insurance firms is analysed.

2.1. Direct financing versus financial intermediation: a contractual theory of the economic function of banks

Any theory of cross-border entry in banking must come to grips with the question of why banks exist, restating Coase's (1937) classic question of why internal transaction (intermediation) replaces direct contracting in the market. Hicks (1974) distinguished between the 'auto-economy' and the 'overdraft economy'. The latter is characterised by the insignificance of direct

⁹ See Dunning and Rugman (1985) for an assessment of the impact of Hymer's dissertation on other theories of FDI.

finance, as borrowers use financial intermediaries and rely on bank credit rather than capital market funding. The crucial question is to determine why agents prefer to contract with financial intermediaries rather than use direct finance. We proceed by analysing the relative efficacy of alternative means of contracting, assuming that agents want to minimise the level of transaction costs when informational asymmetries are present.¹⁰

In an Arrow-Debreu (1954) economy where markets are frictionless and complete contracting is possible, financial intermediation does not exist due to the absence of transaction costs and uncertainty, since there is the possibility of writing contingent contracts for all possible future events. As Williamson (1975, chapter 2) argues, however, complete contracting for all future contingencies is impossible, due to the existence of bounded rationality,¹¹ placing limits on the agent's capacity to process all required information. Thus, contracts necessarily remain incomplete with many implicit rather than explicit corollaries which are difficult to litigate in court (Grossman and Hart, 1986). Once we depart from the assumption of complete contingent contracting and explicitly formalise the existence of transaction costs,¹² sole reliance on direct contracting between agents in financial markets may lead to a Pareto-inferior equilibrium compared to a situation where financial intermediaries exist. To explain the existence of financial intermediation, we therefore have to show that banks are able to help agents economise on the different forms of transaction costs.

The concept of transaction costs is employed with several different meanings.¹³ At the heart of our analysis is the study of the type of contract which borrowers and lenders enter into. The term 'contract' is hereby not confined to purely legal arrangements with its standard characteristics of offer and acceptance, but is interpreted in a broader economic sense, describing any form of relationship between economic agents which establishes an (implicit or explicit) mutual agreement or expectation to perform certain tasks or

¹⁰ Williamson (1989, p.136) notes that such a transaction costs approach to the theory of the firm must entail "an examination of the comparative costs of planning, adapting and monitoring task completion under alternative governance structures".

¹¹ Simon (1947 p. xxiv) defines bounded rationality as agents' behaviour which is "*intendedly* rational, but only *limitedly* so."

¹² Bolton (1990, p.303) notes that "... a large part of the theoretical research effort of the past three decades (scrutinised) the implications of gradually limiting the set of feasible contracts further and further away from the set of fully contingent Arrow-Debreu contracts".

¹³ For example, Leland and Pye (1977, p.382) include only those costs which arise in actual market transactions, excluding information or monitoring costs. Arrow (1969, p.48), on the other hand, defines transaction costs as the "costs of running the economic system", a view which appears too broad for our operational purposes. The view that transactions should be the primary focus of firms' and market analyses goes back to Commons (1934).

behave in a particular way.¹⁴ Since the focus of the analysis is placed on contracts, we therefore introduce a 'contractual' definition of transaction costs, encompassing all costs associated with arranging, completing, monitoring and enforcing contracts. To make our discussion more precise, we distinguish pre- and post-contractual transaction costs.

Pre-contractual transaction costs include the costs of searching for a suitable contracting partner with matching preferences concerning type, length and conditions of the contract. Secondly, as bounded rationality prohibits complete specification of all possible future contingencies, the agreed contract will necessarily be incomplete. Thus, expectations about post-contractual bargaining behaviour decisively determine the contractual agreement. An example is *ex ante* relationship-specific investment which is at least partly non-recoverable in other contractual relationships. The two contracting parties thus recognise their post-contractual interdependence of bilateral monopoly. In particular, an asymmetric distribution of *ex post* bargaining power may jeopardise the efficient level of idiosyncratic investment *ex ante*, since expected opportunistic behaviour by the other contractual party may reduce the willingness to commit to pre-contractual specific investment.¹⁵

Post-contractual transaction costs include the monitoring of the contract as both parties have to check that the other party abides by the agreement. In its simplest form monitoring causes only opportunity costs as time is sacrificed to check on the other party. Real resource costs arise if investment in monitoring technology is required which tends to be more sophisticated the greater the complexity of information and informational asymmetries. Second, in case of contractual disagreements arising from incompletely specified contingencies there may be enforcement costs as arbitration or legal means are required to settle the dispute.

Consider an economy with n potential lenders and m potential borrowers. Lender k has a maximal amount of a_k to invest and borrower j requires funds f_j to undertake a project which yields stochastic returns. The value of capital to the borrower is given by v_j and the lender requires a return of at least r_k given by the next-best alternative use of funds. Thus, direct contracting will only take place if $\exists k, j$ such that $v_j \geq r_k$. If i is the negotiated interest rate at which lending occurs then the lender's surplus is given by $i - r_k$ and the borrower's surplus is $v_j - i$. Both borrowers and lenders have the option of contracting directly or using an intermediary when maximising their respective surplus margins subject to a given level of risk aversion. Let the sum of transaction costs of direct contracting be represented by x_i . If $r_k - x_i > i$ then no direct contract will be agreed upon.

¹⁴ Williamson (1990) therefore suggests replacing the term 'contract' by 'treaty' to avoid unwanted "legalistic" connotations.

¹⁵ See Klein, Crawford and Alchian (1978).

Transaction costs of direct contracting and intermediation depend on a variety of factors. Direct contracting may be difficult for the following reasons: first, differing preferences of borrowers and lenders of funds regarding type, length and maturity of contract may cause incompatibilities between borrowers and lenders. For example, borrowers may require long-term funds for project financing, whereas lenders prefer fairly liquid short-term liabilities. Even where such preferences coincide, there may be considerable search and information costs involved in finding the adequate contracting partner. Second, information impactedness may preclude efficient *ex ante* contracting, since lenders face informational asymmetries which coupled with post-contractual opportunism lead to problems of moral hazard and adverse selection:¹⁶ borrowers hold private information about their probability of being able to repay the loan. The lender therefore faces the problem of determining the optimal interest rate i^* such as to screen out good from bad loans: there is adverse selection, since for a higher interest rate the pool of applicants becomes riskier, and moral hazard results as borrowers are induced to undertake riskier projects to recover the higher cost of capital.¹⁷ As a result, a market for loans may cease to exist due to the 'lemon problem'.¹⁸ In order to reduce adverse selection and moral hazard problems, the lender has to incur considerable transaction costs when assessing the creditworthiness of the potential borrowers, collecting information on the likelihood of repayment.¹⁹

We see that lenders in particular may be unwilling to incur the transaction costs of loan contracts and prefer less risky uses of their funds.

¹⁶ See Hart and Holmstrom (1987) for a survey of the theory of incomplete contracting with asymmetric information. The problem of post-contractual opportunism has recently been incorporated into the theory of incomplete contracts, by requiring contracts to be 'renegotiation proof' (see Dewatripont, 1988 and Hart and Tirole, 1988).

¹⁷ See, for example, Jaffee and Russell (1976) and Stiglitz and Weiss (1981) on the methods of banks to induce borrower self-selection by rationing credit. Bester (1985, 1987) shows that collateralisation may serve as a signalling device where borrowers with a high probability of repayment are willing to accept a higher increase of the collateral for a given reduction in the cost of capital than those with a lower probability of success. Collateralisation thus reduces the problems of adverse selection through 'natural' screening of candidates.

¹⁸ Akerlof (1970). As lenders have imperfect information about borrowers' abilities to repay, lending rates have to incorporate a risk premium to reflect average project qualities. Thus, the presence of 'lemons' in the market tends to drive up rates and (potential) good borrowers who have to bear part of the costs of written-off loans may drop out of the market. The result is a market consisting of many bad borrowers.

¹⁹ Broeker (1990) shows that when there is pre-contractual competition between lenders there may be a winner's curse problem if the outcome of the creditworthiness assessment is not publicly observable, since the 'winner' of the contract has to fear that she is stuck with the borrower that nobody else wanted. On the other hand, there is a free-rider problem insofar as credit assessments are public knowledge, as borrowers have an incentive to free-ride on the monitoring activities of competitors.

Borrowers may face pre-contractual transaction costs as well, however, resulting from the Arrow paradox of information (Arrow, 1962b). For a potential lender correctly to assess the risk of the borrower's project, she needs to have complete information on the project. If she does, however, and assesses the project to be creditworthy she no longer has an incentive to lend the capital but may as well undertake the project herself.

Given these transactional difficulties of direct contracting, both borrowers and lenders may prefer to contract with financial intermediaries instead of engaging in direct contracts. To cover operating costs, intermediaries reduce the margins of both borrowers and lenders, however. In addition, as noted by Hellwig (1991) the longer chain of transactions between borrower and final investor in intermediation may increase transactions costs. Thus, intermediation is only preferred by agents if it offers a less costly contracting alternative.

Financial intermediaries may reduce the problems associated with direct contracting described above in several ways and therefore help agents to economise on transaction costs:

i.) *Coordination function*: financial intermediaries may help to reduce search and information costs simply by co-ordinating and matching lenders' and borrowers' preferred habitats by assuming the role of middlemen.

ii.) *Transformation function*: through bundling and diversification of lenders' funds and own equity, banks are able to transform highly liquid short-term liabilities into largely non-marketable long-term loans and may thus help to reconcile diverging preferences of borrowers and lenders concerning maturity or type of contract.²⁰

iii.) *Monitoring function*: banks may be able to reduce transaction costs associated with moral hazard and adverse selection problems by acquiring special expertise in evaluating the initial creditworthiness of loan applicants as well as developing monitoring technology to detect possible defaults.²¹

²⁰ This pooling of funds allows larger projects to be financed. Yanelle (1989) refers to this as the 'expansionary effect' of intermediation.

²¹ Bernanke (1983) describes a model where the main function of banks is to sort out creditworthy borrowers from loan applicants whose projects do not deserve funding. Diamond (1984) develops a model in which financial intermediaries are delegated the role of monitoring loan contracts. These institutions are able to avoid costly duplication of monitoring and enjoy a net cost advantage due to diversification advantages. In practise, banks have developed quite sophisticated credit analysis systems of screening potential borrowers. The effort invested by banks depends on the amount and riskiness of the loan, ranging from standard 'credit scoring' procedures for consumer loans to extensive industry and company analyses in the case of high-risk venture capital. Additionally, banks have developed risk-management procedures for early detection of liquidity problems, ranging from computerised analysis of

iv.) *Size and learning economies*: compared to individual lenders, banks enjoy economies of scale in establishing common screening and monitoring techniques through centralisation, thereby avoiding wasteful duplication of efforts, but reaping the benefits from learning economies as special expertise and experience accumulates.²²

v.) *Reputation effects*: intermediaries may build up a reputation of not exploiting confidential information provided by borrowers and thus solve the public good nature of information. In addition, a long-term relationship between bank and borrower reduces monitoring and verification costs.

These factors tend to explain why the vast majority of financial transactions are channeled through banks rather than using means of direct contracting.²³ The *raison d'être* of banks is applied to an analysis of the inherent cost disadvantages of foreign institutions in section 2.3.

2.2. Diversification and risk pooling: the economic function of insurance firms

The issue of the economic function of insurance firms seems a lot less contentious than for the case of financial intermediaries. Insurers serve the main purpose of reducing risk for economic agents. There are many different definitions and classifications of risk.²⁴ Any individual economic agent faces the risk of being confronted with 'unforeseen' circumstances which have only a low probability of occurrence but may have disastrous financial effects. Such events include, for example, a fire destroying all personal belongings, car accidents with liabilities to third parties or injury leading to permanent disability. The agent could provide for such events by saving funds which may be used in the case of financial need arising from the occurrence of these

payment streams on the current account to in-depth monitoring of a company's financial performance.

²² Notice, however, that these economies are not limited to financial intermediaries: the recent emergence of 'corporate banks' which are bank-like departments inside industrial firms demonstrates that once an industrial firm reaches a minimum efficient scale, it may pay to internalise financial transactions rather than to contract with an intermediary. Many of the functions traditionally performed by intermediaries such as portfolio and foreign exchange management are now performed by in-house departments.

²³ However, the recent trend towards securitisation may be interpreted as a move away from intermediation. Direct contracting is also observed in the venture capital market, for example, where entrepreneurs sometimes seek direct contractual arrangement with a capital provider. One could argue, of course, that these entrepreneurs have been weeded out by banks' screening procedures and are therefore the "lemons" in the market (Akerlof, 1970).

²⁴ See, for example, Greene and Trieschmann (1988, p.3-10).

events. These funds are unlikely to be sufficient, however, in the case of large financial liabilities. In addition, even though such a 'savings fund' earns interest, there are still significant opportunity costs if the agent could derive a higher marginal utility from spending these funds on consumption.

Rather than providing funds for 'emergency needs' himself, the agent could get together with a sufficiently large group of other economic agents and form a coalition which has the function of pooling the emergency funds which are provided by each agent. Such centralisation can be shown to be cost efficient due to the operation of the well-known 'law of large numbers'.²⁵ Let X_1, \dots, X_n be a random sample from a distribution with finite mean μ and finite variance σ^2 . Then

$$\lim_{n \rightarrow \infty} P\{ |X - \mu| < \varepsilon \} = 1$$

where $X = \sum_{i=1}^n X_i/n$, i.e. the sample mean. The law of large numbers can be easily proved using Chebychev's inequality. The law states that as the sample size increases, the sample mean approaches the true distributional mean. For insurance this implies that as the number of insured increases, the greater the likelihood that the actual distribution of claims equals the expected distribution. Building upon the law of large numbers, it can be easily shown that the average claim per insured approaches the true mean of the claims distribution and that the insurer can therefore predict the actual claims more accurately the greater the number of insured. Insurers therefore serve the following functions in an economy:

i.) *Pooling function*: through the working of the law of large numbers insurers are able to pool the risk of several agents more effectively than if agents were to set aside funds for financial emergencies on an individual basis;²⁶

ii.) *Risk assessment*: insurers are able to predict risk more accurately through accumulating experience to predict actuarial losses. In particular, insurers can effectively set up and monitor schemes to reduce the problems of moral hazard and adverse selection;²⁷

²⁵ See, for example, Cummins (1991) for an overview of the statistical approach to insurance.

²⁶ Note, however, that pooling does not eliminate risk completely, since $nX - n\mu$ can be quite large even if $X - \mu$ becomes small as n increases.

²⁷ See, for example, Stiglitz and Arnott (1990) on the issues of moral hazard and adverse selection in insurance markets.

iii.) *Learning economies*: closely related to the risk assessment function, insurers are able to refine their actuarial techniques and predictive capabilities, the longer they operate in the market;

iv.) *Diversification function*: by operating in several different markets, insurers are able to reduce operating risks and even out large unexpected losses in one particular insurance market by a more favourable loss distribution in another market;

v.) *Reputational effects*: insurers are able to establish a reputation for being financially solvent and prudent in their actuarial management of premiums and claims. This may be particularly important where the economic agent has to pay premiums several years ahead of being able to file claims, such as in life insurance.

This analysis of the economic functions of banks and insurers is now applied to an analysis of possible cost disadvantages of foreign entrants in the next section.

2.3. An application to the theory of cross-border entry: inherent cost advantages of foreign financial services firms

The analysis of the economic function of financial services firms is now applied to analyse the question which cost disadvantages foreign financial services firms may have. Let us note at this stage that we adopt a modified approach from that of the conventional theory of FDI as proposed by Hymer. In addition to analysing inherent cost disadvantages and locational and competitive advantages of foreign firms as compared to the opportunity costs of domestic incumbents,²⁸ I also analyse the competitive position of foreign firms as compared to *potential* domestic entrants. Such a comparison permits a better focus on the question under scrutiny: in particular, when comparing domestic incumbents and foreign entrants it is hard to separate those cost disadvantages which result purely from the entry process and which are incurred by any entrant no matter if domestic or foreign (e.g. gathering market intelligence), from those costs which result purely from the 'foreignness' of the entrant (e.g. lack of know-how about local customs). It is the latter which should be the primary focus of the theory of cross-border entry, as the question under scrutiny is not that of entry in general but that of foreign entry as compared to domestic entry. Using potential domestic entrants as a yardstick therefore allows a better separation of these two distinct issues.

²⁸ See Hymer (1976, p.41-43). For the eclectic paradigm, Dunning states that "(ownership advantages) must be sufficient to compensate for the costs of setting up and operating a foreign value-adding operation, in addition to those faced by indigenous producers or potential producers" (1988, p.2).

The cross-border entry decision can be modeled in a simple decision-theoretic framework where firm-level or locational advantages need to exceed inherent cost disadvantages of operating in unknown territory. In order to predict whether or not cross-border entry will take place, we therefore need to analyse both expected costs and benefits of the entry opportunity. In particular, the nature and the (qualitative, if not quantitative) magnitude of the inherent cost disadvantage of foreign entrants needs to be analysed. The eclectic paradigm of multinational enterprises, however, has almost completely neglected this aspect of the cross-border entry decision. It does not explore the type, size and nature of such an inherent cost disadvantage but exclusively focuses on the competitive advantages which may compensate for such a disadvantage. Without further analysis, however, it is not possible to make useful predictions about cross-border entry, since inherent cost disadvantages differ between firms, markets and countries and therefore constitute a crucial explanatory variable of the entry decision.

Two possible ways of modeling the inherent cost disadvantage of foreign entrants exist: first, one could assume that entrants have to incur a once and for all set-up cost K . Thus, the cost function would include a fixed set-up expense in addition to regular fixed costs only in the first period of foreign operation. This set up cost consists of an entry cost c_e which needs to be incurred by both domestic and foreign entrants into the market and an additional cost c_f which has to be incurred only by foreign entrants. The cost difference between domestic and foreign entrants may result from the fact that foreign firms have to incur higher set-up costs than domestic entrants, since they are unfamiliar with the target market, its legal structure, customs, economic environment and administration. These costs include expenses such as acquiring market intelligence or recruiting and training personnel.²⁹ Potential domestic entrants, on the other hand, may already possess some familiarity with the market and therefore enjoy lower set-up costs.

Alternatively, one can model the inherent cost disadvantage of foreign entrants by assuming that they have continuously higher costs than domestic firms even after entry costs are sunk. Grubel (1989, p.67) seems to have such a continuous disadvantage in mind when he speaks of the "innate advantages accruing to local entrepreneurs" of domestic financial services firms.

As was discussed in the previous section, banks reduce transaction costs by performing several functions. Consider first the coordination function. In

²⁹ The lack of know-how of foreign banks concerning the host country's environment is supported by survey evidence across eight EC countries by the banking consulting firm Greenwich Associates (1988). The Chief Financial Officers of almost 1,000 EC companies were interviewed and asked whether the account officers of both domestic and foreign banks "know the domestic financial needs" of the companies. For foreign banks only 9.5 percent of respondents agreed with this statement, compared to 40.5 percent for domestic banks. The lack of know-how of foreign banks of the domestic operating environment is also illustrated by the observation that foreign banks are more frequently involved in lending to domestic institutions which later experience financial difficulties such as Co-op in Germany or the Federconsorzi in Italy.

order to perform the role of middlemen, banks need a sufficient number of transactional relationships on both the depositors' as well as the lenders' side. Foreign banks may be disadvantaged simply by having a lower number of domestic customer relationships.

Next consider the monitoring function of banks which was identified as a main tool to reduce moral hazard and adverse selection problems. For effective monitoring to take place, banks need to be familiar with domestic business conventions in order to be able to pursue successful credit worthiness evaluations. This requires intimate knowledge of a country's business environment which foreign banks may not possess. In addition, where loans to smaller corporate customers are undertaken, an effective monitoring technology requires a sufficient number of branches which are situated close enough to the customer in order to reduce communication costs. In addition, in areas where learning economies are significant, foreign banks are disadvantaged unless they 'buy in' the required know-how through hiring experienced personnel. Finally, reputational effects are likely to place foreign banks at a significant disadvantage compared to domestic incumbents.³⁰

Foreign insurance companies may also face cost disadvantages during the first phase of entering a new market. In particular they may not be able to perform the risk pooling function as effectively as large domestic institutions unless they enter at a similar size as domestic firms. Even if pure size does not necessarily result in a cost disadvantage, foreign firms are likely to be disadvantaged performing the risk assessment function, as they lack the experience of calculating actuarially correct premiums. This results from less experience with handling actual claim distributions such that foreign insurers are likely to be on a lower point on the learning curve than domestic incumbents. Finally, similar to the banking sector foreign insurers may have reputational disadvantages compared to domestic incumbents, since they face difficulties transferring the reputation of being financially solvent from their home market to the host market.

Given that foreign financial services firms suffer an inherent cost disadvantage, we need to explore what kind of competitive advantage may compensate for this.³¹ In the next section, I first analyse competitive advantages which have their origin at the firm level, while section 3 examines locational factors which may induce cross-border entry.

³⁰ See the discussion of reputation as an entry barrier in the next chapter.

³¹ For the case of banking, Grubel (1977, p. 350) defines the research agenda for a theory of (traditional) multinational banking when stating that "the basic phenomenon ... to be explained by the theory of multinational banking is why a bank abroad can profitably offer lower lending and higher borrowing rates than its domestic competitors and thus attract customers away from them."

2.4. Follow and lead the customer

Probably the most prominent explanation of cross-border entry in service industries is that a firm 'follows' its customers into foreign markets. This explanation is particularly dominant in the banking sector.³² A dynamic version of the hypothesis runs as follows: a financial institution has an established long-term relationship with a domestic firm. The firm then decides to enter a foreign market either by exporting or by multinationalisation. Market intelligence, trade finance or international insurance coverage can be provided by the international department of the home institution without the need to pursue cross-border entry on the part of the financial institution itself. Alternatively, the firm's financial or insurance needs resulting from foreign operations can be served by a cooperating institution of the home bank or insurer, such as a firm which has a strategic alliance with the home supplier. Once the firm decides to actively enter the foreign market by transferring capital and labour, however, the need for direct access to banking and insurance services in the host market increases. This may induce the home financial institution to establish some form of presence itself in the host market in order to better serve the needs of the now multinational firm. Thus, the financial institution's main objective when entering the foreign market is to preserve the overall business relationship with the domestic customer.

The move into the foreign market by the financial services firm is therefore defensive in the sense that it attempts to prevent the customer to do business with a different financial institution in the host market. This would reduce profits for the home supplier as the international activities of the customer are lost and may even jeopardise the entire client relationship if the host country institution is able to serve the firm in the home country as well. This may be the case if the new supplier serving the firm in the host country also possesses a presence in the home country either because it is a foreign firm with a significant presence in the home market or, more likely, because it is a domestic competitor of the home financial institution.

Equally plausible to such a defensive explanation of cross-border movements of financial institutions would be the hypothesis that firms pursue an offensive strategy in the sense that rather than following their customers they lead their customers into foreign markets. A financial institution will undertake such a move if it sees promising business potential in the host market either due to home firms which are interested in entering that market or, additionally, if there are host market firms which constitute potential customers. The latter may be the case if there are firms in the host market which already have business links with the home market or plan to enter it. The home market financial institution has a competitive edge over

³² See, for example, Brimmer and Dahl (1975) or Goldberg and Saunders (1981). Kim and Miller (1983, p.24) note that "just as US banks had followed the international operations of US multinational corporations, so did foreign banks repeat the pattern with their pursuit of home-country subsidiaries which had moved into the United States".



host market suppliers due to its intimate knowledge of the domestic market. Thus, one could hypothesise that an equally significant reason for multinationalisation is that financial services firm lead rather than follow their existing customers or even seek new customers in addition to existing ones.

The follow or lead the customer explanation is usually presented in the context of corporate relationships with only the largest firms which turn or are already multinational. In the single European market one can expect increased cross-border entry movements not only of the largest firms which are already present in most European countries anyway, but especially of medium-sized and even smaller firms which will increasingly exploit business opportunities in other EC countries. Although most banks and insurers have traditionally served this segment through the international department in their home country, a firm which has an extended presence in the host country will have a competitive advantage by being able to provide the firm with local market intelligence and finance. Thus, a financial institution which has a local retail presence in the host country is better able to serve smaller corporate customers from home. Thus, the follow-and-lead the customer hypothesis can be readily extended to the case of small and medium-sized corporate customers.

In the personal customer segment there may be an increasing number of 'Eurotravellers' who require banking services outside their home country when being on business trips or on holidays. In addition, there are a number of customers who work and live in two different countries or have permanent homes in other European countries. A bank with a European retail presence is able to offer significantly cheaper services to these customers. Nevertheless, while the number of such 'European' retail customers is increasing, they are unlikely to become a major force and surely not suffice as an explanation of increased cross-border entry in retail financial services.

In the next section we turn to another explanation when scrutinising competitive advantages of foreign entrants in the form of intangible assets.

2.5. Intangible assets

A dominant explanation in the theory of MNEs is to assume that the firm possesses some intangible asset which can be transferred at low marginal cost to the target market.³³ In manufacturing industries such an intangible asset may be a particular production technology developed and possibly patented by the firm, or specific employee know-how such as marketing skills or

³³ See Hymer (1960) and Kindleberger (1969). Caves (1982, p.3) notes that among the theories of MNEs, the intangible asset approach "has proved most fruitful for explaining non-production bases for the MNE".

accumulated experience. In financial services, however, due to the lack of a patent protection system it is frequently argued that such intangible assets have little or no significance.³⁴ While this may be true for some product differentiation advantages and innovations, it does not necessarily hold for organisational capital or informational advantages, as will now be discussed.

Product differentiation allows firms to create a unique product and thus gain a degree of market power compared to a homogeneous product world.³⁵ However, the scope for direct product differentiation in financial services is comparatively limited due to the low number of product attributes³⁶ and the possibility to easily imitate any product innovation.³⁷ In fact, the number of product innovations or newly developed products is extremely low in financial services as compared to manufacturing industries and consists mostly of rebundling of product attributes rather than new product developments.

Nevertheless, production know-how in financial services may play a more significant role than would appear at first sight. Perhaps the most important input factor in financial services is employee and product know-how. Such know-how is accumulated through learning by doing and results in special expertise which can be passed on to other employees through significant investment in training and education. In addition, product know-how advantages may result from learning economies which occur after a firm has operated in a particular product market for a longer time than competitors (e.g. in the area of international asset management).

A different type of product differentiation is that of building up a reputation. A firm may develop a reputation of being a specialist in a particular area or for providing high-quality services through especially qualified employees. In chapter two, I discussed the significance of consumer confidence and the detrimental effects which a financial services firm failure may have on both individual customers and the economy. Individual

³⁴ Casson (1990, p.17), for example, notes that in banking "(competitive) advantages ... are not only difficult to patent, but difficult to keep secret too".

³⁵ Caves (1982, p.4), for example, notes that "the distinctiveness of the firm's marketing-oriented assets may rest with the firm's ability to come up with frequent innovations; its intangible asset then may be a patented novelty, or simply some new combination of attributes that its rivals cannot quickly or effectively imitate."

³⁶ The main characteristics of a financial product can be enumerated as follows: reputation of supplier and product, length or maturity of financial contract, expected risk and return, resale possibilities (marketability), currency and country of denomination and after-sales services.

³⁷ For example, Citicorp and White, Weld & Co. were the first banks to introduce a Eurodollar certificate of deposit after 15 months of extensive internal legal and strategic consultations. When they finally decided to introduce the new product, the first buyer was Chemical Bank which immediately introduced its own version of a Euro CD (see, Dufey and Giddy, 1981, p.40). A similar story can be told of many products in the retail financial services sector.

depositors or policyholders attach a probability of failure to each firm and assess the firm's quality at least partly based on its financial soundness. Thus, a firm which has managed to build up a reputation of being safe may have a significant competitive advantage over competitors.³⁸ Such a reputation may be transferred to another market at little cost if the firm operates in an international setting where information flows are efficient. While this may be the case in investment banking or reinsurance, in retail financial services reputation in specific areas is difficult to transfer across borders. This results from the fact that a retail financial services firm is less well-known in the host market, as most of these firms have so far been purely domestic operations and while they may be 'brand names' in domestic markets, they are unlikely to have a high recognition value in foreign countries.

In summary, we find only few sources of a possible firm-level advantage which can be transferred to a foreign market in the retail financial services sector. Only product know-how seems to be transferrable to some degree to foreign retail markets, as firms may have accumulated experience in one particular market and have therefore progressed higher on the learning curve than competitors in the host country.

3. Locational factors: the relation between host- and home-country characteristics

In order to answer the question where a financial services firm is most likely to enter we need to address locational advantages which an entering firm may possess in comparison to host-country institutions. Locational advantages are a relative concept which arise from the specific relation between home- and host-country characteristics. They may induce cross-border entry if the host country has certain locational advantages compared to the home country or, alternatively, they may provide a competitive edge if the home country confers certain locational advantages to the entering firm in the host market. Thus, it is not necessarily the case that the host market needs to have 'attractive' locational characteristics to induce cross-border entry. However, it is equally plausible that an entering firm transfers locational advantages from its home market into the host market and thus gains a competitive edge. Thus, locational factors can give the firm a disadvantage in the domestic market and induce foreign expansion, for example, by gaining access to cheaper funds abroad or circumventing a more stringent home country regulatory regime.

Alternatively, the reverse situation may hold where locational factors give the domestic firm a competitive advantage as compared to host country

³⁸ For example, Swiss banks frequently have a reputation of being particularly safe even though this reputation is likely to suffer from the recent downgradings of Swiss institutions by the rating agencies.

firms. Most of the conventional theory of the MNE considers only the 'attractiveness' of the host market (e.g. access to cheap labour) when analysing locational factors. In this analysis I stress that there may be a two-way relationship, since an 'unattractive' host market (e.g. high labour costs) may equally induce cross-border entry. The most important locational factors which may induce cross-border entry are different regulatory regimes, market structure and conduct, funding and borrowing costs (which were already discussed above), and diversification. Each will be discussed in turn.

As was discussed in the second chapter, regulatory factors may induce cross-border entry if the host country offers a more favourable regulatory environment, i.e. one with a lower net regulatory burden. Alternatively, a stricter regulatory environment for domestic financial services firms may confer a competitive advantage on foreign firms which may be less strictly regulated by their home country authorities. While entry for sole regulatory purposes plays a significant role in wholesale financial services (e.g. booking centres in off-shore locations), it is unlikely to be a sufficient explanation for cross-border entry in retail financial services.

A possible reason for cross-border entry in retail financial services which has so far not been analysed is the possibility of firms entering foreign markets characterised by lacklustre competition due to (tacit) collusion among domestic incumbents. Thus, a foreign firm which has no efficiency advantage may still decide to enter a foreign market in order to participate in oligopoly profits. It will be able to earn a positive profit by undercutting domestic firms but still pricing above the competitive outcome.

Whether or not such a strategy is successful depends crucially on the reaction of domestic firms. If incumbents match the entrant's price and quality conditions instantaneously, customers have no reason to change their supplier relationship. If they respond only sluggishly, however, entrants will be able to gain market share at the expense of incumbents and make positive profits. This crucially depends on the significance of switching costs and the entrants' strategies to overcome them.³⁹ As noted by Kessides (1990), there are therefore two opposing effects of high margins on the entry decision: on the one hand, the higher the margins the greater the attractiveness of the foreign market for cross-border entry. At the same time, entrants must expect a more aggressive response of incumbents, as they have proportionately more to lose.

As the final locational advantage explanation of cross-border entry, consider a simple diversification view of multinationalisation. As retail financial services are highly dependent on the general economic situation, a firm can expect risk reduction advantages from diversifying its income stream across several economies. The diversification view of cross-border entry is particularly applicable to the insurance sector where risks such as

³⁹ See chapter four.

natural catastrophes are unlikely to be related across countries. Diversification is also one of the main arguments for liberalising interstate entry in US banking, as it is supposed to lead to a lower dependency on regional economic conditions. Bernanke (1983, p.259), for example, argues that a country with mostly small, independent banks such as the US is more vulnerable to bank failures than countries with only few large banks such as Britain and France. Historical evidence suggests that bank failures in the US have indeed been more common than in Europe.⁴⁰

4. Market imperfections and transaction costs: factors determining the mode of cross-border entry

In this section I consider the question why a financial services firm chooses multinationalisation rather than other forms of cross-border entry to reap the benefits from competitive and locational advantages. The existence of a special competitive or locational advantage of the potential multinational is not a sufficient condition for FDI, as was stressed by Hymer (1960, p.48). An alternative method to exploit the benefits of these advantages would be to operate through the market rather than use internalisation. Thus, a firm could export its product or service, sell a license to a firm in the foreign market or strike a strategic alliance.

The decision between arm's length transaction and multinationalisation depends on an assessment of market transaction costs. In this context the need for an integrated approach to trade theory and the theory of FDI becomes apparent once again: it is possible to re-interpret firm-level and locational advantages as a 'micro foundation' of trade theory. At the firm level either one of these advantages must hold for international trade to occur. Whether the firm chooses to exploit these advantages through exporting or multinationalisation therefore depends on market transaction costs.

I now discuss the relative merits of each means of cross-border entry in order to make predictions about the most likely route of entry given the firm's objectives.

⁴⁰ Jaffee (1989) reports the following average annual failure rates for US banks (excluding thrifts): 1950-59: 5 annual failures, 1960-69: 6 failures, 1970-79: 8 failures 1980-84: 38 failures, 1985-88: 172 failures. This illustrates the dramatic increase in bank failures in the US over the past ten years. In most European countries, on the other hand, bank failures are a rare occurrence. Going back further in time Schwartz (1986) shows that between 1790 and 1930 the US had bank panics in 14 years, while Britain had eight and France and Italy each had four years of bank panics. Bordo (1986) shows that between 1870 and 1933 twenty bank crises and panics occurred in the US, but none took place in Britain, France, Germany, Sweden and Canada.

4.1. Exporting versus FDI: the decision between cross-border provision of services and multinationalisation

Cross-border provision of financial services as a form of 'exporting' may be conceivable where the services sold through the market do not require personal proximity between customer and supplier. This is the case in the market for large enterprises and multinational firms which have significant international activities. It is conceivable, for instance, that a large German firm entertains a banking relationship with a London-based American investment bank if this bank has greater expertise in certain financing techniques or advisory services such as M&A or possesses greater placing power in the bond market than German banks operating in the same market.⁴¹ In particular, for highly specialised services such as equity issues or reinsurance activities personal proximity is no immediate requirement.

The financial services firm will prefer opening a foreign branch or subsidiary over exporting only if the reduction in transaction costs outweighs the cost of foregoing possible scale and scope economies arising from centralisation. A cross-border relationship is more likely to occur in specialised services rather than covering the whole range of corporate banking services, however, as relationship banking requires much contact and communication which is difficult to achieve across borders.

In retail financial services, however, there may be significant transaction costs associated with cross-border provision of loans in particular for personal and small corporate customers. Three stages of a loan can be distinguished (Llewellyn, 1989): the acquisition stage, the raising of the required funds and a monitoring phase. Domestic institutions have a natural advantage in the first and third stages, as they are provided with an extensive branch network. Foreign banks, however, face significant transaction costs in particular concerning monitoring activities on a cross-border basis. Cross-border provision of loans is therefore unlikely to become significant in the retail financial services sector.⁴²

For a foreign firm successfully to enter a domestic retail market, it may therefore be necessary to establish some form of presence in the domestic market or alternatively to establish a cooperative agreement with a domestic

⁴¹ The American investment bank Goldman Sachs, for example, for a long time serviced the German market by 'exporting' from its London European headquarters rather than opening a branch or subsidiary in the German market. It still managed to secure a leading position in the M&A market.

⁴² An example of cross-border lending, however is that of the German Rheinische Hypothekenbank. The bank has actively penetrated the Spanish market where it sells up to DM100 million in new mortgage financing. As it does not (yet) have a branch in Spain, the responsible official flies to Spain, sells the mortgage and returns to Germany. As a bank official describes it: "margins in the Spanish mortgage market are so high that they actually cover such a fairly uneconomical way of servicing the market and still leave a handsome profit".

institution. This results from the fact that the vast majority of services requires advice and personal interaction. In the insurance sector, for example, retail customers require close contact to an agent who handles claims. Similarly, in the area of payment services customers require a sufficient number of outlets for gaining access to their funds. Such outlets are usually provided by the branch network but, in principle, could also be provided by a cooperating bank or an ATM network in the host country. In addition, recent advances in communication technology such as 'home banking' may facilitate the interface between customer and bank and reduce the number of routine transactions requiring personal interaction between customer and service provider.⁴³

Nevertheless, it is difficult to conceive mass retail financial services being provided on a cross-border basis, as communication expenses and language barriers raise transaction costs and preclude successful market penetration on such a basis. In the financial services market for small and medium enterprises personal interface is even more important, as banks have to monitor their loans by analysing the firms' financial performance which appears prohibitively costly on a cross-border basis.

In the high net worth individual (HNWI) market, cross-border provision of services may play a more significant role, as the size of financial transactions increases and transaction costs therefore become less significant as a proportion of the total amount. In addition, individual country or firm advantages such as tax considerations or accumulated know-how in specialised activities rise in significance and may make cross-border transactions more feasible.⁴⁴

While exporting is feasible in some areas of financial services, licensing is much less common. This may be due to the lack of patent protection and the resulting possibility of immediate product imitation. As was argued in the previous section, the main types of special advantages which induce

⁴³ In the US, for example, the limitations on cross-border branching induced an early introduction of technology-intensive distribution methods. Santomero (1990) observes that as banks attempted to expand their geographic markets "telecommunications and electronics began to replace brick and mortar as a delivery system of retail products". An example of such a non-branch based distribution system are the brokerage firms Dean Witter and Charles Schwab which are able to undercut competitors since they rely on electronic distribution systems rather than a high fixed costs branch network. Similarly, Bryan and Allen (1988) note that in 1975, 44 percent of non-mortgage based debt was branch-based, whereas in 1985 this proportion had fallen to 32 percent.

⁴⁴ In practise, we observe a higher degree of cross-border provision of services in the HNWI market. In particular, banks in 'tax havens' such as Luxembourg or the Channel Islands and the 'traditional' HNWI country Switzerland advertise in the international media for their investment, advisory and fund management services which almost always require a significant minimum financial amount on the part of the customer. Frequently, these banks service their clients through their home base rather than host country subsidiaries and therefore this type of service qualifies as exporting rather than multinationalisation under our definition.

cross-border entry in financial services are of an intangible nature such as know-how or accumulated expertise. Markets for trading know-how do not work well, however, as noted by Teece (1982). This may explain why licensing or other direct market transactions are practically non-existent in financial services even though they are more common in other service industries such as advertising or hotels.

In summary, cross-border provision of services is confined to play only a marginal role in retail financial services, since the vast majority of services require at least some degree of interaction between supplier and customer.

4.2. Cross-border majority acquisitions versus de novo entry

De novo entry is a common form of entry in the market for wholesale financial services where it is usually characterised by the setting up of branches or subsidiaries in the major financial centre of the host country. In the first phase, mostly corporate customers from the home country are served and multinational companies with whom the bank already has a business relationship in the home country. After a period of settling in, a branch will usually attempt to establish a relation with the largest local firms.

In retail financial services, however, de novo entry is frequently considered unfeasible due to prohibitive entry costs and the time-consuming process of building up a reputation. However, while de novo entry may be a slower way of entering a foreign retail market, it is not the case that there is necessarily a prohibitive cost disadvantage compared to incumbents. This results from the fact that the relevant costs for incumbents are opportunity costs, rather than accounting costs. Nevertheless, the scope of de novo entry is limited especially when switching costs are high and consumers are 'locked in' with their current suppliers (see next chapter). In addition, de novo entry is more time-consuming, as expertise and special know-how need to be accumulated through a gradual learning process.

Firms may have to pay a wage premium both to current employees who require wage supplements for working in a foreign country, as well as for employees recruited in the host country who may demand a premium if job security is lower for foreign firms than for domestic institutions due to greater risk of failure.

In contrast, acquisitions have the advantage that the firm is already established in the market and has local expertise. Employees of the acquired bank are likely to have accumulated significant know-how and have therefore moved up on the learning curve. This may be a significant advantage where learning constitutes a significant part of establishing a position in a different operating environment. This is likely to be the case in areas such as credit worthiness evaluations where intimate knowledge of domestic legal and accounting rules, the economic environment, as well as payment habits are essential for risk and return assessments. Similarly,

accumulated know-how with the actuarial distribution of claims provides a significant asset in insurance which can only be secured through acquiring an established insurer. There may even be cultural factors which domestic firms are more aware of than foreign institutions and where they have a competitive advantage. One of these factors in retail financial services is that domestic consumers may simply prefer a domestic 'brand name' to a foreign supplier.

Caves (1982) argues that due to these factors acquisitions are characterised by lower risk but also by lower return than *de novo* entry. While the lower risk stems from the established position of the acquired company, the lower return is a result of efficiency in the market for cross-border takeovers. In this market, firms are valued according to their fundamental underlying value to a potential acquirer and thus acquisition prices represent the net present value of the future income stream. Hence, there is no such thing as a 'bargain' in the market for cross-border acquisitions, as current acquisition prices reflect the discounted future value.⁴⁵

In addition to being competitively priced, acquisitions have the drawback that they may bring with them significant costs of integrating or, if necessary, restructuring the acquired firm. This problem may be particularly severe for the case of cross-border transactions where the acquiring firm has to deal with a different corporate culture and economic environment.⁴⁶ There may be substantial control loss where the new owner has to operate at a distance. Such control loss is examined by Williamson (1967) who formalises the earlier intuition of Coase (1937) that as a firm gets larger, there may be managerial diseconomies due to increasing organisational complexity. Williamson finds that the further the distance of headquarters from the actual level of production (such as retail outlets in banking), the greater the dilution of managerial control. This may provide an explanation why cross-border acquisitions present special integration problems as organisational complexity rises.

Control loss in large (multinational) organisations can be reduced by choosing an organisational form which reduces such problems. Drawing on the historical analysis of the development of business structure by Chandler

⁴⁵ In fact, acquisition prices may reflect a substantial premium above the discounted future value. For instance, competitive bidding between potential acquirers may drive up the acquisition price. In addition, there is a considerable degree of asymmetric information on the part of acquirers which have difficulty correctly assessing the 'true' underlying value of the acquisition target.

⁴⁶ Kreps (1990) argues that corporate culture serves an important strategic function in building up a company reputation by influencing employees' behaviour and serving as a signalling device to clients and business partners. Odagiri and Hase (1989) list problems in combining two different corporate cultures as a main reason why mergers and acquisitions have not been as popular in Japan as elsewhere.

(1962), Williamson (1975) cites the M-form as an organisational structure which economises on internal transaction costs. The M-form is characterised by a decentralised structure where a number of cost and profit centres exist within the firm which are managed by headquarters which sets both the incentive structure and performs a monitoring and capital allocation function. Williamson (1985, p.283/284) notes that:

“the M-form structure removes the general office executives from partisan involvement in the functional parts and assigns operating responsibilities to the division ... Not only is the goal structure altered in favor of enterprise-wide considerations, but an improved information base permits rewards and penalties to be assigned to divisions on a more discriminating basis, and resources can be reallocated within the firm from less to more productive uses. A concept of the firm as an internal market thus emerges”.

Applying this M-form framework to the multinational financial services firm implies that foreign subsidiaries and acquisitions do not need to be fully integrated. Rather they can be run on a divisionalised basis where central headquarters sets certain return on capital goals. Williamson notes that such an organisational form is similar to the firm as an internal capital market. Central control through headquarters remains essential for an effective functioning of the M-form. Chandler (1982, p.12) notes from a business history perspective that for US firms

“when growth came through mergers and acquisitions, the major challenge, in addition to rationalising and reshuffling the activities and boundaries of the divisions, was building an effective general office”.

Thus, it is clearly not sufficient to run foreign acquired subsidiaries on a pure market transaction basis but strategic control needs to be exercised by firm headquarters. Nevertheless, it seems that foreign acquisitions are most likely to be run on an M-form organisational basis which may significantly reduce the adjustment and integration costs described by Caves (1982). In addition, leaving day-to-day management to local headquarters allows the exploitation of local know-how which is unavailable to central headquarters. The M-form may be a particularly effective way of organising internal firm transaction where the need for integration is low since economies of scale and scope are not significant, as is likely to be the case in multinational retail financial services.

4.3. Joint ventures

A joint venture (JV) can be defined as a legally independent entity owned by two or more parent companies which actively influence the corporate policy of the venture. They are a mechanism for pooling complementary assets of the parent firms. In the context of cross-border entry we are particularly

interested in JVs which are set up between two or more foreign firms in a host country or those where domestic and foreign firms set up a venture together and the foreign firm does so with the strategic objective of entering the domestic market.⁴⁷

A theory of JVs as a form of entering foreign markets needs to explain under which circumstances firms choose a joint ownership arrangement rather than other forms of cross-border entry such as de novo entry, acquisition or contractual arrangements. In the following section I therefore focus on the special advantages of JVs in comparison to other entry forms.

Consider first the case of two or more foreign firms which set up a joint venture in the domestic country. Alternatively, each firm could pursue its own cross-border entry strategy. Why do they choose a JV? As JVs are mostly new ventures, one needs to explain in particular why a firm chooses this entry form over de novo entry.

One of the main arguments for a JV is that it helps firms to share the risk of a new venture. Risk results from uncertainty related to the success of the entry decision. Even though a firm may undertake a careful examination of the firm-level and locational advantages it possesses in the host market, gathers market intelligence and on the basis of this information analyses its market potential, there is still a significant element of uncertainty left. This results from a combination of imperfect information about the host country's operating environment and the unknown strategic reaction of domestic incumbents. This uncertainty results in considerable difficulties when predicting the demand function over the first few years of operation which is manifested in a significant potential variance of operating profits.

By engaging in a joint ownership venture, the firms are able to reduce their individual stakes and therefore limit their risk. For a risk-averse management the reduction in the return on investment of a smaller stake may be more than compensated for by the reduction in associated risk. Balakrishnan and Koza (1989) argue, however, that JVs are a less efficient means of reducing risk than what could be achieved in the capital market. Specifically, they claim that firms would always have the option of raising capital at a risk-related rate and since investors are able to diversify their portfolio more efficiently than firms, this should be the preferred option for risk reduction. They conclude that "as purely risk sharing arrangements, firms should reject joint ventures" (p.5).

Whether or not this argument holds depends to some degree on the definition of risk. Especially, if we follow a broad definition of risk the capital market may be a less efficient means of sharing risk. To see why, consider the

⁴⁷ See Reynolds and Snapp (1986) and Shapiro and Willig (1990) for an analysis of the competitive effects of horizontal JVs where firms are direct competitors. Bresnahan and Salop (1986) analyse the competitive effects of a cross-border joint venture between GM and Toyota.

following argument: as was explained above, risk of the cross-border entry decision arises due to uncertainty about the future market potential in the host market. At the heart of the uncertainty lies imperfect information about the host country's operating environment etc. Thus, the capital market can only imperfectly estimate the entrant's chances of success and will likely add a risk premium to the 'normal' cost of capital.⁴⁸

If the joint venture with a domestic firm helps to reduce such uncertainty it contributes to a risk reduction which cannot be achieved by the capital market, as the information which the domestic firm possesses is not reflected in the risk-related cost of capital of the foreign firm.

This argument can be reframed in terms of an intangible assets explanation of JVs. I have defined JVs as a means of bringing together complementary assets. In combination, these assets may be worth more than valuing them separately. This is the synergy theory of explaining JVs (e.g. Hennart, 1988).

JVs face stability and steering problems where parent firms have differing objective functions. This may result in free-rider problems where one parent firm tries to reap the benefits of the venture by gathering know-how, for example, while not contributing to the venture in the same way.⁴⁹

A particular problem of JVs in the services sector is the apportioning of the customer base, once the JV is to be split up. Unlike in industrial JVs which are targeted at developing products, for example, JVs in the service sector are burdened by the fact that one of the aims of the venture is to build up a customer base and to 'lock in' these customers. When a services JV is dissolved, therefore, one partner usually buys out the other participating firms.

4.4. Strategic alliances and cooperation agreements

Cooperative agreements and strategic alliances, just like joint ventures, are an intermediate form of organisation between markets and hierarchies. A strategic alliance shall be defined as an explicit, medium- or long-term agreement between at least two firms to co-operate in a range of activities. This definition is very similar to Goto's (1982) definition of business groups

⁴⁸ See Poitevin (1989) who presents a model where the financial market knows the marginal costs of incumbents but has only prior probabilities about the entrant's marginal costs. Such uncertainty in financial markets makes entry more difficult, as incumbents can pursue a strategy which lets the entrant go bankrupt. See also Benoit (1984), Brander and Lewis (1986) and Martin (1989).

⁴⁹ Kogut (1989), however, reports data on factors which tend to influence JV stability and finds that R&D ventures (which tend to be know-how intensive) are more likely to be stable than other ventures in the area of marketing and distribution, for example.

as "coalitions of firms pursuing their common interests through a system which coordinates decisions made by member firms". Such agreements may be supported by mutual minority share holdings. We can distinguish multilateral cooperation groups where three or more firms agree to cooperate in certain areas from bilateral strategic alliances with only two cooperating partners. Similar to joint ventures, cooperation groups have the advantage that they allow the pooling of complementary assets. However, their main distinguishing characteristic from a JV is the lack of incorporation of a separate legal entity in which the parent firms hold equity stakes. Rather, allied firms transact directly and not through means of the JV.

The choice between a cross-border acquisition and that of a strategic alliance can be framed in terms of a transaction cost analysis between arm's length contracts and integration. At the heart of any strategic alliance is a long-term contract which regulates the details of the agreement as well as possible pay-offs and incentive structures. An acquisition, however, is characterised by conferment of residual rights of control over the target's assets to the acquirer. Possible incentive problems for the case of integration (i.e. cross-border acquisitions) are analysed by Grossman and Hart (1986). They observe that ownership, as distinct from an alliance, for example, has the benefit for the acquirer of getting a greater share in residual profits and being able to freely exercise property rights. However, there are also costs attached to integration arising from the fact that the acquired firm's top management has a lower share of the residual income stream and thus a lower incentive to invest in specific assets.⁵⁰

As is well known from the transaction cost literature, long-term contracts face problems of opportunistic behaviour due to bounded rationality and impacted information and may lead to underinvestment in specific assets (Williamson, 1989; Klein, Crawford and Alchian, 1978).

If two mainly domestic firms have entered an agreement to serve each other's customers in their respective home markets then there is little threat of breach of agreement, as neither firm has the opportunity to entice away the client in the cooperating firm's home market. If, on the other hand, both firms are already multinationalised and have a sizeable presence in the cooperating firm's home market then a strategic alliance is an unlikely outcome. This reasoning suggests that strategic alliances are more likely to be struck between medium-sized firms, since the largest firms may become or may already be direct competitors.

Kay (1991) argues that the completion of the internal European market should increase export and cross-border M&A activities, whereas cooperative agreements such as JVs and strategic alliances are likely to decrease. This results from the fact that with the reduction of barriers to cross-border entry a

⁵⁰ Hart and Moore (1990) extend this analysis to incorporate the incentive effects on employees.

'go-it-alone approach' becomes easier and there is therefore a reduced need for cross-border cooperation with another firm. In addition, as competition increases on a European scale, firms become more reluctant to share information with other firms who may become potential competitors in the near future. Kay also presents some evidence that the share of JVs as a proportion of total cross-border entry activities has fallen most recently in the manufacturing sector.

In the financial services sector, however, this reasoning does not necessarily apply. As will be argued in the next chapter, significant barriers to cross-border entry persist. In addition, cross-border provision of services is unlikely to account for a high proportion of cross-border activities especially in retail services. Thus, the scope of cross-border entry vehicles in financial services is reduced. Cross-border collaborative activities are therefore substantially more attractive than in manufacturing industries and for many firms which lack the necessary financial resources to pursue an extensive acquisition programme to be the only feasible cross-border entry route.

5. Conclusions

In this chapter I have developed a theory of cross-border entry activities in the retail financial services sector. A brief review of traditional trade theory focuses on comparative cost differences as the main explanatory factor of international activities. However, trade theory while serving as a first approach to the question of cross-border penetration, throws up as many questions as it answers. In particular, a firm-level approach to the theory of cross-border entry is needed in order to reveal the sources of possible capital and labour productivity differences.

Such a firm-level theory is developed on the basis of the eclectic theory of multinational enterprises which builds on an analysis of corporate-level competitive advantages transferrable to foreign markets and locational factors which may induce cross-border entry. The firm-level analysis builds on a scrutiny of the economic functions of banks and insurers. In principle, foreign banks can perform exactly the same functions as domestic banks but they may suffer from cost disadvantages due to a reputation which has yet to be established, a lower position on the learning curve and fewer transactional relationships which makes the basic intermediation function more costly. Similarly, foreign insurers face cost disadvantages, as they may not be able to perform the risk pooling function as effectively as large domestic firms due to the operation of the law of large numbers. In addition, foreign firms have less experience with risk assessment and may face reputational disadvantages.

In order to compensate for such inherent cost disadvantages foreign firms need some competitive advantage which they can transfer to the foreign market. It was argued that the follow-or-lead the customer hypothesis

is not only applicable to the largest corporate customers but applies equally to medium and small-sized firms and even to some extent to personal customers who travel extensively across Europe. Similarly, product know-how resulting in learning economies can be transferred to foreign markets at low marginal costs.

Among locational factors which may induce cross-border entry, high oligopoly profits in foreign markets may be particularly significant. However, expectations of incumbents' reactions are crucial in determining the attractiveness of foreign markets. This question is further discussed in the next chapter. Moreover, diversification across several national markets can achieve risk reduction at constant returns if these markets are less than perfectly correlated.

Concerning the mode of entry, it was argued that cross-border provision of services will play only a marginal role in retail financial services, as the vast majority of services require at least some degree of personal interaction between customer and supplier. De novo entry faces the problem of building up a distribution and customer network entirely from scratch. In retail financial services, acquisitions or strategic alliances are therefore likely to be the most likely entry routes. While large firms are likely to prefer acquisitions, medium-sized institutions may opt for alliances due to lack of financial resources to undertake a large-scale acquisition programme and a lower degree of competition across national borders. Joint ventures are an intermediate form of entry between de novo and a strategic alliance and therefore face both advantages and problems of these two entry forms.

Chapter Four: Barriers to Cross-Border Entry in European Retail Financial Services

In a single European financial services market with no entry barriers we would expect price and efficiency differences to be eliminated by foreign entry. In practise, however, there are a range of entry barriers in the retail financial services sector.¹ Generally, one can distinguish between regulatory barriers to cross-border entry and market- or industry inherent entry barriers.² While the former are attacked by the internal market programme, the latter are likely to persist and remain largely unaffected by regulatory efforts towards market integration.

Generally, several sources of potential entry barriers have been identified in the literature. In his classic work on entry barriers, Bain (1956) focuses on the ability of incumbent firms to raise price above long-run average costs without inducing potential entrants to enter an industry. He defines the maximum entry-forestalling price (or limit price in modern parlance) as the highest price a firm can charge without inducing entry.

Bain's definition encounters a number of operational and theoretical problems, however: to determine the limit price, it is necessary to make assumptions about post-entry strategic behaviour and so the limit price depends crucially on entrants' *expectations* about the incumbent's reactions, which in turn may be influenced by the incumbent through building up a reputation of 'fighting' entry.³ In addition, expectations are dependent on the

¹ The importance of entry barriers in retail financial services is pointed out, but not further analysed by Caminal, Gual and Vives (1990, p.299) who query whether "barriers to entry in the retail and small-firm area (will) persist and be sufficient to deter foreign institutions from acquiring a substantial part of the national markets".

² In addition, there may be managerial barriers to cross-border entry which may stem from a lack of internationally experienced personnel, know-how, limited ambition or unrecognised opportunities. See Schroath and Korth (1989) for an attempt to explain the lack of foreign entry activities of US insurers by such managerial barriers.

³ Consider a market with two players: a potential entrant and an incumbent monopolist who has the option of fighting entry or to co-operate. In his 'chain-store paradox' Selten (1978) shows that the only perfect Nash equilibrium in a finitely-repeated game occurs where entry and co-operation take place at each stage. This results from a simple application of backward induction, as it does not pay to fight entry in the final repetition of the game. However, Selten's result depends crucially on the assumptions of complete and perfect information, such that players have full information on the game tree structure, pay-off functions and players' previous moves. Relaxing these rather unrealistic assumptions, one can show that it may pay a firm to fight entry in the first few stages of the game to gain a reputation of 'being tough'. To

credibility of the threat: for example, if it is more profitable *ex post* for the incumbent to share the market with the new entrant by co-operating, then the threat to fight entry may suffer a credibility problem. We see that Bain's definition, while having the merit of relating market structure to conduct, encounters operational problems.

A different definition of entry barriers is given by Stigler (1968): he focuses on asymmetries in cost and demand conditions between an incumbent firm and a potential entrant and defines an entry barrier as a cost of production "which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry".⁴ Thus, any competitive advantage of incumbents relative to potential new entrants must be considered a barrier to entry, whereas no such barrier exists if both face identical cost and demand conditions.⁵

Stigler's definition is again different from the preceding ones, since it focuses on market asymmetries. Consider cross-border entry in financial services: in contrast to Demsetz, Stigler would not consider prudential regulations a barrier to entry if these have to be met both by incumbent banks and potential entrants. However, if an Irish bank has to incur substantial communication costs to offer banking services to Continental customers, it clearly operates at a cost disadvantage compared to local institutions. This would be considered a barrier to entry by Stigler, but not by Demsetz and Bain (if pricing is competitive).

Each of the major potential sources of barriers to entry are now analysed for the financial services sector. The focus is hereby placed on barriers to *cross-border* entry in the EC, rather than entry in general, although some issues are obviously identical.

obtain this result, Kreps and Wilson (1982) employ the assumption that there is a small but positive probability that "there may be a short-term benefit from a fighting response" (p.256). Milgrom and Roberts (1982) account for an arbitrarily small but positive probability that "a simple behavioural rule guides the actions of the established firm" (p.285) such as, for example, always fighting entry even if a negative pay-off results. Under both assumptions it can be shown that building up a reputation of fighting entry may be sufficient to deter further entry in subsequent stages (see Philips, 1988, p.204-18 for a more complete discussion).

⁴ Von Weizsäcker (1980, p.400) adds the requirement that such a cost disadvantage needs to imply "a distortion in the allocation of resources from a social point of view". This requires explicit modelling of the demand side for a full-fledged welfare analysis of entry barriers.

⁵ Demsetz (1982) suggests a much stricter definition of entry barriers: he refers to entry barriers as government-induced legal restrictions such as, for instance, tariffs or regulations. According to Demsetz any public restriction which tends to increase production costs should be considered a barrier to entry. For example, minimum capital requirements would be considered an entry barrier by Demsetz, but not by Bain, as long as firms compete away supra-normal profits. Demsetz' definition stems from a somewhat naive belief in the working of a competitive economy, however: he argues that in the absence of government intervention, competition in an unregulated market economy will eradicate monopoly rents in the long run and that the only persistent obstacle to free entry in a particular market is some form of government restriction.

1. Regulatory barriers to cross-border entry

As was discussed in the third chapter, foreign entry can take the form of *de novo* entry, acquisition of domestic institutions or some type of co-operative agreement. Thus, regulatory restrictions on foreign entry can be differentiated according to the mode of entry. Additionally, one has to differentiate between entry by EC institutions and entrants from non-EC countries. Entry by EC institutions is discussed first.

1.1. Entry by other EC institutions

Official restrictions on *de novo* entry in banking are non-existent in all EC countries, as prudential rules applying to new entry, such as minimum capital requirements, for example, do not discriminate between domestic and foreign institutions.⁶ Freedom of establishment is also fully established in the insurance sector since 1973 in the non-life and since 1979 in the life sector. The PW study therefore comes to the conclusion that already in 1988 "in general, there are no overt barriers to the establishment of foreign firms in the countries surveyed" (p.8).

Acquisitions of domestic banks, however, are subject to a higher degree of regulatory supervision. Official restrictions on acquisitions by foreign institutions exist in Italy, France, Spain, Greece and Portugal, where the public authorities need to give their consent to such transactions. Even though discrimination on the basis of nationality of the acquirer is legally unfounded, it can be argued that covert restrictions continue to apply.

An example of overt interference in a cross-border acquisition attempt, is the Bank of Spain's intervention in the long-delayed takeover of Banco Comercial Transatlantico (BCT) by Deutsche Bank. As noted by Price Waterhouse, foreign acquisitions of banks in Spain are "only granted exceptionally and usually for the acquisition of a distressed bank" (p.74). Caminal, Gual and Vives (1990, p.295) note that government intervention in Spain "seems to be founded in the belief that ... (it is necessary) to prevent national banks from being taken over by foreigners". Nevertheless, the Spanish authorities did eventually allow some takeovers by foreign banks such as Deutsche Bank's eventual acquisition of BCT or Credit Lyonnais' purchase of Banco Comercial Espanol.

⁶ In Spain foreign banks were mostly limited to having no more than three branches but several exemptions were granted to foreign banks wishing to operate in the retail market. All remaining restrictions were phased out by 31 December 1992. In Italy some minor limitations on the range of services and territorial expansion of foreign banks existed and conveyed an incumbency advantage to indigenous banks. However, the deregulation of branching restrictions in 1989 reduced this bias. All remaining restrictions are eliminated by the 'banking passport' of the Second Banking Directive, as discussed in chapter two.

In Britain an example of overt public interference is the 1981 takeover attempt of Royal Bank of Scotland by Hongkong and Shanghai Bank (HSB) which failed due to an intervention by the Bank of England on regulatory grounds.⁷ Finally, in France, a similar willingness of public regulators to intervene against foreign acquisitions can be observed. The Bank of France and the Ministry of Economy have the possibility of intervening in any foreign share acquisition where the stake exceeds 20 per cent of outstanding shares.⁸

In practise, acquisition of domestic banks may therefore be subject to substantial resistance from the regulatory authorities, the more so, the larger and more significant the target bank. This resistance of domestic authorities against foreign takeovers is probably less pronounced in the insurance sector.⁹ Such regulatory intervention in banking is usually justified on industrial, monetary or competition policy grounds. First, industrial policy concerns may arise because large banks can have substantial influence on domestic industry through cross-participations and direct shareholdings, as well as their ability to monitor individual firms' business policies. Therefore, the government may prefer to keep the banking industry under domestic ownership to be able to exercise greater influence on management.

Secondly, since banks are the main channel for the operation of domestic monetary policy, public authorities may resist against these institutions 'falling into foreign hands'. It is far from clear, however, why and how foreign-owned banks should transmit monetary policy measures any differently from domestic institutions. Moreover, monetary policy becomes more rather than less effective if there is greater competition in the deposit and loan markets induced by the entry of foreign banks. This results from the fact that in a price-rigid market the effectiveness of domestic monetary policy is reduced through lack of interest rate response by banks who may collude to keep loan rates high and deposit rates low. Fine-tuning through monetary policy means is therefore made easier if greater competition forces domestic institutions to respond to changes in public interest rates.¹⁰

⁷ In a takeover attempt of Midland by HSB in 1992 the Bank of England does not seem to interfere.

⁸ Franks and Mayer (1990, p.209) note that in the industrial sector "it is thought that the French government has delayed takeovers by foreign firms while a 'French solution' has been sought." Even some French academics cannot refrain from giving advice on how "to solve the problem" that private French banks can be subject to foreign takeovers (e.g. Artus, 1990, recommends to increase the share of institutional investors).

⁹ As the example of Generali's takeover attempt of Compagnie du Midi illustrated where Generali ended up taking only a minority shareholding.

¹⁰ For the case of Italy, for example, the OECD comments that "the effectiveness of monetary policy is also impaired by the financial markets' lack of responsiveness to the impetus imparted by monetary policy. This is reflected in the fact that when money market rates

Thirdly, a separate set of competition policy issues is raised if a potential foreign acquiror is publicly owned. It has been argued that public ownership may result in a competitive advantage in the target bank's market due to cheaper funding sources of the publicly owned bank. In particular, the UK Industry and Trade Ministry pursued a tough line on planned acquisitions in the UK market by French publicly-owned banks which was only abandoned after a threatened investigation by the Commission of the EC on grounds of discriminating against foreign acquirors.¹¹

Explicit or covert regulatory restrictions are likely to continue to exist, even after the Second Banking Directive is fully implemented, since it provides scope for domestic regulators to oppose acquisitions by foreign firms. More specifically, Article 11 determines the rules of acquiring a "qualifying holding" in a credit institution. First, the acquiror needs to inform the domestic authorities of any proposed acquisition and a change in the stake it holds in the institution exceeding 20%, 33% and 50%. The competent regulatory agency is then given three months to decide whether it will give its permission to the acquisition "in view of the need to ensure sound and prudent management of the credit institution". While this procedure applies to both domestic and cross-border acquisitions, it may leave potential scope for covert - though not legally founded - discrimination against foreign acquirors.

In practise, however, overt regulatory barriers to cross-border entry are not likely to pose a significant barrier. Perhaps more important are entry barriers which result from domestic regulations applying equally to domestic and foreign banks and are therefore not targeted at restricting foreign entry, but nevertheless constitute *de facto* regulatory barriers.¹² An example of this kind of entry barrier is the French policy of subsidising loans to particular sectors of the economy, including agriculture, housing and exports. As de Boissieu (1990, p.10) notes "traditionally, the financing of the French economy has been effected largely through subsidised interest rates" and these loans still accounted for 42 per cent of total credit granted to firms and households at the end of 1987. For foreign entrants into the market for loans, it is therefore essential to have equal rights to grant credit at subsidised rates. In

change, banks adjust their interest rates only slowly and to a limited degree" (OECD, Economic Survey on Italy, 1990, p.51).

¹¹ This concerns in particular the acquisitions by Credit Lyonnais which were referred to the MMC even though the Office of Fair Trading had no objections on competition policy grounds. In the case of Credit Lyonnais' attempted acquisition of credit-card processor Signet the delay caused by the MMC investigation was charged to have caused Signet to be acquired by American Express Company (see *Financial Times*, 11 June 1991).

¹² The PW study only lists "differences in licensing, minimum capital and solvency requirements and territorial restrictions (which) may make some EC countries less attractive than others for foreign bankers" (p. 80). All of these barriers will either be harmonised or be subject to mutual recognition after 1 January 1993.

the allocation of subsidised loans, however, the government may decide to favour domestic banks over foreign-owned institutions.¹³ A second example of such hidden barriers to cross-border entry stemming from domestic regulations is the privilege of the French Post Office bank, savings banks and mutual banks to offer tax-free passbooks, so-called A and Blue passbooks. This privilege not granted to either domestic or foreign commercial banks confers a significant competitive advantage in the retail sector.¹⁴

In the insurance sector, the PW report also finds little discrimination of foreign insurers: "insurance appears to be similar to the banking sector in that established foreign and domestic insurers are treated in a homogeneous manner, with there being little in the way of open discrimination." However, there may be similar implicit entry barriers which arise from regulations which are not directly aimed at erecting foreign entry barriers but nevertheless make foreign entry more costly. An example from the insurance sector is rate regulation in Germany which raises premiums above competitive levels and requires insurers to pay out excessive profits to customers. Due to this *ex post* pricing practise new (foreign) entrants cannot tell their customers the effective prices charged for the insurance cover, as they only learn actual prices after at least the first period of operation. New foreign entrants therefore face a significant entry barrier, as they are unable to quote exact prices for their products (Outreville, 1990).

One may argue that entry barriers for foreign firms rise as the regulatory intensity in the target country increases. In insurance, for example, the level of regulatory intervention seems highest in Germany. For this country, Finsinger and Pauly (1986, p.4/5) note that "the sheer complexity of the regulatory review process, the thousands of written and unwritten rules, forms to be filled in ... can only be learned by doing". In particular, they observe that in Germany "firms must learn how strictly regulations must be observed, how they can be circumvented etc. until a new firm is on equal footing with the old experienced ones". These barriers will change, however, with the entry into force of the third generation EC Insurance Directives, as was discussed in chapter two.

These examples illustrate that domestic regulations which are not explicitly aimed at restricting foreign entry may nevertheless constitute a significant barrier to foreign entry. Such covert barriers appear more

¹³ Such subsidisation runs contrary to Articles 92 and following of the Treaty of Rome concerning state aids and shall therefore be discontinued in the future.

¹⁴ Hernot and Levy-Lang (1990, p.92) report that such tax-free passbooks account for more than eighty percent of outstanding passbooks in 1987. The original economic policy objective of these tax-free passbooks is not to deter foreign entry (even though this may be a side effect), but to finance long-term low-interest loans for low-rent housing institutions (*habitations à loyer modéré*). However, they are likely to be either discontinued or extended to all banks in the future.

important than remaining regulatory entry barriers in the financial services sector.

1.2. Entry by non-EC financial services firms

Entry by non-EC institutions is subject to a different regulatory regime than intra-EC entry, as the principles of the Second Banking and Insurance Directives concerning mutual recognition and home country control do not apply. Instead, the Second Banking Directive, the Second Non-Life Directive and the Motor Insurance Directive contain 'reciprocity' provisions which call for "effective market access comparable to that granted by the Community to undertakings from that third country". As the insurance reciprocity provisions closely follow those of the Second Banking Directive, I discuss reciprocity in the context of banking.

EC financial institutions report any difficulties when entering non-EC markets to their national authorities which inform the Commission accordingly. The Commission may then be given a mandate by the Council to open negotiations with a third country whenever that country "is not granting Community credit institutions effective market access comparable to that granted by the Community to credit institutions from that third country" (Art. 9 (3)). As a possible sanction, the Commission may impose (temporary) restrictions on market entry by credit institutions from the country concerned.¹⁵

To avoid repeated scrutiny by the domestic authorities of market access in a third country whenever a financial institution from this country wishes to enter, the Second Banking Directive applies the principle of home country control in a somewhat modified version to non-EC entrants: once such an institution has been authorised to operate in at least one EC country, it may enter any other Member State without requiring further authorisation from the host country's authorities. Initial authorisation, however, requires that the reciprocity provisions are fulfilled. These reciprocity provisions do not apply to subsidiaries of non-EC institutions which are already established in the EC by the end of 1992, however, as these enjoy an identical status to EC institutions through a 'grandfathering' clause in Article 9 (4) Para.4 which exempts already authorised institutions from repeated authorisation.¹⁶ This grandfathering clause may explain the rapid increase in international entry and acquisition activities by non-EC institutions (see chapter 6), aiming to establish a foothold in the EC market to avoid possibly more stringent reciprocity rules after 1992.

¹⁵ These need to be approved by the Council after a three months period; Art. 11(3).

¹⁶ For branches of third country enterprises, however, the reciprocity provisions do not apply, as they remain sole responsibility of each Member State. Accordingly, the single European passport does not apply to branches authorised by one Member State.

Whether or not reciprocity will constitute a significant entry barrier for non-EC institutions depends to a large extent on the way the Commission enforces the reciprocity provisions. If they are subjected to a strict interpretation then the Commission could challenge the separation of commercial and investment banking in the US and Japan, for example, since no comparable restrictions exist in most European countries. Personal interviews at DG15 of the Commission, however, revealed that no such intentions exist. As the Vice-President of the Commission, Sir Leon Brittan (1991, p.3) clarified "there will be no grounds for (the Commission) to seek sanctions against a country which treats foreign banks no less favourably than native ones and offers genuine market access to them". This concerns in particular the separation of commercial and investment banking in non-EC countries which will not be challenged by the Commission. It is also unlikely that the delegation of insurance licensing in the US to the state rather than the federal level as imposed by the 1945 McCarran Ferguson Act will be challenged under the reciprocity provisions.¹⁷ Nevertheless, the reciprocity provisions give the Commission considerable bargaining power when negotiating over market access with third countries. Apart from obvious cases where market access of foreign firms is explicitly limited by quantitative or qualitative entry barriers, the Commission can also address the *de facto* discrimination of EC institutions in countries with no overt barriers to foreign entry.¹⁸

To summarise, the reciprocity provisions in the EC Banking and Insurance Directives constitute first and foremost a bargaining tool for the Commission to negotiate full market access in third countries rather than serving the purpose of constituting an actual entry barrier in the European Community for non-EC banks.

1.3. Cross-border acquisitions and the lack of a market for corporate control in European financial services

It has been argued by the Commission of the EC that in a single European market there must be equal opportunities to undertake acquisitions across national borders in order to be able enter foreign markets. Currently,

¹⁷ However, restrictions by some US states concerning foreign insurers are likely to be challenged. These include states which do not allow the operation of foreign insurers which are partly or entirely owned by the government (e.g. New York) or which impose additional deposit and capital requirements on foreign insurers.

¹⁸ In personal discussions, Commission officials have cited Turkey as an example where there are no overt barriers but where it may take up to three years to obtain the required banking license. That the Commission already uses this bargaining power becomes obvious in the speech by Sir Leon Brittan before the American Chamber of Commerce (1991, p.4/5) where he lists a number of requirements concerning market access and in particular a full grandfathering provision for established EC banks in the US.

however, there is a conspicuous absence of such a level playing field for cross-border takeovers in the EC. This may have distortionary competition effects when establishing the internal market, since it provides unequal opportunities for firms entering other European markets through acquisition. In May 1990, the Commission therefore announced a set of measures aimed at reducing barriers to cross-border acquisitions, by proposing a common set of directives for takeover regulation in the 13th Company Law Directive (COM, 823, 88), as well as various amendments to existing Directives.

The corporate control view of takeovers is due to Alchian and Kessel (1962), Marris (1963)¹⁹ and Manne (1965). The view that acquisitions occur in order to replace an inefficient management of the target firm is currently probably the most influential theory of explaining domestic industrial M & A behaviour, in particular in the US and Britain.²⁰ Is this approach equally applicable to *cross-border* acquisitions in a service industry such as banking or insurance however? Additionally, does the corporate control theory apply to takeovers in Continental Europe where hostile bids are still mostly unknown?²¹ If these transactions serve to discipline and replace inefficient management and thus help to move resources to their highest-valued use, then this may call for a supportive public policy to reduce barriers to cross-border acquisitions.

Generally, cross-border takeovers compete with other devices aimed at replacing an inefficient incumbent management. These are, for example, replacement of operating managers by the board of directors, exerted pressure by main creditors or influential shareholders (e.g. the government, other banks, institutional investors, individual shareholders with a large stake) or simply a vote by shareholders in the annual meeting. In particular, however, cross-border takeovers 'for control' compete with *domestic* takeovers aimed at gaining control of an inefficiently run firm.

If we assume that foreign acquirers suffer from a cost disadvantage compared to a domestic bidder or that managerial inefficiencies are more likely to be detected by a domestic firm rather than a foreign observer, then it

¹⁹ Marris (1963, p.189) noted that "any firm which refused to maximise the welfare of its shareholders would instantly be taken over".

²⁰ For the United States, Varian (1988) states that "it is generally agreed that such (acquisition) activities are primarily a manifestation of the 'market for corporate control'." Similarly, Philips (1989) notes that the idea that acquisitions are the outcome of the market for corporate control "has gained widespread acceptance" and that "all in all, mergers 'for monopoly' have become mergers 'for corporate control'."

²¹ France is the only Continental European country with some significant hostile takeover activity (six bids in 1988). These have led the French President Mitterand to warn against "gangsterism and the law of the jungle" (*Le Monde*, 14 February 1989). In Germany, only two hostile takeovers attempts have occurred so far (Feldmühle and Continental) and both have failed.

would be impossible that a cross-border takeover takes place for control reasons alone, since domestic firms would always be first to take over an inefficiently run institution.

Let us take a closer look at the possible sources of cost disadvantages of a foreign acquirer. These may stem from several sources, for example:

- *Takeover-related fees*: advisors such as investment banks, lawyers or consultants usually charge higher commissions for foreign than for domestic acquisitions.
- *Organisational restructuring*: incumbent management needs to be replaced by a new team either from the acquiring firm or recruited in the target country's labour market. If close knowledge of the domestic market environment is essential for effective management then a foreign acquirer unfamiliar with local customs and tastes may be at a disadvantage.
- *Search and information costs*: the costs of searching and detecting managerial inefficiencies in foreign markets may be higher than in domestic markets. Managers may be less well-informed about the quality of managers of foreign firms due to information impactedness (possibly severed by language barriers) and bounded rationality (impossibility to monitor managerial performance of a vast number of potential foreign targets).
- *Regulatory and institutional barriers to foreign takeovers*: foreign bidders may be subject to a different regulatory regime than domestic transactions or may be disadvantaged due to cultural bias (e.g. preference to sell to domestic acquirer,²²).

Nevertheless, there may be factors which tend to reduce these cost disadvantages. First, a foreign acquirer may, for example, appoint managers from its own ranks who are experienced in the market of the target firm and familiar with the local business environment. If it does not command over such suitable staff itself then it may be able to recruit personnel familiar with the local business environment in the target managerial labour market.²³ If the managerial labour market is fairly competitive in the sense that the foreign acquirer does not have to pay a wage premium only because he is foreign, then he may be able to compensate any cost disadvantage which stems from a lack of knowledge with the target market by recruiting suitable managers.

²² See section one above.

²³ This strategy was frequently pursued by Japanese banks entering foreign markets.

Second, consider the cost disadvantage due to higher information and search costs of a foreign bidder. One could argue that in the European Community, where a vast number of specialised information services exist, there is no *a priori* reason to expect that information about managerial inefficiencies should cross national borders only at a cost premium. In particular, with continuing market integration and 'Europeanisation' of competition in financial services in the context of the internal market programme, managers will be more likely to look beyond national borders to search for inefficiently run banks which constitute prime takeover targets.

Third, the regulatory, institutional, or cultural bias towards domestic transactions requires closer scrutiny of the legal and institutional framework in the EC countries which exceeds the scope of this study. Let it suffice to note at this point that since the corporate control view of takeovers is usually associated with the phenomenon of the hostile tender bid and these are largely confined to the Anglo-Saxon countries, some authors have concluded that the 'corporate control' theory of acquisitions is not relevant to other European countries, such as Germany or France, for example.²⁴ One may dispute, however, whether the market for corporate control is really inactive in the Continental European countries or just takes a different *form* than in the Anglo-Saxon countries.²⁵

To summarise, it was argued in this section that the threat of cross-border acquisitions may well impose a disciplining constraint on incumbent management even though barriers to cross-border takeovers especially in the Continental European countries contribute to a lack of a level playing field for cross-border takeovers. The biggest obstacle to cross-border acquisitions in the financial services market remains unaffected by the legislative efforts on part of the Commission, however: that of public ownership of financial services firms in some EC countries, in particular banks. This is discussed in the next section.

²⁴ For example, Fairburn and Kay note that "the market for corporate control is active in Britain and the United States ... but in most industrial countries - even ones with a developed stock market, such as Japan, France, Germany, or Switzerland - the hostile takeover bid is legally impracticable or virtually unknown in practice" (1989, p.28).

²⁵ An inefficient management may be replaced through other measures than the hostile tender bid. In particular, large shareholders such as institutional investors or family owners may exert considerable pressure on the incumbent management to change corporate policy or push them into resignation (see Shleifer and Vishny, 1986). Whether or not hostile bids are required to replace an inefficient management therefore depends on the relative efficacy of these alternative replacement mechanisms (for a comparative analysis of the market for corporate control in France, Germany and the UK, see Franks and Mayer, 1990).

1.4. Public ownership of financial services firms

A question which deserves particular attention in the context of entry barriers is that of public ownership. In the EC countries less than half of the largest 162 banks are privately owned.²⁶ It follows that only few banks can become subject of a cross-border acquisition attempt. In addition, it is frequently argued that publicly owned banks enjoy cheaper funding costs and other regulatory advantages over their privately owned competitors, since their liabilities are explicitly guaranteed by the government. Thus, does public ownership constitute a significant competitive distortion in the single financial market?

Table 4.1 presents evidence on the structure of ownership, average size and two performance measures for the largest 162 EC banks.

Table 4.1 Ownership, size and performance of largest 162 EC banks in 1988

Type of Ownership	Proportion	Mean Assets*	Pre-tax ROA	Pre-tax ROE	Capital/assets ratio
Private	43%	32.6	0.77%	16.4%	4.8%
Public**	41%	26.9	0.61%	14.3%	3.7%
Co-operatives	9%	35.9	0.89%	17.3%	5.2%
Mutuals	7%	9.0	0.81%	14.8%	6.1%

* in ECU billion

** central or local government ownership

Source: *The Banker*, 1/89, p.39.

The table illustrates the large number of banks owned by national or local governments. It shows that a corporate control market can only operate for less than half of the largest banks in the EC, due to the closed ownership structure of publicly owned banks, mutuals and cooperatives which constitute 57 percent of the largest 162 EC banks. Publicly owned institutions are slightly smaller in terms of mean assets than private banks and co-operatives. In particular, however, they are characterised by lower profitability, both in terms of return on assets and equity, and are not as well capitalised as non-publicly owned institutions. This may be surprising considering the popular claim that publicly owned companies have access to cheaper funding sources than private firms due to the advantages of government borrowing.²⁷ These result from the lower risk premium which the market attaches to public as compared to private loans, due to the lower risk of insolvency.

²⁶ Unfortunately, no comparable data are available for the insurance sector.

²⁷ Vickers and Yarrow (1988, chapter 2) note that differences in the objective functions of owners may explain differences in performance. Publicly owned institutions may have the goal to maximise general economic welfare rather than maximising profits.

In general, it is not clear whether public ownership leads to changes in the objective function of bank management. As is stressed by de Boissieu (1990) for the case of France, for example, whether or not nationalisation or privatisation leads to changes in banks' objective functions depends crucially on the extent and effectiveness of 'moral suasion' of the central bank and other regulatory agencies (e.g. the Finance Ministry). Nevertheless, it is recognised that public ownership may confer competitive advantages on the bank. When discussing the weak pre-BIS rules capital ratios of French banks, Metais (1990, p.144) acknowledges that "their public ownership status probably more than compensated for the risks presumably attached to their lower capital ratios".

Publicly-owned banks can also pursue unconventional methods of boosting capital in order to meet the BIS guidelines and the EC Solvency Directive. French Credit Lyonnais, for example, engaged in an intricate series of 'financial engineering' manoeuvres which include the issue of shares to other state-owned enterprises.²⁸ It is difficult to determine whether or not publicly-owned banks enjoy cheaper capital costs due to such 'engineered' capital injections, as details of the deals are hardly ever available. Nevertheless, it seems clear that publicly-owned banks enjoy the advantage of being provided with capital at non-market rates.

2. Market-inherent barriers to cross-border entry

2.1. Economies of size

2.1.1. Scale economies

Bain (1956) argued that if scale economies are present, the potential entrant faces a predicament: coming in at a level below the minimum efficient scale (MES) results in a cost disadvantage compared to incumbents. If, however, a level above the MES is chosen the new entrant may contribute significantly to total industry output so that prices and profits fall - possibly even below unit costs so that a loss results. Since the incumbent also makes a loss, however, we need to know the strategic interactions between the firms to predict who will be squeezed out. Economies of scale would not be considered a barrier to entry under Stigler's definition if entrant and incumbent face the same cost and demand conditions. This results from the argument that the entrant only has to match the incumbent's scale of activity to be on equal terms and therefore no competitive disadvantage exists.

²⁸ Credit Lyonnais was injected with fresh capital by the Caisse de Dépôts and exchanged shares with state-owned Rhône-Poulenc and Thomson-CSF resulting in a total capital increase of FF9.8 billion (Alexander and Shreeve, 1991).

In addition to posing a potential barrier to cross-border entry, economies of scale play a significant role in the EC internal market programme. For example, the Price Waterhouse study (1988, p.20) claims that "the expanded market opportunities presented by an integrated European financial services market would enable prices to fall below existing lowest prices, as economies of scale are exploited" (emphasis added).

For single-output production, scale economies refer to decreasing long-run average costs, as the scale of activity increases. In the case of a multiproduct firm, scale effects are defined either as ray economies or product-specific economies.

Ray economies of scale measure cost behaviour of a proportionate output change as the composition of the output bundle remains unchanged.²⁹ For a multiproduct output vector Q , ray average costs are defined as $C(\alpha Q) / \alpha$, where α is a scalar of the level of output. Ray economies of scale are then defined as

$$(1) \quad S_r = C(Q) / \sum_{i=1}^n Q_i MC_i$$

where S_r greater, equal or smaller than one implies increasing, constant or decreasing returns to scale.

To measure product-specific scale economies, Bailey and Friedlaender (1982) introduce average incremental costs (AIC). For the two-product case these are defined for each product as follows:

$$(2) \quad AIC_1 = C(Q_1, Q_2) - C(0, Q_2) / Q_1$$

i.e. average incremental costs for the first product are total costs less the costs of not producing commodity 1, divided by its output (analogously for the second good). Product-specific returns to scale are then given by:

$$(3) \quad S_i = AIC_i(Q) / MC_i$$

Again, S_i greater, equal or smaller one implies increasing, constant or decreasing returns to scale.

What are the potential sources of size-related cost reductions in financial services? Two main sources can be distinguished: 'production' and financial scale economies. Production scale economies refer to the case of spreading fixed costs such as research or technology expenses over a larger scale of activities. Even though most banks have a research department, the costs of these are hardly comparable with R&D expenditures in other industries.

²⁹ See definition 3 of Baumol (1977, p.811) and definition 2 of Panzar and Willig (1977, p.484).

Expenses on new technology, such as setting up a central processing department or acquiring computer systems, may be substantial, but are unlikely to provide a major source of cost advantages.

Financial scale economies may be more significant in banking than production economies. These result firstly from diversification advantages: generally, as the scale of activity increases, the bank can diversify across risky assets and liabilities, and thereby reduce the variance of earnings at a constant level of expected returns. For example, as the number of depositors increases, the variability of withdrawals is reduced and proportionately fewer liquid reserves need to be held. Conversely, a larger scale of activity may lead to a reduction in the variability of returns at a constant level of risk. This may allow the bank to increase its leverage. An additional aspect which may lead to cost advantages for larger banks is some kind of *de facto* guarantee of the central bank that large institutions are not allowed to fail to avoid a financial crisis. This may allow larger banks to pursue riskier strategies, achieving higher returns.³⁰

In the insurance sector financial scale economies may result from the operation of the law of large numbers, as a larger number of independently distributed risks leads to a lower variance of claims which allows the insurer to charge lower premiums. Possibly even more importantly, insurance firms invest large amounts of assets in the capital markets. Again, there may be diversification advantages for larger insurers. Additionally, a large insurer may enjoy a lower probability of failure than a smaller one and may therefore be able to earn a higher return on the invested funds in the capital markets.

Empirical evidence on scale economies is almost non-existent for European banking, contrasting with myriad studies available for the US.³¹ The question whether economies of scale actually exist in the US banking sector is far from settled, however, due to different methodological approaches to estimating cost functions econometrically. First, one has to define what it is that banks actually 'produce'. While some authors (e.g. Sealey and Lindley, 1977) consider deposits to be an input factor which combined with labour and physical capital produce loans as an output, it seems preferable to include deposits as an output rather than as an input. This results from the fact that services for depositors constitute an important element of labour and capital costs (Humphrey, 1991). Banking output should therefore include deposit services such as current and savings accounts, time deposits, fund management and payment services.

Related to the definition of banking output is the definition of the cost variable. While some studies consider only operating costs such as labour and physical capital (e.g. Nelson, 1985), others include interest expenses. Interest

³⁰ This moral hazard problem is discussed in section two of chapter two.

³¹ See Clark (1988) for a recent review of the US literature.

expenses usually exceed actual operating costs and include the cost of purchasing funds in the interbank market as well as interest paid on deposits. As Humphrey (1990) shows, purchasing funds is to some extent a substitute for deposits gathered through a retail network and since the latter causes high operating costs whereas the former does not, estimates of scale economies which do not include interest expenses in the cost variable tend to be biased towards banks with a greater proportion of purchased funds. Thus, it seems preferable to include interest expenses in the cost variable.

A third critical issue is the specification of the cost function to be tested. Most early studies have used a simple log-linear Cobb-Douglas function (e.g. Benston, 1965; Bell and Murphy, 1968) and can largely be disregarded as this specification is not able to capture a U-shaped cost curve but pre-supposes that returns to scale are identical across the whole range of activity levels. More recently, the Cobb-Douglas specification has therefore been replaced by more general translog functions which avoid this strong assumption and are also better able to capture scope effects (see below).³²

Most US studies do not find evidence for significant economies of scale in banking, with more recent studies even providing evidence for diseconomies beyond a certain activity level (e.g. Athanasios, Subhash and Miller, 1990). Typically, the cost function estimated displays a U-shaped form with most major size economies exhausted at a capital size of around \$50 million (e.g. Berger *et al.*, 1987; Mester, 1987).³³ A similar result is obtained in the few European studies: Dermine and Röller (1991), for example, use data for the French mutual funds industry and find that economies of scale are relevant only for small institutions with total assets of up to FF2.9 billion and diseconomies setting in for larger firms. These empirical results seem to confirm the conclusion of the theoretical discussion that scale economies are exhausted at a fairly low level of firm size.

The empirical evidence on the relative insignificance of scale economies strangely contrasts with the practitioner's view on the importance

³² See Benston, Hanweck and Humphrey (1982) for the first application of the translog cost function.

³³ One needs to differentiate between small and large banks. The inclusion of small banks is likely to distort results, as they enjoy a number of regulatory advantages under US law. These include the fact that deposit insurance premiums are collected on all deposits and not just on insured deposits, such that small banks which depend almost exclusively on insured deposits are effectively subsidised by larger banks which pay premiums also on uninsured deposits. In addition, larger banks hold more non-interest bearing reserves, since reserve requirements are graduated and, finally, most consumer protection laws have explicit exemptions for small banks, reducing the regulatory burden. Most of the available US evidence is based on FCA data which does not include the larger banks with deposits above \$1 billion. Hunter and Timme (1986), Shaffer (1988), and Hunter *et al.* (1990), however, focus on large banks and find more significant evidence for scale effects.

of sufficient size to compete successfully, however.³⁴ In particular in the US, where the empirical evidence on the relative insignificance of scale effects seems strongest, there have been a range of large-scale mergers with the stated objective to reach bigger scale to be able to cut costs.³⁵ A similar economic rationale based on size economies was given for the domestic mergers in Spain and the Netherlands, where it was argued that domestic banks needed to be “of sufficiently large size to compete effectively in the European internal market” (see section 4.1 below). According to the empirical evidence on scale economies, however, such ‘mergers for size’ seem to be ill-founded.³⁶

In the insurance sector, there have been fewer studies on the existence of scale economies and these have so far not led to a clear picture. Again, the majority of early studies can largely be disregarded, since they use the restrictive Cobb-Douglas production function. Similarly to the banking studies, there is some disagreement as to the right output measure of the insurance firm (see, for example, Hornstein and Prescott, 1989; O’Brien, 1991). This debate seems less fundamental, however than for banking: the most common output measure is premium income (either gross or net of reinsurance), while some authors have argued in favour of “total claims”. In a recent study on scale economies, however, Suret (1991) using the translog production function shows that results are virtually identical using either output measure.

Suret (1991) finds significant scale economies in the Canadian property/liability sector only for medium-sized firms with assets between \$40 and \$100 million. Prosperetti (1991) finds evidence for scale economies in the Italian non-life sector, while Kaye (1991) also finds modest scale economies for the UK life insurance industry. According to her regressions, the rate of the increase in average costs to premium income is 92 percent. Finally,

³⁴ For example, *The Economist* reports an estimate that a merger between any two big US banks may lead to cost savings of 30 percent, due to pooling of computer systems, as well as merging or closing directly competing branches (see ‘Big-bank mergers’, *The Economist*, 26 January, 1991, p.86).

³⁵ These include the 1991 mega-mergers between Manufacturers Hanover/Chemical Bank, NCNB/C&S Sovran and Security Pacific/Bank America. In the latter merger cost savings are expected to result from redundancies, branch closures and the combination of computer systems. All these measures are thus targeted at cutting fixed costs and thereby reduce operating costs for a given level of output, i.e. they are founded on the belief that scale economies are significant.

³⁶ Of course, the significance of scale effects depends to a certain extent on the type of market in which the bank operates. In wholesale banking, for example, a larger scale of activity may manifest itself in a wider international branch network which could lead to a stronger competitive standing with large multinational firms. Since most empirical studies have so far looked at ‘traditional’ banking activities such as deposit-taking or consumer and commercial loans, but do not consider other activities such as capital-intensive foreign exchange transactions or technology-intensive credit card or electronic fund transfer systems they cannot be generalised to these areas.

Fecher *et al.* (1991) examine the French insurance industry and find for a sample of 84 life and 243 non-life firms that scale economies are present in both sectors even though being comparatively modest in size. A comparative study of several countries by Imfeld (1991) finds scale economies for the Dutch non-life sector but not for the German non-life sector. As a tentative conclusion, we can state that there is some evidence for the significance of scale economies in the insurance sector. Cost advantages resulting from size seem modest at best, however.

Possibly most interestingly, all studies find significant differences in terms of average costs between firms of the same size. Imfeld (1991) shows that average costs as a percentage of premiums range from 5 percent to 65 percent for firms of the *same* size in several countries examined. Prosperetti (1991) shows that in the Italian insurance sector this figure ranges from 15 to 110 percent. Similarly in the banking sector, Berger and Humphrey (1991), stratifying banks according to size, find that cost differences among banks in the same size cluster are significant and may average up to 34 percent.

These results suggests that efficiency issues may be much more important than previously thought. Thus, a firm which is large may at the same time be inefficient and therefore have lower profits than a highly efficient small firm. It seems that profitability in financial services has much less to do with pure size than with internal efficiency. This implies that entrants should not face significant entry barriers resulting from pure size advantages which they could not compensate by an efficient cost structure.

2.1.2. Scope economies

As financial services typically involve multiproduct services, we also need to consider economies of *scope*.³⁷ Formally, these are defined as follows: let Q_i be an output vector of $i = 1, \dots, n$ products. A cost function is then called strictly sub-additive if

$$(4) \quad C \left(\sum_{i=1}^n Q_i \right) < \sum_{i=1}^n C(Q_i)$$

for all Q such that $\sum_{i=1}^n Q_i > 0$. In a two product case, economies of scope exist for a strictly sub-additive cost function if

$$(5) \quad C(Q_1, Q_2) < C(0, Q_1) + C(Q_2, 0)$$

³⁷ See Panzar and Willig (1982) for a short account on scope economies and chapters 3 and 4 of Baumol, Panzar and Willig (1982) for a more general treatment.

where $C(0, Q_1)$ and $C(Q_2, 0)$ are called stand-alone costs.³⁸ This implies that the cost of jointly offering services Q_1 and Q_2 is smaller than offering them separately. A measure of scope economies is thus given by:

$$(6) \quad S_c = C(Q_1, 0) + C(0, Q_2) - C(Q_1, Q_2) / C(Q_1, Q_2)$$

Scope economies in financial services may derive from several sources:

i.) *Shared inputs*: common inputs may be utilised more efficiently when applied to various products, avoiding excess capacity. This applies particularly to spreading fixed costs, for example from maintaining a retail branch or agent network which enables firms to distribute a range of financial services, or computer systems which may be used to support various financial analyses.

ii.) *Intangible assets*: a special case of shared inputs are intangible assets such as managerial know-how, brand loyalty or reputation.³⁹ Managerial and employee know-how, for example, is probably the most important input factor in financial services with labour costs constituting by far the largest contributor to a firm's operating costs. It is likely that know-how can be transferred at little costs to new products or services.⁴⁰

iii.) *Marketing economies*: Another category of scope economies exist in the marketing and distribution area. Customers may prefer to acquire a range of financial products all from one institution, rather than maintaining relationships with a number of service firms, since 'one-stop shopping' saves on transaction costs such as transportation and communication expenses.

iv.) *Diversification*: similar to the case of scale economies, financial services firms may be able to reduce risk by diversifying across different activities and by matching the maturity of assets and liabilities.⁴¹

In retail banking where customer-supplier interactions are frequent, personal customers may prefer to purchase a range of products such as various payment services, portfolio management services or loan arrangements from the same institution. It follows that financial institutions

³⁸ See Willig (1977).

³⁹ Informational economies are another example of an intangible asset: for instance, Gilligan *et al.* (1984) note that credit analyses of bank customers with current and/or deposit accounts are less costly than for 'unknown' loan applicants.

⁴⁰ Prescott and Visscher (1980) scrutinise firms' investment in 'organisational capital' which consists of personnel information (i.e. knowledge about the abilities of employees), matching of employees to form optimal teams and investment in human capital through training, for example.

⁴¹ For example, foreign exchange risk in foreign loan activities can be hedged by forward options.

entering this market have to come in at a sufficiently diversified level to compete effectively with incumbents.

As Teece (1982) points out, however, these factors alone are not sufficient for necessitating internal organisation, but must be complemented by transaction costs when using the market. If, for example, contractual agreements could be devised to exploit the presence of scope economies then firms may as well use the market instead of internalising transactions. As is stressed by Teece, however, markets for trading intangible assets such as special know-how, for example, are riddled with market failures and thus reaping the benefits stemming from these sources may require internal organisation. This does not necessarily apply to other shared inputs such as the retail branch or agent network, however, where contractual agreements are conceivable and actually practised in reality.⁴²

The empirical evidence on scope economies in banking is limited to US studies and as yet somewhat contradictory: Murray and White (1983), Gilligan and Smirlock (1984), and Kim (1986) all find evidence for the existence of significant cost complementarities. Berger *et al.* (1987), however, scrutinise a sample of US banks with less than \$1 billion in deposits and do not find evidence for scope economies. A similar insignificant result is found by Hunter *et al.* (1990) who apply the same methodology to a sample of the largest 400 US banks and Mester (1987) who analyses a sample of Savings & Loan Associations.

In the insurance sector, Suret (1991) finds no evidence for cost complementarities or scope economies in the Canadian property/casualty sector. To the author's knowledge no other studies exist on scope economies in insurance.

Negative results do not necessarily imply that scope economies are insignificant, however: Berger *et al.* (1987) note that scope effects arising from marketing and diversification economies, while revenue-enhancing, may not immediately feed through to the cost function. Statistical estimates of the cost function are therefore likely to underestimate the long-term effects of scope effects, as the effects on revenue are only insufficiently captured. Thus, it may be the case that the cost function actually displays *diseconomies* of scope, while profits increase as the number of products increases because the revenue-enhancing effect outweighs the cost increase.

Economies of scope may serve to explain an observed trend towards universal banks, with formerly specialised banks expanding their line of activities. Similarly, the recent increase of banks selling insurance products could be explained by scope economies, as banks have established customer

⁴² Such as in a distribution alliances, for example, where a bank distributes insurance products for a (foreign) insurer through its retail branch network.

relationships, as well as employees with financial expertise who do not require as much new training as novices to the field.⁴³

Scope economies encounter clear limits, however: as the number of services offered increases, economies of specialisation are foregone, due to bounded rationality on the part of employees or limits on the possible complexity of the organisation.⁴⁴ In addition, it is not clear that internal organisation is required to reap the benefits of scope economies. Alternatives are joint ventures or co-operative agreements with other financial institutions which offer complementary products. Which of these alternative means of organisation is chosen depends on an appraisal of transaction costs, as was discussed in chapter 3.

2.1.3. *Some evidence on the size/profitability relation for European banks*

The lack of evidence on scale and scope economies for European banks mainly stems from the scarcity of detailed data on cost structures which is more readily available in the US. I have therefore chosen to test the more general hypothesis that size is positively correlated with profitability. This approach has the obvious drawback that it is not able to pin down the source of differing profitabilities and therefore gives no insight into the relative significance of scale and scope economies and differing degrees of market power. It has the advantage, however, that it is able to capture size advantages stemming from revenue-related scale effects. Consider, for example, a retail bank which takes into account customer transaction costs when maximising profits. Maintaining a large branch network reduces customers' transportation costs and may therefore enhance revenue although adding to costs. Thus, a profit-maximising bank which takes customer transaction costs into account may appear to have higher costs than a bank which solely minimises costs. Only if we analyse the relation between size and profits are such revenue-related scale effects captured. Thus, the hypothesis tested in this question is whether larger banks enjoy greater profits, where size is measured in both capital and assets.

I assembled a sample of the largest 173 EC banks from the biggest 1000 banks worldwide and calculated two correlation coefficients. Table 4.2 reports the Pearson product-moment correlation coefficients for each of eleven EC countries⁴⁵ and one-tailed significance tests.

⁴³ In addition, informational economies may play a significant role since banks can monitor current account movements to check on the selling potential of insurance business.

⁴⁴ This point is already discussed in Coase's seminal paper (1937): Coase notes that "as a firm gets larger, there may be decreasing returns to the entrepreneur function, that is, the costs of organising additional transactions within the firm may rise". It is also referred to as the 'Penrose-effect', as Penrose (1959) focused on diminishing returns of adding additional management to a firm.

⁴⁵ Ireland has only two banks among the top 1000.

Table 4.2: Size/profitability correlation for largest 173 EC banks

	n	cap/ POC	ass/ ROA
Belgium	10	-0.34	-0.44
Greece	5	-0.93	0.32
Germany	31	0.58***	0.37*
UK	16	-0.4	-0.46
France	17	-0.25	-0.26
Spain	27	0.15	0.33*
Italy	30	-0.09	-0.5
Luxemb.	5	-0.88	-0.96
Netherl.	8	-0.11	-0.28
Denmark	15	0.43	0.53*
Portugal	9	0.31	0.09
EC total	173	0.03	-0.04

Variables:

n: number of observations; *cap*: tier-1 capital; *ass*: total assets; *POC*: profits on capital; *ROA*: return on assets.

Significance levels:

* 5%-level; ** 1%-level; *** 0.01% level.

Source: compiled from top 1,000 banks listing in *The Banker*, July 1990.

At the country level, the correlation between capital and profits on capital is significant only in Germany. A similar correlation between asset size and returns on assets leads to a significant relationship for Germany, Spain and Denmark.⁴⁶ In other countries such as the UK, France and Italy, size seems to be *negatively* correlated with profitability, i.e. smaller institutions are on average more profitable than their large counterparts. I also ran some simple OLS regressions of the form $POC = \alpha + \beta CAP$ and $ROA = \alpha + \beta ASSETS$ for each individual country. These regressions largely confirmed the results of the correlation analysis. Only for Germany was there a statistically significant relationship between *POC* and *CAP* with the following regression equation: $POC = 8.55 + 0.002CAP$ where the t-statistic for the coefficient was 3.81 which is significant at the 0.1 percent level (R-Square: 33.4). There was actually a negative relationship between *ROA* and *ASSETS* for the case of the UK, statistically significant at the 5 percent level, and for Greece between *POC* and *CAP* significant also at the 5 percent level (R-Square: 86.4). For all other

⁴⁶ These results show a more significant relationship between size and profitability than found by Steinherr and Gilibert (1989). This may be due to their smaller sample size and their choice of correlation coefficient (Spearman rank instead of Pearson).

EC countries, there was no statistically significant relationship between either size measure and ROA and POC respectively.

These results suggest that the predicted higher profitability of large institutions stemming from size advantages does not hold for most European countries. Smaller banks should therefore not be at a competitive disadvantage compared to their larger rivals. In addition, attempts by public authorities to make domestic financial institutions more competitive by supporting large-scale mergers seem to be misguided and are even likely to achieve exactly the opposite result considering the integration problems which inevitably result from a merger.

Even where size effects may be important such as in electronic distribution and processing systems, it is not clear that they necessarily constitute a potential source of entry barriers if public policy ensures market access at reasonable prices. Rather than resulting from size economies, entry barriers are more likely to arise from the established position of the incumbent having build up a reputation or from switching costs which lead to customers being 'locked in' with their current supplier. It is this question which is analysed in the next section.

2.2. Reputation and switching costs

An incumbent firm may enjoy a competitive advantage over a potential entrant due to consumer preferences for the incumbent's products or services as a result of product differentiation.⁴⁷ This may arise, for instance, if there is an established 'brand loyalty': a firm may have earned a reputation of supplying good quality with its service products and following a prudential strategy when managing its assets. A new entrant still has to prove that its service quality is superior or at least equal to the incumbents' services. In addition, new entrants first have to demonstrate that their solvency is sufficient to cover possible liquidity problems. An established reputation may allow the incumbent to charge above unit costs without inducing entry, since entrants have to incur higher selling expenses or are only able to sell their products at a price discount. Thus, the incumbent enjoys an absolute cost advantage until entrants have established their services on equal terms.⁴⁸ Building up a reputation, however, is a time-consuming process and

⁴⁷ According to Chamberlin (1933, p.56) products or services are differentiated if "any significant basis exists for distinguishing the goods (or services) of one seller from another". In particular, Chamberlin stresses that product differentiation may stem from intangible factors such as the location of a branch or agent, "the general tone or character of the establishment", or the specific relationship between banker/agent and customer.

⁴⁸ Product differentiation also impacts competition between incumbents: Martin (1989) shows that a higher degree of product differentiation leads to a higher probability of non-cooperative collusion being sustainable *ceteris paribus*, as it reduces the incentive to depart from such an equilibrium.

therefore the initial extra costs for establishing itself on the market act as a deterrence, the more so the higher the costs and the longer the required 'break-in' period.

Farrell (1986) formalises this reasoning and shows that in an experience-goods industry such as financial services, reputation can become an entry barrier when the incumbent has a first-mover advantage. The entry barrier will be higher the greater the consumer surplus offered by the incumbent, as the first entrant faces a less severe moral hazard problem than succeeding entrants who have yet to prove that they offer high-quality services, similar to those of the incumbent. This may be difficult where consumers realise that an entrant can make a higher profit through 'fly-by-night' entry, i.e. by offering a low quality product and then exiting the market once customers discover this fact.⁴⁹

Klemperer (1987b) analyses strategic entry deterrence of incumbents if consumers face switching costs when changing suppliers.⁵⁰ Under these circumstances, it may pay the incumbent to sacrifice short-run profits in order to build up a customer base, by lowering price in the first period and thus 'locking in' consumers. In subsequent periods, prices can be increased just below the level of switching costs. Incumbents therefore enjoy some degree of market power, once they have build up a customer base, even if products are completely homogeneous and no other barriers to entry and exit exist. Farrell and Shapiro (1988) show that in an overlapping generations model with Stackelberg competition, incumbents faced with entry at a price p continue to price at $p + s$ where s are switching costs and therefore leave new customers to the entrant. This results from the fact that it is more profitable for the incumbent to 'milk' locked-in customers rather than reduce price to competitive levels.

Switching costs may be substantial in retail financial services. First, there may be significant search costs of collecting information on prices and quality of different offers. Search costs in insurance seem to be greater than in banking, as insurance conditions are usually highly specific⁵¹ and thus require a greater number of transactions with several agents or sales representatives. Prices in retail banking are usually standardised and more easily obtainable.⁵²

⁴⁹ Compare the BCCI-scandal where the vast majority of customers did not discover the fact that the bank was embezzling funds, however.

⁵⁰ See also von Weizsäcker (1984) who constructs a model where price sensitivity rises, as switching costs increase and thus competition between suppliers rises rather than decreases.

⁵¹ For example, the price of automobile insurance for a 25-year old male driver with a history of two car accidents, driving a 3-year old Fiat with 90 horsepowers.

⁵² As will be argued in the next chapter, however, it requires detailed information on the number of services used to calculate and compare relevant prices, as banking mostly involves product bundles rather than individual products.

Second, actual switching costs result from the transfer of accounts or policies, as this process is likely to involve costs including, for example, the need to communicate the new banking relationship or insurance policy to business partners, redirecting standing orders for the case of banking or the need to learn new rules and regulations for making claims in the case of insurance.⁵³ This results in a potentially significant first-mover advantage of incumbents.⁵⁴

In addition to factual switching costs, there may be 'psychological' barriers to changing an established relationship solely as a response to price differentials: these result from a possibly year-long personal relationship between banker and customer creating an atmosphere of trust and loyalty which may be immune to minor price differences. Similarly, an insurer has acquired information about the claims history of the insured. Such a year-long relationship may constitute an informational asset and may lead to a situation of asset specificity. Asset specificity results from the fact that the information which both sides gain about each other cannot be costlessly transferred to another banking or insurance relationship⁵⁵ and leads to lock-in effects, as is explained by Williamson (1981, p.1546):

"The reason why asset specificity is critical is that, once the investment has been made, buyer and seller are effectively operating in a bilateral ... exchange relation for a considerable period thereafter".

Casual evidence suggests that banks do indeed follow a strategy of attracting new customers in the retail area by offering accounts at below-cost prices. An example of such a strategy are the expense-free accounts offered to students in most countries. In the UK, for example, students are offered various 'incentive packages' by the large commercial banks which not only include free account management, as well as cash and credit cards, but also a 'start-up bonus' of up to twenty pounds. The focus on students and starting-out employees reflects the difficulty of acquiring new customers through

⁵³ Switching costs may also result from government regulations. Berghe (1990), for example, reports that until very recently some insurance branches required the consumer to sign up for a period of 5 to 10 years. See Harris and Schulenburg (1991) for an analysis of the implications of search and switching costs in the insurance market.

⁵⁴ A first-mover advantage may stem from the highly idiosyncratic relationship between firm and customer (see, for example, Sharpe, 1990): once the financial services firm has sunk the costs of acquiring information about the loan or insurance applicant, it is able to offer better terms for a new loan or insurance contract, as it holds private information about the characteristics of the applicant which has yet to be obtained by another firm with no previous relationship with that particular customer. Thus, financial services firms are able to 'lock in' current customers and exercise a certain degree of market power.

⁵⁵ Sharpe (1990) builds a model of the bank-corporate customer relationship where customers are 'informationally captured', since banks holding inside information about characteristics of their customers may exercise *ex post* market power even if the market is competitive *ex ante*.

other forms of competition such as price or quality differentiation. Once these new customers have been 'locked in', prices can be raised towards higher levels, as switching costs may prevent customers from changing banks until a significant price differential is reached. Similarly, insurance companies offer rebates for a history of low claims which may lead to lock-in effects if such rebates are not fully transferrable to another insurer.⁵⁶

Switching costs are reduced if products are 'separable' from the whole product bundle. This may be the case, for example, for credit cards where customers maintain separate accounts with a credit card supplier without the concurrent need to shift their whole account to the credit card supplier. Similarly, consumer credit can be offered directly by the merchant or dealer rather than by a bank. Moreover, switching costs in banking are further reduced by the recent trend of personal customers to maintain two or more banking relationships which enables them to compare prices more effectively and switch to the supplier with lower costs for a particular service.⁵⁷ In insurance it is lot more common to maintain relationships with several insurers since the transaction cost savings of purchasing all products from the same insurer are significantly smaller than in banking.

In insurance, additional entry barriers may arise for foreign insurers where distribution channels are such as to favour long-term transactional relationships between customer and supplier which increase switching costs. This is likely to be the case where the main distribution channels are exclusive agents rather than brokers or non-tied agents. In Germany, for example, 79 percent of insurance products are sold by tied agents who work exclusively for one insurer and only 16 percent are sold by brokers (Aerthoj, 1990, p.162). In the UK, in contrast, 70 percent of non-life insurance products are sold through brokers, whereas only 18 percent are sold by exclusive representatives. Clearly, it is easier for a foreign insurer to enter a market where it can induce established brokers to distribute its products rather than establishing a sales force or agent network from scratch. This also stems from the fact that switching costs are likely to be lower if the customer uses a broker mainly due to lower search costs. Even for brokers or independent agents there are likely to be cost disadvantages for foreign insurers, however. In France, for example, foreign insurers had to pay significantly higher commissions to independent agents to induce them to distribute their products: commissions as a percentage of premia in 1987 were on average 80 percent higher for foreign insurers than for domestic firms (Salomon Brothers, 1990).

⁵⁶ In particular in motor insurance bonus/malus schemes are important which may reduce regular premiums by up to 75 percent. Unless such rebates are fully transferrable in case of changing the insurer, significant switching costs arise.

⁵⁷ Large firms entertain several banking relationships and are therefore more likely to be able to compare prices for individual products. Even in Germany where the Hausbank principle originated, the largest firms on average maintain 19 banking relationships (Greenwich Associates, 1988).

Firms' optimal strategy in the presence of switching costs is to help agents reduce switching costs in the 'acquisition' period of new customers and increase switching costs, once customers have been locked in. Casual observation indicates that financial services firms do indeed follow such a strategy: some firms offer sign-up bonuses and help new customers with administrative costs of account and policy transfers, while at the same time increasing switching costs by offering rebates or charging for account closures.⁵⁸

What are the effects of switching costs on (potential) entry? Klemperer (1989) analyses a four-period model of a market with a homogeneous product. In periods 1 and 2 the market is served by a dominant firm and fringe firms enter in period 3, taking the incumbent's quantity as given. After entry, prices fall as new entrants undercut the incumbent to gain market share and the incumbent responds by lowering price as well. The special feature of the model, however, is that prices rise again in period 4, as new entrants have 'locked in' their acquired customers. Thus, price behaviour follows that of a temporary price war, rather than a permanent reduction in prices. In addition, Klemperer shows that when switching costs are small and information complete about entry in period 3, firms will engage in limit pricing, i.e. lowering prices in period 2 to lock in as many customers as possible and to prevent or reduce new entry in the next period.

This model has interesting implications when applying it to the financial services market: first, it implies that new (cross-border) entry does not necessarily result in lasting price reductions. Instead, a temporary price war may be followed by price hikes, as new entrants have 'locked in' consumers. Second, in the 'run-up period' to an open market (i.e. period 2 in Klemperer's model) domestic incumbents may attempt to lock in customers before foreign entry occurs by offering attractive conditions. Such predatory behaviour, serving the sole purpose of deterring foreign entry, is difficult to detect, however, as price reductions are likely to be interpreted as pro- rather than anti-competitive behaviour.⁵⁹

The presence of switching costs may also affect the strategy of entry deterrence of incumbents: as was discussed in chapter one, many financial institutions have been invading each others' lines of business, broadening the scope of products offered. Thus, firms which traditionally divided the market among each other, have now become direct competitors. Generally, this broadening of product lines is interpreted as a sign of increasing competition in the financial services market.

⁵⁸ Some banks in Italy charge up to 20 ECU for closing accounts.

⁵⁹ Price reductions with the sole purpose of locking in customers are unlikely to be detected by the Areeda-Turner test (1975) for predation, as price always exceeds marginal costs (see Klemperer, 1989, Appendix 2).

Does this observed trend towards retail financial services market *necessarily* result in increased competition, however? Klemperer (1990) offers an interesting analysis of multi-product competition in the presence of 'shopping costs' and brand (or firm) loyalty. In the absence of switching costs, it is well-established that firms usually act according to the 'principle of differentiation', i.e. rather than competing head-to-head (e.g. as integrated financial services 'supermarkets'), firms prefer to differentiate products, since this allows them to charge higher prices and avoid Bertrand competition (see, for example, Shaked and Sutton, 1982 and Neven, 1985).

When consumers face switching costs, however, this result may be reversed. Consider the following example: there are two financial services firms located some distance apart in a small town. Both firms first decide on the range of products to be offered and subsequently on the price charged. Two strategies are available to the firms: either to offer the whole (undifferentiated) product line ('supermarket' strategy) or to specialise on particular differentiated products ('specialist' strategy). If both firms choose the supermarket strategy and they are not differentiated in any other respect (such as qualification of employees, for example), then consumers will maintain relationships with one firm only, as location is the only differing characteristic.⁶⁰ If, however, each firm offers a different product range then consumers may maintain relationships with both institutions to reap the benefits of specialisation. If both players choose the specialist strategy, then the incentive to cut prices may be greater than for the supermarket outcome, where more customers are 'locked in' with one of the two identical suppliers and are therefore less sensitive to price movements in single products.⁶¹ Hence, when firms choose specialist strategies the resulting non-cooperative equilibrium may be characterised by lower prices (and profits) than the supermarket outcome, since in the latter case the 'lock in' effect of customers is stronger.⁶² Social welfare, defined as consumer surplus plus industry profits is always lower when firms offer identical product lines than in the case of

⁶⁰ See also Shaked and Sutton (1990) who focus on the question which demand characteristics lead to a large number of specialised firms offering only few products (such as specialist banks) or alternatively to a small number of firms offering a complete product range (universal banks). They frame their analysis in terms of an 'expansion effect' defined as the increase in profits from introducing a new product, and a 'competition effect' which measures the difference between industry's profits under monopoly and competition.

⁶¹ In addition, there may be an aggravated informational asymmetry. If consumers have only one supplier relationship then they are less likely to be informed about competitors' prices than when they have several supplier relationships.

⁶² Which strategy is more profitable to firms depends on the distribution of shopping costs and on consumer preferences concerning product variety (see Klemperer, 1990, p.13-15). A supermarket strategy is more profitable if, for example, many customers have switching costs which differ at different firms (e.g. one firm has a particular high degree of customer loyalty) and which are not so large as to make customers completely insensitive to price changes at other suppliers.

product differentiation or specialisation.⁶³ Therefore, the trend towards an integrated financial services market does not necessarily enhance competition in the presence of consumer switching costs and significant lock-in effects.

2.3. Strategic entry deterrence of domestic incumbents

The possibility of strategic entry deterrence was already mentioned in the previous discussion of switching costs. I now focus on three particular areas where entry-detering strategies may play a significant role.

2.3.1. Domestic consolidation as a means of deterring foreign entry

Faced with the threat of increased foreign entry, a frequently pursued strategy by EC financial services firms to adapt to the changing competitive environment is to engage in domestic majority and minority acquisitions. Domestic concentration and consolidation is seen as an effective way of preparing the domestic industry for further increases in competition from foreign entrants after 1992. In countries like Spain and Italy it is therefore actively supported by the public authorities. In addition, domestic consolidation is sometimes rationalised by the 'excessive' number of financial institutions in the EC, not viable in a single financial market, as smaller firms supposedly lack critical size to compete effectively.⁶⁴

For Spain, for example, Vives (1990, p.408) notes that in many domestic mergers "the government seems to have intervened in the belief that a large size is needed to compete in the European market and to avoid takeovers of national banks by foreigners". The two largest banks in Spain, Banco Bilbao Vizcaya and Banco Central Hispanoamericano, were both formed by merger with the active support of the public authorities.⁶⁵

A similar situation exists in Italy where the central bank actively supports projected merger plans between various regional banks.⁶⁶ Over the

⁶³ See Klemperer (1990, p.12).

⁶⁴ For example, Hawawini and Rajera (1990, p.15) argue that concentration has to increase first in domestic markets and subsequently on a European level.

⁶⁵ For the latter merger, one observer noted that the Spanish economics minister "has long been urging the banks to merge to protect themselves from foreign competition and reduce the risk of (foreign) takeovers" (*The Banker*, June 1991, p.7/8). Apparently a stern believer in the benefits of scale economies, the minister was also quoted as saying that the banks' size was "totally insufficient" for the single European market (*ibid.*).

⁶⁶ The governor of the Bank of Italy recently noted that "{banks in Italy} are characterised by greater weight of operating costs and medium size. The first Italian bank in the world's top 100 ranks at 35. There are only three in the the top 50" (as quoted by Lane, 1991, p.16).

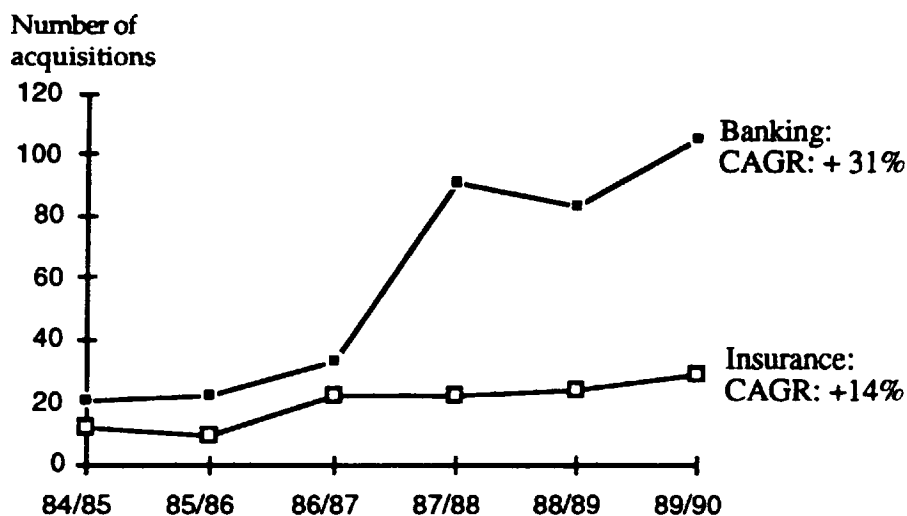
period from 1986 to mid-1988, forty-one mergers and acquisitions have already taken place in Italy and this number is expected to continue to rise.⁶⁷

While official statements of both regulators and public authorities cite economic efficiency as the main rationale for increasing domestic concentration, an equally plausible economic interpretation is that domestic authorities attempt to raise barriers to cross-border entry activities by foreign banks. Such entry barriers may result from the fact that a more concentrated oligopoly is able to coordinate strategies more effectively to pursue entry-detering strategies.⁶⁸ Increased domestic consolidation may thus serve to deter foreign entry, as a more concentrated domestic oligopoly is likely to react more aggressively the more concentrated the industry (see, for example, Kessides, 1990). Alternatively, regulators may merge banks which are particularly 'vulnerable' to foreign takeovers into bigger institutions which are more difficult to acquire.

As is shown in figure 4.1, the number of such domestic transactions has increased substantially, especially since 1986/87.

⁶⁷ See Bruni (1990). Most mergers have so far been between small banks, however (Onado, 1990). The largest acquisition so far was that of Banco di Santo Spirito and 65 percent of Banco di Roma by Cassa di Risparmio di Roma in 1991/92 to form Banca di Roma, the second-largest bank in Italy.

⁶⁸ See Davidson and Denercke (1984), however, who show that if a tacitly collusive agreement enforced by trigger strategies is initially unstable then domestic mergers may actually lower the probability of collusion being stable. This results from the fact that a domestic merger increases the profits which are attainable at the threat point and thus cheating is punished less severely, making it more profitable.

Figure 4.1: Number of domestic acquisitions in financial services in the EC

CAGR = Compound Annual Growth Rate

Source: Report on Competition Policy, EC Commission (1991, p.233); CAGR: own calculations.

Does this rise in domestic acquisitions lead to a rise in domestic concentration levels? While several authors report concentration ratios, the quoted figures are frequently not coherent. For example, two authors who have calculated 5-firm concentration ratios for the EC countries disagree by as much as 30 percent for the same country.⁶⁹ These differences usually result from different proxys for market shares, as precise data are seldomly available.

In addition to such data problems, one must recognise that the *r*-firm concentration ratio is only an imperfect indicator of effective market power. For the case of differentiated products, market power depends not only on market share but also on price elasticity, as market power is lower for more price-elastic products, as well as expected reactions of competitors who may change their output levels more or less significantly to changes in the product's price, and also on the degree of product differentiation, since for highly differentiated products the *r*-firm concentration ratio underestimates market power if calculated as a proportion of total rather than effective output.⁷⁰

⁶⁹ Neven (1990, p.171) calculates a 5-firm concentration ratio of 55 percent for Italy, while McKinsey (1990) reports only 25 percent. Since Neven does not reveal the basis of his calculations, the reasons for the differences cannot be examined.

⁷⁰ See Martin (1992). Since financial products are certainly differentiated, concentration indices are likely to underestimate effective market power.

Table 4.3: R-firm concentration ratios for banking and insurance in 1988/89

	Insurance			Banking		
	CR 3	CR 5	CR10	CR3	CR5	CR10
Germany	22	29	42	18	26	41
UK	31	44	60	22	29	35
France	32	45	65	31	45	63
Italy	39	50	65	29	42	68
Netherl.	32	42	60	67	87	n.a.
Spain	33	39	50	27	38	56

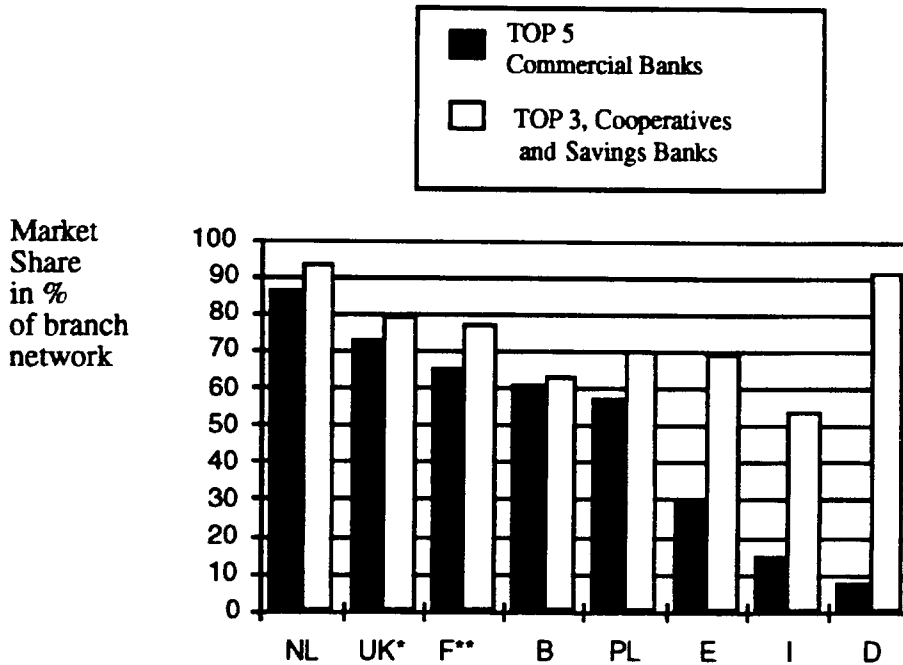
Source: own calculations from data in Sigma, 1/1992; OECD; The Banker.

Concentration in insurance is about the same in the six EC countries surveyed in table 4.3 with Germany being least and Italy most concentrated. In banking there are greater differences among the EC countries with some of the smaller countries being highly concentrated. In particular, Dutch banking is highly concentrated and concentration has even increased since 1988. After the domestic banking mergers, the three-firm concentration ratio stood at 87 percent in 1990.

The low concentration ratio for the UK is actually misleading as UK banking assets include all subsidiaries of foreign banks which deal with international activities rather than the UK market. Focusing on the retail banking sector, it becomes apparent that domestic concentration is higher than for general banking activities. As individual market share data were not available to compute the Herfindahl-index, r-firm concentration ratios are presented which were calculated as the proportion of the total retail branch network accounted for by the largest five commercial banks and the largest three banks plus the savings and cooperative banks in each country.⁷¹ These are presented in figure 4.2.

⁷¹ See Kwoka (1985), however, who shows for a sample of 314 1982 US manufacturing industries that the 2-firm, 4-firm and Herfindahl indices are highly correlated. However, Sleuwagen and Dehandschutter (1986) regress different concentration indices against a market performance indicator and show that the H-index has greater explanatory power. This may result from the fact that the r-firm concentration ratio neglects everything below the cut-off point (see Hannah and Kay, 1977).

Figure 4.2: Concentration ratios in retail banking in 1988



* UK includes Postoffice Bank
 ** Top 2 + Savings + Coop. Banks

Source: McKinsey (1990).

In particular in the Netherlands and the UK the largest five commercial banks have a significant market share, whereas in countries such as Germany and Italy the regional savings and cooperative banks play a significant role in the retail sector.⁷² Since 1988 domestic concentration has increased even further especially in Spain⁷³ and the Netherlands.^{74 75}

⁷² In the Netherlands, for example, the merger between ABN and Amro led to a market share of 33 percent in brokerage, provoking a warning by the chairman of the stock exchange that effective competition is jeopardised (Bakker, 1991).

⁷³ Due to the October 1988 merger between the fourth-largest Banco de Bilbao and the sixth-largest Banco de Vizcaya, the merger between two of the largest savings banks La Caixa and Caja de Barcelona to form the largest bank in terms of deposits, the 1991 conglomeration of six public banks to form Corporacion Bancaria de Espana, the country's largest bank and finally the 1991 merger between seventh-largest Banco Hispano Americano and fourth-largest Banco Central which now ranks as the biggest private bank.

⁷⁴ Especially due the 1989 merger between the fourth and fifth largest banks, NMB and Postbank, and the 1990 merger between ABN and AMRO, second and third largest bank respectively.

⁷⁵ In specific segments, market shares may be even higher. In France, for example, the largest three banks have a market share of 49 per cent in the bank credit market and 55 per cent in

Farrell and Shapiro (1990) examine the price effects of mergers in a Cournot oligopoly setting. They find that if horizontal mergers do not generate significant synergy or size economies, they will raise price. Even if they do generate such cost savings, these need to be fairly substantial to lead to actual price reductions to the benefit of the consumer, the more so the bigger the firms which are merging.

Considering the empirical evidence on the relative insignificance of size economies in most areas of financial services, one may have doubts about whether the required cost savings are sufficient to justify large-scale mergers. Moreover, mergers always entail significant adjustment and integration costs. In a study of a range of domestic bank mergers, Adolf *et al.* (1991) find significant post-merger problems arising from difficulties combining different corporate cultures, the duplication of top and middle management positions, different salary systems, incompatible computer systems and advertising costs.⁷⁶ Thus, the anticipated synergy and efficiency benefits which are supposed to compensate possible increases in market power all too often prove to be elusive.⁷⁷

A second economic justification for domestic consolidation is the notion that increased foreign competition may serve as a disciplining device on domestic prices. Increasing competition in the internal market on a European-wide scale, it is argued, requires larger domestic units to compete effectively with bigger foreign firms. In an integrated European financial market the concentration indices are supposedly supra-national: Caminal, Gual and Vives (1990, p.297), for example, claim that "the relevant concentration indices for an integrated market are global (European or even worldwide) ... and not national". While this may be true for wholesale banking and reinsurance activities, it certainly does not hold for the retail

demand and time deposits. The top eight banks have a market share of almost ninety per cent of all banking activities (de Boissieu, 1990, p.19). In Spain the largest six banks account for approximate market shares of 78 percent for deposits and 66 percent in loans even though losing market share to the savings banks (Caminal, Gual and Vives, 1990).

⁷⁶ In the merger of Banco de Bilbao and Banco de Vizcaya, for example, there are significant problems in combining two different corporate cultures and with closures in the oft-duplicated branch network where one-quarter of its branches shall be closed by 1993.

⁷⁷ In addition, mergers may not be privately profitable: Salant, Switzer and Reynolds (1983) show that horizontal combinations may actually lead to a reduction in the merging banks' profitability, since the merged firms lose market share. However, their model rests on the unrealistic assumption that the merged bank is identical in size to its competitors. Perry and Porter (1985) specify a model in which the merged bank has control over the combined amount of an input factor whose total supply is limited and show that the incentive to merge is greater than in the SSR model. Davidson and Denercke (1985) examine a price-setting oligopoly with product differentiation and show that mergers are generally profitable, since both the merged bank as well as competitors raise prices. Finally, Kwoka (1989) shows that with non-Cournot behaviour, mergers are likely to be more profitable in a competitive industry or when absorbing a more rivalrous firm (i.e. one with a small conjectural variation).

financial services markets where the relevant geographical market are more likely to be national and may even be local or regional.⁷⁸

The relevant geographic market includes all products which are 'good' substitutes in demand or in supply. Thus, two regions A and B should be included in the same geographic market if a price increase in region A induces consumers to switch to region B or if such a price change induces the producer from region B to enter region A. This implies that regions A and B are in the same geographic market only if the extent of substitution on either the demand or the supply side is sufficiently great such that a single firm controlling region A would not find a price increase profitable unless it is able to control the prices in region B as well. Applying this principle to the retail financial services market, it seems most plausible to assume that the relevant geographic markets are so far still national, since barriers to cross-border entry are still sufficiently great to allow price differences to persist without immediate entry from foreign producers. In addition, consumers are still restricted due to prohibitive transaction costs to maintain cross-border business relationships with foreign retail financial services suppliers. Thus, substitutability both on the demand and supply sides is not sufficient to prevent national market power to be exercised.⁷⁹

The notion that opening a domestic market to foreign competition can serve as a substitute for a stringent national merger policy is theoretically examined by Ross (1988). He shows that for an oligopoly with dominant domestic firms and foreign firms constituting the competitive fringe, the price effects of a domestic merger depend entirely on the elasticities of the domestic demand and foreign supply curves. If the foreign supply function is relatively price inelastic due to significant start-up costs, for example, as is likely to be the case in retail financial services, it may be that for a more open economy domestic mergers have greater price-increasing effects. Thus, it is not evident *a priori* that opening up the domestic market to foreign competition can justify permissive merger policy on the grounds that foreign competition will discipline domestic firms with increased market power.

Empirical evidence on the disciplining effects of foreign entry is presented by Geroski (1989). He regresses domestic and foreign entry against expected industry profits, market size and the industry growth rate and finds that neither domestic nor foreign entry "appear to provide much in the way of a substantive challenge to incumbents in the market" (p.25).

⁷⁸ In the cross-border merger between Belgian Groupe AG and AMEV where the new EC merger control regulation was applied, the Commission considered the relevant markets in life and non-life insurance to be national rather than Community-wide.

⁷⁹ An amusing story about defining the relevant geographic markets in the US is told by Rose (1989, p.22/23) who recalls a conversation with a local banker who boasted an amazing 7 percent return on assets, compared to the 1 percent US average. Asked how he attained such an outstanding performance the banker replied: "It's simple. We are the only bank in town; branching is outlawed, and the nearest town is 70 miles away."

Moreover, if regulatory policies of domestic public authorities go as far as actually hindering acquisitions of domestic banks by foreign institutions then such interventions may jeopardise the expected beneficial effects of integrating European banking. Instead of opening domestic markets to foreign competition, authorities may create more concentrated domestic oligopolies which are only ineffectively disciplined by foreign firms especially in the retail area.

The EC merger guidelines which took effect in September 1990 do not provide a sufficient tool for preventing increased domestic concentration, as mergers with a mainly domestic significance do not fall within the scope of the regulation.⁸⁰ Thus, there may be a significant threat to attaining the original objectives of market integration, if domestic authorities attempt to protect domestic producer surplus by actively supporting greater concentration and at the same time hindering acquisitions by foreign entrants.

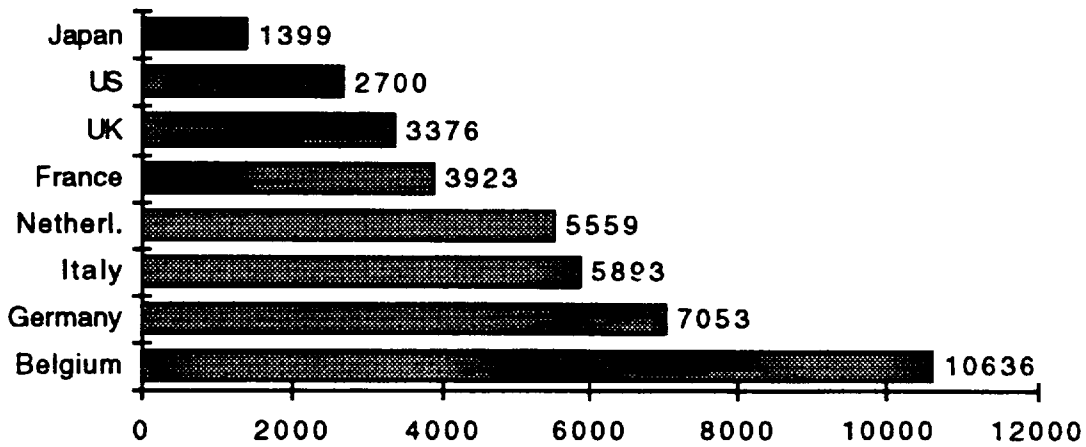
2.3.2. *The example of ATM networks*

Automated Teller Machines (ATM) have had a major impact in retail banking over the past decade. An ATM allows the customer to make certain routine transactions at the machine without requiring face-to-face interaction with a bank employee. Among the services offered are usually at least cash dispensation and balance inquiries, but sometimes even the possibility to order cheques or information packages and make deposits and giro credits. It is expected that the range of services provided by ATMs will increase even further in the near future. The increased usage of ATMs provides not only a source of saving personnel costs for banks but also the possibility to provide banking services at non-branch locations ('off-premise') such as shopping malls or supermarkets. Figure 4.3 illustrates the rising significance of ATMs in the Western industrial countries.

⁸⁰ Article 1 (2) in conjunction with Article 5 (3a) of the EC merger regulation defines two criteria for bank mergers to have a "Community dimension": first, one-tenth of combined total assets of the banks involved has to exceed ECU 5 billion. Second, one-tenth of total assets multiplied by a ratio of loans and advances to Community residents divided by transactions with non-EC residents has to exceed ECU 250 million of at least two banks involved in the concentration. The second provision essentially excludes acquisitions of EC banks abroad, as well as acquisitions of EC banks by non-EC institutions with little previous involvement in the EC. A bank concentration does not fall under the regulation, however, if more than two-thirds of the loan activity of each of the banks involved takes place within one and the same Member State.

Figure 4.3: Number of ATMs in 6 EC countries, Japan and the US in 1990

Number of inhabitants per ATM



Source: Bank for International Settlements; Statistics on Payment Systems, December 1991.

In contrast to the US where ATM networks are independently operated or are set up as joint ventures of a number of banks,⁸¹ most European banks have their own ATM networks. Still, it is mostly possible for the customer of bank A to use the ATM of other banks B, ..., N which are inter-linked through a network switch. Bank B, however, charges bank A a 'foreign fee' for the usage of the ATM which is then usually passed on by bank A to the customer. The foreign fee charged by bank A to the customer is likely to be higher than if the customer uses the bank-owned network. Thus, banks with a large network have the competitive advantage of offering the customer more possibilities for ATM transactions.

Does the rising significance of electronic distribution and processing networks constitute a potential source of size advantages and barriers to entry?⁸² ATMs are an example of network externalities where the utility of using a system depends on the number of other users in the network, as well as the compatibility of the system with other networks. Katz and Shapiro (1985, 1986a,b) analyse a static oligopoly model in which such consumption externalities exist. Assuming that consumers form rational expectations about the future size of the network, they find that if consumers expect one firm to be the market leader, they are willing to spend more to enter the leader's network to participate in the greater network externalities. Thus, (expected)

⁸¹ See Salop (1990) and Gilbert (1990) who discuss the competition policy aspects of jointly owned ATM networks in the US.

⁸² We discuss this question in the context of ATMs, but the general thrust of the arguments applies equally to other banking technologies where network externalities are present such as alternative clearing systems or computer-based asset trading systems.

market leaders are able to charge higher prices and are more likely to oppose network link-ups of smaller firms and efforts to establish common compatibility.⁸³ Social welfare, however, may be increased through inter-linkage of networks.⁸⁴

Consider the case of a bank wishing to enter a foreign retail market. As it is nearly impossible to establish an extensive branch network from scratch, another possibility would be to rely on alternative distribution channels such as telephone or home banking. In particular, a foreign bank may want to enter an existing ATM network in the target country to establish a means of interacting with its customers on a nation-wide basis. Domestic banks, however, have an incentive to keep out foreign intruders into the market, especially if these entrants disturb a (tacitly) collusive domestic pricing equilibrium. Restrictions to access the domestic ATM networks may therefore serve as a means of strategic entry deterrence.

Therefore, in areas where significant network externalities exist, public policy intervention may be required. Two alternatives exist to ensure reasonable access of foreign institutions to domestic ATM networks: First, strict competition rules prohibiting 'bribes' between firms could be relaxed:⁸⁵ Katz and Shapiro show that allowing firms to make side payments increases the likelihood of firms adopting an industry-wide standard if (and only if) compatibility raises joint profits by more than joint costs. Thus, public policy could rely purely on a co-operative market outcome to ensure accessibility of networks. Such a market outcome is likely to maximise social welfare if there is a mutual interest of firms to enter each others' markets. If, however, a bank from a relatively efficient market (such as the UK, for example) wants to enter a less efficient market (e.g. Spain), but banks in Spain have little interest in entering the UK market due to little chance of success, even allowing for side payments does not necessarily lead to a welfare-maximising outcome. In such a case direct intervention by the competition policy authorities may be required. As national regulators may have little interest to open the domestic market to foreign competition, market access needs to be monitored at the EC level.

⁸³ The classic example being IBM's efforts to hamper computer compatibility with low-price competitors (e.g. by introducing a new standard in its PS-2 personal computer system).

⁸⁴ Farrell and Saloner (1985), however, show that agreeing on and adopting a common standard for the network may also have socially harmful effects. These stem from the fact that when firms have incomplete information about competitors' willingness to switch to a new technology, there may be inertia in adopting a new (and welfare-improving) technology once firms have agreed on a common standard.

⁸⁵ Such as Article 85 (1) of the Treaty of Rome, prohibiting co-operative agreements between firms intended to limit or distort competition, e.g. by sharing markets (Sec. 1c) or controlling markets and technological development (Sec. 1b).

To illustrate the possibility of market failure in the case of side payments, consider a simple game with the following pay-off structure where the first term in brackets gives the Spanish bank's pay-off:

		UK bank		
		grant access	no access	
Spanish bank	grant access	$(a + \beta - \mu, b + \mu - \beta)$	$(c + \beta, d - \beta)$	
	no access	$(e - \mu, f + \mu)$	(g, h)	

where β and μ stand for the level of side payments. We assume that the domestic bank loses some market power by granting access to the foreign institution. Consider first the case of $\beta, \mu = 0$. Clearly, whenever $(e > a, g > c)$ and $(d > b, h > f)$, the dominant strategy equilibrium obtains where both banks prefer not to grant access. In other words, if the loss in domestic market power exceeds the profits to be made in the foreign country for at least one bank then, not surprisingly, neither bank will grant access.⁸⁶

More interestingly, allowing for side payments may lead to an asymmetric outcome. Suppose that the British bank has a greater interest in entering the Spanish network, but stands to lose little of Spanish entry into its market and is thus indifferent to granting access (i.e. let $a = c, e = g$ and $\mu = 0$). It may then set a level of β which just compensates the Spanish bank for its loss in market power. A necessary condition for the Spanish bank to agree to access is $\beta > e - a$ and $\beta > g - c$. The British bank will only be interested in bribing the Spanish bank if $b - \beta > f$ and $d - \beta > h$. In other words, if the gain to one player exceeds the loss to the other player, access will be agreed. Thus, when side payments are allowed, the likelihood of at least one firm granting access is increased. Nevertheless, a no-access equilibrium may still obtain when the expected profit from entering for the British bank is not sufficient to compensate the Spanish bank for loss in monopoly power, i.e. if $e - a > b - f$ or $g - c > d - h$. In such a case, even allowing for side-payments leads to a no-access equilibrium and thus public policy intervention may be required.⁸⁷

Equivalently, we could consider the players to be a perfectly coordinated cartel of the banking industries rather than individual banks. In this case the assumption that the cartel takes into account the loss in market power may be more reasonable. The domestic banking industry may enter a (tacitly)

⁸⁶ This outcome seems to be prevalent in practise. Kane (1987, p.139) argues that "what began as cooperatively shared ATM networks within the US or a single European country are increasingly competing with each other across countries".

⁸⁷ In practice, access is frequently granted to a *type* of card rather than to a particular bank or issuer. Such a practice largely avoids the entry deterrence problems discussed in this section. Issuers may be discriminated against as well, however, as the example of American Express in France demonstrates where the majority of banks opposed interoperability with the AMEX ATM network.

collusive agreement not to grant access to foreign banks to prevent successful entry into the retail area. However, the problem with such a collusive agreement is that individual banks may cheat if they are offered a sufficiently high 'bribe' by the foreign bank.⁸⁸ Thus, a collusive equilibrium is unlikely to be stable.

2.3.4. Branch proliferation

Faced with the threat of increased cross-border entry, incumbent retail financial services firms may decide to increase their number of outlets to fill up location space. Similar to Schmalensee's (1978) model of crowding the product space through brand proliferation, banks may attempt to crowd the geographic location space by opening an excessive number of branches. Bonano (1987) builds on models by Hay (1976), Prescott and Visscher (1977) and Eaton and Lipsey (1979) which analyse strategic entry deterrence in spatial competition settings. These models show that an incumbent firm or the ruling cartel have an incentive to open retail branches to make new entry unprofitable in order to protect excess profits. They can do so by ensuring that there are no profitable locational niches left which a new entrant may occupy. For such locational preemption to be effective, incumbents have to invest in new branches just slightly before new entrants would come into the market in the absence of preemption. Locational entry deterrence is more effective if the investment in new branches is likely to have a large element of sunk costs, since this increases the commitment value of investment (Judd, 1985).

Entry deterrence is usually analysed in the context of only a single incumbent or a tightly coordinated cartel. In contrast, the financial services industry is characterised by oligopoly interaction with its associated problems of coordinating strategic decisions. With several incumbents entry deterrence may become a public good: all domestic banks profit from the successful prevention of cross-border entry and can therefore free-ride on the investment undertaken by competitors.⁸⁹ Gilbert and Vives (1986) examine such a situation with several non-cooperating incumbents and a single entrant and come to the conclusion that incumbents never under-invest in entry-deterrence. This somewhat counter-intuitive result depends on their assumption that investment in entry deterrence by a single firm actually increases revenues and therefore confers immediate benefits on the firm which invests in excluding rivals. In the context of branch proliferation this assumption may not be unreasonable since increasing the number of branches is likely to increase revenues at the same time.

⁸⁸ This point is raised by Caminal, Gual and Vives (1990, p.296) who question "whether the large banks will be able ... to coordinate their actions to make entry of foreign institutions difficult (e.g. by denying them easy access to the main ATM systems)."

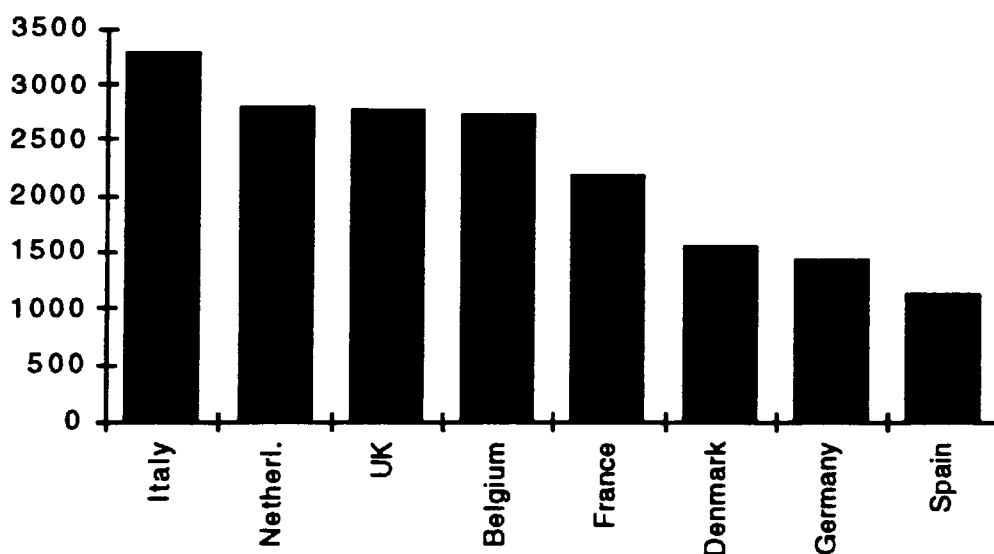
⁸⁹ See also Waldman (1987, 1991) who examines a situation where there are not only multiple incumbents but also a sequence of potential entrants.

Neven (1990) points out that banks will open branches until the marginal cost of collecting deposits through a retail network equals the interbank rate. Although this neglects, of course, the fact that branches serve not only as deposit collection units but also as distribution and monitoring centres for loans and other products, it provides some useful insight into the rationale for branch proliferation. Banks in high deposit margin countries attempting to erect barriers to foreign entry have a greater incentive to engage in branch proliferation than banks in low-margin countries. This results from the fact that since the difference between the marginal cost of financing by deposit collection through branches and interbank financing is greater, opening branches is more lucrative. Thus, maintaining a high number of branches is not only a cheaper way of refinancing in high margin countries, but may at the same time serve the function of deterring foreign entry.

Figure 4.4 illustrates the density of retail branch networks in the EC countries. It shows significant differences in the number of inhabitants served by a particular branch. While Germany, Denmark and Spain have a particularly high number of residents per branch, Italy seems to be under-banked in terms of number of branches. Not surprisingly, table 4.4 reveals that those countries with the highest branch density also had the largest growth rate of domestic branches. In particular, the case of Spain stands out where the number of branches has almost tripled, since 1960.⁹⁰ It is also apparent that in most countries the level of branches has stabilised since 1980 and in some cases has even started to decline again.⁹¹ This seems to suggest that as far as the number of branches is concerned, a level of saturation has been reached in some countries and that new entry may be constrained to acquiring existing branches, rather than establishing an entirely new branch network from scratch.

⁹⁰ The average size of retail branches in Spain is substantially smaller than in all other EC countries, however.

⁹¹ In France, for example, the deregulation of branch banking in 1966/67 led to a vast increase in branches, peaking in the early 1970s. This has led to overbranching in some areas and since 1986 commercial banks have started to close unprofitable branches (see de Boissieu, 1990).

Figure 4.4: Number of inhabitants per bank branch in 1989/90

Source: same source as table 4.4.

Table 4.4: Number of Branches in 8 EC countries from 1960 to 1991

	1960	1970	1980	1984	1991	CAGR
Spain	n.a.	12,642	24,566	31,117	34,519*	+4.9%
France	n.a.	15,037	23,659	25,676	25,632*	+2.6%
Italy	9,211	10,807	12,175	12,965	17,721	+2.4%
Belgium	1,870	3,151	3,811	3,741	3,618	+0.7%
Germany	30,027	40,800	44,666	44,698	43,977	+0.4%
Netherl.	3,459	5,177	7,399	6,529	5,371	+0.2%
Denmark	2,368	3,465	3,707	3,581	3,318	-0.2%
UK	n.a.	n.a.	19,796	20,541	20,560	n.a.

Note: all data are without Postbank outlets

* data are for 1989

CAGR = Compound Annual Growth Rate calculated from 1970

Source: OECD (1989, p.127; 1991); Denmark: Annual Statistical Yearbook; Germany: Deutsche Bundesbank; France: de Boissieu (1990, p.12); Italy: Lane (1991); UK (data include building societies): Bank for International Settlements, Statistics on Payment Systems; CAGR: own calculations.

In other countries such as Italy, on the other hand, branch openings were for a long time heavily restricted which changed only in March 1990. Since then, there were 2,562 new branch openings in a one-year period alone, an increase in total branches of 14 percent. Branch proliferation in Italy thus provides an example of how the threat of foreign entry may result in moves

by domestic regulators to relax unnecessarily restrictive domestic regulations. At the same time, of course, such moves of filling up location space make entry by foreign banks more difficult, as remaining locational niches are likely to be occupied by domestic institutions.⁹²

2.4. Retail financial services: a contestable market?

It is frequently argued that financial services can be considered a contestable market where potential competition may be sufficient to ensure a near-competitive outcome. Dermine (1991, p.33), for example, states that "overall, the analysis of barriers to entry from the demand and supply side predicts great contestability, especially in the deposits and consumer loan markets".⁹³ In this section, I analyse this claim that retail financial services can be considered to be a contestable market.

A market is called 'contestable' if it fulfills the following three conditions (Baumol, Panzar and Willig, 1982; following Shepherd, 1984):

- there are no 'Stiglerian' entry barriers, i.e. the entrant can match and duplicate all dimensions of costs, technology, brand loyalty and other characteristics of the incumbent firm;
- the incumbent firm is assumed not to respond to new entry and to keep its price, quality and output at the pre-entry level;
- exit from the market is costless, since sunk costs are negligible due to a perfectly efficient second-hand market.

If these propositions held then it is easily shown that a market would satisfy the following long-run welfare properties: first, long-run profits must be zero; second, costs are minimised by incumbent firms and third, price has to equal marginal costs.⁹⁴

⁹² In practice, branch proliferation does not necessarily deter foreign entry when margins are sufficiently high, as the example of Spain demonstrates where foreign entry in retail services has been very active despite the high number of branches. This casts some doubt on the likely success of a strategy of branch proliferation to deter foreign entry.

⁹³ Similarly, Spence (1983, p.987) suggests that hit-and-run entry may be more likely in service industries where sunk costs are claimed to be lower. Neven (1990, p.176) argues that for financial services which can be dissociated from a branch network "barriers to entry and exit ... seem rather small. As a result, the market for those services is to some extent contestable, so that the mere threat of competition should discipline the existing firms." Nelson (1988) builds a model of banking competition assuming contestable market conditions.

⁹⁴ First, long-run profits must be zero because any positive profit means that an entrant could come in, replicate the incumbent's product and services, slightly undercut prices and take away all business from the incumbent. When profits are bid down to zero the entrant can leave the market at no cost, since exit is assumed to be costless ('hit-and-run-entry'). Second, costs are minimised by incumbent firms, since any deviation from cost minimisation (just like supra-

Does the retail financial services market fulfill the rather stringent conditions required for these welfare properties to result? The assumption of a complete absence of Stiglerian entry barriers implies that products cannot be differentiated, since otherwise hit-and-run entry will not be possible. Indeed, there seems to be little scope for tangible product differentiation in banking or insurance services, as products and services are highly substitutable and any product innovation can be easily and instantly replicated due to the absence of patent protection in services. As was discussed above, however, services may be differentiated due to reputation, distinguishing a year-long service relationship from a newly established relation. In addition, switching costs constitute a substantial barrier to entry which may lead to cost disadvantages for a potential entrant. Thus, the assumption of a complete lack of entry barriers does not seem to be fulfilled for retail financial services.

Secondly, the assumption of no strategic interaction between incumbent and entrant seems fairly unrealistic, since an incumbent would clearly have an incentive to respond to entry to avoid losing market share to the new entrant.

Finally, the assumption of zero sunk costs is hardly ever fulfilled, as new entry almost always requires expert skills or corporate involvement which cannot be sold or transferred costlessly.⁹⁵ It is hard to imagine a firm entering a new market without acquiring at least some kind of information about market conditions in the form of a market research survey, for instance. Additionally, corporate management will invest some time in planning market strategies and the firm thus incurs an opportunity cost in terms of lost managerial time spent on alternative projects. Both of these examples show that a firm when leaving the market will not be able to recover the whole investment outlay. Nevertheless, sunk costs may be lower in retail financial services than in most other industries, as comparatively little investment in non-recoverable specific assets needs to be made.⁹⁶

normal profits) constitutes an invitation to entry. Another firm could come in, produce the same output at lower costs, sell it at the same price and earn a profit. Third, price has to equal marginal costs. It cannot be less than marginal costs because a firm could reduce output and earn a positive profit. On the other hand, price cannot exceed marginal costs if there are at least two firms in the market. If price were greater than marginal costs it would pay another firm to come in and produce a slightly greater output than the incumbent, charge slightly less, thus taking away business from the incumbent, and earn a supra-normal profit.

⁹⁵ Martin (1989) shows that even the slightest deviation from the zero sunk costs assumption leads to the breakdown of the possibility of hit-and-run entry.

⁹⁶ Investment in fixed costs such as equipment and offices is likely to be recoverable at market-going prices and therefore not sunk (see, for example, Tirole, 1988, p.307-8 for the distinction between fixed and sunk costs). Baumol, Panzar and Willig (1983, p.494) stress the salvage value of assets as the distinguishing characteristic of sunk costs. The degree of sunkness varies from complete (no salvage value) to zero (where assets can be sold at the purchase price).

In summary, in the retail financial services market significant entry barriers preclude the welfare properties of the contestable market model to hold. It would therefore be premature to conclude that potential competition alone suffices to attain a near-competitive outcome. On the other hand, one should not underestimate the important role which may be played by potential competition. It has been argued, for instance, that the threat of foreign entry in a liberalised European financial market has by itself sufficed to induce a restructuring in the Spanish banking market (see Vives, 1990). This issue is quite distinct, however, from the set of welfare properties associated with contestable market theory, as domestic banks may act to raise barriers to foreign entry through tighter tacit collusion or by raising domestic concentration, as a 'preparation' for 1992. A more concentrated domestic industry makes foreign entry less likely, as retaliation can be expected to be more tightly coordinated (see above). Thus, the mere threat of potential foreign entry may achieve exactly the opposite of what contestability theory would predict: a further departure from a competitive market outcome. In retail financial services, it may therefore require *actual* rather than potential entry to break into domestic oligopolies and move closer to a more competitive market.

3. Conclusions

In order to assess the likelihood of entry, I undertook an analysis of barriers to cross-border entry in retail financial services. Two main sources of entry barriers were identified: first, barriers arising from the regulatory environment which are attacked by the EC internal market programme. Second, entry barriers which I called 'market-inherent' arising from the particular market structure or product characteristics. These are likely to persist - though becoming less severe - even after the integration of European financial markets.

While official regulatory barriers are continuously being dismantled, covert restrictions may continue to apply as domestic regulations usually allow a substantial degree of discretion to be exercised by the public authorities. Regulatory resistance to takeovers of domestic firms by foreign institutions is greater in banking than in insurance, as the banking sector is considered to have a strategic role for domestic economic policy.

The lack of a corporate control market in the EC may be especially severe in the banking sector. In addition to the lack of a level playing field for cross-border takeovers, the large extent of public ownership in some EC countries prevents the establishment of an effective market for corporate control.

A number of factors which may lead to market-inherent barriers to entry were discussed. Size economies do not appear to be significant in most areas of financial services. An analysis of a possible correlation between size and profitability of the largest 173 EC banks suggests that greater size does not lead

to greater profitability. Size economies do not seem to pose a barrier to cross-border entry in financial services.

In contrast, incumbency advantages arising from firm reputation and switching costs may constitute the most significant barriers to entry in the retail financial services sector. Thus, price differentials do not necessarily induce a switch from one supplier to another. This allows incumbents to exercise a certain degree of market power. In addition, price reductions may only be temporary, as they are aimed at locking in new customers. Barriers to entry arising from switching costs are likely to be greater in banking than in insurance which is partly due to the fact that the latter industry is characterised by less-frequent interaction. In addition, reputational factors may be less significant in insurance than in banking. Finally, there are fewer joint products in insurance such that individual products are separable. This further facilitates entry in insurance where a foreign firm can enter only one particular product market. In banking, however, there are fewer stand alone products. These include in particular card-based services but not the general product bundle of payment and deposit services.

Faced with the threat of increased foreign entry, domestic regulators and institutions may attempt to implement entry-detering strategies. These include especially domestic consolidation which is supposed to make indigenous institutions more competitive but may only have the effect of increasing domestic market power. It was shown that domestic consolidation has increased significantly in some EC countries. Further, domestic banks may attempt to exclude foreign banks from domestic networks such as ATMs or clearing systems. Such entry-detering collusion on the part of indigenous institutions is likely to be unstable, however, as individual banks may have little to lose but much to gain when being 'bribed' by a foreign bank. Finally, branch proliferation by domestic banks may have the objective of closing potentially profitable locational niches to foreign entrants.

In summary, it therefore appears that the insurance sector is characterised by fewer barriers to foreign entry than retail banking. We would therefore expect a greater degree of foreign penetration in insurance than in retail banking.

Chapter Five: The Potential Impact of Foreign Entry on Domestic Competition

The 1988 Price Waterhouse study employs the assumption that as barriers to foreign entry are reduced, domestic markets will become more competitive due to the threat of potential or actual foreign entry. I first develop some theoretical notions about the potential impact of cross-border entry on domestic market structure, conduct and performance in retail financial services in the first section. The second section then presents empirical data on the possible and actual effect of cross-border entry and discusses the extent and possible reasons for price differences of financial products across EC markets.

1. Competition in retail banking with cross-border entry: theoretical concepts

1.1. Cross-border entry can increase price competition: the example of the deposit market

I first consider a simple model of banking competition in the deposit market to analyse the potential impact of foreign entry on domestic market structure, equilibrium prices, quantities and social welfare. A very similar model can easily be constructed for the insurance sector where firms compete on premiums rather than on deposit rates.

Analysing the liability and asset side of the bank separately is justified by the Klein-Monti model (Klein, 1971; Monti, 1972).¹ The essence of this separation theorem can be easily illustrated. Assume that refinancing and opportunity costs are exogenously given by the interbank rate and the rate on government securities respectively. To maximise profits, banks will then equalise the marginal cost of deposit collection with the interbank rate and further equalise the marginal return on assets with the riskless rate on government paper. In other words, in such a stylised setting decisions taken on the asset side of the bank's balance sheet are completely independent of the liability side. While real resource costs are a common input to both asset and liability activities and thus create some degree of

¹ See Baltensperger (1980) and Santomero (1984) for thorough reviews of banking models.

interdependence, the basic thrust of the model seems a reasonable approximation of banks' actual decision-making processes.²

In contrast to the Klein-Monti model, however, I assume an oligopolistic domestic market characterised by Cournot competition.³ The assumption that banks determine the quantity rather than the 'price' (i.e. the interest rate) of liability products may be justified by the empirical observation that banks determine the composition of refinancing at the beginning of each period and adjust prices, i.e. deposit interest rates accordingly. For example, a bank may decide at the beginning of the year on a total target quantity of retail deposits as a proportion of total funds. Retail branches are then given individual target quantities of retail deposits. Headquarters can adjust the deposit interest rate after observing the residual demand curve. Thus, the assumption of quantity competition may not be unjustified in banking deposit markets.

Denote r_d as the interest rate paid on deposits, D_j as the quantity of deposits chosen by bank j and r_i as the refinancing rate or the rate on a government security which are assumed equal and exogenous.

To simplify the exposition we use a simple linear example for a case of duopoly. The results also obtain for more general cost and demand functions and for an n -firm oligopoly, however (see, for example, Tirole, 1988, p.219-20). The inverse deposit demand function takes a simple linear form and is given by:

$$(1) \quad \begin{aligned} r_d &= a + r_i + bD \\ \Leftrightarrow (r_i - r_d) &= -a - bD \end{aligned}$$

Note that the quantity of deposits demanded increases with the deposit interest rate and that a is negative. The symmetric cost function is also linear with constant returns to scale and no fixed costs:

$$(2) \quad C(D_j) = cD_j$$

where c is the marginal real resource cost of servicing deposits (e.g. labour costs). In a perfectly competitive market the difference between the deposit interest rate and the interbank rate has to equal the real resource marginal costs of servicing deposits, i.e. $r_i - r_d = c$. Thus, symmetric equilibrium output is given by $S = (-c - a) / b$.

² In particular, banks' management accounting systems calculate individual margins for each product or service given by the interest rate differential between the cost of refinancing (mostly approximated by the interbank rate) and the rates paid or earned. Operating costs are frequently allocated according to time and motion studies.

³ In the notation and the oligopoly problem I follow Martin (1992).

Period 1: Domestic Cournot Duopoly: Consider now the familiar Cournot duopoly. The residual demand curve for bank 1 is given by

$$(3) \quad r_d = a + r_i + bD_1 + bD_2$$

The optimisation problem is therefore:

$$(4) \quad \begin{aligned} \max \pi_1 &= (r_i - r_d)D_1 - C(D_1) \\ &= -a D_1 - b(D_1)^2 - bD_1D_2 - cD_1 \end{aligned}$$

Thus, the first order condition is:

$$(5) \quad \partial \pi_1 / \partial D_1 = -a - 2bD_1 - bD_2 - c = 0$$

The reaction function for bank 1 is therefore:

$$(6) \quad D_1 = 1/2 (S - D_2)$$

with S being the equilibrium output in a perfectly competitive market, as defined above. Analogously, the reaction curve for bank 2 can be derived as

$$(7) \quad D_2 = 1/2 (S - D_1)$$

Deposit levels and the equilibrium interest rate are given by

$$(8) \quad D_1 = D_2 = 1/3 S; \quad r_d = 1/3 a + r_i - 2/3 c$$

Bank profits are given by

$$(9) \quad \pi_i = (-1/3 a - 1/3 c)D_1$$

Consumer surplus is given by

$$(10) \quad CS = \int_0^{2/3 S} (r_i + a + bD_1) dD_1$$

which can be solved to get

$$(11) \quad CS = 2/3 bS$$

Cross-Border Acquisition: We now assume that there is a second period in which foreign entry is permitted. As was argued in chapter three, entrants need some competitive advantage to compensate for operating at a distance and in a foreign environment. I assume here that such a competitive advantage results in greater efficiency and therefore lower marginal resource costs. A star (*) will denote the

foreign bank. We continue to have a Cournot duopoly, but bank 2 has been acquired by a foreign firm and has been made more efficient (e.g. due to knowledge transfer, increased investment). The 'foreign' bank therefore has a cost function

$$(12) \quad c^*(D_2) = c^*D_2$$

where $c^* < c$. The reaction curves are given by

$$(13) \quad D_1 = 1/2 (S_1 - D_2); \quad D_2 = 1/2 (S_2 - D_1)$$

with $S_1 = (-c - a) / b$ and $S_2 = (-c^* - a) / b$. Solving for equilibrium outputs,

$$(14) \quad \begin{aligned} D_1 &= 1/3 (S_1 + (c^* - c) / b) \\ D_2 &= 1/3 (S_2 - (c^* - c) / b) \end{aligned}$$

Thus, the more efficient foreign bank is able to increase its market share. The equilibrium deposit rate is given by

$$(15) \quad r_d = 1/3 a + r_i - 1/3 (c^* + c)$$

This establishes our first proposition:

Proposition 1: With Cournot competition a cross-border acquisition which makes the acquired bank more efficient always leads to an increase in the deposit rate and thus to a rise in consumer surplus.

Proof: Compare the equilibrium deposit rates in equations (8) and (15). As they only differ in the third terms, we can perform a simple *reductio ad absurdum*: Suppose

$$- 2/3 c \geq - 1/3 (c^* + c)$$

which is equivalent to $c \leq c^*$ but contradicts our initial assumption $c > c^*$. Thus, we must have

$$- 2/3 c < - 1/3 (c^* + c)$$

and therefore the domestic duopoly equilibrium deposit rate is lower than the post-acquisition deposit rate. To show that consumer surplus rises as the deposit rate increases is trivial. *Q.E.D.*

To determine the impact of foreign entry on domestic social welfare we need to specify the exact form of the social welfare function, as the effects on consumer

surplus (CS) and domestic producer surplus (PS) may be of opposite signs.⁴ We assume here a simple additive relationship of the form $SW = CS + PS$. One could also consider a weighted welfare function if it is assumed that CS should be given greater importance than PS. It is obvious that consumer surplus will increase if foreign entry leads to a higher deposit rate. Domestic producer surplus, however, will decrease as domestic banks lose market share to foreign entrants. Thus domestic social welfare will decrease overall if the latter affect dominates the former. Foreign entry may therefore lead to lower domestic social welfare, as rises in consumer surplus may be outweighed by losses in domestic producer surplus.

It is obvious that as the weight of consumer surplus in the social welfare function rises, the detrimental effect of the reduction in domestic producer surplus becomes less significant until in the limiting case of $SW = CS$ foreign entry inducing a rise in the deposit rate is always welfare-improving.

To summarise, I have shown in this section that for a simple example in the deposit market foreign entry increases the deposit rate and thus leads to a rise in consumer surplus. As domestic banks are likely to lose market share, however, producer surplus decreases as domestic profits fall. This potential loss in producer surplus is one of the main arguments for protecting the domestic financial services sector from foreign competition in many countries.

De novo entry: Consider next de novo entry of foreign firms into the domestic market. It is a standard characteristic of Cournot models that prices and profits fall, as the number of firms increases.⁵ This can easily be illustrated for a simple linear example. Let Q be defined as aggregate output, i.e.

$Q = \sum_{i=1}^n q_i$ where q_i is the output of firm i . Assume a linear demand and cost structure with the demand function given by $P(Q) = 1 - Q$ and the cost function given by $C_i(q_i) = cq_i$ for all firms. Firms' profit-maximising condition is given by:

$$(16) \quad 1 - Q - q_i - c = 0$$

Since we have a symmetric equilibrium, we have $Q = nq$ and therefore individual output is given by

$$(17) \quad q = (1 - c) / (n + 1)$$

The price for the product is therefore

⁴ Unlike most other studies of banking integration, I explicitly model the impact on producer surplus. Neven (1990, p.176), for example, only notices in a footnote that "one should ideally also take into account the change in producer surplus".

⁵ See, for example, Tirole (1988, p. 221).

$$(18) \quad p = 1 - nq = c + (1 - c) / (n + 1)$$

Individual firm profit is given by

$$(19) \quad \pi_i = (1 - c)^2 / (n+1)^2$$

It is easy to see that as the number of suppliers in the market increases, prices and profits fall until in the limiting case the market becomes perfectly competitive. Consumer surplus increases, whereas domestic producer surplus falls. Of course, it would be too simplifying to transfer this prediction to the financial services market with its characteristics of significant product differentiation, switching costs and quality competition. Nevertheless, the Cournot model provides a useful starting point to analyse the effects of cross-border entry on prices.

1.2. Cross-border entry can reduce X-inefficiency

Lack of competition in the domestic financial services market may not only lead to higher prices for consumers but also to reduced efficiency of indigenous financial services firms. The notion that lack of competition may lead to failure of minimising costs inside the firm was pointed out in several contributions by Leibenstein (e.g. 1966, 1975, 1987), which he referred to as X-inefficiency. Intuitively, X-inefficiency refers to the fact that as competition increases, firms are forced to organise production more efficiently to reduce costs and become more competitive. Leibenstein stresses that market structure has not merely effects on the pricing decisions of market participants but also on the internal structure of the firm. In the extreme case of monopoly, he notes that one observes a significant degree of internal inefficiency which needs to be taken into account when determining the overall allocative efficiency of a certain market structure.

This intuition is formalised by Selten (1986) who builds a model where X-inefficiency decreases, as the number of firms increases. In Selten's model the degree of X-inefficiency is exogenous, however. Willig (1987) builds a model where entry increases competition such that the price elasticity of demand increases. At the same time, entry shifts the residual demand curve facing each individual firm inward which tends to reduce firm efficiency. Martin (1992b) shows that in a Cournot principal-agent setting the latter effect dominates the former, as a greater number of firms leads to lower marginal revenue for the individual firm and therefore a lower incentive for the principal to induce the agent to minimise costs.

In general, however, one may expect that as foreign firms enter the national market and increase the level of competition, domestic institutions are forced to become more efficient and place greater emphasis on cost-effective provision of services. Thus, in countries where domestic firms have had scope for not minimising costs due to lack of domestic competitive pressures, for example by maintaining an excessive labour force, we expect significant pressure to streamline

the organisational structure, since otherwise foreign entrants will be able to offer products and services at lower prices than domestic firms without having to cut their margins.

1.3. Cross-border entry can spoil collusive domestic equilibria

Many national financial services markets have for a long time been characterised by tacit or even explicit collusive agreements between national players. Such agreements not only concern pricing arrangements but also the non-introduction of new, less profitable products, replacing existing profitable products or the tacit agreement to refrain from entering each other's lines of business. Such collusive equilibria were frequently tolerated and sometimes even encouraged and imposed by the regulatory authorities which legitimated such an approach by the need to prevent against excessive competition. In many EC insurance markets, for example, firms explicitly collude in the setting of key parameters which determine the setting of premiums. Clearly, in a more integrated European market with increased cross-border entry of non-domestic financial services firms which do not belong to the national collusive groups, the stability of such collusive equilibria will likely break down, as foreign firms do not participate in the collusive agreement. As an example, I discuss interest rates on demand and time deposits.

In chapter two, regulatory restrictions on paying interest on current and savings accounts were discussed and it was argued that these are likely to disappear when foreign banks are able to circumvent such restrictions through the home country rule. Government regulation is not solely responsible for the national differences in current and savings account interest rates, however. No restrictions on such activities exist in Germany, the UK and since March 1987 in Spain. But while competitive forces have led to the introduction of interest-bearing current accounts in both the UK and Spain, no interest is paid on demand deposits in Germany and savings deposits are rewarded at significantly below money market rates.

Whether any individual bank has an incentive to introduce interest-bearing current accounts depends on its perception of the short-term benefit of cheating on a possible collusive equilibrium.⁶ The benefit from introducing interest-bearing current accounts by gaining market share depends largely on the speed of replication by other players. If the 'aggressive' bank expects competitors to respond instantly by matching its terms, then little to no benefit can be expected. If, however, the aggressor expects other players not to replicate its moves instantaneously then it may be able to lock in new customers. Other firms are unlikely not to respond to the aggressor's move, however, especially if they have much to lose by sticking to the collusive equilibrium and threaten to engage in a

⁶ The idea of cheating on a collusive equilibrium was introduced by Stigler (1964) and more recently incorporated into a supergame framework (e.g. Rees, 1985).

costly interest rate war.⁷ If this is the case then the threat of retaliation is credible, deterring players to deviate from the cooperative equilibrium. Players can influence each other's expectations by building up a reputation for severely punishing any deviation from the collusive equilibrium (Kreps and Wilson, 1982; Milgrom and Roberts, 1982). In addition, multimarket contact between players, as is very common in financial services, can increase the credibility and severity of a retaliatory move, since cheating in one market can be punished in a range of other markets in which the players operate (Bernheim and Whinston, 1990).

As in any collusive equilibrium, players therefore compare the short-term benefits of cheating with the discounted value of future losses from reverting to a non-cooperative equilibrium.⁸ Long-term losses from competition in interest rates are likely to be significant: margins on sight deposits are the largest single contributor to banks' profits averaging up to 80%,⁹ and thus any reduction in margins is likely to severely impact profits. Considering the significance of retail deposits as a relatively cheap source of funds, it therefore appears that domestic banks have little to gain but much to lose from introducing interest on sight deposits.

For foreign banks the strategic considerations of introducing competitive interest rates may be rather different. Suppose that foreign banks have a comparatively small market share and that they estimate the probability that domestic incumbents will retaliate to be fairly low. If domestic banks emulate the introduction of interest-bearing accounts by foreign banks, they lose proportionately more, since they have a significantly higher market share.¹⁰ Thus, if the expected loss from introducing interest-bearing current accounts exceeds that of losing market share to foreign banks domestic banks will not respond by emulating foreign banks' strategies. The loss from a reduction in market share is likely to be small, due to the presence of significant 'lock-in effects' in retail banking. The loss from the introduction of interest-bearing current accounts, on the other hand, is likely to be significant, as was shown above. Thus, it may be rational to expect that domestic banks will not or only partially respond to the

⁷ Slade (1989) develops a model where such interest rate wars are equilibrium strategies of a supergame, rather than being the result of one bank cheating on a collusive equilibrium. This results from shifts in the demand function which require players to calculate new equilibrium prices through trial and error by changing prices and thus has the appearance of a price war.

⁸ The author had the opportunity to witness a discussion in the Board of Directors meeting in a large German bank on whether or not to introduce interest-bearing current accounts in the retail market which exactly followed this game-theoretic reasoning.

⁹ A study by McKinsey of the profit and cost structure of banks in the largest six EC economies reveals that in 1987 sight and savings deposits margins accounted for 76% of positive revenues in the personal customer market and for 82% in the corporate market (see Faßbender and Leichtfuß, 1990).

¹⁰ Similar to McGee's argument on predatory pricing (1980, p.296): (Cutting the price) will ... cost the predator more than the prey".

introduction of high-yield accounts. In this situation, a foreign bank may choose to introduce such accounts, as it is likely to gain market share since domestic banks do not follow. In practise, we indeed find that foreign banks frequently choose such a strategy in countries where domestic banks pay little or no interest on current accounts.¹¹

The decision of whether or not to introduce interest rates on the current account additionally depends to a large extent on the type of funding which the bank uses. If retail deposits are an important source of funding, the loss associated with introducing competitive rates will obviously be large. If, however, the bank funds itself mainly in the interbank market, it has little to lose but much to gain by introducing competitive rates. As foreign banks may be more likely to fund themselves in the interbank market due to their restricted access to retail deposits, they are more likely to introduce competitive rates than domestic institutions.

1.4. Cross-border entry can increase quality and variety of services

Financial services firms compete not only on prices but also on the quality level of services provided. Quality of services, for example, include product variety, the qualification and quality of advice given by employees, the reliability of services, the number and appearance of branches or the convenience of delivery systems (e.g. possibility of home banking, accessibility of insurer's sales force, opening hours of branches).

Foreign financial services firms can enter the domestic market and decide to compete on the quality level of services provided in addition to or instead of competing on prices. For example, if domestic firms do not invest sufficiently in the training of employees such that the quality and service level is low, a foreign firm may invest significantly in training in order to be able to offer better services to customers.

Foreign financial services firms may not only compete on the quality level but may decide to introduce new products in the domestic market which domestic firms were too slow to introduce. Foreign financial services firms frequently lead the way of introducing new products.¹² Examples in banking include money market funds where there may be a (tacitly) collusive agreement between domestic banks not to introduce these products, as they constitute a highly effective substitute for demand and savings deposits but are usually more costly to the bank

¹¹ This was the case in Spain (Citibank and Barclays Bank) and Germany where foreign-owned banks (KKB-Bank owned by Citicorp and CC-Bank owned jointly by Banco Santander and Royal Bank of Scotland) introduced current accounts with significantly positive rates, whereas domestic banks pay little or no interest (see the case studies in chapter seven).

¹² For the case of Spain, for example, Caminal, Gual and Vives (1990) note that "foreign banks have led the way in introducing new financial products."

than the traditional liability products due to higher interest rate costs and management fees. However, if a foreign bank decides to introduce such products domestic banks are quickly forced to follow suit, as has occurred in Spain, where money market funds were introduced by Barclays Bank and Citibank, and Germany where the large Swiss banks were the first to introduce this innovative product, forcing German banks to offer similar products only one year after the initial introduction by the Swiss banks. This example illustrates that new products are not a likely source of a continuous competitive advantage for foreign firms, as they are easily replicated by domestic firms, in particular if the newly introduced products turn out to be successful. I will discuss examples of new product and process introductions of foreign banks and insurers in more detail in chapters seven and eight.

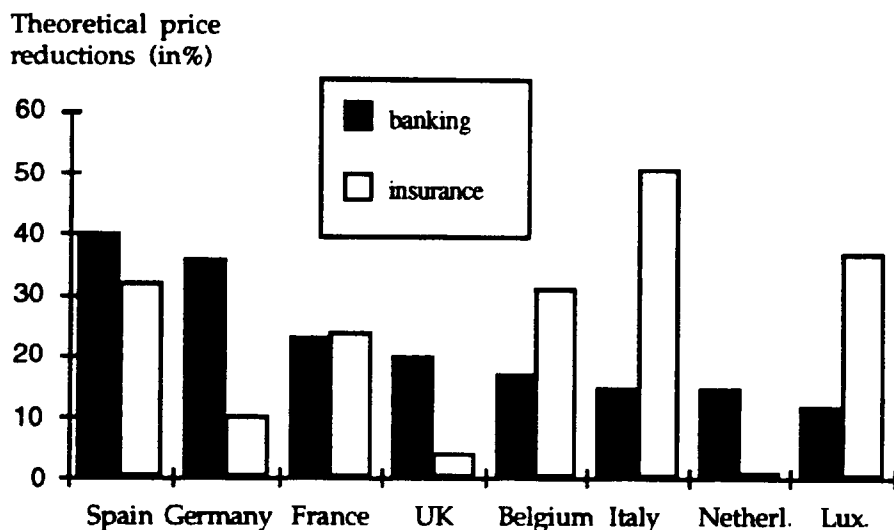
Even if a competitive advantage arising from introducing new products or competing on the quality level may not last long for the foreign firm which may even withdraw again from the market, as many of the innovative US banks have in Europe, the consumer is likely to have benefited by having gained access to an increased choice of products and service level varieties which are now offered also by domestic firms. This stems from the fact that once domestic firms have incorporated new products into their product line, they are unlikely to drop them again due to likely resistance from customers.

2. The potential impact of cross-border entry: empirical data

2.1. The Price Waterhouse study on financial services: a critical assessment

The Price Waterhouse (PW) study on the “costs of non-Europe” in EC financial services (1988) attempts to quantify the likely effects of European market integration on prices of financial products. The study employs the following methodology: a sample of seven banking, four brokerage and five insurance products was selected and current prices or margins in eight EC countries identified. The average of the four lowest observations was calculated for each product and this measure was taken as a benchmark for the maximum possible price reductions after financial integration. To account for continued national divergences even after complete integration, these potential price reductions were adjusted downwards by one-half. The resulting margins are presented in figure 5.1. While the PW study differentiates between banking and brokerage services, I have included the two retail brokerage products in the banking data.

Figure 5.1: Potential price reductions in financial services according to the PW study



Source: Price Waterhouse (1988, p.22/23)

For banking services, the largest price reductions are expected to occur in Spain, Germany and France. While in Spain all nine sample products are more expensive than the EC 8 average, with foreign exchange and mortgages being most expensive in Europe, it is consumer credit which contributes most significantly to the top positions of Germany, France and the UK.

It is apparent that prices for insurance and banking services are not necessarily correlated: Luxembourg, for example, which has a very open banking system with the lowest prices in the surveyed countries, has at the same time the second-highest premiums for insurance. This suggests that prices vary not only between countries, but also across sectors within the same country.

Prices for insurance products are notoriously difficult to compare across different countries. This stems from differing underlying risk and loss distributions which justify different premiums. Finsinger (1986, p.154) accounts for differences in underlying risk when comparing life insurance premiums in the highly regulated German market and the less tightly regulated British market and finds that the most expensive British firms charge 25 percent less than the cheapest German firms. He concludes that "regulation should be held responsible for the relatively high German net premiums". Finsinger's price data are confirmed by the PW-study (1988, p.113). Thus, despite the difficulties of international price differences in the insurance sector there seems to be substantial evidence that price levels vary significantly across European countries, at least partly due to different regulatory regimes.

Since the estimates of the Price Waterhouse study constitute the basic input for the welfare calculations of the Cecchini report, it is worthwhile to take a closer look at the method of data collection in order to understand its limitations. While there has been some criticism of the conclusions drawn by the authors of the Cecchini report about the predictions concerning the persistence of price differences after 1992 (e.g. Melitz, 1989, p.401), our main criticism is more fundamental: a thorough examination of the Price Waterhouse approach to collecting data on price differences reveals crass methodological and statistical weaknesses, especially for the banking sector: for example, for two of the selected seven banking products, commercial drafts and traveller cheques, only one multinational bank with retail branches in all surveyed EC countries was included in the sample. This leads to a significant lack of representativeness of the price estimates for these products as the (foreign) bank whose prices were surveyed may pursue different pricing strategies than other domestic banks. In addition, for some other banking products the sample for each country includes only two banks which may lead to significant distortions and the inclusion of random price differences. The sample size for the banking data therefore appears too small to draw statistically valid inferences about the population. In the insurance sector, however, the sample size was higher with six to twelve companies surveyed in each country such that the insurance data appear more reliable.

Apart from this lack of statistical representativeness in the banking sector, the methodology employed in the PW study can be criticised for an even more important reason: it takes only insufficient account of joint products in banking and the resulting possibilities of cross-subsidisation. As a German banker noted in a personal interview:

“there is no point to compare prices for individual products, due to cross-subsidisation. When banks make their pricing decisions, they look at the whole product bundle and make sure the whole customer relationship is profitable, rather than performing cost-price analyses for individual products. It is well-known, for example, that some payment services are priced below costs, while losses in this area are more than compensated by the margins in demand and savings deposits.”

The PW study, however, does not take account of such a possibility of cross-subsidisation in the banking sector and therefore its price comparisons for selected products across European countries are likely to convey a distorted picture of actual price differences. Joint products are less common in the insurance sector where customers frequently maintain relationships with several insurers.

For these reasons, the Price Waterhouse banking price data which constitute the input for the welfare simulations lack representativeness and may therefore seriously flaw the calculations which are based on these data. Due to the methodological weaknesses of the PW study in the banking sector, I have chosen to repeat the price survey for six EC countries for the area of retail banking.

2.2. Price and margin differences in retail banking: new international data for the EC

2.2.1. Methodology

Since data on price differences are crucial for predicting the competitive and welfare effects of increased foreign entry, I decided to collect new international data to get an idea of price differences across European countries. Prices in retail banking are easiest to compare, as public regulations in most EC countries require banks to publish their prices charged to personal customers. Published prices in retail banking, as usually posted in branches, do not always reflect actual prices, however: while in Germany or the UK posted and actual prices are identical,¹³ there is a possibly significant divergence in Italy, for example. This results from discretion on the part of bank managers to determine freely the rates which are actually charged for retail services, whereas such price discrimination is legally prohibited in Germany and the UK. Nevertheless, posted prices convey an impression of the prices charged to most customers and in the actual price survey varying prices were taken into account by asking the bank managers to give an estimate of the range and most common prices charged.

In contrast, prices in the market for small-to-medium enterprises are virtually non-comparable, since there is considerable price discrimination both between customers and regions. It is quite common to find the same bank charging different prices for the same services in cities and rural areas or price discrimination between customers. Much depends on the level of regional and even local competition and the perceived attractiveness of the customer. Prices in this market are frequently negotiated rather than set at a fixed level. I therefore decided not to collect any data for this market segment, since they would most likely be distorted and convey a false picture of reality.

One observation which was made in the course of collecting price data in several EC countries was the lack of price transparency even in the retail banking area. This was especially the case, of course, in countries where prices are *de facto* negotiable rather than being set at a fixed level. But even in countries where prices are standardised and all customers are charged the same rates, price transparency is reduced by several factors: frequently, banks reduce transparency by offering 'package' solutions where a basic price is paid for a package of bank transactions which include, for example, a credit card, current account, free cheques and giro transfers. Each bank offers its own individual package with a different content. Thus, while bank A's package may include free cash withdrawals, bank B may offer a package with free ATM transactions.

¹³ With very limited scope for branch managers to offer better conditions to their best customers.

In order to be able to compare prices in such circumstances, a customer therefore needs to know exactly the quantities of transactions which she undertakes. A typical retail customer uses around ten to fifteen bank products q_1, \dots, q_n per year. These are charged prices p_1, \dots, p_n . The relevant total cost for the consumer is therefore $C(q, p) = \sum q_i p_i$. Thus, a consumer first needs to know the exact quantities of each product which she uses. However, to determine such a 'frequency distribution' of monthly or annual banking transactions requires not only considerable effort but bounded rationality may also impose inherent limits on such calculations.¹⁴ Consider now a customer who has nevertheless determined her average usage quantities q_1, \dots, q_n and calculates the total cost $C(q, p)$ of the product bundles of two banks A and B, i.e. compares

$$\sum (q_i^A p_i^A) \quad \text{with} \quad \sum (q_i^B p_i^B)$$

In order to determine the cost of the two product bundles it is, of course, necessary to know individual prices for each of the products used. One may have doubts, however, whether consumers will actually undertake such a fairly complicated procedure for several banks.¹⁵

In order to take account of the problem of cross-subsidisation discussed above, it was decided to develop a typical customer profile drawing on a customer database of 115,000 personal customers of a large German bank.¹⁶ I performed a statistical analysis to determine the products which are used most frequently by personal customers and to get an insight into the average number of transactions for each product. The result of this analysis was a 'typical' product bundle of a personal customer on an annual basis. The products are shown in table 5.1.

¹⁴ Such an analysis may be aided by the monthly or quarterly bank statements, however, if these include all relevant transactions.

¹⁵ See the discussion of switching costs in chapter four. In addition, there may be considerable irrationality and price insensitivity in the banking market: Ausubel (1991, p.70-72), for example, presents impressive evidence on consumer irrationality in the credit card market. US consumers borrow at extremely high interest rates on their credit cards despite the availability of much cheaper loan facilities from their bank.

¹⁶ This work was done while I was working as a summer associate for a consulting firm.

Table 5.1: Typical product bundle and prices surveyed for personal customers

	Prices surveyed
Current account	Basic price (p.a.) with 200 transactions, interest rate on sight deposits
Savings account	Interest rate on 6-months deposits (CDs)
Money market account	Interest rate
Giro transfer	Price per transaction;
Cash deposit/withdrawal	Price per transaction;
ATM transaction	Price per transaction;
Cheques/Eurocheques	Price per cheque
Purchase/sale of shares	Price per transaction of ECU 2,500;
Securities account	Basic price p.a. for keeping 10,000 ECU account
Purchase/sale of bonds	Price per transaction of ECU 2,500;
Traveller cheque	Commission for \$500 traveller cheques
Foreign exchange transaction	Margin above spot rate for \$US and basket of four major EC currencies
Credit cards	Basic Price (p.a.), interest rate for overdraft
Consumer credit	Interest for current account overdraft, interest for loan of ECU 15,000 paid back over 5 years

Source: Own analysis drawing on database of large German bank.

Of course, it must be recognised that banking habits vary between European countries. For example, while ATM transactions are very common in the UK and Spain where ATMs have the greatest density, these may still be relatively rare in other EC countries. While Germans still deposit around fifty percent of their assets in simple low-yielding savings accounts, the French make much more use of money-market funds. The British use cheques to make ninety percent of domestic payments, while Germans use giro transfers, Eurocheques and automatic debit notes in about equal proportions. Thus, the product bundle needs be adapted to the country-specific banking habits to convey a true picture of the domestic price structure. Ideally, one would like to have a typical product bundle for each country. As this was unavailable, however, I constructed a typical product bundle on a heuristic basis in cooperation with bank officials in the other EC States.

For these product bundles in the personal customer sector, I surveyed prices in six European countries. These countries are Germany,¹⁷ the UK,¹⁸ Italy,¹⁹

¹⁷ In Germany these banks are Deutsche Bank, Dresdner Bank, Commerzbank, KKB Bank, BfG Bank, Sparkasse, Volks-und Raiffeisenbank, Norisbank, Bayerische Vereinsbank, Hypobank.

¹⁸ Barclays Bank, National Westminster, Midland, Lloyds, Abbey National, TSB, Royal Bank of Scotland.

Belgium,²⁰ the Netherlands,²¹ and France²². For each of these countries, the cost of a typical product bundle was determined and price differences are analysed.

2.2.2. The data

After I collected the data, prices were converted into ECU. In order to calculate and compare margins across the EC countries, the opportunity costs of funds needed to be determined for banks in each individual country. While the cost of funds obviously differ between banks depending on the structure of liabilities, an approximation is given by the money market rate (maturing of three months) which was decided to be taken as a yardstick against which margins were calculated. These were taken from the *The Economist* for the week in which the data were collected.

As an example of the calculations which were performed for each of the six EC countries, I analyse the case of Germany. The price structure of German retail banks is illustrated in table 5.2. It is evident that prices vary substantially for some individual products. In particular, the prices for the current account vary substantially between banks, while prices for products where price transparency is high such as credit cards or share and bond commissions are almost equal for all banks.

¹⁹ In Italy data were collected for Banco di Roma, Istituto Bancario San Paolo di Torino, Banca Nazionale del Lavoro, Banca Commerciale Italiana, Monte dei Paschi di Siena (Banca Toscana), Banco di Napoli, Banca Popolare Novara, Banca Nazionale dell'Agricoltura, Banco Ambrosiano Veneto, Banca Nazionale delle Comunicazioni, Banca d'America e d'Italia.

²⁰ Generale Bank, Bank Brussels Lambert, Kredietbank, Credit Communal de Belgique, Bacob Savings Bank

²¹ ABN-AMRO Bank, Rabobank, NMB Postbank, Verenigde Spaarbank.

²² Credit Agricole, Credit Lyonnais, BNP, Societe Generale,

Table 5.2: Price differences in German retail banking

	Spread	Mean
Interest on current account	0 - 2.5%	0.5%
Interest on savings account	2.5 - 3.5%	2.8%
Interest for consumer credit	13.2 - 16.2%	14.6%
Interest for negotiated overdraft	12.75 - 14.9%	14.2%
Cost of credit card p.a.	19.5 - 29.3 ECU	22 ECU
Cost of current account package	21 - 75 ECU	62 ECU
Eurocheque card p.a.	4.8 - 9.8 ECU	5.4 ECU
Cost per cheque	0 - 0.07 ECU	0.2 ECU
Commission per share transaction	1%	1%
Commission per bond transaction	0.5%	0.5%
Cost p.a. of share/bond account	0.2 - 1.71%	1.2%
Traveller cheques	1%	1%
Margin on foreign exchange	2.3 - 4.2%	3.2%

Source: Own price survey 1992.

Table 5.3 illustrates the basic findings of the price survey for the six EC countries.

Table 5.3: Comparison of price and margin differences in retail banking for six EC countries

Prices are in ECU

	FRG	UK	Italy	Belg.	Neth.	France
Margin on curr. acc.	+8.85%	+8.8%	+5.5%	+9.1%	+8.2%	+9.97%
Margin on savings acc.	+6.55%	+3.65%	+0.8%	+2.7%	+5.2%	+5.5%
Margin on cons. credit	+5.25%	+12.3%	+7.8%	+6.2%	+5.3%	+5.1%
Cost p.a. of curr. acc.	62	0	260	84	0	0
Cost of credit card p.a.	22	15	26	19	20	27
Commission per share transaction	1%	1.6%	0.7%	6%	1%	1.2%
Commission per bond transaction	1%	1.2%	0.5%	4%	1%	0.9%
Cost p.a. of security account	50	0	35	0	35	34
Commission for \$500 traveller cheques	4	5	10	6	6	4
Margin on foreign exchange	3.2%	4.5%	4.2%	3.5%	4.5%	3.9%

Source: Own price survey 1992.

The data collected indicate significant differences in the pricing structure between the EC countries. In the UK, France and the Netherlands, for example, banks do not charge transaction costs on current accounts and therefore need to cross-subsidise the losses made in this area by charging high prices in other areas. The main area which is used for the purpose of cross-subsidisation seems to be consumer credit where UK banks charge more than twice than German banks. Brokerage transactions are particularly expensive in Belgium, even though no annual security account maintenance costs are charged. In France there is also a significant degree of cross-subsidisation but margins on intermediation services are lower than in the UK.²³

2.2.3. Possible reasons for international price differences

From the collected data, it appears that price differences are significant across the EC countries. The Price Waterhouse study employs a simple mono-causal explanation. It states that "at present, in the non-integrated Europe the various barriers to the completion of the internal market in financial services result in

²³ De Boisseu (1990b) notes that "French banks systematically overcharged intermediation operations" due to "underpricing of numerous ancillary and payments services".

different prices being charged in different countries" (p.180). Price differentiation may be the result of a variety of other factors, however, only one of which are barriers to European market integration. Generally, one can identify four main reasons why prices for financial products may vary in different countries (Llewellyn, 1992):

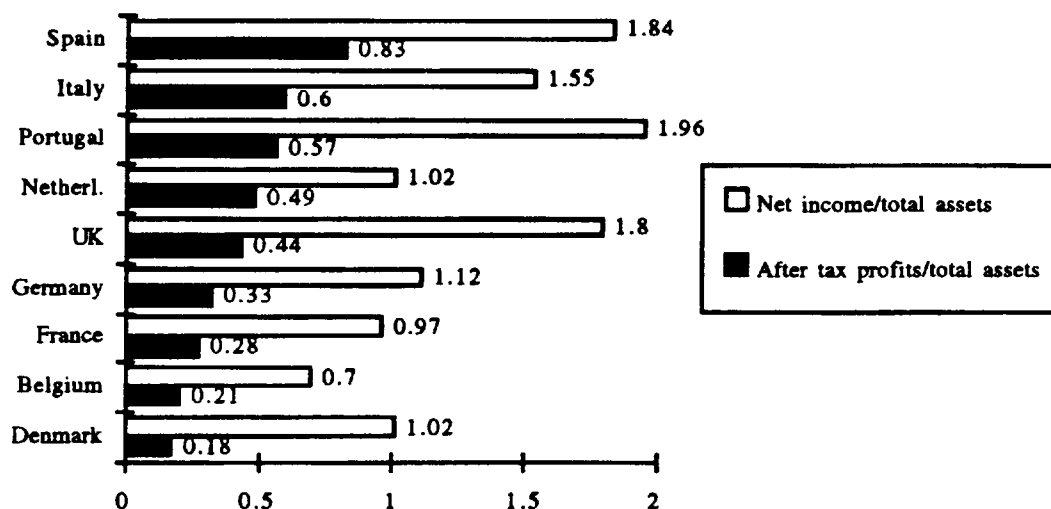
- differences in the underlying cost, demand and technological conditions;
- differences in industry structure and conduct which lead to cost and price differentials (e.g. cross-subsidisation of different products);
- varying degrees of openness to foreign entry, resulting in different levels of intensity of domestic competition (e.g. high entry barriers facilitating collusion between domestic suppliers and thus leading to higher prices);
- regulatory differences, imposing different cost and pricing structures (e.g. reserve requirements).

Thus, whether price differences will persist even in a fully integrated European financial services market free of regulatory restrictions, is not only a question of reducing barriers to foreign entry, but depends on a variety of other factors.

2.2.4. Do higher prices lead to greater profits?

Banks enjoy widely varying degrees of profitability across the EC countries. Table 5.4 reports a profitability measure, the return on assets (ROA) for nine EC countries.²⁴ Since annual reported profits may vary significantly from year to year, especially due to the high write-offs on LDC loans which all banks spread differently over the reporting periods, an average figure for the four-year period from 1986 to 1989 is reported in order to even out such fluctuations. In addition, a net income figure is reported which in the OECD accounts is defined as profits before bad debt provisions and taxes. This figure is less biased by provisions for LDC loans. Data were taken from the latest OECD report on bank profitability (1991).

²⁴ No data for Ireland and Greece were available. Luxembourg was excluded due to the high number of foreign banks which do not operate in domestic commercial banking.

Table 5.4: Return on assets for EC commercial banks from 1986 to 1989

Source: own calculation from data in OECD (1991).

A comparative analysis of accounting measures encounters well-known problems stemming from different accounting, legal and regulatory environments, and therefore has to be pursued cautiously. Spanish banks, for example, provide fairly high bad debt provisions, reducing reported operating profits, while German banks and insurers may have large hidden reserves which do not appear in published accounts. Danish banks, on the other hand, are required to value security holdings at current market prices at the end of each financial year which leads to high fluctuations in operating profits.

Despite these differences in accounting conventions which make cross-country comparisons more difficult, it seems fairly clear that banks enjoy the highest profitability in Spain and Italy for the period 1986 to 1989. UK banks had particularly high provisions for bad loans and therefore after-tax profits were significantly lower than net income.

Table 5.5 presents performance measures for the non-life sector in five EC countries which were averaged out over the time period from 1985 to 1989. Unfortunately, data for other EC countries were not available.

Table 5.5 Operating results of non-life insurers in five EC countries over 1985 to 1989 time period

	Return on assets	Return on equity	underwriting results (in % of premia)	investment income (in % of premia)
Germany	2.5	16.6	1.3	9.1
France	1.1	8.5	- 11.1	14.2
Italy	1.1	7.5	-12.5	16.3
UK*	n.a.	n.a.	-11.8	15.1
Netherl.	2.1	7.7	- 5.5	11.1

* data for the UK are for 1982 to 1986

Source: own calculation from data in Sigma 3/1988; 6/1991.

It becomes apparent that insurers in Germany achieved the highest profitability both in terms of return on assets and return on equity. This results primarily from positive underwriting results which contrasted with negative results in the other four EC countries. Underwriting losses in these countries were more than compensated by higher investment income, however, such that the overall results were positive in all countries during all years.

2.3. Differing efficiency levels in European financial services: the example of labour productivity

In order to measure internal efficiency in banking I report some data on labour productivity in table 5.6. W represents remuneration per employee in banking divided by the national average for all industries and provides an indicator of the wage level in banking relative to other sectors. L represents bank assets (in thousand ECUs) divided by the number of employees in banking and constitutes an approximation of labour productivity. P represents personnel costs as a percentage of total banking assets in 1989.

Table 5.6: Wage levels and productivity in banking in 10 EC countries

	W	L	P
Italy	2.1	940	2.2
UK	2.0	1,387	1.0
Belgium	1.9	917	0.9
Luxemb.	1.9	3,701	0.3
Greece	1.8	874	1.8
Spain	1.7	822	2.2
France	1.6	788	1.2
Denmark	1.3	750	1.3
Netherl.	1.2	1,035	1.2
Germany	1.1	1,022	1.4

Source: Neven (1990, p.173) and own calculation from data in OECD (1991).

Wages in banking seem to be particularly high in Italy, compared to the industry average. Even though the UK, Belgium and Luxembourg have similarly high levels as Italy, one has to take into account that wage levels are naturally higher in these countries due to the fact that they host major financial centres and thus include a relatively greater proportion of high salaries of investment banking employees.

High wage levels and personnel costs in Italy, Spain and Greece are combined with low labour productivity. This seems to suggest that there may be a significant degree of X-inefficiency in these countries, as domestic banks fail to minimise costs.

2.4. Collusive equilibria in banking: the example of deposit interest rates

Table 5.7 reports average margins on demand and savings deposits for 1991 in six EC countries and compares these with the margins for the period from 1980 to 1985. These are calculated as the three-months money market rate rate less the average interest rate paid on 3 to 6-months retail deposits.

Table 5.7: Average margins for demand and savings deposits in 1991

	Margin on demand dep.		Margin on savings dep.	
	1980-85	1992	1980-85	1992
Germany	6.5	8.85	2.8	6.55
UK	10.8	8.80	2.5	3.65
Italy	4.3	5.50	3.4	0.80
Netherl.	5.6	8.20	2.8	5.20
France	11.7	9.97	4.3	5.50
Belgium	11.2	9.10	5.6	2.70

Source: 1980-85: Baltensperger and Dermine (1990); 1992: own price survey.

It appears that margins have not decreased significantly even though competition in the area of interest rates has markedly increased in some countries such as the UK. Despite the arguments in favour of sticking to a collusive agreement on paying low deposit interest rates reviewed in section 1.3, some players cheated by introducing interest-bearing deposit accounts and thus spoiled the cooperative equilibrium, instigating a costly 'interest rate' war. In the UK, building societies were the first to introduce such accounts prompting first Midland and Lloyds and then also Barclays and Nat West to follow suit in 1989.

In the UK, building societies were quite successful in capturing market share after introducing interest-bearing current accounts (Llewellyn, 1990). This was mainly due to the rather lagged response of the clearing banks which were slow to recognise the jeopardy of losing customers to the new entrants. It seems that by 1991, however, the 'interest rate war' has settled down with margins having increased back to the level of the beginning of the 1980s.

2.5. Quality levels in retail banking

Quality levels in banking are hard to quantify, since one cannot put a price on the quality of advice given by employees. As an example of the convenience of the delivery system I look at opening hours of retail branches in the European countries. Table 5.8 illustrates these for eight EC countries.

Table 5.8: Opening hours of retail branches in eight EC countries in 1992

	Opening hours	Total per week
UK	weekdays: 9.00 - 17.00, Saturdays: 9.00 - 12.00	43 hours
Germany	only weekdays: 8.30 - 16.00(Thursdays: 18.00, Fridays: 15.30), smaller branches close for lunch for one hour,	39 hours
Italy	only weekdays: 8.20 - 13.20; 14.45 - 15.45	30 hours
Belgium	only weekdays: 9.00 - 12.30, 13.30-16.00, large branches do not close for lunch	30 hours
Greece	Mon. - Thursd.: 8.00 - 14.00; Fridays: 8.00 - 13.30	27.5 hours
France	9.00 - 12.00; 14.00 -16.00; large branches do not close for lunch	25 hours
Spain	9.00 -14.00; in winter also Saturdays 9.00-13.00	25 hours
Portugal	only weekdays: 8.30 - 11.45; 13.00 - 14.45	25 hours

Source: Own survey.

Table 5.8 shows that there are significant differences in the accessibility of branches to customers ranging from 43 hours in the UK to only 25 hours in Belgium, France, Spain and Portugal. While opening hours are at least partly related to labour laws and the power of labour unions in a particular country, they are also a result of the degree of competition. This becomes apparent looking at the example of the UK where over recent years opening hours were expanded to include Saturday openings which were first introduced by Lloyds in 1987, forcing the other major clearing banks to follow suit. One may expect that as competition increases, banks will be forced to make more efficient use of their main delivery channel, increasing the accessibility of bank branches to their retail customers.

3. Conclusions

This chapter has analysed the potential impact of foreign entry on domestic competition in retail financial services. It was shown that for the simple case of Cournot competition in deposit markets both cross-border acquisitions and de novo entry lead to higher deposit rates and thus to an increase in consumer surplus. As domestic firms lose market share to foreign entrants, however, domestic producer surplus decreases and this decrease may outweigh the increase in consumer surplus.

In addition to stimulating price competition, cross-border entry may spoil domestic collusive equilibria such as (tacit) agreements not to compete on deposit rates or agreements to fix insurance premiums. Further, foreign financial services firms can bring new expertise to the market in the form of introducing new

products or may increase quality competition by offering existing products at a higher quality level. Finally, if foreign entrants are more cost-efficient than domestic firms this may induce a restructuring of domestic firms and reduce X-inefficiency.

A close analysis of the Price Waterhouse study reveals that there are some insufficiencies concerning statistical sampling in particular in the banking sector and it was therefore decided to gather additional data on price differences in retail banking across six EC countries. It became obvious that there are significant differences in the pricing structure of retail products across the EC countries. The degree of cross-subsidisation is particularly high in the UK, France and the Netherlands where banks charge no transaction costs on the current account. Losses in this area are subsidised by high margins in the area of consumer credit, especially in the UK.

In order to examine the degree of X-inefficiency, an analysis of wage and productivity levels in banking was undertaken. It was shown that wage and personnel expenses were high and labour productivity low in Italy, Spain and Greece which provides evidence for some inefficiencies in these countries.

As an example of the quality level in retail banking opening hours of retail branches were compared across the EC countries and it was shown that there are substantial differences in the accessibility of branches. As competition increases, one may expect banks to make more efficient use of their main delivery channel.

Chapter Six: The Scale of Cross-Border Entry in EC Financial Services: an Aggregate Analysis

This chapter provides an aggregate overview of cross-border trade activities, majority and minority acquisitions, joint ventures, strategic alliances and *de novo* entry for the EC as a whole, as well as analysing trends for different EC countries. In order to evaluate the relative importance of cross-border entry activities in European financial services, these have to be assessed in a time-series and comparative perspective. In this chapter I therefore present and analyse existing and newly collected statistical data and thereby deal with the following questions:

- has there been an increase in cross-border entry activity in the most recent past and which form of entry has increased most significantly?
- can we distinguish significantly different trends in cross-border transactions for different EC countries?
- which countries are the main targets of foreign entry activity and which are the main acquirers?
- what is the preferred mode of cross-border entry?
- are there significantly diverging trends in entry activity by EC and non-EC institutions?

In the next section I analyse intra-EC cross-border entry activities, whereas section two I examine entry into the EC by non-EC banks and insurers. As there is currently no comprehensive database for cross-border entry in EC financial services, data from various private and public sources needed to be compiled, analysed and synthesised into a database listed in the appendices.

1. The extent of cross-border entry in EC financial services: intra-EC activities

To ensure international comparability of cross-border entry data, it is imperative to define clearly what constitutes cross-border entry in the different EC countries for the purposes of the study.¹ I follow the definitions

¹ Concerning cross-border acquisitions, for example, Franks and Mayer (1990, p.198), note "how sensitive international comparisons of acquisition activity are to definitions of a takeover".

given in chapter one, concerning exports, acquisitions, joint ventures, strategic alliances and de novo entry.

1.1. International trade in financial services

I first look at the development of exporting and importing of financial services over the past decade. Table 6.1 shows data on the development of intra-EC trade in financial services which were derived from the 1991 foreign trade statistics data of *Eurostat*. Intra-EC trade is hereby defined as cross-border provision of services between any two EC countries. Credits are exports to another EC country and debits are imports. As is apparent from the table, exports have increased more significantly than imports both in absolute terms as well as expressed as a percentage of international trade in all services. 'Total services' include the three categories transport, travel and 'other services' such as advertising and business services. Intra-EC trade in financial services accounts only for a small proportion of total intra-EC services trade, however. This reflects the difficulty of exporting or importing financial services in particular in mass retail services. Those services which are traded are mainly large-scale international loans for governments or multinational firms and reinsurance activities.

Table 6.1: Intra-EC trade in financial services
(in million ECU)

	Credits <i>Banking</i>	in % of total services	Debits <i>Banking</i>	in % of total services	Credits <i>Insurance</i>	in % of total services	Debits <i>Insurance</i>	in % of total services
1980	918	1.6%	902	1.6%	947	1.6%	1,051	1.9%
1982	1,300	1.8%	1,373	2.1%	1,370	1.9%	1,302	2.0%
1984	1,700	2.1%	1,505	2.0%	1,772	2.1%	1,879	2.5%
1986	2,238	2.5%	1,836	2.1%	3,320	3.7%	2,238	2.6%
1988	3,064	3.0%	2,456	2.4%	2,592	2.5%	2,342	2.3%
CAGR	+ 16.2 %		+13.3 %		+13.4%		+10.5%	

Total services include travel, transport and other services (e.g. advertising, business services)

CAGR: Compound Annual Growth Rate

Source: own compilation from Eurostat, International Trade in Services, 1991; Series 6D.

From table 6.1 it is also apparent that intra-EC trade is approximately of the same magnitude in insurance and banking services. Table 6.2 presents the same type of data for *extra-EC* trade. This concerns trade of EC countries with non-EC nations. In absolute terms extra-EC is clearly more significant than intra-EC trade. In 1988 both credits and debits were more than twice as large for extra-EC trade than for intra-EC trade. As a percentage of total services extra-EC trade also plays a limited overall role, however. Exports have increased by more than imports with the EC being a net exporter of both banking and insurance services. Thus, free trade in financial services enables

the EC countries to successfully penetrate non-Member states which should be borne in mind in the current GATT-negotiations over services trade liberalisation.

Table 6.2: Extra-EC trade in financial services
(in million ECU)

	Credits <i>Banking</i>	in % of total services	Debits <i>Banking</i>	in % of total services	Credits <i>Insurance</i>	in % of total services	Debits <i>Insurance</i>	in % of total services
1980	2,440	1.9%	2,132	1.8%	2,310	1.8%	2,299	1.9%
1982	3,628	2.2%	3,643	2.4%	3,404	2.0%	2,872	1.9%
1984	4,591	2.3%	3,132	1.8%	4,334	2.2%	4,069	2.4%
1986	5,863	2.9%	3,749	2.1%	7,331	3.6%	4,205	2.3%
1988	7,536	3.4%	5,082	2.4%	6,175	2.8%	4,721	2.2%
CAGR	+ 15.1 %		+11.5 %		+13.1%		+9.4%	

Total services include travel, transport and other services (e.g. advertising, business services)

CAGR: Compound Annual Growth Rate

Source: own compilation from Eurostat, *International Trade in Services*, 1991; 6D.

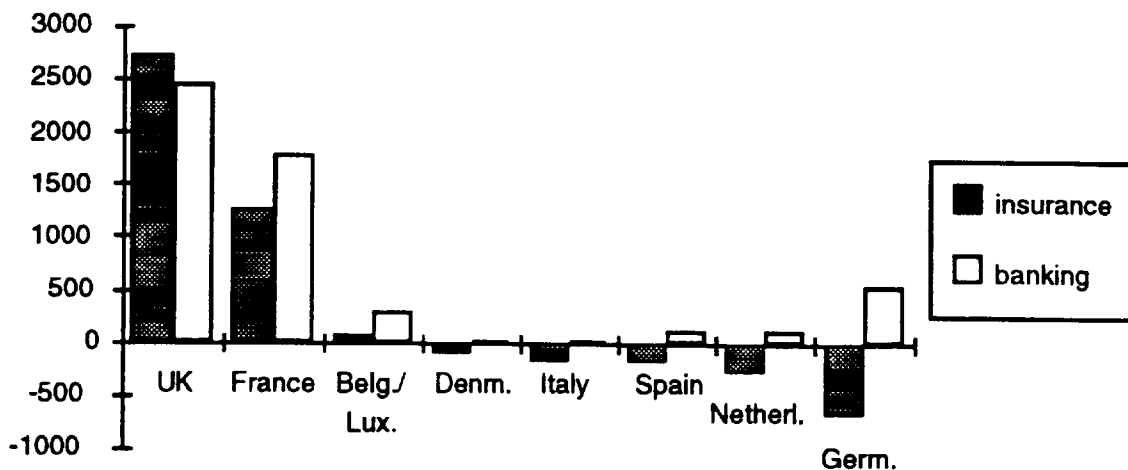
From figure 6.1 which shows trade in financial services in 1988 it is evident that the significance of trade varies greatly between the EC countries. Especially the UK and to a lesser extent France are net exporters of both banking and insurance services. Italy, Spain, the Netherlands and especially Germany are all net importers of insurance, while being net exporters of banking services.

Table 6.3 shows trade in banking services for the EC countries. The data refer to loans and deposits to non-banks and are therefore not distorted by the international interbank market. The first two columns represent imports and exports of credits, i.e. loans to residents. Imports therefore represent loans by foreign banks to domestic residents, whereas exports refer to international loans by domestic banks to residents in foreign countries. The biggest importers of bank credits are Germany and Italy. This seems somewhat surprising considering the low penetration of foreign banks of these markets. Less surprisingly, the biggest exporters of bank credit are Belgium/Luxembourg with the latter country being a booking centre for loans due to its favourable regulatory and tax system and the UK which is home to the world's most internationalised financial centre.

The next two columns refer to cross-border deposits. Imports thus represent deposits of non-residents (both firms and individuals) at domestic banks, whereas exports stand for deposits of domestic residents at foreign banks abroad. The biggest importer of deposits is the UK, followed by Belgium/Luxembourg and France. Germany has the biggest flow of deposits into foreign countries.

Figure 6.1: Net trade of 9 EC countries with world in financial services in 1988

millions ECU



Source: own compilation from Eurostat, International Trade in Services, 1991; 6D.

Table 6.3: Trade in banking services in 1990

In \$ billion

	Imports of credits	Exports of credits	Net exports	Imports of deposits	Exports of deposits	Net exports
Denmark	33.7	6.4	- 27.3	2.5	3.6	+1.1
Portugal	8.1	0	- 8.1	0.4	4.7	+4.3
Netherl.	53.9	49.3	- 4.6	59.0	53.1	- 5.9
Italy*	72.8	0	-72.8	31.3	0	- 31.1
Belg/Lux	27.8	185.8	+ 158	188.7	39.6	- 149.1
Germany	83.6	112.1	+ 28.5	61.7	122.1	+ 60.4
Spain	17.8	13.6	- 4.2	26.5	13.7	- 12.8
France	29.4	141.9	+ 112.5	127	44.5	- 82.5
UK	55.4	259.4	+ 204.0	322.4	67.4	- 255.0

* Data for are for 1988

Source: IMF International Financial Statistics, 1992.

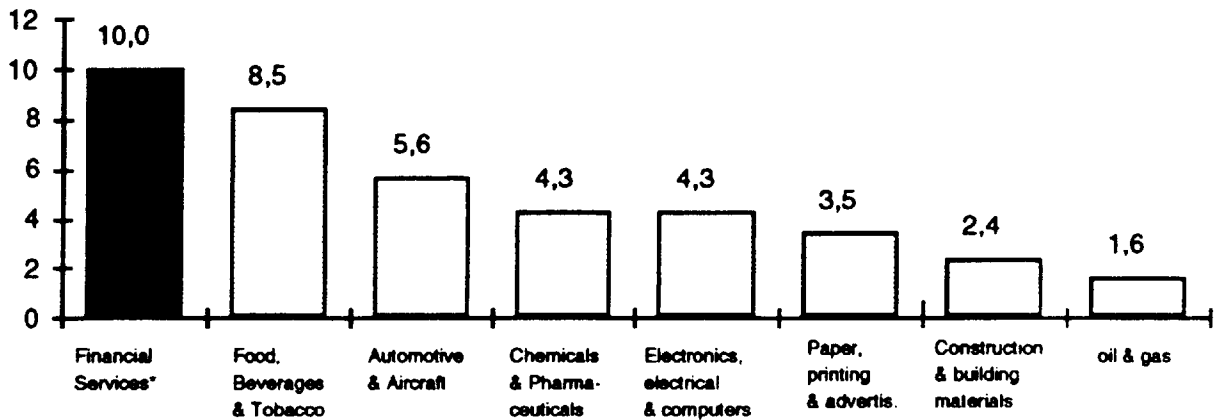
As part of aggregate banking output, cross-border provision of financial services as a form of 'exporting' is still of limited overall significance, however. Neven (1990, p.157) calculates export/output ratios for the EC countries. The biggest exporter is the UK but even here exports as part of total banking output do not exceed 9.7 percent.

1.2. Cross-border acquisitions

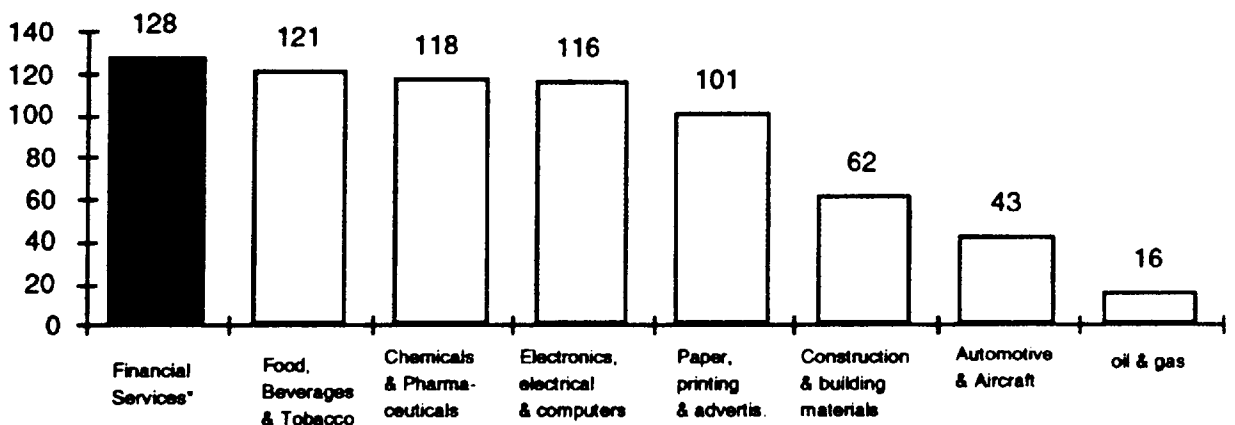
Figure 6.2 lists the number and value of cross-border majority acquisitions for the main EC industries in 1989. It is obvious that cross-border activity has been highest in financial services, both in terms of disclosed value of deals and also concerning the absolute number of transactions. This underlines that cross-border acquisitions in financial services constitute a significant means of cross-border entry even when comparing it to other industries such as chemicals and food&beverages which traditionally have been characterised by high merger and acquisition activities.

Figure 6.2: Number and value of cross-border majority acquisitions in European industries in 1989

Disclosed value in \$ billion



Number of deals

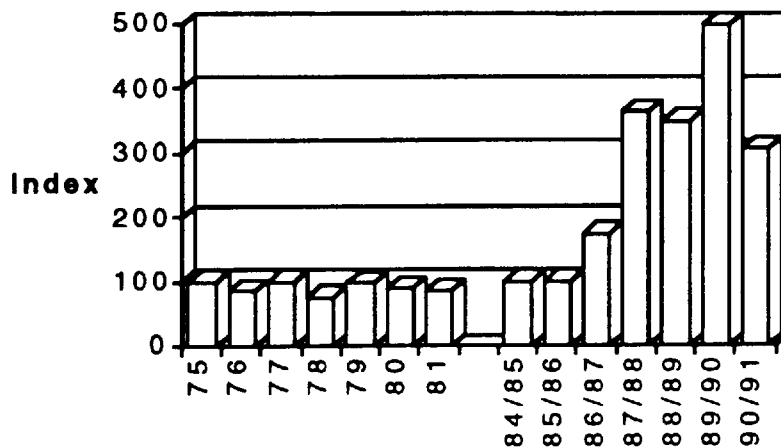


Source: Translink as quoted in M&A Europe, 1/1990.

The most consistent data on acquisition activity in the financial services sector are those provided by the Commission of the European Communities. Figure 6.3 gives an overview of acquisitions (both national and cross-border) in the financial services sector in the EC since 1975, as surveyed by the Directorate General for Competition in its annual reports on competition policy. No data were collected between 1981 and 1983 resulting in a structural break and hindering direct comparison of the two time series from 1975 to 1981 and 1984 to 1991.

Nevertheless, it is quite obvious that there has been a significant increase in acquisition activity over the past decade. In the second part of the 1970s, acquisition activity stayed relatively constant with few fluctuations. The 1980s, however, have witnessed a dramatic expansion of acquisition activities, especially since 1986 but levelling off again in 1990/91. Whether the increase in acquisition activity is due to the vision of a single European financial market cannot be ascertained at this stage, without undertaking a more detailed analysis of the motives of these transactions. Yet, the increase in M&A activity is not unique to financial services: other industries have witnessed a similar increase in acquisition activity. Nevertheless, the increase in financial services acquisition activities seems to have been particularly pronounced.

Figure 6.3: Number of acquisitions in EC financial services from 1975 to 1991



Note: 1980/81 includes business services, renting leasing and hiring; index is re-based in 1984/85

Source: own compilation from various issues of the annual reports on competition policy, Commission of the EC, 1976-1992.

The Commission of the EC in its annual reports on competition policy has published separate data on majority and minority acquisitions in EC financial services only since 1984/85. It has thereby differentiated between two types of cross-border transactions: those where EC companies from different member states are involved ('EC mergers'), and transactions

between EC firms and companies from outside the Community with "effects on the Community market" ('international mergers').

Figure 6.4 reports the development of majority acquisitions in EC banking and insurance since 1984/85. International acquisitions have been rising steadily over the past five years with a compound annual growth rate of sixty percent. Intra-EC acquisitions experienced a negative trend until 1986, but increased substantially since then.

Minority acquisitions have also risen continuously from 1984/85 to 1989/90. Again, international transactions outnumber intra-EC deals with an annual growth rate of almost forty-five percent, compared to twenty-eight percent for EC acquisitions. This illustrates the desire of non-EC institutions to gain a foothold in the EC market by acquiring an interest in EC institutions. A comparison of figures 6.4 and 6.5 shows that the number of minority acquisitions exceeds that of majority stakes. This is quite distinct from the situation in other industries, where majority deals by far outnumber minority transactions² and may result from the larger capital requirements necessary for taking over a financial institution, as compared to an industrial firm,³ as well as the lack of suitable targets for majority acquisitions in most EC countries.

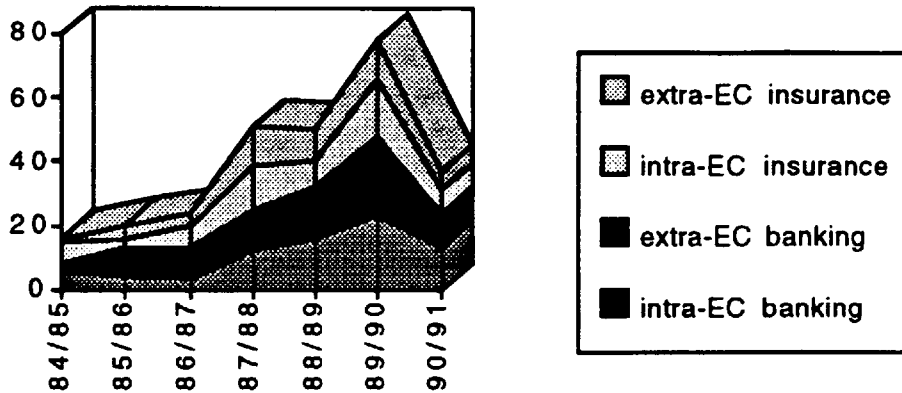
The decline in both majority and minority acquisitions in 1990/91, only one year before the target date for the European internal market, seems to indicate that most financial services firms have already carried out their European cross-border acquisitions in the years before.⁴ Since firms have anticipated the '1992' date in their strategic planning since 1987, one may expect that the number of cross-border acquisitions has peaked in 1989/90.

² See EC (1991, p.228-30).

³ It has been estimated that acquiring a European bank requires a premium of 30-40% over net asset value (see 'Against the urge to merge', *The Banker*, p.192, July 1990).

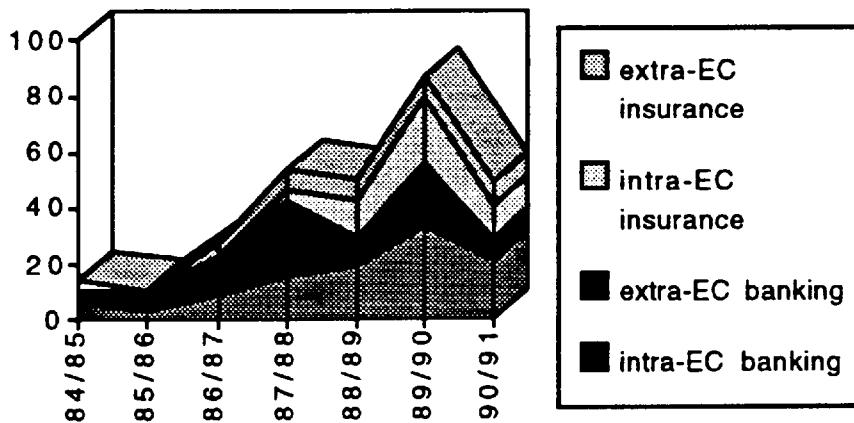
⁴ This became also apparent in the personal interviews which are reported in the next chapters.

Figure 6.4: Majority acquisitions in EC financial services



Source: Report on Competition Policy, EC (1992).

Figure 6.5: Minority acquisitions in EC financial services



Source: Report on Competition Policy, EC (1992).

The data published by the EC Commission are strictly on an industry level and do not allow firm-level disaggregation. Thus, no additional analyses besides those listed in the report on competition policy can be undertaken. Furthermore, the Commission does not collect data on de novo entries and strategic alliances.

To remedy this situation I decided to build up a comprehensive firm-level database of EC acquisitions. Rather than collecting data on a random basis, I decided to proceed systematically by first identifying the largest EC

banks and insurers from the annual listing of the world's 1,000 largest banks in the magazine *The Banker* and the Financial Times listing of the largest EC firms and then surveying various public sources on cross-border acquisitions and other entry activities. This was supplemented by a systematic analysis of press clippings and annual reports. I found that for banks there was a 'natural' cut-off point for the sample around EC rank 60 of the *Banker's* annual listing, as smaller banks are characterised by very few cross-border entry activities. Thus, banks ranked between places 60 and 100 usually pursue few cross-border entry activities, while banks on places 100 and above almost exclusively operate in domestic markets. This finding corresponds to the prevalent notion among practitioners that only the biggest banks are significant players in cross-border operations.⁵ Similarly, in insurance the largest forty EC firms are by far the most active as far as cross-border entry activities are concerned. The database therefore includes the largest sixty EC banks and the largest forty EC insurers, both ranked in terms of their capital.

The second decision which needed to be made before constructing the database was the time period covered. Since the focus of the study is on the impact of the internal market on the financial services sector, I decided that 1986 would be the best base year, as the Single European Act was passed at the beginning of that year. The resulting database therefore covers cross-border entry activities from January 1986 to the beginning of 1992.

Concerning cross-border acquisitions, the database includes 243 intra-EC majority and minority acquisitions, which are listed individually in appendices one and two. Table 6.4 provides a list of the biggest cross-border majority acquisitions between 1986 and 1992. These are valued in ECU at the time of the transaction. Since the actual price paid for the acquisition is not always revealed, the transaction value had to be approximated by the size of the acquired firm's capital multiplied by the acquired percentage stake. Thus, the absolute figure does not necessarily convey a true picture of the actual transaction value but is likely to understate the actual price paid, as substantial premiums over capital size are not uncommon especially in banking acquisitions. For example, Deutsche Bank actually paid \$603 million for Banca d'America e d'Italia, almost twice its size of capital. As the actual price of most of the other acquisitions is not revealed, however, I decided to stick with the approximation even for cases where the purchase price is known in order to facilitate comparisons. Transaction values in the database thus convey an impression of the relative value of the acquisition rather than providing an accurate account of the actual size of the deal.⁶

⁵ In France, for example, the biggest three banks accounted for two thirds of the foreign direct investment of French banks, while the largest seven institutions claim 98.2 percent of banks' FDI (see Commission Bancaire, Rapport Annuel 1986). Our sample of the largest 60 EC banks includes the largest ten French banks and therefore captures the vast majority of cross-border entry activities. Similar data can be reported for other European countries.

⁶ An alternative approach would have been to calculate the average difference between capital size and purchase price and apply it to those transactions where the purchase price is unknown. Since the purchase price is usually known for only the largest transactions and the

Table 6.4 The biggest intra-EC cross-border majority acquisitions between 1986 and 1992

Banking:

Acquiror	Acquired bank	Year of transaction	Approximated value of transaction
Deutsche Bank	Morgan Grenfell, UK	1989	ECU 500 million
Credit Lyonnais	Slavenburg's Bank, Netherl.	1987	ECU 416 million
Deutsche Bank	Banca d'America e d'Italia, Italy	1986	ECU 293 million
Credit Lyonnais	Banco Comercial Espanol, Spain	1990/91	ECU 250 million
Barclays Bank	L'Europenne de Banque, France	1990	ECU 245 million
Barclays Bank	Merck Fink, Germany	1990	ECU 160 million
National Westminster	Banque de L'Union Europenne, France	1988	ECU 123million
Amro Bank	Frankfurter Kreditbank, Germany	1990	ECU 97 million
National Westminster	Banco Nat West March, Spain	1985/89	ECU 84 million

Insurance:

Acquiror	Acquired insurer	Year of transaction	Acquisition price
Victoire (Suez)	Colonia, Germany	1989	ECU 2 billion*
Allianz	Rhin et Moselle, France	1989	ECU 930 million
UAP/Liberty Life	Sun Life, UK	1989/91	ECU 771 million
Axa	Equity and Law, UK	1987	ECU 675 million
Allianz	RAS, Italy	1987	ECU 560 million
Allianz	Cornhill Insurance, UK	1986	ECU 450 million
Victoire (Suez)	Niew Rotterdam, Netherl.	1989	ECU 350 million

* estimated

Source: Appendices 1 and 2.

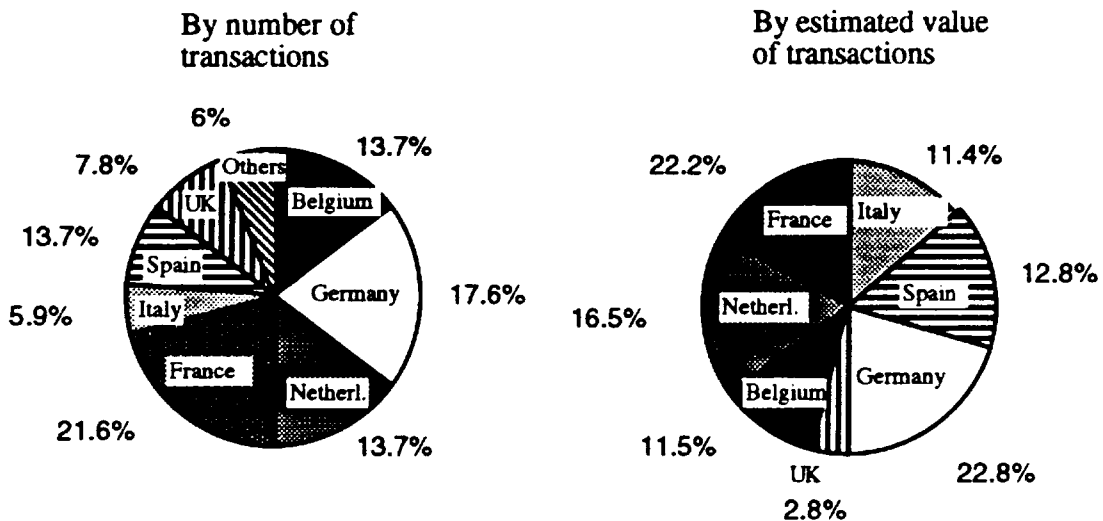
With Deutsche Bank's acquisition of Morgan Grenfell, the largest transaction in banking so far has been in the area of investment rather than retail banking. The other banking acquisitions, however, were broadly in the area of retail banking with some of the acquired banks being specialists in particular areas of banking, such as Merck, Fink & Co. focusing on private banking. It is further obvious and not surprising that the largest cross-border acquisitions are undertaken by the largest European banks. No clear country focus can be identified with the largest acquisitions being evenly distributed across the largest EC economies. Both in absolute and relative terms, Germany's Deutsche Bank has so far been the biggest acquiror, followed by Credit Lyonnais, Barclays and National Westminster.

premium may be higher for these transactions, there is a danger of overestimating the purchase price for smaller transactions. I therefore decided to stick with objectively verifiable data.

In insurance it is also the largest firms which have so far undertaken the biggest acquisitions. The most active acquiror has been Allianz which has followed an expansionary internationalisation strategy (see chapter eight). Allianz is followed by Suez (Victoire) which has undertaken the largest cross-border transaction so far, acquiring 52 percent of Germany's Colonia, the second-largest insurer in the country for an estimated price of more than ECU2 billion.

Can we identify a clearer trend of the target countries of majority acquisitions when including the whole sample of transactions between 1986 and 1992? On a more aggregated level, figure 6.6 provides an analysis of target countries both in terms of number of transactions and in terms of estimated transaction value for 51 majority acquisitions of the largest 60 banks.

Figure 6.6: Target countries by number and transaction value in EC banking majority acquisitions



Basis: 51 majority acquisitions between 1986 and 1992 with an estimated total transaction value of ECU 2,869 million.

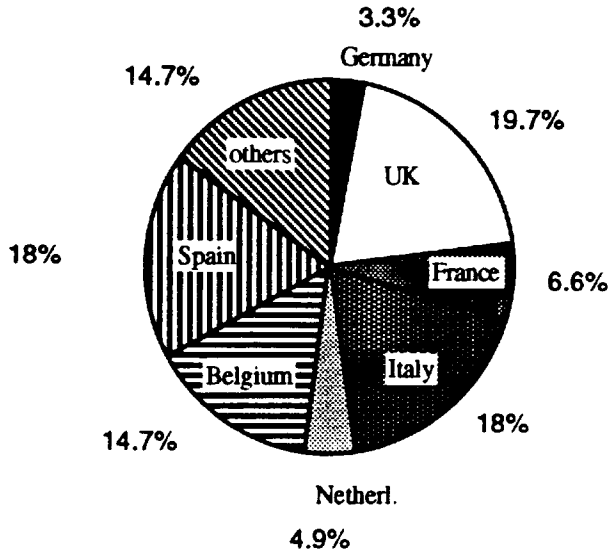
Source: Appendix 1.

Cross-border entry by means of majority acquisitions has been most significant in France, Germany, Spain and the Netherlands, in that order. France and Germany are naturally attractive, since they are the largest economies in the EC. Spain has been the target of frequent cross-border acquisitions as it is perceived to have significant market potential and domestic banks were long considered to be complacent. It is interesting to note, however, that the regulatory barriers to cross-border entry which existed in Spain until 1989 have apparently not lead to a reduction in the number of inward acquisitions. It is also interesting to see that in the UK with its complete absence of regulatory entry barriers there have been very few acquisitions by other EC banks in the commercial banking field which

contrasts with a large number of acquisitions in the investment banking and brokerage field (see below).

Figure 6.7 presents the same analysis for the insurance sector. As data on the transaction value of the acquisitions were scarcely available, target countries had to be analysed by the number of inward acquisitions only.

Figure 6.7: Target countries by number in EC insurance majority acquisitions



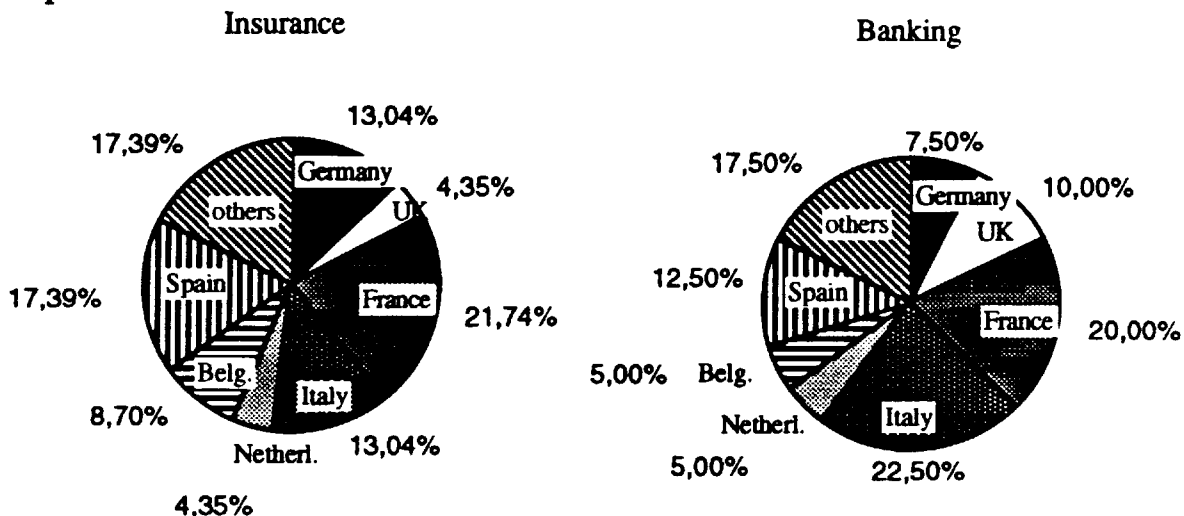
Basis: 61 majority acquisitions between 1986 and 1992

Source: Appendix 2.

From figure 6.7 it becomes apparent that the largest number of inward acquisitions has so far taken place in the UK, Italy and Spain. Italy and Spain in particular are perceived to have significant market potential, as they are currently underdeveloped in terms of insurance coverage. Germany in contrast has witnessed very few inward acquisitions despite the fact that it is the largest insurance market in Europe. This is likely to be a result of the significant regulatory entry barriers which make foreign entry in Germany more difficult.

Is there a significant difference between the target countries of majority and minority acquisitions? Figure 6.8 presents an analysis of the target countries of minority acquisitions for both banking and insurance.

Figure 6.8: Target countries in EC banking and insurance minority acquisitions



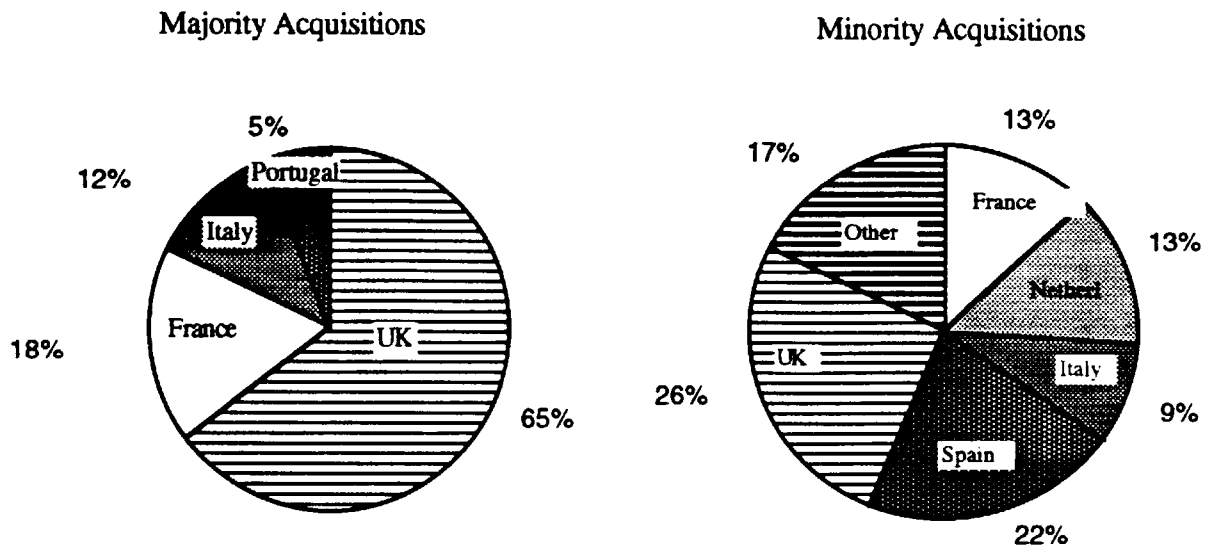
Basis: 66 minority acquisitions between 1986 and 1992

Source: Appendices 1 and 2.

In banking, Italy and France are the countries with the most minority acquisitions, followed by Spain and the UK. In the insurance sector, France and Spain followed by Italy and Germany hold the lead positions. Minority acquisitions may reflect a cautious approach on the part of foreign firms when entering these markets. Rather than taking the risk of fully acquiring a firm, entrants prefer first to gain experience in the target market by setting up a minority stake in a foreign bank or insurer, sometimes accompanied by a cooperative agreement or alliance, with the option of expanding it later into a majority stake.

In the database a classification was undertaken into the areas of retail or commercial banking on the one hand and brokerage and investment banking on the other. While this differentiation is at odds with our broad definition of universal banking, it allows a better analysis of the latter category. In figure 6.9 an analysis of the target countries of both majority and minority acquisitions is given.

Figure 6.9: Target countries of majority and minority acquisitions in brokerage and investment banking



Basis: 17 majority and 23 minority acquisitions between 1986 and 1991

Source: Appendix 1.

It is obvious that the UK with London as Europe's leading financial centre attracts the greatest entry activity in the area of brokerage, fund management and investment banking. The leading position of the UK is much more pronounced in majority than minority acquisitions which may reflect the requirement for most big European banks to maintain or acquire a definite presence in London. Minority acquisitions are significant in Spain which may reflect the cautious strategy of foreign entrants.

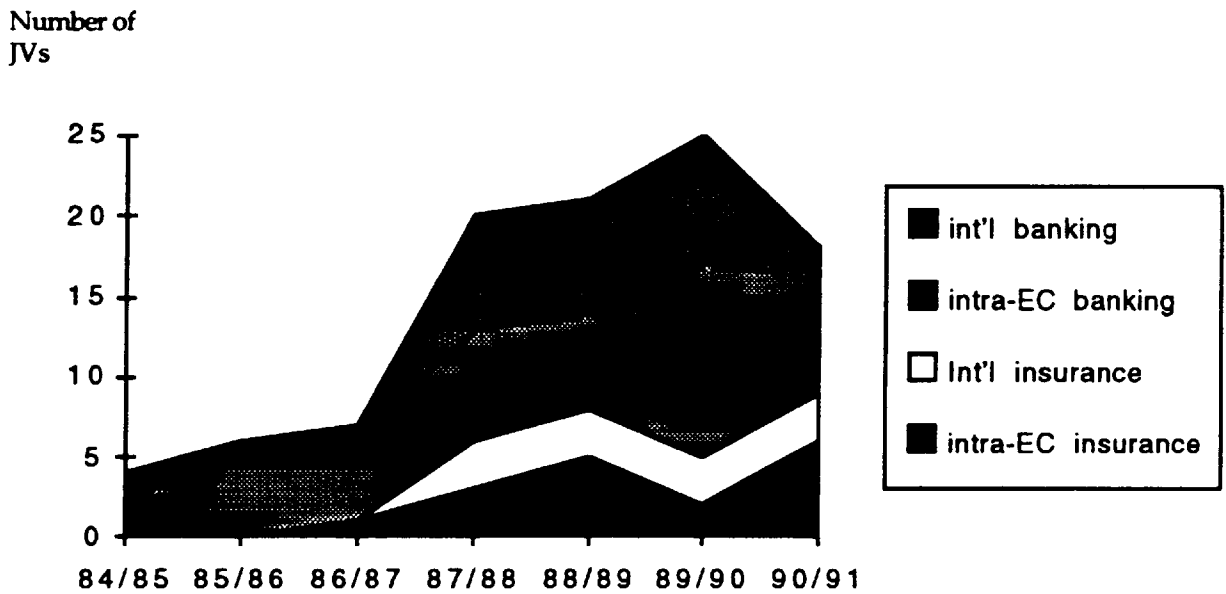
Finally, one can observe the conspicuous absence of countries with universal bank systems such as Germany from the list of target countries.⁷ Thus, foreign entrants who want to enter brokerage or investment banking services in these countries have to choose *de novo* entry, since there are few specialised firms which could be acquired in these countries.

⁷ Entry into the German market is made even more difficult by German company law which proffers the option of limiting voting rights, as was illustrated in the legal battle between German Aachener & Münchner Insurance and French AGF which held a 25 percent stake but was denied appropriate voting rights for a considerable period of time.

1.3. Joint Ventures

Cross-border joint ventures in European financial services play a less significant role in cross-border activities than cross-border acquisitions. Figure 6.10 reports the number of joint ventures from 1984 to 1991.

Figure 6.10: Cross-border joint ventures in EC financial services from 1984 to 1991



Source: EC Competition Policy Reports, 1987 and 1992.

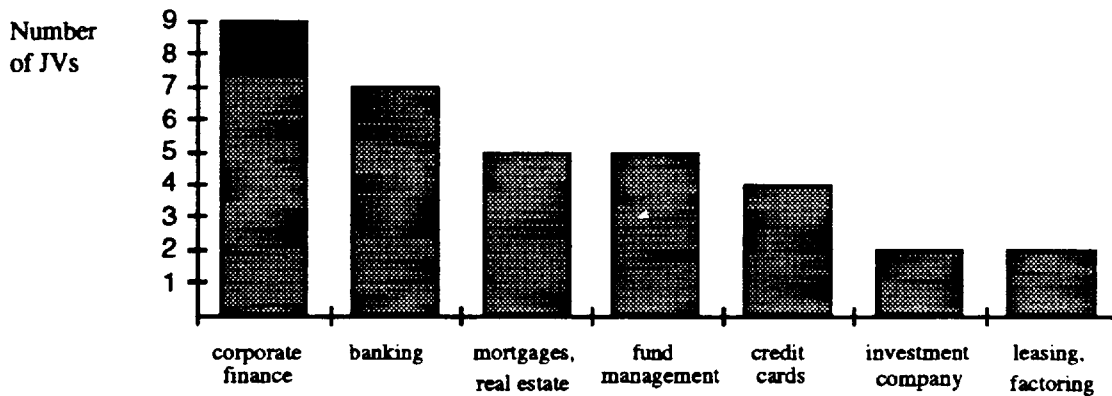
Nevertheless, the number of joint ventures in financial services is not significantly lower than in other industries. This may be surprising at first sight, since most industrial joint ventures are in the area of R&D, which plays only a minor role in financial services. Similar to cross-border acquisitions, there was a greater number of JVs in the banking sector than in the insurance sector.

The database listed in appendix one contains 34 joint ventures of the 60 largest European banks between 1986 and 1991. A classification of the main area of the banking JVs is shown in figure 6.11. It illustrates that the greatest number of JVs are in the area of corporate finance including merger and acquisition services and buy-outs. A qualitative analysis of the JVs reveals that of the seven banking joint ventures, six are in non-EC countries, more recently particularly in Eastern European countries.⁸ This seems to suggest

⁸ Examples are the 1991 JV between Dresdner Bank and BNP which cooperate with Hungary's OKHB bank to provide trade and project finance in Hungary or the International Moscow Bank,

that banks preferably engage in general banking JVs to enter markets where they have not been present before, as this allows them to share the entry risk and to draw from common expertise.

Figure 6.11: Classification of joint ventures



Source: Appendix 1

Another popular area of cross-border banking joint ventures is credit cards where one bank may own a card logo and establishes a joint venture with other foreign banks to distribute the card and establish the processing facilities. Also the development of supra-national means of payments such as the Eurocheque system and ATM machines compatible to the EC-card are examples of joint ventures. One of the most widely used credit cards in Europe, the 'Eurocard' (Access in the UK) is also organised as a joint venture in some EC countries. In Germany, for example, a credit card company (GZS) was set up as a joint venture of the main German banks which each own a stake in the firm. This company was responsible for the marketing, distribution and processing of the Eurocard. Most recently, however, as the Eurocard has increasingly come under pressure from other credit cards both marketing and distribution were decentralised with each bank now selling their own version of the Eurocard. Processing, on the other hand, where significant scale economies are likely to favour centralisation is continued to be handled by the JV firm.

Concerning the number of participants, we find that a surprisingly high number of JVs have more than two stake-holders: 41 percent of JVs have three or more participants. This shows that banks are not deterred from entering agreements where ownership is not clearly defined and business policy always needs to be determined in cooperation with two or more partners in the JV.

a JV between Bayrische Vereinsbank, Credit Lyonnais, Banca Commerciale Italiana and other Western banks.

In the insurance sector there are 19 joint ventures recorded for the largest forty EC insurers. The vast majority of these JVs are in Italy or Spain and are between domestic banks in these countries and large insurers from the UK, France and Germany. I discuss an example of such a distribution alliance in chapter eight.

1.4. Strategic alliances and cooperations

Strategic alliances play a significant role in European banking, whereas they seem to play a smaller role in the insurance sector. In the insurance field we find a larger number of cross-shareholdings between the large European firms which may play a similar role to the alliances in the banking sector. Most cross-shareholdings are not accompanied by explicit alliance agreements, however, and are therefore difficult to evaluate.

Alliances in the banking sector are not recent innovations: the first European 'interest group' was established as early as 1968 with the aim of promoting international expansionary activities. Table 6.5 reports the member banks which are part of the three major co-operation groups in the EC. As is apparent from the table, these groups include most of the largest European banks.

Table 6.5: Member banks of European co-operation groups

<i>ABECOR</i>	<i>EBIC</i>	<i>Europartners</i>
<ul style="list-style-type: none">• ABN• BBL• Barclays• B. International• BNP• Hypo Bank• Dresdner Bank• Österreich. Land. Bank• Banca Nazionale del Lavoro	<ul style="list-style-type: none">• Amro• B. Commerciale Italiana• Creditanstalt Bankverein• Deutsche Bank• Generale Bank• Midland Bank• Societe Generale	<ul style="list-style-type: none">• Commerzbank• BancoHispano• Credit Lyonnais• Banco di Roma

Source: company reports, press clippings

The first co-operation group formed among European banks was *EBIC* in 1968. Its stated purpose was to help members expand internationally by forming five consortium banks in key geographic areas. Members also agreed never to compete in domestic retail banking against each other.⁹ From the 1970s to 1982 the group established own operations in London, New York and

⁹ This clause needed to be cancelled due to an order by the EC Commission on competition policy grounds.

the Pacific area. From 1983 onwards, however, various partners withdrew from the consortium banks to pursue their own activities, rather than continuing the joint efforts.¹⁰ The consortium banks therefore fulfilled the purpose of pooling risk in international expansion and gaining experience in new markets. As soon as individual banks discovered profit opportunities, however, they preferred to pursue non-cooperative strategies, competing directly in the new markets rather than continuing to collude in the form of the consortium banks. The consortium banks thus served a useful purpose in introducing member banks to new geographic markets, but outlived their usefulness as partners were able to set up their own operations based on the knowledge base acquired from the joint venture.

The *ABECOR* group was formed in 1974 as "a forum to study matters of mutual interests" to its partners. Activities have so far included working parties on country analysis, finance of international trade, computer systems and a joint training center.¹¹ The group has established joint branches in Tokyo, Singapore, Teheran and Hongkong. In addition, co-operation at the top management level has led to closer ties between individual members such as BNP and Dresdner which has led to share swaps and co-ordination of strategies (such as their joint failed bid for Yorkshire Bank).

The *Europartner* group which was formed in 1971, comprises two publicly owned banks (CL and Banco di Roma) and two privately owned banks (Commerz and Hispano Americano) which makes multilateral shareholdings difficult to achieve.¹² It established joint branches in Tokyo, Singapore, Sydney, Johannesburg and Mexico.¹³

These multilateral cooperation groups were mostly targeted at pooling resources to enter markets outside Europe. As soon as member banks discovered that they had accumulated sufficient know-how to pursue an

¹⁰ For example, Midland withdrew from European American Bank suffering from poor results in 1985, as a result of its Crocker acquisition; Deutsche left in 1989 and Generale in 1990, leaving Amro as majority shareholder. Amro also took over the European Banking Company in 1985 from its other partners. The European Arab Bank, suffering from poor results, was terminated in 1985. Midland, Italiana and Societe Generale withdrew from European Asian Bank which then sold out to Deutsche in 1987. Finally, Fuji acquired the European Pacific Finance Corporation.

¹¹ Recently, member banks together with EBIC members, three US banks, Credito Italiano and SE Banken have agreed to set up a European Clearing House in London to net foreign exchange contracts on a multilateral basis.

¹² Credit Lyonnais' offer to swap 4% of its capital for 20% of Hispano Americano was rejected by Hispano on the grounds that CL was interested in a takeover rather than in co-operation. The rejection prompted CL to acquire 83% of Banco Commercial Espagnol from Banco Santander.

¹³ Other groups include the Interalpha group including among others National Westminster, San Paolo di Torino and Kredietbank and the 1990 cooperation agreement between the European savings banks.

independent strategy, they withdrew from the alliance. Nevertheless, the multilateral agreements formed the basis for the successive type of alliance which are mostly bilateral. For example, Dresdner Bank and BNP and Commerzbank and Hispano Americano formed bilateral alliances which had their roots in the multilateral cooperation groups.

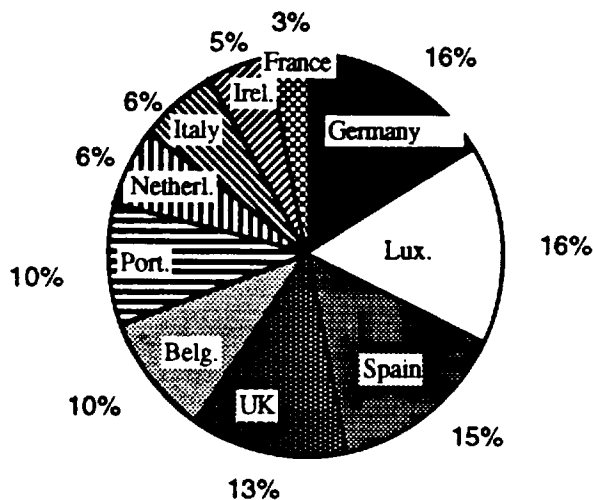
Another significant change from the multilateral groups is that today's alliances are no longer exclusively focused at markets outside Europe. In contrast, they frequently concern the countries of the contracting partners directly such as in distribution alliances.

The database lists 34 cooperative agreements between the largest sixty EC banks in the time period from 1986 to 1992. Of these, 35 percent were general strategic alliances often accompanied by share swaps or mutual stakeholdings. 41 percent of these cooperative agreements concerned only a specific area such as mortgages or M&A services. Finally, 24 percent of cooperative agreements are aimed at providing reciprocal assistance to clients, for example, by enabling customers to use the branch network of the cooperating bank in the foreign country or by assisting corporate clients in providing information about the foreign market.

1.5. De novo entry

Direct representation in a foreign country through opening a representative office, branch or subsidiary still constitutes a significant route of entry. The database lists 59 new openings and 5 upgrades from representative office to branch or from branch to subsidiary for the sixty largest EC banks from 1986 to 1992. However, almost none of these de novo entries were in the area of retail banking, but most were in the area of corporate or investment banking. From the data collected for the insurance sector it appears that de novo entry was a lot less common in insurance than in banking over the respective time period. Nevertheless, those de novo activities taking place in the insurance sector were frequently in the retail sector. Figure 6.12 analyses the distribution of target countries of the banking *de novo* entry activities.

Figure 6.12: Target countries of *de novo* entry activities of EC banks



Source: Appendix 1

The figure shows that Germany and Luxembourg lead the ranking. This needs to be assessed in relation to acquisition activity. Cross-border acquisitions into Germany are relatively rare in the corporate and investment banking sector due to lack of suitable targets and barriers to entry resulting from the universal banking system. Nevertheless, as Germany is the largest economic power in the EC, representation in this market is important and *de novo* entry is a more feasible route of entry than acquisition. Luxembourg, on the other hand, provides a particularly favourable regulatory and tax environment and it is therefore significant to have a subsidiary in this country. Spain which only recently relaxed entry barriers has been subject to much *de novo* entry activity as foreign bank representation had been comparatively low before 1986.

2. Cross-Border entry activities into the EC by non-EC firms

2.1. Entry into the EC by US financial services firms

US banks were the first to enter the European countries and induce the process of multinationalisation of the banking industry in the 1960s. The large US commercial banks differed in their selection of entry approaches to the European market. The biggest bank Citicorp operated largely through greenfield entry in the wholesale area and through acquisition in the retail area. In the words of a Citibank official (Huertas, 1990, p.255):

"Citicorp's expansion into foreign markets took the form of wholly-owned branches or subsidiaries. Few joint ventures were tried. Nor did the company take significant minority positions in many foreign banks. The clear preference was for complete control, and the exceptions to that rule tended to end in failure (from Citicorp's point of view)."

This strategy which is similar to the current EC strategies of Deutsche Bank and Barclays Bank (see next chapter) contrasted with that of the second-largest US bank, Chase Manhattan. This bank primarily engaged in joint ventures with local banks in Austria, Belgium, Ireland and the Netherlands, while pursuing greenfield entry in Greece and Italy (Wilson, 1986).

In general, European retail operations of US banks were mostly unsuccessful, while these banks play a much more significant role in wholesale and investment banking. Attempts to penetrate the UK retail market through greenfield entry by opening so-called money centre boutiques in the 1970s ended in failure as domestic banks were quick to emulate the American banks product and service strategies. Ever since, this example seems to have deterred not only American banks but also other multinational banks to try to enter mass retail banking through *de novo* entry.

Despite the emerging vision of the internal European market, US banks have recently engaged in substantial divestment or withdrawal in their European operations in the second half of the 1980s. While this was partly motivated by lack of success, it was primarily the need to raise capital which induced the US banks to sell off some of their (successful) European operations (Bank of America's sale of Banca d'America e d'Italia to Deutsche Bank or Chase's sale of its Belgian operations to Credit Lyonnais). In conclusion, considering the substantial difficulties of the large US banks in their home market, it seems that they will play a less significant role in the Europe of the 1990s than they have done in the previous three decades.

US insurers have also played only a marginal role in the European countries. Life insurers have traditionally been inward looking and have virtually no presence in Europe. The only exception is Metropolitan Life of New York, the second-largest US life company, which set up a joint venture with Spanish Banco Santander in 1987. The joint venture, Seguros Genesis, which distributes life insurance products through the Santander's branch network has grown substantially and now belongs to the largest ten life insurers in the Spanish market. In addition to this joint venture, Met Life acquired the UK insurer Albany Life in 1985. Since acquisition, revenues have risen by 90 percent and assets under management have doubled to \$2 billion in 1990.¹⁴

¹⁴ The fourth-largest US life insurer, New York Life also acquired a small UK insurer, Windsor Group which comprises Windsor Home Loans and a life insurance subsidiary with total assets of £150 million. Other acquisitions of major US insurers have so far not taken place.

Non-life US insurers have entered the European market only on a slightly more significant scale.¹⁵ Still, the extent of the European presence is in no way comparable to the presence of US banks in investment banking. The 'follow the customer' movement was at lot less pronounced in insurance than in the area of corporate banking.¹⁶ Among the companies represented in Europe are the American Insurance Group (AIG) which has by far the largest presence and the most explicit expansion plans in Europe. The group has set up a central European subsidiary called UNAT in Paris to coordinate its European strategy. Its strategic focus is on commercial clients in Europe, in particular on multinationals where the group believes to have a competitive advantage due to its wide international presence. In the UK, AIG is also active in the middle corporate market through its ten regional branches which serve brokerage firms. The life insurance subsidiary of AIG, the American Life Insurance Company (ALICO) has centralised its activities in Paris and plans to expand across the EC after having obtained licenses for most European countries. In Greece, ALICO is the largest international life insurer. Most other US insurers do not have a European presence and currently do not seem to have plans to enter the EC markets.

2.2. Entry into the EC by Japanese financial services firms

Japanese banks were the latest entrants into the European markets. Their entry activities are almost exclusively focused on non-retail financial services, however. The late entry resulted from the regulatory restrictions which the Ministry of Finance imposed on domestic banks until 1971. With the exception of the Bank of Tokyo, domestic banks were not allowed to open branches or subsidiaries in overseas markets. As these restrictions were lifted, the Japanese banks began an unparalleled expansion into foreign wholesale markets. In Europe the main target countries were the UK, being the host of Europe's biggest financial centre and the target of significant Japanese FDI, and Germany where Japanese multinationals have significant export business and also undertook substantial investment. The reasons for entry into these two countries differed, however. While Japanese banks mainly serve Japanese corporate customers in Germany, they additionally attempt to penetrate the local market for medium-sized firms in the UK. For this purpose, Sumitomo, Mitsubishi and Sanwa have opened representative offices in UK cities besides London.

¹⁵ US insurers were some of the earliest entrants into Europe; in 1889 four US insurers accounted for more than 20 percent in the growth rate of the German life insurance market, for example. These firms had to cease trading in 1894/95. however, as they could not satisfy regulatory requirements laid down by the German authorities (see Kuerble, 1990).

¹⁶ Schroath and Korth (1989, p.632), for example, conclude that "a notable exception to those US service industries following their domestic customers abroad was the US property and liability insurance industry."

It is noteworthy that the Japanese banks almost exclusively entered by greenfield entry in Europe rather than through acquisition, joint venture or alliance. This can partly be explained by the preference of Japanese companies to enter through internal growth rather than acquisitions (see Odagiri and Hase, 1989). When analysing entry of Japanese banks into the UK securities industry, for example, Dueser (1990, p.120) notes that "... instead of buying into well-established broker and jobber firms (they certainly had the financial resources for it and many of their US and European competitors did buy British firms) they increased the capitalisation of their subsidiaries, took on new staff and widened their scope of financial instruments."

When entering international banking in Europe, Japanese banks followed a simple approach to create a competitive advantage: they operated with lower margins than their European and American competitors and cut prices to what some Western bankers have charged to be dumping levels.

So far, Japanese banks have completely abstained from entering European retail business. The only exception so far is the UK corporate market for medium and even small firms. Between 1977 and 1983 Japanese banks doubled their market share of UK domestic lending, but did not manage to further increase their share until 1987 (Dueser, 1990, p.121).

Germany has been the second most important target country of Japanese banks. In contrast to the UK, however, they have so far not been able to penetrate the local market to a significant degree. More than 60 percent of customers come from Japan, and only an estimated 5 percent of big German companies maintain a banking relation with a Japanese bank.

As Dueser (1990, p.166) comments "Japanese banks' chances in the market segment of small- and medium-sized Western European companies seem slim...". Interviews with Japanese bank officials revealed no intentions to enter European retail markets in the foreseeable future. More recently, the difficulties of the Japanese banks to meet the BIS guidelines on capital adequacy, which were at least partly designed to eliminate the competitive advantage of the Japanese banks due to their lower required capital ratios,¹⁷ as well as the dramatic decline in the Japanese stock market have led to a more restrictive approach to international expansion.

In the insurance sector Japanese firms have so far only followed their commercial customers into European markets but have not been active in the retail segment. Similar to the banking sector, the Japanese insurers have entered mainly by setting up branches or representative offices in the EC countries rather than by acquiring domestic firms. The penetration process of the European insurance markets of Japanese insurers is less advanced than for the banking sector, however, as they serve almost exclusively Japanese

¹⁷ A significant motive of the harmonisation measure was "... to remove an important source of competitive inequality" (BIS, 1987, p.1) which is most likely to refer to the Japanese banks.

clients from their home markets and have not started acquiring domestic customers in their host countries.

2.3. Entry into the EC by other non-EC financial services firms

Among the other firms which have entered the EC market on a significant scale are the Swiss banks and insurers. While the 'big three' Swiss banks operate primarily in the corporate sector, the Swiss insurers have actively penetrated the retail sector in other EC countries. Winterthur, for example, holds a strong position in Spain where it is the fourth-largest non-life and life insurer in terms of premia and the largest foreign insurance company. Similarly, Zurich insurance is among the largest fifteen non-life insurers in the Italian market. In the German market, the Swiss insurers have a market share of 8.7 percent in life and non-life business.

Two of the largest acquisitions in the UK market were undertaken by Australian firms: Australian National Bank acquired Yorkshire Bank in 1990 for a purchase price of £976 million. Yorkshire Bank has 247 branches and assets of £3.2 billion. The acquisition makes Australia National the largest foreign retail bank in the UK, as it had already purchased Clydesdale Bank and Northern Bank which when merged with Yorkshire results in a branch network of more than 700 branches and is thus the seventh-largest bank in the UK overall. Australian Mutual Provident, by far the largest insurance group in Australia and New Zealand with a domestic market share of more than 30 percent, purchased the Pearl Group for £1.24 billion in 1989 which has a market share of 3 percent in the UK market. When merged with London Life, an earlier acquisition of the Australian group, it will command a total market share of 5 percent in the UK market.

3. Conclusions

In this chapter I have provided an aggregate overview of cross-border entry activities in the EC. Concerning the role of cross-border provision of services, I have shown that exporting constitutes only a fairly insignificant amount of total services trade, where extra-EC trade plays a slightly more significant role than intra-EC trade. These data show that exporting of financial services will play a limited role even in a fully liberalised internal market. This is likely to stem from the fact that close supplier-buyer interaction is required in financial services in particular in the retail sector which is still difficult to achieve across national frontiers.

Most of the succeeding analysis on acquisitions, alliances, joint ventures and de novo entry was based on an original database collected for the largest sixty European banks and the largest forty insurers for the period from 1986 to the beginning of 1992. A comparison of cross-border acquisition activity in financial services with that of other industries in the EC reveals that the

financial services industry is particularly active in this area with the number and disclosed value of transactions exceeding those in other industries.

An analysis of acquisitions in EC financial services since 1975 suggests that there has been a significant increase in transactions, especially since 1986. Whether this rise is due to the plans of establishing a single European market in financial services remains a hypothesis to be tested in the next chapter, however, where firm-level data provide an insight into the motives for cross-border entry strategies. The number of minority acquisitions exceeds those of majority acquisitions both in banking and insurance. The most recent decrease in cross-border acquisitions seems to suggest that most firms have already undertaken their European expansion plans in preparation of the internal market, however. The recent decrease in cross-border transactions just one year before the scheduled completion of the internal market seems to suggest that much of the '1992'-induced activities have been completed and one is therefore unlikely to expect a significant increase in activities in the next year.

Joint ventures play a less significant role than cross-border acquisitions but account for a similar proportion of total cross-border entry activities as in other industries. JVs in the banking sector are mostly in the corporate finance sector, while in insurance there are a number of distribution ventures where a firm from a Northern European country uses the retail network of a bank in a Southern European country to distribute insurance products.

Strategic alliances have been a common form of cross-border cooperation for some time, especially in the banking sector. Recent evidence suggests that such agreements have become increasingly popular, as a less costly alternative to a majority acquisition. In particular, multilateral alliances have been replaced more and more by bilateral alliances. In the insurance sector, strategic alliances are mostly in the area of distribution.

Finally, de novo entry activities still account for a large number of cross-border entry activities of European banks but almost exclusively in the area of corporate and investment banking, while being less common in insurance. Those de novo entries taking place in insurance are also in the area of the retail sector, however.

Entry by non-EC institutions has so far been targeted mostly at the market for large corporates and institutions. This process has been much more advanced in banking than in the insurance sector where US and Japanese firms play only a marginal role. US banks which were the first to start a significant cross-border penetration move in Europe are now frequently divesting partly due to significant problems in their home market and partly due to lack of success in European markets. Of the large US banks only Citibank retains a conspicuous presence in European retail banking and this bank's strategy will be discussed in the next chapter. The Japanese banks have so far not made attempts to penetrate European retail banking with the only exception of the UK market where they have entered the small and

medium-sized corporates market. It is noteworthy that they have entered almost exclusively through de novo entry rather than acquisitions. Neither US nor Japanese firms are likely to play a significant role in European retail financial services in the foreseeable future, however.

Chapter Seven: Cross-Border Entry in European Retail Banking: Interview Evidence and Case Studies

There are several conceivable approaches to collecting empirical evidence on the determinants and effects of cross-border entry in financial services in order to test the hypotheses developed in the preceding chapters. For the case of acquisitions, for example, one such approach would be to collect data of a random sample of cross-border transactions and pursue a statistical analysis of characteristics of acquirer and acquired firm over time. Considering the relatively low number of cross-border acquisitions in particular in retail financial services, however, the population size would most likely not be sufficient to draw statistically valid inferences. In addition, a purely statistical approach would miss out on many of the details which can only be insufficiently captured by an exclusively quantitative approach.

Therefore, the approach chosen in this chapter to test the hypotheses developed in the theoretical section is two-fold: first, I undertook a series of interviews with a sample of the largest EC banks, in particular with those banks which are actively engaged in cross-border entry activities in the retail area. The results of these interviews are presented in the next section.

Next, I identified the most important cases of cross-border entry in the form of cross-border acquisitions and alliances. These were then analysed in greater detail through firm-level interviews and are reported on in the form of case studies. As Tirole (1988, p.4) notes:

“industrial organisation theorists have often felt more comfortable with case studies* than with statistical analysis - perhaps because it may be easier to recover the industry’s basic conditions and behavior from rich case studies than from selective statistics ...”.

In view of the complexity of strategies and impact of cross-border entry activities, such a case-study approach indeed seems to be the most suitable method to uncover the internal events of the banks involved.

1. Cross-border entry in the EC: evidence from focus interviews

1.1. A note on research methodology

In the previous chapter data on the cross-border entry activities of the largest sixty EC banks were collected which formed the basis for aggregate analyses. Clearly, such an aggregate view encounters limits when attempting to gain an insight into the basic determinants and the impact of cross-border strategies of banks. I therefore decided to undertake an in-depth firm-level analysis to gain additional information on the basic determinants of cross-border entry activities.

While the next section contains detailed case study analyses, this section presents evidence from a range of interviews which were undertaken with a sample of the largest EC banks. While interviews are a common method of undertaking empirical research in many of the social sciences, they are still fairly uncommon in economics. In economic science, the most common approach is to translate a theory into a statistically testable form and subject the data to econometric scrutiny. For our purposes, such an approach seems unsuitable for two reasons, however: first, most of the hypotheses which are to be tested are difficult to formulate in purely quantitative terms. For example, if foreign banks offer higher quality services this is hard to quantify. Second, the population of banks which engage in cross-border activities especially in retail banking is too small to make sophisticated statistical analysis worthwhile. For these reasons, it was decided to undertake a range of interviews to get a richer understanding of the complex determinants of cross-border entry activities.

The interview method, however, is viewed with some suspicion in the economics profession. Blinder (1991, p.90), for example, notes that "economists are skeptical that you can learn much by asking people". This skepticism is best exemplified by the 'billiard player' analogy of Friedman (1953) who argued that a theoretical physicist is able to explain better the nature of the billiard game than the player. As Shiller (1991, p.97) notes, however, the "overliteral interpretation" of this analogy has led many scientists to repudiate the approach of ever asking economic agents directly about their behaviour. In contrast, Shiller (1991, p. 97) holds that

"it would be a disastrous mistake to ask a physicist to model the behavior of a billard player without allowing the physicist to get the player's help in the modeling process. The physicist will not understand the strategy of the game, will not know what the player's short-run objectives would be on a given shot, and will likely omit considerations ... that may be difficult to theorize about or about which the physicist does not have full information."

The most important objection to interviews is that economic agents in interview situations may not tell the truth or reveal their true objectives. This problem appears especially severe in situations where agents have an

incentive to hide their true intentions. It is hardly conceivable, for instance, to try to explore the area of predatory pricing by directly asking firms whether they price below costs to squeeze out other firms in the market. Equally hopeless would be the attempt to discriminate between mergers for market power and efficiency by directly asking the companies concerned, since they have every incentive to conceal a market power strategy in the presence of anti-trust laws.

For the area of cross-border penetration in financial services, however, firms have no particular incentive to conceal their true strategic objectives, since the questions asked do not concern areas where firms would have to fear anti-trust scrutiny. In addition, none of the questions asked related to secret or sensitive areas of firms' strategy. Blinder (1991, p.90) addresses this issue when justifying his own research approach to collecting empirical evidence on price stickiness and notes that "as long as people are not pathological liars, interviews may elicit useful information". And further he notes that:

"The imperfect knowledge we can pick up from interviews and questionnaires should not be compared to some epistemological ideal, but to the imperfect knowledge that nonexperimental scientists can deduce theoretically or glean from econometric studies. By this more reasonable standard of evidence, data culled from interviews certainly look admissible."

Once the interview approach was decided upon, it was necessary to decide between formal and semi-structured interviews. Formal interviews are characterised by the fact that the wording and sequence of questions asked are standardised and that the interviews are conducted in a uniform way. Formal interviews have the advantage that they reduce interviewer's bias which may occur in informal interviews where different interviewers phrase questions in different ways and stress different points. Since I did all the interviews myself, such interviewer bias in informal interviews was reduced anyway, however, and therefore one of the main advantages of formal interviewing would not obtain. In addition, considering the complexity of the topic under scrutiny which requires a significant degree of probing, pre-set questions in a pre-determined order seemed too inflexible an approach.

At the other extreme, non-directive interviews are characterised by a lack of set questions and there is no pre-determined schedule of asking or recording questions. While such an interview approach allows maximum flexibility, it has the major drawback that the answers of the respondents are hardly comparable due to differing question sets. Thus, non-directive interviews may provide useful background information for the study but do not permit a comparative analysis of the collected information.

To give the interviews a basic structure and to ensure that all respondents were asked the same core set of questions, I decided that the

'focus' interview is the most suitable approach. Focus interviews are a compromise solution between formal and non-directive interviews. They have a semi-structured form, characterised by a degree of standardisation where a number of pre-set questions are asked in exactly the same way and order (see, for example, Moser and Kalton, 1979). In addition, there is a list of topics which need to be covered and which are in the form of open questions whose order can be adapted by the interviewer. Finally, and most importantly, the interview is *interactive* such that the interviewer has complete freedom to probe further, ask supplementary questions and focus on points which the respondent mentions or neglects in her answer. Thus, the interview takes the form of a dialogue, rather than being a rigid question-answer exercise. As Moser and Kalton (1979, p.298) note, a focus interview has the advantage that it "gets away from the inflexibility of formal methods, yet gives the interview a set form and ensures that all the relevant topics are discussed". In addition, semi-structured interviews "can 'dig deeper' and get a richer understanding than the formal interview" and result "in a fuller and more rounded picture than is attainable by formal methods" (Moser and Kalton, 1979, p.299/300).

The obvious drawback of focus interviews is the difficulty of analysing and quantifying the obtained data. These difficulties result from the fact that the answers are not necessarily comparable and that the type of questions asked does not easily lend itself to statistical analysis. Nevertheless, these objections do not disqualify the approach, since it is exactly the intention of focus interviews to dig deeper where statistical analysis reaches its limits. As Moser and Kalton (1979, p.301) note "if this gain (of informal interviews) is not to be sacrificed, the analysis must retain a fair amount of detail and not merely be compressed into a series of statistical tables".

As was discussed in the previous chapter, the population of banks which actively consider undertaking cross-border entry in retail services is limited to approximately the largest sixty EC institutions. Our sample is by no means statistically representative of this population, as it is limited to the largest banks in Germany, the UK and France. However, as it is almost exclusively banks from these countries which are expected to make a significant impact in the EC, the interviews cover the most significant actors in the area of cross-border activities. They aim to convey an impression of the general view among bankers about the impact of regulatory changes in the context of the internal market programme and in particular about the significance of cross-border entry and the current and potential future role of foreign banks.

Rather surprisingly, the response rate of banks turned out to be 100 percent. None of the banks which were addressed refused to grant an interview.

1.2. Interview results: summary and analysis

The first set of questions addresses the expected impact of the internal market programme on the banking industry. It was unanimously agreed that the '1992' programme has little to no impact in the market for large corporates, multinational firms and financial institutions, as this sector is already characterised by intense competition on an international scale. A National Westminster official is representative of the general opinion when stating that "in this market everything concerning internationalisation has already taken place. It can easily be described as one of the most international markets in the world". Several bankers explained that as an orientation the biggest 500 companies in each country are targeted as potential customers for its foreign branches. All bankers noted that the largest firms and institutions in each country maintain relationships with several domestic and foreign banks and that they operate in international wholesale markets which are already largely unrestricted by national boundaries. This confirms our decision not to analyse this market, as it is largely internationalised already.

In the markets for small and medium-sized corporates the impact of internationalisation is viewed to be more significant. This stems in particular from the fact that this market has so far been largely untouched by foreign banks due to the lack of an adequate distribution network and a higher perceived risk. In addition, these corporates may be most affected by European market integration, as those firms which have so far been largely domestic operators may go through a transformation process by expanding business coverage to other European countries. For such an internationalisation process they require banks' assistance when entering foreign markets which opens market opportunities for both domestic players which can provide foreign services as well as foreign banks from the countries which are to be entered. Thus, bankers expect to some extent a repetition of the internationalisation movement which has already taken place for the largest corporates. Even though the middle market is therefore perceived as offering significant profit opportunities, foreign banks are frequently deterred by lack of know-how. A Commerzbank official explains:

"the middle market has significantly higher margins, but at the same time the associated risk is substantially higher as well, since foreign banks mostly lack intimate knowledge of the local market."

In order to penetrate this market successfully it is therefore seen as vital to acquire the necessary know-how either by recruiting experienced personnel in the host market or by acquiring indigenous institutions which are experienced in the target sector.

Concerning the mass retail market there is also perceived to be significant potential for increased cross-border penetration. At the same time, however, bankers acknowledged significant barriers to entry stemming primarily from the difficulty of obtaining the right distribution channels due

to lack of suitable acquisition targets and the limited suitability of cross-border provision of services in most retail services. Increased cross-border penetration was thought to be more likely for those products which are to some extent separable from the banking product bundle such as card-based products and also mortgages. It was estimated that by the year 2,000 increased cross-border penetration in retail banking will play a more significant role with a few of the largest European banks having established a presence in the most important regions. To guard against these major European players mid-sized banks will enter an increasing number of cross-border alliances, as they lack the financial resources to pursue acquisitions on a large scale. It was also seen as likely that once the European corporate law framework is in place, there may a range of cross-border mergers between mid-sized institutions.

Countries which were judged to be especially interesting for cross-border entry activities were Spain, Italy and France. Bankers from the UK and Germany expected little increase in competition in their home market from increased cross-border entry activities, especially since the two markets are already characterised by free capital flows and no explicit regulatory barriers to cross-border entry by foreign institutions. Thus, foreign banks which want to enter these countries have probably done so already, as entry has been largely unrestricted.

Banks use different criteria when assessing the 'attractiveness' of a foreign market in the retail banking area. High margins were mentioned most frequently as being the main criterion for evaluating cross-border entry opportunities. Nevertheless, additional criteria come into play. As a Dresdner Bank official explains:

"High margins alone do not make a market attractive. If you base your entry decisions only on the level of margins, you may be stuck in a market with little potential, once these high margins are competed away. Thus, high margins represent short-term phenomena, whereas a bank should base its cross-border entry decision on long-term criteria"

This statement has as an implicit assumption that 'hit-and-run entry' in retail banking is not possible due to significant sunk costs. This confirms the view that retail banking can hardly be considered to be a contestable market.

The procedure followed at Dresdner Bank, for example, to determine attractive foreign markets for cross-border entry activities in the retail sector includes an analysis of GNP, income and savings level per head on a regional rather than a country basis. All regions which have at least the level of the lowest regional per head income in Germany are considered potential candidates for cross-border entry. Such an analysis leads to a map of

'interesting' European regions, stretching from the Scandinavian countries over the UK, Germany and France to northern Italy.¹

While most bankers were aware of the general principle of the home country rule, only few were familiar with its legal details, in particular concerning the possibility of offering products in other EC countries under the home country regulatory regime. None of the banks have (yet) developed specific plans for incorporating extended product and branching possibilities in their strategic planning in order to exploit the opportunities offered by the home-country rule.

2. Case studies of cross-border majority acquisitions

The starting point for the empirical analysis of cross-border majority acquisitions is Williamson's query (1975, 1985) if it is possible to merge two firms and improve performance by operating them as before except for selective intervention in areas where integration is likely to be profit-enhancing. The frequently disappointing results of industrial mergers and acquisitions seem to suggest that such a simple procedure is not always feasible.² This may be the result of limits to firm size which makes intra-firm organisation increasingly costly, due to diminishing returns on management. Alternatively, there may be problems in combining two different corporate cultures which hinder a strategy of selective intervention.

In addition to this problem of selective intervention, the case studies focus on the following four main questions:

- generally, what are the main motives for cross-border entry in banking?
 - more specifically, does entry occur to quickly gain a foothold and acquire market share in foreign markets, reap the benefits of size economies, or exploit profit opportunities in inefficient markets?
 - or are such transactions aimed at acquiring foreign competitors, strike a pre-emptive position against takeover attempts or reduce competition through collusive agreements?

- are cross-border transactions 'successful' in the sense of achieving the main motives (e.g. synergy benefits, gain market share in foreign market) for which they were pursued?

¹ In terms of this analysis, Spain would not be an interesting market for cross-border entry. Nevertheless, as the Spanish economy has significant growth potential, it is usually included in the category of target countries.

² See, for example, Meeks (1977) and Ravenscraft and Scherer (1987, 1989) for empirical evidence on the frequently disappointing results of industrial mergers.

- in which areas lie the main problems of these combinations (e.g. different corporate cultures which need to be reconciled)?
- what is the impact, if any, on competition, structure and conduct in the domestic market?

When approaching these questions a first step was to assemble publicly available data on the transactions from business papers and industry reports. A second step then consisted of contacting the banks directly and acquiring information through company documents (e.g. annual reports) and, as the final step, interviews at the corporate level with the institutions involved.

Such an analysis goes further than most previous empirical studies which mainly rely on financial data to assess the success of acquisitions³ and are almost exclusively focused on industrial rather than service sectors. Financial studies are unable to reveal the actual motives and causes of cross-border entry, however, since they do not uncover the internal firm processes and strategies which have preceded and followed the transaction.⁴ The following empirical research is intended to be a contribution towards elucidating these internal events of the bank.

2.1. Deutsche Bank's acquisitions in Italy and Spain

2.1.1. Deutsche Bank's European strategy

Deutsche Bank (DB) is the largest and most profitable German bank and the eleventh-largest bank world-wide in terms of capital in 1990. It is the classic example of a German universal bank with its line of business ranging from standard retail banking, with more than 1,000 domestic branches, over wholesale and merchant banking, such as underwriting and stocktrading which constitutes half of its activities, to life insurance which the bank entered as the first of the three large German commercial banks in 1989.

DB is the biggest retail bank in Germany with the greatest amount of saving deposits and mortgages. Nevertheless, due to the significant role played by savings and cooperative banks its market share in retail banking is only about five percent. However, DB plays an important role in security transactions where it accounts for approximately 20 percent of settlements and foreign trade finance where it is estimated that it settles almost a quarter of all of Germany's international trade activities. Moreover, DB has significant influence in German industry through direct equity participations

³ Notable exceptions are the studies by Ravenscraft and Scherer (1987) and Cowling *et al.* (1980).

⁴ Caves (1989) provides the most recent summary of the existing financial evidence and tries to explain why *ex ante* excess return studies come to more optimistic conclusions concerning value creation in acquisitions than *ex post* profitability studies.

(e.g. 28 percent stake in Daimler-Benz), representation on more than 400 supervisory boards and the *Depotstimmrecht* where individual security holders delegate to their bank the right to represent them in the annual meeting.

Originally founded in 1870 to provide an alternative to the dominant British overseas banks (see Hertner, 1990, p.102), DB today has around 300 offices in 60 countries and 20 percent of its total work force of 67,000 employees work abroad. Foreign operations account for almost 40 percent of assets and contribute 33 percent of revenues.

DB has pursued an extensive internationalisation process in the past six years. In 1986 it acquired Banca d'America e d'Italia from Bank of America and in 1989 it purchased Banco Comercial Transatlantico in Spain and Morgan Grenfell in the UK. I focus here on the former two acquisitions as they are in the area of retail banking, whereas Morgan Grenfell is exclusively engaged in investment and merchant banking activities.

With its aggressive expansion strategy in Europe, DB has taken the lead not only among its German competitors of which none have engaged in any significant foreign acquisitions, but also among European banks: it is estimated that DB has spent the most resources of all European banks for its expansion activities in Europe.

The main strategic objective of DB for entering other European markets is to defend its position in Germany as well as reducing the variability of income through diversification. The strategic rationale of DB is summarised by the speaker of its Board of Directors, Hilmar Kopper (1989) who states that "the more national your business today, the bigger the danger ... so anyone who wants to maintain his home market position in the long run must expand into the European internal market". DB has set the objective to operate in all European wholesale markets with special emphasis on investment banking and corporate finance services. In addition, it enters the retail banking sector "in countries with strong potential" which are mainly Italy and Spain where acquisitions were already made and France where the bank is still searching for an adequate acquisition target.

Deutsche's preferred mode of entry is clearly through acquisition. As Kopper explains: "we understand acquisitions as a chance to build up positioning advantages which the competition cannot match in the short term". In a personal interview, a Deutsche Bank official further explains that alternative means of cross-border entry and in particular joint ventures and strategic alliances are unlikely to be employed. The distaste for joint ventures stems at least partly from "frustrating experiences" in the previous JVs in which Deutsche Bank was previously involved. These were the European-American Bank & Trust Company and the European Asian Bank where DB finally decided to buy out the other JV members due to "perpetual in-house quarreling". One particular problem mentioned was the difficulty of apportioning the customer base after the joint venture runs out. Strategic

alliances are repudiated by Deutsche due to their low profit potential and perceived difficulties of cooperation. As Kopper (1990, p.69) explains: "according to our experiences, there is little inclination to cooperate closely in multilateral alliances".

Economies of scale and scope feature prominently in the strategic vision of Deutsche. It aims to pursue a strategy of "pan-European marketing" which refers not only to the organisational centralisation of research and product development, but in the words of Kopper also concerns "supranational development of selected customer and product groups through European brands with central production". Additionally, "the adaptation of diverse EDP systems in the larger market and the joint European development and use of know-how" are expected to lead to "higher efficiency, cost digression and ultimately lower prices". DB identifies the "upmarket services sector" as having a particular potential for size effects on a European scale. Examples of this market include money and asset management and M&A services. Evaluating this strategic approach, it seems doubtful whether these projected scale effects will ever play a significant role in mass retail banking. As new product development is comparatively scarce in retail operations, the beneficial effects of "central production and R&D" are likely to be negligible. We have seen in chapter five that the empirical evidence does not seem to confirm the significance of scale economies. In addition, potential synergy effects in the area of retail banking seem minimal. Thus, they do not constitute sufficient economic justification for large-scale European acquisitions. The expected benefits of scale economies in Deutsche Bank's European strategy may therefore likely turn out to be elusive.

2.1.2. Banco Comercial Transatlantico

In 1989 DB increased its stake in Spain's Banco Comercial Transatlantico (BCT) from 39 percent to 67.2 percent and further to 96.9 percent in 1990. BCT is mainly a retail bank with 106 branches and 1,800 employees. BCT had originally been founded and was fully owned by Deutsche Bank before the Second World War but was then confiscated by the Franco regime after the war. DB had made repeated attempts to increase its stake in BCT to a majority holding but until March 1989 was frustrated by the Bank of Spain and the Economics Ministry which viewed any acquisition of domestic institutions by foreign banks as a threat to the other indigenous banks.

Soon after its acquisition DB began to implement a programme for BCT which is supposed to fundamentally reform some areas of the bank over a three-year period. The strategic vision for BCT is that of a universal bank structured similar to the German paradigm. Following this concept, new subsidiaries were founded which include an insurance company and a consulting firm. In addition, a financial institutions group was established in close cooperation and with know-how transfer of DB headquarters to provide specialised services to these institutions. The whole group now

offers a range of financial services from the traditional banking services over real estate to leasing and corporate banking.

Concerning the integration of BCT into the Deutsche Bank group, the degree of internationalisation of BCT is planned to be increased significantly. This has already had some effect on the bank's balance sheet. Loans to foreign entities increased from PT156 million in 1988 to PT 2.8 billion in 1990, while liabilities to foreigners rose from PT28 billion to PT 67 billion in 1990.⁵ Not surprisingly, particularly direct and portfolio investment in Germany has risen substantially due to the new links between BCT and its mother company.

In addition to a broadening of the product range and refocusing international business, substantial investments were made in updating the bank's technological position with the aim of reducing operating costs. As Hilmar Kopper (1990, p.71) explains: "Considering the increasing level of competition and resulting lower prices, the relative cost position of a bank becomes more and more important". In particular, investments in information technology were made with the aim of a "nearly complete renewal of the current technology". These include purchase of personal computers for branches, the development of a customer database and the expansion of the ATM network (only eight machines were in operation in 1989 even though Spain has the highest density of ATMs per person in the EC).

This strategy of investing heavily in technology provides some evidence that a formerly relatively inefficient bank is being made more efficient through capital inflow by the acquirer as well as knowledge transfer in selected areas. In the medium run, this strategy should be expected to result in increased profits and/or greater efficiency through lower costs. An analysis of the bank's balance sheet and profit and loss account is shown in table 7.1. 1988 can be considered the pre-acquisition year, whereas 1989 and 1990 are the first two post-acquisition years. When assessing the general profitability of the bank, one needs to take into account that funding costs have increased continuously since 1988 due to the high-yielding savings and current accounts first introduced by Barclays and Citibank in the Spanish market which forced other Spanish banks including BCT to offer similar accounts. The average interest paid on deposits increased to 9.4 percent compared to 7.9 percent in the previous year, resulting in a lower deposit rate margin.

⁵ The 1990 figures include the former Madrid branch of DB which was integrated into BCT in 1990.

Table 7.1: Analysis of BancoTrans financial statements

In ECU million

	1988	1989	1990	CAGR
profits (before tax)	14.96	18.60	21.24	20.5%
operating costs	58.91	68.99	84.41	21.5%
revenues from financing activities	118.44	182.86	237.75	50.1%

Source: Annual reports.

Against this difficult operating background, BCT managed to increase its profits significantly. On an inflation-adjusted basis profits before tax increased by 16.3 percent in 1989 and by 7.2 percent in 1990. Operating costs increased by almost the same percentage as profits. Thus, the increases in operating profitability do not stem from a cost reduction programme or a shedding of staff. Rather they result from a significant increase in revenues, particularly from an expansion of loan activity to firms and private customers which more than doubled between 1988 and 1990.

The increase in operating profits at constant operating costs provides some evidence that BCT managed to expand its market position, although no detailed market share data exist to substantiate this observation. BCT attempts to gain a competitive edge by heavily investing in information technology and by expanding its international business activities. However, as DB officials stress it does not follow a policy of undercutting competitors on prices. Nevertheless, it may play a role in stimulating competition, especially in the Catalan area where it has a particularly strong presence, since its significant investments in automation and technology are likely to force competitors to follow suit.

2.1.3. Banca d'America e d'Italia

In December 1986 DB acquired the Italian retail bank Banca d'America e d'Italia (BAI) from Bank of America for a purchase price of \$603 million. The bank was founded in 1918 as the Banca dell'Italia Meridionale and acquired by Bank of America. Since its inception it was therefore always a foreign-owned bank which initially focused on the many Italians who worked in the US but maintained accounts in Italy. This historical link also determined the distribution of the branch network which though covering the whole country is more concentrated in the regions of Liguria, Campania and Puglia. BAI today has 120 branches and employed 3,105 people in 1990. After the phasing out of restrictions on free branch openings in 1989 by the Bank of Italy, most Italian banks have engaged in new branch openings. BAI also follows an aggressive expansion strategy with the opening of 27 branches in 1990/91, an increase of almost 30 percent. Rather than opening branches in places where it has not been present hitherto, the bank decided to

concentrate the new openings in the areas and cities where it is already present in order to expand the local coverage.

The bank focuses on the personal customer market and the market for small-and-medium sized enterprises. A DB official explains that the middle corporate market in Italy has a significant growth potential, as it is currently not given full attention by the Italian banks. The strategic objective is therefore to continue to develop this market. In addition, investment banking services are to be expanded and to be integrated into the worldwide network of Deutsche Bank group. The possibility to draw on this international network gives BAI a significant potential competitive advantage even over the big Italian banks which have a comparatively low degree of international representation.

DB has followed a decentralised approach to post-acquisition integration of BAI. According to BAI officials there has been little direct management influence at BAI which was already profitable when acquired. Rather than interfering directly in the business policy of BAI, Deutsche Bank sets an annual return on investment target for BAI, but leaves it entirely to local management how to achieve this goal. As a DB official explains: "local management knows their market much better than we do. It would be unwise to interfere in their strategic decisions". This policy of restraint on part of Deutsche Bank can be explained by the fact that the main reason for Bank of America's sale of BAI were capital needs rather than dissatisfaction with the performance of the Italian subsidiary. Thus, the acquisition was not a case of a takeover for 'corporate control' reasons where an inefficient bank is taken over, its management is replaced and performance improves in the post-acquisition years. This is documented among other things in the fact that top management was not replaced in the aftermath of the acquisition and the President continues to be Italian. In addition, only three of the 15 members of the Board of Directors are from Deutsche Bank. This documents the considerable autonomy which BAI preserves for itself.

BAI is primarily a retail bank for personal customers and small businesses. In 1990 seventy-seven percent of its business were accounted for by the personal customer segment. Deposits by personal customers accounted for 86 percent of total deposits, while deposits by firms only constituted 13.1 percent. In the consumer credit segment BAI is at times the market leader among Italian banks. BAI was the first Italian bank to introduce a credit card, the 'Bancamericard'. Until 1985 this was virtually the only credit card in the Italian market and thus had a market share of almost 100 percent, guaranteeing high profits. In 1985, however, the Italian banks founded a joint venture to provide an alternative with the 'Carta Si' card. Since then competition has increased significantly and commissions from dealers decreased from 5 percent to 2-3 percent.

A BAI official notes that in retail banking there have been next to no changes after the acquisition of DB. Thus, the strategic vision of a 'European' bank in the retail sector has so far not been realised. This is documented by

the fact that personal customers from Deutsche Bank enjoy no special benefits when transacting with BAI (e.g. when being on holiday or business trips). The same holds for BAI personal customers who deal with the mother bank in Germany.

Concerning the pricing strategy of BAI, it offers some 'promotional' services cheaper than other Italian banks. For example, it offers free giro transfers to pay for gas, water or electricity for which other Italian banks charge up to two ECU. BAI was also the only bank which did not charge for the use of ATMs of other banks in contrast to competitors which charge an average 1.3 ECU per transaction. This practice was abandoned at the end of 1991, however, since it turned out to be "too costly" and a service charge similar to the average market rate was introduced. A comparison of prices and interest rates of BAI as compared to the average of the ten largest Italian retail banks is provided in table 7.2.

Table 7.2: Analysis of BAI's pricing strategy

In Lit

	BAI	Average of largest Italian banks
Charge for current account p.a.	50,000	45,000
Charge per account transaction	1,950	1,800
Interest rate on current account	6-7%	4.5%
Cost of credit card p.a.	70,000	40,000
Interest rate for consumer credit	16.5 - 17.5%	18%
Share transaction	0.2%	0.7%
Charge for securities account p.a.	50,000	50,000
Bond transaction	0.3%	0.5%

Source: Price survey chapter five.

It becomes obvious that BAI by no means follows a price strategy of undercutting the indigenous Italian banks. In contrast, it actually charges higher prices for some of the basic banking services, while paying a slightly higher rate on deposits and charging less for consumer credit. From these price data it does not appear that BAI pursues a strategy of consistently undercutting domestic banks on prices.

The strategic focus of BAI has been broadened under the new ownership, however. A BAI official explains that while Bank of America intended BAI to be a retail bank for personal and small business customers,

Deutsche Bank places greater emphasis on corporate banking also for mid-sized and large firms. Accordingly, the change after the acquisition was greatest in the area of international and investment banking activities. DB has encouraged the development of investment banking activities in cooperation with DB headquarters and the worldwide network of DB branches and subsidiaries. A capital markets department was built from scratch over the past five years and BAI has acted as lead manager of Euro-Lire issues together with DB's London capital markets subsidiary. It has concentrated efforts on certain niche markets such as commercial paper, where it managed to increase significantly its business. The main share of bilateral employee exchanges between BAI and other members of the DB group also takes place in the area of investment banking where knowledge transfer is most active. Due to this expansion in activities BAI managed to enter the market of bigger firms and even multinationals.

A natural competitive advantage of BAI lies in import/export trade with Germany where it is able to provide advice and fast and efficient transactions. Another competitive advantage of BAI which arises from its smaller size lies in the fact that as compared to the publicly-owned banks, its organisational structure is more efficient. A BAI official asserts that "whereas the more bureaucratic publicly-owned banks may need two to three weeks to reach a decision on a loan arrangement, for example, we can make such a decision in a single day."

Another area where there are potential synergy effects is that of M&A services where BAI can provide advice to Italian customers who want to acquire in Germany, in particular after the integration of the Morgan Grenfell group into DB's European network.

An analysis of BAI's financial statements for the past seven years is shown in table 7.3. All figures are inflation-adjusted. As BAI was acquired in December 1986, 1987 is the first post-acquisition year. Pre-tax operating profits rose by 37.6 percent between 1987 and 1990. The slump in the pre-acquisition year 1986 can be explained by extraordinary bad loan provisions and did not result from a reduction in the gross intermediation margin. Overheads on average have increased slightly more (by 0.75%) than the gross intermediation margin. Particularly noticeable is the most recent increase in net income from commissions. Partly, this resulted from an increase in foreign exchange trading where commissions increased by almost 500 percent in 1990. The annual report attributes this to "the close cooperation with the Foreign Exchange Department of Deutsche Bank" where significant synergy effects were achieved. In particular, in DM/Lire foreign exchange BAI has achieved a leading position.

Table 7.3: Analysis of Banca d'America's financial statements

In ECU millions (inflation-adjusted)

	Pre-tax operating profits	% change	Gross inter-mediation margin	% change	Net income from commissions	% change	Over-heads	% change
1984	52.22	-	154.83	-	60.03	-	149.64	-
1985	56.13	+7.4	160.36	+3.6	66.37	+10.6	158.41	+5.9
1986	28.96	-48.1	186.40	+16.2	61.97	-6.4	182.41	+15.1
1987	49.27	+70.2	208.24	+11.7	66.28	+6.9	197.19	+8.1
1988	53.48	+8.5	229.28	+10.1	79.25	+19.5	227.11	+15.2
1989	63.59	+18.9	264.79	+15.5	87.75	+10.7	253.56	+11.6
1990	67.79	+6.6	284.04	+7.2	135.46	+54.4	286.03	+12.8

Source: Financial Statements BAI 1984-90.

The area where the impact of the acquisition was greatest is that of international banking. Under the ownership of Bank of America, BAI was engaged in third world lending and had to make substantial bad debt provisions for these loans in 1986 on the initiative of its new owner Deutsche Bank, which proscribed high write-offs on third world loans. After years of declining business in international banking, a new strategy was enacted in 1987 under the new ownership which focused attention on the less risky European market. This re-orientation proved to be successful. Table 7.4 illustrates the significant increase in international banking activities.

Table 7.4: International banking activities of BAI since 1987

In ECU million

	International Commercial Transactions	Percent change	Percentage change in Italy's total net trade	Non-commercial international banking services	Percent change
1988	2.33	+16%	+11%	1.76	+23%
1989	3.83	+64%	+16%	3.19	+81%
1990	4.20	+10%	+5%	5.18	+63%

Source: Annual reports, BAI; Banca d'Italia

It is apparent that BAI managed to increase its proportional share of commercial trade financing as well as substantially expanding its invisible trade transactions. These increases need to be assessed against a previous period of contraction in BAI's international banking business. This illustrates that under the new ownership, international banking is the area which has been most affected in the post-acquisition years.

In summary, BAI seems to be an example of a cross-border acquisition where selective intervention in the sense of Williamson (1975, 1985) has worked to improve overall performance. Most notably perhaps, the acquisition had no impact at all on retail banking strategy where synergy effects or knowledge transfers from Deutsche Bank to BAI are non-existent. From the collected price data it seems that BAI as a foreign-owned bank does not attempt to undercut indigenous banks on prices or conditions. There is also no evidence that efficiency in the form of labour productivity has increased significantly.

This picture is different for the area of corporate and investment banking where the impact of the cooperation with DB's headquarters has been more substantial. This illustrates that synergy effects in cross-border acquisitions are easier to obtain in the area of corporate and investment banking.

DB officials note that both BAI and BCT achieve among the highest returns on investment in the Deutsche Bank group. This shows that banks in these two countries still enjoy relatively high profitabilities. Rather than attempting to undercut competitors on prices and thus jeopardising these handsome profits, however, both banks participate in the high margins.

2.2. Barclays Bank's European retail strategy

Barclays Bank is the largest and most profitable British bank and the eighth-largest in the world in 1990 in terms of capital. In 1990 it suffered from a significant reduction in operating profits which was mainly caused by the recession in the UK economy.

Barclays has traditionally been a bank with a wide international presence, stemming from its significant involvement in overseas banking. In contrast to most other European banks, Barclays' international presence historically involved not only corporate banking services but also retail services. In fact, international banking as pioneered by the British overseas banks had its origins focusing on the retail rather than the corporate sector. Thus, Barclays has accumulated considerable experience in international retail financial services.

While Barclays had a wide international retail presence in many non-EC countries, its presence in the EC retail banking sector was fairly insignificant until 1988. In mid-1988, the Board of Directors therefore set up an internal strategy team to assess the market potential of the Continental EC markets and formulate a response to the 1992 programme. The internal market programme seems primarily to have provided a psychological stimulus to take a closer look at the European markets. The internal strategy team was split up into two groups which looked separately at the personal and corporate sector and these units remain organisationally and geographically separated ('Corporate' being in London, and 'Personal' in

Northampton). Barclays sees the greatest market potential in other EC economies in the sector which it refers to as "local quality private banking". This refers to personal customers in the medium to higher income bracket. As a Barclays Director formulates: "if there is blood to be spilt in the post-1992 market for financial services, this is the sector where some of the biggest battles will be fought". The bank sees this market as being most easily accessible to cross-border entry, since delivery channels are such that there is an increasing reliance on non-branch based distribution methods such as plastic cards, ATMs, telephone and home banking. The following sections focus on Barclays' country strategies in the personal sector.

In the personal sector, Barclays was present in 1988 only in Spain and France. It had been the first bank to acquire a domestic bank in Spain in 1981 after the restrictions on foreign bank entry were reduced in 1978. Similar to Citibank it acquired a failed institution, Banco de Valladolid, from the Spanish government which had taken over the bank. In France, Barclays has been present since the turn of the century and had 34 branches serving around 30,000 personal customers in 1988.

The internal review on European retail operations resulted in a clear strategic focus on the four biggest Continental countries Spain, Italy, Germany and France. In these countries the strategic objective is to gain a market share of 2 to 3 percent of the total personal customer market and around 7 percent of the higher income personal customer market. Other EC countries are largely disregarded concerning the personal customer market, since the expected revenue potential is considered to be too low to merit the extensive investment required to obtain a sufficient return on capital.

Barclays distinguishes two basic distribution channels in its European retail financial services strategy: the traditional branch-based channel and a "central delivery" approach which is mainly characterised by direct selling through credit cards. The bank views itself as having a significant competitive advantage in the central delivery area due to its long-standing experience with 'Barclaycard', first introduced in 1966. Barclaycard has a market share of around 40 percent in the UK market with eight million cardholders. In 1988 it earned a profit of £99 million in its credit card division or just under 7 percent of total group profits and boasted a return on capital employed of more than 40 percent over the period from 1984 to 1988, by far the highest of the UK commercial banks. Since the UK is by far the largest European credit card market, Barclays is at the same time the largest bank issuer of credit cards in Europe. It is in this sector in which it expects significant cross-border entry opportunities in the Continental EC countries. A Barclays official notes that in the area of card-based products the bank has a "significant know-how advantage which can be transferred to other European markets and which gives us an edge over competitors in those countries".

In addition to boasting significant profit potential as a stand-alone product, credit cards are also considered an entry product for delivering

additional financial products. Thus, once a customer relationship is established the bank plans to offer additional financial products such as insurance services, other payment services and loan facilities. The advantage of a central delivery approach is obviously the lower entry costs, compared to the traditional branch-based channel. A Barclays official notes, however, that the central delivery approach does not always suit the cultural habits of other EC countries. While German customers may be used to maintaining business and banking relationships through telephone or mail and thus make a central delivery approach feasible, Italian and Spanish markets require a branch-based presence.

In Italy, the bank has sold off its consumer credit unit BAFIDO to French Societe Generale in 1990. A Barclays official noted in a personal interview that the divestment resulted from the need to realise assets in the Italian market due to the dismal results in corporate banking services, rather than from a lack of success of the consumer services unit. Despite the divestment the Italian personal customer market remains on the priority list of Barclays over the next five years.

Entry into the German market was given the top priority of European cross-border entry activities. A Barclays official remarks that "a presence in the German market is an absolute must for any bank which considers itself European". In 1990 Barclays acquired the German Merck Finck Bank, a Munich-based private bank specialised in the market for high net-worth individuals. In addition, it purchased a venture capital credit card processing company, CFS Finanzsysteme, from Berliner Bank in 1988 which constituted the base for entering the German credit card market in 1991. More importantly than just giving Barclays a small market share, the acquisition of CFS provided Barclays with credibility in the German market. A Barclays official notes that "once we had acquired CFS, suddenly German banks started taking us seriously. However, if they had known that we were interested in buying CFS they would have made sure to snap it up to prevent our entry". Prior to acquiring the processing firm, Barclays had made several attempts to penetrate the German credit card market but faced significant resistance from the large German banks. As a Barclays official notes, "the German banking system has a highly cartelised structure which makes it very difficult for foreign banks to enter the market". For the specific case of credit cards, processing, issue and marketing of cards was for a long time undertaken by a joint venture firm of the largest German banks, the *Gesellschaft für Zahlungssysteme* (GZS) which was able to successfully exclude foreign banks. Only after Barclays complained to the German Federal Cartel Office did the GZS admit Barclays.

The central delivery approach to the German market is triangular: first, CFS Finanzsysteme offers a store debit card in cooperation with several retailers and has so far issued 140,000 cards. After acquiring CFS, Barclays started a joint venture with the retail department store *Hertie* to provide a store credit card with loan facilities which by now has 450,000 customers. In addition to this credit card the joint venture 'Optimus Bank' of which

Barclays owns 49 percent also offers insurance and other bank services to its *Hertie* customers and thus the store card constitutes a typical entry product to cross-selling other financial products. In 1991, Barclays also entered the standard credit card market directly. Similar to its UK credit card strategy Barclays offers both Eurocard and VISA as a 'package' in the German market. It currently offers no current account or payment facilities besides a credit card account. Payment facilities are to be introduced in the near future, however, to make the range of services comparable to that of regular bank account. To make such an account attractive it offers a 4 percent interest rate on sight deposits (September 1991) and also offers a revolving credit facility which is a novelty in the German credit card market where credit card bills need to be paid in full at the end of each month. With an interest rate of 14.7 percent in September 1991, Barclays was in the range of negotiated current account overdraft loans by other German banks. Barclays advertises its credit cards as being offered by "Britain's largest credit card issuer" stressing its experience advantage in the handling of credit card facilities. In September 1991 Barclays had acquired 30,000 new customers for this product.

In France, Barclays has been present since 1917 when the first branch was founded which transformed to a subsidiary in 1968. Barclays Bank S.A. is active in both the retail and corporate sector belonging to the largest 25 banks in the country. In the retail sector it is the largest foreign bank with a branch network of 34 offices spread across the country. In the personal sector it mainly targets the high-income group with a strategy of being at the forefront of new product developments. These include, for example, the "Compte Permanent" which is the first direct marketing bank account with a revolving credit facility where all transactions are undertaken over the phone or by mail. Direct mail solicitations were sent out to more than one million households over a one-year period alone. Barclays, S.A. made net profits of ECU25.5 million in 1990 (1989: 18.2 million; 1988: 13.8 million).

In order to further enforce its market position in France, Barclays acquired the French retail bank *Compagnie L'Européene de Banque* from *Crédit Commercial de France* in November 1990. The latter bank had been dealt as one of the few potential acquisition targets in France and was under repeated scrutiny by other potential acquirors, among them *National Westminster Bank*. *L'Européene de Banque* with total assets of ECU1.97 billion in 1990 together with its subsidiaries has thirty-seven branches and sales offices in France and had around 1,000 employees in 1990. It made an after-tax profit of ECU1.26 in 1990 (1989: 9.6 million; 1988: 5.8 million). Its branch network is currently being merged with Barclays' French branch network to form a single network of around 70 branches and offices. In addition, *L'Européene de Banque* owns *Laffite Investissement* which has the second-largest sales agent network in France and distributes a whole range of investment fund products including life insurance. After the takeover by Barclays eleven of the thirteen members of the Board of Directors were replaced by members of the French Barclays subsidiary. A Barclays official notes that "there is still a lot of work to be done in France. There is no central delivery system in place yet and we are in the middle of a painful merger

process". In 1989 Barclays Bank S.A. achieved a return on assets of 0.4 percent which was significantly below the average for French banks of 0.97 percent over the 1986-89 period.

Table 7.5 provides an analysis of Barclays pricing strategy in the French retail market.

Table 7.5: Analysis of Barclays' pricing strategy in France

In ECU

	Barclays	Average of largest French banks
Charge for current account p.a.	0	0
Margin on foreign exchange	2.0%	3.9%
Interest rate on savings account (6-months deposits)	4.5%	4.5%
Cost of credit card p.a.	23.1	27
Interest rate for consumer credit	14%	15%
Share transaction	1%	1.2%

Source: Price survey chapter five.

It appears that Barclays provides most services at least at slightly lower prices than the average of the largest French banks.

Of all European countries, Barclays has had the biggest impact in the Spanish market. In 1988 it had a branch network of around 100 branches in Spain. In Spain it now has a retail network of around 225 branches. It was the pioneering bank to introduce the 'small-branch' concept, i.e. branches with only few employees which are mainly aimed at collecting deposits. The small branches are linked to a regional 'hub', which is a larger branch providing the more advanced services to the smaller branches. This centralisation of administrative services allowed a ratio of 70 percent front office and 30 percent back office activities in the smaller branches which was exactly the opposite ratio of most established Spanish banks and permitted a greater orientation towards customer services. The small branches have lower fixed costs and therefore allow the opening of a greater number of retail outlets and permit a quicker geographic expansion process. While Barclays has the highest number of branches in Spain of all the foreign banks, it is still small compared to the large Spanish banks which have up to 2,000 branches. Despite its comparatively small size in terms of branches, Barclays was able to make a tangible impact on competition in the Spanish banking market. In particular it was the first bank together with Citibank to introduce significantly positive interest rates on the current account and is

frequently referred to as having started the deposit rate war by forcing domestic banks such as Santander to follow suit. A Barclays official explains the significant growth of Barclays in Spain by its aggressive deposit rate policy: "when we started our deposit interest rate strategy we were too small to disturb the large indigenous banks. It was only after we started to tangibly hurt the big banks by taking away customers when they were forced to respond by offering equally competitive deposit rates."

In addition to pursuing an aggressive price strategy, Barclays introduced an innovative personnel policy by recruiting university graduates and placing them on an 18 months training programme after which they were placed in charge of a small branch. This practice was fairly uncommon in the Spanish banking sector which for a long time had a very low proportion of university graduates. Barclays' personnel policy was also emulated by other Spanish banks.

Barclays' Spanish subsidiary made profits before tax of ECU52 million and paid out ECU13.3 million to its shareholders. Profits before tax have increased by 52 percent in comparison with 1989. The return on assets was 0.9 percent which was below the Spanish average of 1.8 percent.

In summary, Barclays' European cross-border entry activities have so far had the most significant impact in the Spanish market. Barclays' Spanish subsidiary is probably the best existing example of a foreign entry activity which had a significant impact on competition in the domestic retail banking market.

2.3. National Westminster's European retail strategy

2.3.1. Nat West's approach to expansion in European retail banking

National Westminster Bank which is the second-biggest British bank in terms of capital has actively pursued cross-border entry activities in the EC countries over the past decade even though to a lesser extent than its domestic competitor Barclays Bank. It currently has a presence in all EC countries except Portugal and Denmark although its involvement in retail banking differs significantly across the EC countries. Spain is by far the most important market for Nat West in terms of a retail presence with two major acquisitions in 1985 and 1987. The Spanish acquisitions are discussed in greater detail in the next section.

Nat West identifies the high net worth individuals market and the mid-sized corporate market as most likely to be affected by increased Europeanisation. In particular, in asset management it perceives scope for scale economies across the Nat West group with Nat West being world-wide market leader in custody management. In addition, it sees spin-off effects from wholesale into retail banking such as in areas of foreign exchange

management and treasury-linked products which it aims to exploit through cross-functional know-how transfer.

Cross-border entry is viewed as being primarily about finding the right distribution vehicle. Even though Nat West has so far chosen mostly acquisition and de novo entry it does not principally repudiate alliances and joint ventures. It therefore does not necessarily follow a 'stand alone' approach like Deutsche Bank or Barclays Bank.

Apart from Spain, Nat West has a notable retail presence in the Netherlands where it acquired a 40 percent stake in Van Lanschot Bankiers in 1986 which is the seventh-largest bank in the country in terms of capital in 1990. This stake was further increased to 80 percent in 1990 by buying out Rabobank. Van Lanschot is primarily a private bank which currently has 21 domestic retail branches and operates in the markets for medium to large corporate, institutional investors and high net-worth individuals. In addition, it maintains a subsidiary in Luxembourg which at the same time serves as the local base for the whole Nat West group. Van Lanschot is clearly no case of a takeover for corporate control, as it was highly profitable even before the acquisition. It is to retain its name and independence, while increasing cooperation with the Nat West group in selected areas such as asset management where know-how and labour transfer inside the group is to be promoted. In 1990 Van Lanschot made a net profit of Dfl 27 million down from Dfl 29 million in the previous two years but is still the most profitable European subsidiary of the Nat West group. Accordingly, there is no perceived need to engage in significant restructuring measures.

In contrast, the French subsidiary of Nat West has fared less successfully. In 1988 Nat West acquired the five branches of Banque de L'Union Europeenne which were then merged with the existing network of Nat West's five branches in France. The ten branches have no clear regional focus but are evenly spread over the largest French cities. Activities are predominantly targeted at five sub-markets in the corporate banking sector, namely multinationals, UK corporates, the French middle market, project finance and the public sector. This focus on the corporate market in France has not been successful in profit terms, however. The bank lost FF 74 million in 1988 and 1989 and FF 44 million in 1990. Recently, it was therefore decided to enter the more profitable private banking market on a greater scale. In 1989 Nat West acquired a brokerage firm, Sellier, which has a large retail clientele. As Nat West is currently too small to offer broad retail services in France, however, it plans to focus on the high-net market in the personal customer segment. In order to implement this strategy there are plans for considerable expansion of the branch network. This expansion is to be achieved through organic growth rather than further acquisitions.

In the German market, Nat West is only represented in the corporate market through Deutsche Westminster. This subsidiary is likely to be scaled down again to the legal status of branches of the Nat West group in order to evade the stricter regulatory rules such as separate endowment capital and

separate solvency and liquidity ratios for the German subsidiary. In addition to serving the corporate market, there is also a strong interest to enter the German retail market, since it is perceived to be "the most important retail market in Europe, but also the most difficult to enter", as a Nat West official describes it. Unlike in some other European countries, German banks are perceived to be very efficient and high margins stem from perceived collusion among domestic banks. A Nat West official cites as an example of the "almost cartel-like situation in Germany" the life insurance sector where a foreign bank when introducing a new product needs to get approval from an authoritative body on which all the main domestic competitors are represented.

In Italy Nat West entered into a joint venture with Credito Italiano in 1972 to form Banca Credit West with Nat West holding a 30 percent stake which was later diluted to 19% when Credito Vesuviano joined the JV. Credit West has 18 branches in the Lombardian region and operates in the personal customer and mid-sized corporates markets. It is currently viewed by Nat West as a profitable portfolio rather than a strategic investment. However, since Nat West considers cooperation with a strong local player to be the most suitable entry vehicle into the Italian market, there may very well be an increase in the stake in the JV.

In summary, Nat West has the most varied portfolio of entry approaches of the largest European banks, ranging from de novo over acquisitions to JVs. A Nat West official describes it as an "opportunistic" approach to cross-border entry where all possible entry vehicles are considered. Thus, unlike Barclays and Deutsche Bank which follow a 'stand-alone' approach to cross-border entry which excludes most types of joint ventures and strategic alliances, Nat West is not principally opposed to these cooperative forms of cross-border entry.

2.3.2. The strategy in Spanish retail banking since 1985

Outside the UK, Nat West has the largest retail presence in Spain where it first opened a branch in 1917 which was later closed and not re-opened until 1964 as a representative office which in 1979 was converted into a branch. In 1985 Nat West decided to enter the Spanish market on a more significant scale by acquiring a minority stake of 49 percent in March Bank which was increased to 84 percent in 1989 and further to 99 percent in 1990. The acquired bank first changed its name to 'Nat West March' in 1985 and later to 'Nat West Espana' after a majority stake was acquired. In 1987 Nat West additionally acquired the regional bank Banco de Asturias which has a wide presence in the regions of Asturias and Galicia and is exclusively focusing on the personal customer market. The latter bank was organisationally integrated into the Banco Nat West group in 1990 by linking computer systems and subjecting it to management control through Banco Nat West headquarters. Over the past three years the number of branches of Banco Nat West increased significantly by 41 percent from 92 branches in 1988 to 130

branches at the end of 1991. Banco Asturias increased its number of branches by 33 percent from 64 to 85 over the same period, so that Nat West had a total branch network of 189 offices in Spain. There are plans for continued significant expansion of the branch network over the next years. In 1990 the bank made a profit before tax of ECU30.7 million, achieving a return on equity employed of 15.4 percent and a return on assets of 1.3 percent which was below the average ROA for Spanish banks of 1.8 for the 1986-89 period. Profits increased by 35 percent in comparison to 1989. Profits had increased already by 20 percent in 1989 which illustrates the significant profit potential which still exists in the Spanish market.

The main reason for entering the personal customer segment in Spain was the perceived profit opportunities which were judged to be considerably higher than in most other EC countries. These resulted not only from high margins due to high prices but also from the perception that through service quality improvements customers could be lured away from the domestic banks. As a Nat West official describes it: "Spanish banks have a very low quality of services. We therefore perceived scope for a cross-border entry strategy which focuses on providing higher service levels than domestic banks, rather than trying to undercut domestic competitors on price". The focus on quality is reflected, for instance, in the bank's marketing positioning and advertising campaigns where it attempts to position itself as the "Grupo de la Calidad" (group of quality). The Nat West group does not attempt to compete with the domestic banks on the price variable. In contrast to Barclays and Citibank, Nat West was therefore not an active player in instigating the deposit rate war but was following rather than leading.

2.4. The strategy of a non-European bank: the example of Citibank

2.4.1. Citibank's European retail strategy

Citibank is the largest American bank and ranks twenty-first in the world in terms of capital in 1990. Since 1975 it has been organisationally separated into "Global Consumer Banking" and "Global Finance Business". In retail banking Citibank is active in 36 countries with 34.5 million customers and thus the most international retail bank in the world.

In a re-orientation of its corporate strategy for the 1990s and beyond, Citibank considers worldwide retail banking as the most important pillar of its business, planned to account for about seventy percent of total activities by mid-1990 as compared to the current fifty percent. The main reason for this shift in business focus stems from the high profitability of consumer banking as compared to the finance division: profits in retail banking increased continuously from \$93 million in 1982 to \$1 billion in 1990. These contrasted with losses of around \$550 million in the global finance division (including bad debt provisions) where the bank was heavily involved in third world loans and was the first to make substantial write-offs and provisions for these loans.

One of the most important target areas in Citibank's worldwide retail strategy is the European market where Citibank has been present since 1963 and is currently operating in eight countries. The strategic vision of Citibank is to become the first and possibly biggest truly 'European' retail bank with an extended presence across the EC countries. In addition, it wants to be part of the biggest five to ten domestic personal customer banks in the EC countries where it is present.

Citibank's strategy in European retail banking is based on three principles: European-wide presence, standardisation of products and services as far as feasible, and strong orientation towards electronic banking and product innovation. These three pillars shall be discussed in turn.

Concerning European-wide presence, Citibank is clearly only at the beginning of what would have to be a significant expansion process. It is currently in the process of significantly altering its business portfolio. While the European retail organisation consisted of 24 separate business units in 1988, under the new European strategy only around ten to twelve units will be maintained with the others being sold off. The divested business units include auto finance firms in France, Belgium and Austria as well as Banco Centro Sud, the unsuccessful venture of Citibank into the Italian middle corporate market. The core business units are in the area of branch-based retail banking and credit card facilities including the VISA and Diner's Club franchises in some countries. Currently, it has a mentionable presence in branch-based retail activities only in Germany with 300 branches, Spain with 100 branches, Belgium with 65 branches and Greece with 17 branches. It is planned, however, to expand coverage of the Italian, French, British and Dutch markets at the rate of one new country per year over the next five years. Concerning the choice of the entry vehicle, Citibank considers *de novo* entry as a feasible alternative to acquisitions after some disappointing experiences with the acquisition approach in Europe. In contrast to Deutsche Bank, for example, Citibank has mostly acquired 'turnaround' banks such as Banco del Levante in Spain which was a failed bank taken over by the regulatory authorities. Citibank has so far not been able to turn the acquired bank into a profitable operation. Similarly, in Italy Banco Centro Sud which was bought from Banco di Roma in 1985 had a significant asset portfolio problem with an extraordinarily high bad debt write-off rate and was divested again in 1991. These examples indicate the problems attached to the acquisition of 'problem' banks. Under the *de novo* approach it may take longer to establish a position in the market but it has the advantage that newly opened branches can be designed and located according to the European strategy of the bank, rather than having to invest a large amount to redesign and possibly relocate branches when a domestic bank is acquired which needs to be integrated into the European group strategy. Newly opened branches of Citibank are to be located in densely populated urban areas where "there is no prejudice against foreign banks", as a Citibank official explains.

Citibank is probably the only bank which approaches the EC market with a unified strategy stressing similarities in consumer needs rather than current differences in habits across the European countries. A Citibank official explains that "despite different banking habits, the basic needs and fundamental processes in retail banking are identical such that eighty percent of the business activities are very similar". Accordingly, Citibank perceives synergy effects stemming primarily from know-how and labour transfer inside the Citibank group. As markets may be in different stages of development, know-how acquired in a mature market can be shifted to a market which is just developing. Thus, a competitive advantage may be secured through transferring expertise gained in one market to another market where domestic competitors have not progressed as far on the learning curve. An example of cross-border know-how transfer is the introduction of money market funds which are fairly novel in most European countries but where Citibank has gained significant experience over the past decade in the US market. Similarly, Citibank is one of the first banks to introduce aggressive marketing strategies such as direct mail and telephone solicitation which are a novelty in many European markets but have been standard practice in the US.⁶

All national group members are to lead the name "Citibank" in order to increase the recognition value throughout Europe. This implies that acquired banks in Europe have to change their name to be recognisable as part of the Citibank group. All European branches are to have a uniform design and outlay, offering a unified range of services with compatible and linked computer systems and ATM networks. A first example of such a 'European' product which is distributed by all branches of Citibank in Europe is the investment fund 'CITINVEST' which consists of European assets and is centrally administered in Luxembourg.

Apart from the area of asset management which is an obvious candidate for centralisation, Citibank further perceives some centralisation potential and thus the opportunity to achieve economies of scale in the area of processing facilities. These include not only payment services and credit cards which are already centralised to a significant extent but also other technology-intensive areas such as phone-banking facilities which may be offered by a centralised European phone banking centre. The latter is also an example of how regulatory restrictions may be circumvented through a European-wide presence: since labour laws in Germany and Belgium do not allow Sunday work, Citibank decided to offer Sunday phone banking through its Spanish subsidiary. Thus, German or Belgian customers who undertake Sunday phone banking are connected to Citibank employees who work in the Spanish phone banking centre.⁷

⁶ Citibank claims synergy effects in this area: for example, a direct mail solicitation concerning credit cards was undertaken in Spain and after it proved extraordinarily successful exactly the same solicitation was used in Germany drawing on the experience gained in the Spanish market.

⁷ Telephone costs are reduced by the fact that Citibank owns its own PTTs.

Citibank's strategy is further characterised by a strong focus on product and technological innovation and introducing new products into markets, rather than competing exclusively on price. For example, in Spain it was the first bank together with Barclays Bank to introduce interest-bearing current accounts and was later followed by Banco Santander. In addition, it was the first bank to introduce money market funds in Spain being again followed by the domestic banks but so far retaining its position as market leader. It is also the first bank to have introduced "24-hour banking" in the Spanish, German and Greek markets. These are instances of a foreign bank bringing new expertise to the domestic market, forcing domestic banks to follow suit by adapting their product and service range accordingly.

Concerning the organisational structure of Citibank's European retail operations, it is almost arch-typical of Williamson's M-form: a central headquarters in Brussels determines the general strategic guidelines regarding standardised branch outlay and design, for example. In addition, it sets return on capital goals for the different operating units and monitors and audits the different national subsidiaries. Each national subsidiary is run on a profit centre basis, however, and the implementation of the detailed business strategies is left to local management.

The European retail strategy shall be further illustrated with the German group member of Citibank: the former KKB Bank which according to Citibank officials serves as a role model for the process of European expansion.

2.4.2. Citibank's European acquisitions: the example of KKB Bank

KKB Bank was acquired as early as 1973 by Citibank, but significant managerial influence started to be exercised only in the mid-1980s when Citibank began to reorient its worldwide business focus towards consumer banking and realised the potential of a unified European market. Currently, the German subsidiary is by far the largest retail subsidiary of Citibank in Europe and outside the US. By the end of 1991 KKB Bank changed its name to Citibank Private Banking AG to be recognisable as Citibank's German subsidiary.

The bank focuses exclusively on the personal customer market and can therefore be considered a specialised bank in Germany with its universal bank system. It had 303 branches in Germany and 3,455 employees in 1990 serving more than two million personal customers. Since 1985 it has significantly expanded its product range introducing life insurance, mortgage financing, credit cards and brokerage services.

Being a medium-sized bank in the personal customer segment, how does Citibank attempt to gain a competitive advantage over the big

commercial banks on the one hand, and over the savings and mutual banks on the other hand which are especially strong in this market?

Citibank's market positioning can be summed up in two strategic objectives: technological leadership and market innovation. In response to a need for a new positioning to create a tangible edge over competitors, KKB Bank decided in 1988 in cooperation with Citibank on a new business strategy, the most important part of which is the focus on 'electronic banking'. Electronic banking, i.e. the automation and support of banking services by information systems can be split into the areas of 'back office' and 'front office'. The former refers to the computer support of the internal organisation in the bank such as customer databases or system-supported communication and transactions. In the back office area, KKB was the first and is still the only German bank which operates an online-network between all its branches. In order to achieve this link, the bank invested DM 60 million in the back office area. Automation and centralisation in the back office area allow employees to focus on know-how intensive advisory services, since they reduce the burden of routine operations.

In the front office area, the bank has recently introduced three innovations which have so far not been copied by other German banks and may therefore provide a potential competitive advantage: an expert system supporting investment decisions, telephone banking and "24-hour banking". First, the expert system RAMSES introduced in 1988 provides a tool for the customer in cooperation with the bank employee to devise an optimal investment strategy taking account of personal risk and return preferences. It is the first of its kind in the market and was apparently well-received by the customers.

Second, telephone banking introduced in May 1989 offers the possibility to undertake bank transactions such as giro transfers or payment services by telephone. This offers an alternative to visiting the branch and thus compensates for the lower number of branches compared to the large domestic competitors. In addition, it offers banking facilities outside the usual branch opening hours. Telephone banking thus replaces the earlier introduced form of 'homebanking' by videotext which was taken up by only 0.05 percent of German personal customers even though all banks offered this service.⁸

The third innovation of KKB is "24-hour banking": KKB was the first German bank to offer ATMs in all its branches. The ATM technology of the bank is an example of knowledge (or technology) transferral within the Citibank group: the ATMs employed in Germany were developed by TTI, a subsidiary of Citicorp in the US and tested by Citibank in the New York City

⁸ In stark contrast to the situation in France where the Minitel system enjoys widespread popularity. This difference in acceptance rates may result from the differing pricing policies of the national telecom firms since France Telecom has provided Minitel facilities at no charge.

area where 1,100 machines were installed. As the machines were well-received, they were transferred to other Citibank group members.

The Citibank ATMs offer significantly more facilities than the standard machines currently in use by the other big German banks which offer exclusively cash withdrawal facilities. The Citibank machines are based on a user-friendly touch-screen technology and currently offer balance inquiries, cheque ordering, product information and money transferrals between Citibank accounts. These current services will soon be expanded to include the whole range of payment services including giro transfers and account information. The touch-screen technology of the Citibank ATMs allows expansion of ATM capabilities through software adjustments without the concurrent need to change the hardware as in conventional ATMs, thus allowing considerable flexibility in modifying the range of services offered by ATMs.

The installation of these new ATMs provides a potentially significant technological edge over other banks. If competitors were to match the technological state of the Citibank machines they would have to completely replace their current machines, a significant and unlikely investment, as they have only just introduced their machines and are still in the expansion process.

KKB was also the first bank to introduce the possibility to withdraw from ATMs with credit cards rather than only with Eurocheque or bank cards. Other banks were soon forced to follow suit and today all banks offer these facilities.

A final market innovation was the introduction of life insurance products in 1985 (similar to TSB Group in the UK) which set in motion a trend by the other banks to offer similar products. Deutsche Bank was the first of the big commercial banks to follow KKB's move and today virtually all banks offer a number of insurance products.

In view of these innovative moves, a Citibank official states that KKB has been charged by the other German banks as "breaking established rules of the game".

The bank also engages in an aggressive price strategy in selected areas. It was the first to reduce the annual price for its Visa card in 1988 and thus started a 'price war' in the credit card industry. With an average annual price of DM 120, KKB introduced its VISA card at a 'promotional' price of DM 45. This has led to various adjustments by other players in the market and by the end of 1991 the average price had decreased to DM 40 (KKB in the meantime has increased its price back to DM 60). KKB was also the first to introduce significantly positive interest rates on current accounts and above average rates on their savings accounts. Table 7.6 provides an analysis of the price strategy of Citibank in Germany.

Table 7.6: Analysis of Citibank's pricing strategy in Germany

In DM

	Citibank	Average of German banks
Current Account*	86.40	112
Consumer credit	16.25%	14.6%
Cost of credit card p.a.	60	40
Interest on current account	2.5%	0.5%
Interest on savings account	3.5%	2.5%
Eurocheque card p.a.	20	10
Eurocheque per cheque	0.10	0.05
Annual costs of sec. acc.	1.5%	1.2%

* with 200 transactions

Source: Price survey chapter five; data are for September 1991.

It is obvious that Citibank does not follow a consistent strategy of undercutting domestic competitors on prices. While it offers significantly higher interest rates on current and savings accounts, it also charges the highest rate for consumer credit among the surveyed German banks. In addition, it charges higher prices for Eurocheques which is the basic cheque used in many domestic transactions and for the annual costs of maintaining a securities account. Thus, while it offers better than average conditions in the deposit rate area which receives a lot of public attention, it recovers these higher funding costs in other areas.

Did the aggressive strategy of KKB Bank pay off in terms of profits? Table 7.7 analyses the financial statements of Citibank Germany over the period from 1986 to 1990 and compares these with the development the same data for all German banks as surveyed by the Bundesbank.

Table 7.7: Analysis of KKB's financial statements from 1986 to 1990

	After-tax operating profits*		Interest rate income		Com-mission surplus		Operating expenses	
	KKB	All banks	KKB	All banks	KKB	All banks	KKB	All banks
1987	+1.2%	-7.7%	+9.2%	+0%	+44.2%	+9.1%	+2.6%	+5.1%
1988	-39.5%	+10.1%	+2.7%	+2.9%	+2.7%	+17.2%	+7.1%	+4.4%
1989	+56.4%	-1.4%	+3.0%	+0.8%	+19.3%	+16.0%	+9.7%	+4.3%
1990	+37.6%	+12.1%	+9.8%	+6.2%	+29.4%	+12.9%	+10.2%	+8.3%

* Percentage figures in comparison to preceding year

Source: Own calculations from annual reports of KKB and Deutsche Bundesbank banking statistics.

It becomes apparent that KKB Bank managed to increase its operating profits substantially above the average of all German banks in the past two years. This resulted from an increase in both interest rate income and commissions which outpaced that of other German banks. The slump in after-tax profits in 1988 resulted from significant investment outlays in new branches and introducing new computer technology both in the back and front office areas. At the same time, however, operating expenses increased above average resulting from the significant investments in technology.

Citibank Germany is still one of the most profitable banks in Germany, however. In 1990 it had a return on assets of 0.6 percent as compared to an industry average of 0.21%. Profits on capital were also significantly above the industry average.

3. Case studies of cross-border strategic alliances

3.1. Banco Santander and Royal Bank of Scotland

3.1.1. Background and strategic objectives of the alliance

Royal Bank of Scotland (RBS), the seventh-largest British bank, and Banco Santander, the fourth-largest Spanish bank, are both medium-sized banks in their home markets. Banco Santander had one of the highest profit on capital ratios of the large Spanish banks in 1990, whereas RBS's profit performance is only slightly above the UK average. Both have reasonably successful merchant bank subsidiaries and have been seeking to expand internationally, as their presence outside their home country was very limited.

In the 1980s RBS expanded significantly to grow from a largely regional bank to a major player in the UK market with a network of approximately

850 branches after the absorption of its English subsidiary Williams and Glyn's. RBS has an approximate market share of 40 percent in the Scottish banking market, 15 to 20 percent of the North West of England and 4 to 5 percent of the total UK market. Its international banking presence in Europe was basically non-existent up to 1988, however. Early in 1988 the bank therefore recognised the need to expand its European coverage. The three options considered were opening representative offices or branches, acquiring a foreign bank or engaging in a strategic alliance. Opening branches was excluded since it was judged as requiring too much time to establish a sufficient presence and thus this entry vehicle did not meet the requirement of quickly increasing international presence. A cross-border acquisition was excluded because of high costs and high goodwill write-offs which were seen as being difficult to justify to shareholders. It was therefore decided to pursue the third possible entry vehicle and in early 1988 RBS started searching for a European partner with whom it could engage into a broad strategic alliance. After an initial selection process there were five potential European banks which met the criteria of being roughly the same size as RBS in order to avoid a possible takeover and shared a similar interest in European expansion. Since Banco Santander had been going through a similar strategic evaluation process, it was decided by the two banks to set up a working committee in April 1988 to evaluate possible areas of cooperation.

Banco Santander was formed in 1857 also as a regional bank and has since grown to become the fourth-largest Spanish bank. It was the first bank to leave the 'gentleman's club' of Spanish banks by breaking explicit or tacit collusive agreements. An example of its aggressive strategy are the high-yield current accounts introduced by Santander which forced other banks to follow suit.⁹ Santander also follows the most determined international strategy of the large Spanish banks by having acquired a small Belgian and German bank and swapping 30 percent of its Italian subsidiary Banco Jover with 30 percent of Cariplo's Istituto Bancario Italiano.

In October 1988 both banks signed a co-operation agreement and exchanged cross-participations. These took the form of a share swap: Santander bought 10% of RBS with a total value of \$89.6 million. RBS acquired 2.5% of Santander and purchased 50% of the German CC Bank and Belgian Credit du Nord Belge, the other halves being owned by Santander. The agreement is supported by swaps of Board members and personnel and by a surveillance committee consisting of the chairmans and strategy directors who meet every six weeks. Moreover, the respective chairmans have been appointed to the allied bank's board and representatives of the partner bank work in the London and Madrid branches to monitor the local implementation of the alliance.

The co-operation agreement includes a 'non-aggression' pact which includes the agreement to service each other's clients in their respective

⁹ See chapter five.

foreign markets and to jointly enter foreign markets. Thus, it precludes cross-border entry in the cooperating bank's home market. Considering this provision an RBS official notes in a personal interview that "everybody congratulated us on having 'entered' the highly profitable Spanish market. It turns out, however, that we have actually agreed not to enter ourselves but leave domestic business entirely to Santander".

In the personal customer market the alliance provides for mutual usage of the branch network. After the two mainframe computer systems were made compatible, Santander and RBS introduced the Interbank On-line system (IBOS) in November 1990. IBOS allows instantaneous and direct money transfer between all 850 RBS and 1,400 Santander branches and is thus the first on-line cross-border payment system with these facilities. These money transfers are provided at significantly lower costs than through regular clearing channels (0.2 percent with a minimum of £5 and a maximum of £10, as compared to at least £10 to £15 for regular transfers). In addition, standing orders can be carried out at a cost of £2.50 (end 1991) and personal customers can withdraw at any ATM or deal over the counter in any branch of the allied partner bank. Moreover, an RBS customer can open an account with Santander in any RBS branch and vice versa. The IBOS network is to be expanded to other European countries if suitable banks are found. In November 1991 the two banks announced that French Credit Commercial de France is to join the system.

Although the alliance has had important spin-off effects in the retail banking area, the original strategic rationale was clearly in the corporate banking sector. It was perceived that there was a significant danger of losing corporate customers to competitors unless both banks were able to provide indigenous facilities in European foreign markets. As stressed by an RBS official, the main strategic objective was thus to defend local corporate customers who consider expanding into Europe. The danger of losing customers to the cooperating bank in the host country is reduced by the fact that the latter bank is not able to provide services in the home country.

A joint venture was set up in Gibraltar to provide off-shore facilities and serve expatriates. In addition, a stake in a Gibraltar-based mortgage company was acquired which provides housing finance in Spanish market. Another joint venture includes a development capital company in the Spain (drawing on RBS's subsidiary Charterhouse expertise in this area), Vista Capital de Expansion with an initial funding of £32 million in 1990 and a joint acquisition of a Portuguese bank, Banco de Comercio e Industria, whose branch network was increased from 25 to 80 branches since acquisition.

The possibility of a cross-border merger or a takeover of RBS by Santander is not excluded by RBS officials. The alliance agreement includes a condition that voting rights arising from the reciprocal shareholding shall only be exercised in accordance with the recommendation of the other group's board, any increase of share holdings needs approval of the other board and any disposed shares need first to be offered to the other group.

These provisos guard against a hostile takeovers by the respective alliance partner. As RBS is still quite vulnerable to a takeover due to its widespread share ownership and Santander is very well-capitalised, it is not unlikely that the alliance between the two banks may eventually result in a merger. As an RBS official notes, this could happen if Santander jumps in as a white knight if some other predator makes a hostile bid for RBS.

3.1.2. A joint venture in Germany: the example of CC-Bank

The German joint venture of the two banks is CC-Bank which was first fully acquired by Santander in 1987. At the end of 1988, RBS acquired 50 percent of CC-Bank and thus the two banks are now shareholders with equal stakes. The German bank has around forty branches and had 738 employees in 1990 with assets of around ECU 800 million.

No change in top management took place after the acquisition which seems to indicate that the takeover was not one for corporate control. The supervisory board consists of one member of RBS and two members of Santander which also appoints the current chairman. The top management (Vorstand), however, continues to consist only of German members.

CC-Bank operates exclusively in the personal customer market and offers the full range of banking services including credit cards, brokerage and insurance services. In order to create a competitive advantage in this market, CC-Bank offers what are probably the highest interest rates on deposit and current accounts in Germany: in 1990 these were 5 percent on current and credit card accounts compared to an average 0.25 percent of other banks, and 7.5 percent on savings accounts compared to a mean of 2.8 percent paid by the biggest German banks. Due to these high interest rates, CC-Bank has been able to attract new deposits on current and savings accounts against the general trend of declining deposits on these accounts in German banking. Over the three-year period from 1987 to 1990 the bank managed to increase its deposits from private customers by more than 60 percent.

On its asset side, the bank focuses on a market niche which is somewhat neglected by the large German banks: it specialises on financial solutions for private customers of merchants such as electronics or car dealers. The market leader in this segment is another foreign-owned bank, Citibank Germany. In car leasing, for example, CC-Bank is among the biggest five financial services firms in Germany. CC-Bank maintains relations with more than 11,000 merchants and is called in by the dealer whenever a customer needs a loan or leasing arrangement, rather than paying for the good in full. Thus, it provides consumer credit through a 'retail' network of 11,000 dealers rather than relying only on its own branch network. This constitutes a clever way of compensating for the small branch network of the bank. Further, it helps customers economise on transaction costs: rather than requiring the potential purchaser to go to her bank first to get a loan arrangement, the merchant is able to offer a customised financial solution

'on the spot' after around 10 to 15 minutes consultation with a service center of CC-Bank which has the same opening hours as the merchant. More than 90 percent of such loan arrangements are in the range of less than ECU10,000. These low amounts help to reduce the risk of possible defaults.

With this business strategy CC-Bank managed to increase its business volume significantly over the past years. After-tax profits increased by 36 percent from ECU1.9 million in 1989 to ECU2.6 million in 1990 which was paid out to the two main shareholders.

3.2. Commerzbank and Banco Hispano Americano

Commerzbank is the smallest among the 'big three' German universal banks. Hispano Americano is the sixth-largest Spanish bank with above average profitability. Both are members of the 'Europartner' network which was established in 1970/71 and additionally includes Banco di Roma and Credit Lyonnais. The Europartner group has been strained by the domestic mergers of Banco di Roma with Banco Santo Spirito and Hispano with Banco Central. Post-merger integration problems are most likely to distract these members from the European cooperation aspect for a while.¹⁰ In addition, Credit Lyonnais has pursued its own acquisition strategy in Spain with the FF 2,200 acquisition of Banco Commercial Espanol. This acquisition followed the offer by CL to engage in a mutual shareholdings agreement with Hispano which the latter bank declined, however, because it feared a takeover attempt by CL rather than a cooperation agreement. Since CL through its Spanish acquisition will be a direct competitor in the Spanish market, Hispano decided to withdraw from the alliance. Due to these strains the Europartner group was practically dissolved in July 1991 after other European cooperation groups such as ABECOR were already dissolved. Plans of Commerzbank and CL to engage in a share swap of 10 percent were abandoned in September 1991. This resulted mainly from CL's strategy of pursuing its own interests rather than cooperating with its Europartners. It bought banks in both Spain and Italy (Credito Bergamasco) and opened a branch in Germany, thus becoming a direct competitor to the other members of the alliance.

Commerzbank has held a 10 percent stake in Hispano since 1983. This stake was diluted to 4.5 percent by the pooling of equity in the merger with Banco Central. In July 1989 Hispano acquired a 5 percent stake in Commerz. In December 1991 the two banks announced that the mutual shareholding is going to be increased to 10 percent stakes for both groups.

The strategic alliance between Hispano and Commerz focuses on the retail banking area. As a Commerzbank official explains: "We have the

¹⁰ Another cross-border alliance failed due to a domestic merger: in August 1991 Banco de Bilbao sold its 7.3% stake in Hambros due to internal problems after its merger with Banco de Vizaya.

vision of a linked branch network where any individual customer from each of the cooperating banks can use the branches of the other bank in the foreign country and be serviced just like a domestic customer." In contrast to the RBS/Santander alliance, however, progress in this direction has been much slower.

In retail banking the alliance between the two banks focuses on travellers, both private and business, who visit the country of the cooperating partner. For private customers each bank issues a so-called "Travel card" which serves as identification for the other bank. For business customers there is the analogue of the "Business Card" which enable the business traveller to use the branch network of the other bank which provides logistical support.

In contrast to the RBS/Santander alliance, banks can use the cooperating bank's branch network to distribute its own products. An example of this is the "Spain mortgage" which is a DM mortgage sold and monitored by a Hispano branch. It is aimed at the German investor who intends to buy property in Spain. Hispano provides support when searching, selecting and valuing a suitable object and aids with the legal side of the transaction. In return, it maintains the current account of the investor (e.g. pensions, water, electricity) and also funds for asset management. This points at one of the problems with the alliance: the cooperating bank has an incentive to entice away the customer should there be an opportunity.

The strategic alliance has not been free of problems. One Commerzbank official remarks that while the alliance is "theoretically an interesting and challenging concept", it is "extremely difficult to accomplish in practice, however". Among the problems cited are difficulties in disseminating information about the alliance in all concerned branches.

In addition to the current areas of cooperation, it is planned to offer joint cheque books, ATM cards and savings accounts and to establish a unified computer system, as well as closely co-ordinating treasury, capital market and M&A activities. Similar to the RBS/Santander alliance, both banks agreed not to open branches in the cooperating bank's home country. This, of course, has implications for the impact of alliances on competition. Instead of fostering price competition through own entry activities, allied banks leave the foreign market entirely to the cooperating bank. Even though the cooperating bank may distribute products and service customers of the partner, it is not induced to change its pricing strategy for domestic customers. Thus, the impact on domestic prices is likely to be negligible. Nevertheless, there may be enhanced product variety, as the range of products increases. Thus, through cooperative agreements banks can distribute products by the foreign partner which were previously unavailable in the domestic market or only available at higher costs.

4. Conclusions

This chapter has first provided some evidence from a range of interviews with banks on the general impact of the regulatory changes in the context of the internal market programme. Most practitioners agree that the impact of 1992 is likely to be minimal in the market for large corporates and institutions. Retail banking is seen to be more affected but it may well take another ten years before greater cross-border penetration in this sector is achieved.

In addition, this chapter has presented a series of in-depth case studies which analyse the strategic objectives, the impact on competition and the implementation and success of cross-border entry activities in the retail banking area. The main cases of cross-border acquisitions and alliances were selected and followed up in the form of firm-level interviews.

For cross-border acquisitions it becomes apparent that post-acquisition strategies vary significantly for individual cases. While for some cases a hands-off approach is pursued by the acquirer, other acquisitions are actively integrated into the group following a unified European strategy. It appears that acquired banks do not follow a strategy of consistently undercutting indigenous institutions on prices. However, they frequently do offer better conditions on selected products such as deposit interest rates, like CC-Bank and Citibank in Germany or Barclays in Spain, or credit cards such as Citibank and Barclays in Germany and may therefore force domestic competitors to follow suit. In addition, it seems that foreign institutions frequently compete on quality and efficiency of services. Examples are Deutsche Bank in Italy whose decision-making process is a lot quicker than that of the large Italian banks or National Westminster in Spain which focuses its market positioning entirely on providing better service quality than indigenous banks. In addition, foreign banks are frequently forced to rely on technology-intensive distribution methods in order to compensate for the lower number of branches. Thus, they may introduce new distribution methods such as home banking and advanced ATMs, as Citibank has done in Germany, which may eventually be copied by domestic competitors. Thus, foreign banks are frequently competing on service quality and efficiency of distribution rather than merely on prices.

Does actual or potential foreign entry in retail banking place constraints on domestic firms and reduce their ability to exercise market power? I have argued that foreign entry can have several potential effects on domestic market conduct. First, it can break up domestic (tacitly) collusive equilibria, as foreign banks are 'outsiders' to the domestic banking community and may attempt to gain business by offering existing services at lower prices. Alternatively, they can introduce new products or compete on quality of services rather than prices.

Our empirical evidence seems to suggest that foreign banks in the retail area compete on the price level only in selected areas. This may concern the area of interest rates on deposit accounts, for example, where foreign banks are often the first banks to offer significantly positive or above average rates which in some cases induces domestic banks to increase their rates in response.

Possibly more importantly, foreign banks frequently compete on the quality and efficiency level. This means that foreign banks often invest heavily in technology to gain a competitive edge. Firstly, this probably results from the simple fact that price cuts can be immediately matched by domestic competitors, whereas a technological edge requires more time to be imitated by competitors. More importantly, foreign banks are to some extent forced to compete on efficiency, technology, and quality levels, as they cannot compete with domestic banks in terms of the extent of the retail branch network. They therefore have an incentive to probe into alternative distribution methods such as non-branch based methods. Innovations in the field of product-delivery methods may bring considerable benefits to the consumer, as they are likely to facilitate the communication and interaction with banks. In particular, new distribution methods introduced by foreign banks may be copied by domestic institutions.

In general, it seems clear, however, that in the retail area the impact of foreign banks on domestic competition is less than in wholesale activities, since entry barriers are significantly greater in retail banking. Such entry barriers stem particularly from customer switching costs and the lack of suitable acquisition targets in most European countries. In contrast to investment banking, geographic expansion in the retail sector entails large fixed costs, as product delivery still necessitates a large number of distribution outlets. Only when communication technology has progressed so far as to make non-branch based distribution methods widely acceptable will foreign banks be able to make a greater impact on domestic competition in the retail banking sector.

The impact of strategic alliances on competition seems less conspicuous. Although they may in principle bring new products to the market, they are frequently of a defensive nature intended to provide internationalisation at low cost and low risk. As the example of Royal Bank of Scotland and Banco Santander shows, however, such an alliance can bring significant benefits in the retail area where technological cooperation between two large branch networks leads to a simplification of cross-border transactions. Most other alliances, however, have yet to produce real benefits for the participants and an impact on competition.

Chapter Eight: Cross-Border Entry in European Insurance: Survey Evidence and Case Studies

Analogous to the preceding chapter, this chapter presents empirical evidence on the cross-border penetration process in European insurance. The first section reports on a questionnaire which was sent to the largest European banks and insurers, while the second section presents individual case study analyses of cross-border entry activities in the insurance sector.

1. Results from the questionnaire survey

1.1. A note on research methodology

In addition to undertaking personal interviews, I decided to undertake a questionnaire survey on cross-border entry among EC insurance companies. The objective is to compare the results of such a systematic study in the insurance sector with those in banking. The population was defined as all EC banks and insurers which may be affected by cross-border entry activities either in an active sense, i.e. by undertaking cross-border entry themselves, or in a passive sense by being affected by increased competition from foreign firms.

In the banking sector, the annual listing of the largest 1,000 banks worldwide was used to extract the largest EC banks in each country and addresses were compiled from *The Banker's Almanac*. In the final sample 138 banks were included.

By far the the best sampling frame which covers the population of EC insurance companies is the annual Financial Times publication *World Insurance* which contains addresses and data for the largest insurers in each of the twelve EC countries. While it is not clear which criteria are applied for including an insurer into the publication, the annual covers all of the major European firms. For each of the EC countries all general insurers included in the latest edition were selected. Thus, firms which specialise in marine or industry insurance were not included in the final selection of addresses. The final distribution of firms across the twelve EC countries is shown in table 8.1.

Table 8.1 Number of firms and response rates for individual EC countries for survey

	Banking			Insurance		
	Number of firms included	Number of responses	Response rate (in percent)	Number of firms included	Number of responses	Response rate (in percent)
Germany	24	11	46	20	10	50
France	26	8	31	26	11	42
UK	28	7	25	23	8	35
Italy	15	6	24	14	4	29
Belgium	7	3	43	12	3	25
Spain	9	3	33	8	2	25
Portugal	4	1	25	5	0	0
Ireland	5	1	20	5	0	0
Netherl.	6	2	33	7	2	33
Denmark	7	0	0	5	2	29
Greece	4	0	0	6	3	38
Luxemb.	3	1	33	3	1	33
Total	138	43	31	134	46	34

The questionnaire was sent out on March 16/17, 1992 with the request to have it returned by April 16, 1992. Each questionnaire was accompanied by a letter which explained the purpose of the study. The letters were addressed to the public relations departments which were asked to forward the questionnaires to the responsible department. At the beginning of April, follow-up calls were undertaken to those firms which had not responded by that date. The final distribution of returned questionnaires by countries is also presented in table 8.1. It is obvious that the number of responses from some EC countries such as Luxembourg, Denmark, Portugal and Ireland was too low to draw any representative conclusions for the population of banks and insurers in these countries.

The overall response rate was 31 percent for banking and 34 percent for insurance. In the following section, I report some of the most interesting results for the aggregate sample. I generally do not differentiate by countries, as the number of responses per country was too low to draw any statistically representative conclusions.

1.2. Results from questionnaire

In this section, I give a broad overview of the answers of the questionnaire and compare these between the two sectors. I focus on the most interesting issues, rather than providing a comprehensive question-by-question analysis. In particular, I compare the responses of the banking and insurance sectors. Many of the factual data which were derived from the questionnaire were incorporated into the appendices or are cited as examples in other parts of the thesis and are therefore not dealt with in this section.

Currently, 87 percent of insurance firms regard foreign firms to be competitors in at least one branch of insurance. This figure was even higher in the banking sector with 94 percent, but referred almost exclusively to the investment banking and multinational corporate markets. This confirms the notion that foreign banks currently play only a marginal role in retail banking. Foreign insurers were considered to be significant competitors in particular in property insurance (mentioned by 73 percent of respondents) followed by the life sector (with 55 percent). This response was largely similar for the different EC countries. In health insurance, there was a larger degree of divergence with the large majority of German firms stating that there are no significant foreign competitors, whereas foreign firms were considered to be more important competitors by Greek, French and Spanish respondents. This divergence results from different degrees of openness to foreign entry in the health insurance sector.

34 percent of respondents in insurance considered foreign firms to be "moderate" competitors in the personal customer market segment, another 38 percent even regarded them to be "significant" competitors. This starkly contrasted with the banking sector where only 12 percent of respondents considered foreign banks to be strong or significant competitors in the retail banking sector. This percentage was significantly higher for the Spanish market where 45 percent considered foreign banks to be at least "moderate" competitors. This confirms that the Spanish market is more heavily penetrated by foreign banks in the retail sector, despite former official entry barriers discussed in chapter four. The percentages for the small and medium-sized corporate market segment were slightly higher both in banking and insurance, while 64 percent of insurers considered foreign firms to be strong competitors in the market for multinational firms. In banking, this figure was even higher with 93 percent. Foreign banks thus play the most important role in the more easily accessible wholesale banking market.

In insurance, firms expect the greatest impact of the internal market programme to occur in the retail sector. However, firms from the Southern European countries, in particular Spain, Portugal, Italy and Greece also expect a significant increase in competition in the market for large corporates where multinational industrial coverage is expected to become of increasing importance. In the banking sector, 42 percent of banks expect a

“sizeable” impact of the 1992 programme in the retail sector. 84 percent of respondents, however, expect that “no change” is taking place in the market for multinationals, since competition is on an international scale already. This confirms the conclusion from the interview evidence, reported in the previous chapter.

Concerning individual insurance sectors, the largest impact is expected to take place in the life sector where 92 percent of respondents expect a “big” or at least “sizeable” impact. This probably results from the fact that life insurance, in contrast to the non-life market, still offers high margins and has so far been a fairly protected industry in most EC countries. There was no differentiation according to countries. In other sectors, however, responses varied by countries. Health insurance, for example, is expected to be little affected in Germany and the UK, while being more likely to be affected in Spain, Portugal and Greece. In both motor and personal liability insurance, the internal market programme is expected to have less of an impact.

Spain, Germany and France are expected to be most affected by regulatory changes on the EC level in insurance. This conforms with the analysis in chapter two where it was noted that these countries follow the material control system of *ex ante* supervision which needs to be abandoned under the Third EC Insurance Directives. Spain also leads the ranking of the most attractive European countries for cross-border entry activities, closely followed by Italy and France. Germany, however, only ranks seventh, after the three countries already mentioned and Greece, Portugal and the UK. In banking, Spain is considered to be most attractive due to high margins, followed by France and the UK.

Only 58 percent of respondents currently take the single insurance passport into account in their strategic planning. This figure was slightly higher in the banking sector with 64 percent. However, this figure differed significantly between the large firms where the rate was more than 90 percent, and the smaller largely domestic firms where only 15 percent incorporated the changes on the EC level into their strategic planning. Among the expected changes resulting from the single insurance passport, insurers mentioned increased direct marketing activities, increasing importance of brokers, increasing product variety and variance of premium levels, less transparency of products for consumers and, interestingly, deregulation followed by re-regulation in ten years.

64 percent of respondents in insurance could list an example of a product from the retail sector which was introduced by a foreign firm either at a lower price than domestic products or as a product innovation. Examples from the banking sector were all from the wholesale sector and referred mainly to derivative products and foreign exchange products. This confirms the more conspicuous role of foreign insurers in the retail sector

compared to foreign banks which still concentrate their efforts on the wholesale sector.

Only a minority of insurers believe that foreign firms pursue an aggressive price strategy (42 percent), while 76 percent think that they follow mainly an innovative strategy. This is a result which is confirmed in the following case studies. In banking, a greater number of banks consider foreign banks to compete on the price level, especially in the wholesale sector. The vast majority of both insurers and banks expect an increase in foreign entry activities in their domestic market. 85 percent of respondents agreed with the view that such foreign entry will lead to downward pressure on domestic prices, due to increased competition.

Synergy effects deriving from operating Europe-wide were perceived to be significant by 85 percent of respondents and these concerned in particular the possibility of know-how transfer. Scale or scope economies were considered to be less important, confirming the empirical evidence analysed in chapter four.

Concerning the significance of regulatory barriers, it is interesting to observe that 82 percent of respondents considered regulatory barriers as "not so important" in insurance. In banking, regulatory barriers were perceived to be "important" or "very important" by 42 percent of banks. The most important barrier in insurance was perceived to be lack of the right distribution channel which 66 percent of insurers considered to be "very important". This was closely followed by "lack of intimate knowledge of the foreign market" which 45 percent considered to be very important. In contrast, the lack of a level playing field is considered to be "not so important" by the majority of insurers. In banking, the "lack of suitable acquisition targets" figure more prominently which 61 percent of banks consider to be at least "important" as a barrier to cross-border entry. It is interesting to note that none of these barriers to entry are likely to be affected in any significant way by the internal market programme.

The major cost disadvantages which insurers perceive during the first phase of entering a foreign market are lack of local market know-how and insufficient distribution channels. Reputational disadvantages and the fact that one is a 'foreign' firm were considered to be less significant in insurance, while being more significant in banking where 54 percent of banks referred to these factors as being at least "important". It was noted several times that it takes at least three to five years to turn a foreign start-up into a profitable operation due to the high set-up costs which need to be amortised over several years.

Among the firm-level advantages which can be transferred to a foreign market and which may lead to a competitive advantage, the follow-the-customer explanation is the most frequently cited view in the banking sector

where 78 percent of respondents consider this aspect to be “very important”. In insurance, however, this explanation is less significant, whereas know-how is viewed to be the most important source of competitive advantages at the firm level.

Concerning competitive advantages stemming from locational aspects, lower efficiency of insurance firms in the host country is considered to be “very important” by 55 percent, while diversification advantages are regarded as important or very important by 68 percent. In banking, locational advantages stemming from funding costs differences between the home and the host country were considered to be “important” by 62 percent of respondents. Similarly, regulatory factors were considered to be “important” or even “very important” by 53 percent of banks.

In insurance, 64 percent of respondents believe that successful entry in the personal customer market through de novo entry is possible, while only 19 percent considered exporting to be a feasible entry strategy. In banking, these figures were even lower: merely 12 percent regard de novo entry to be feasible, while 8 percent consider exporting to be feasible in the personal customer segment.

As the main disadvantages of both joint ventures and strategic alliances, respondents listed differences in management attitudes and the coordination of strategic planning. This was very similar in banking and insurance.

In summary, it emerges that respondents from the insurance sector expect a significantly greater impact of the internal market programme in the retail financial services sector than banks. At the same time one has to realise, however, that foreign insurers in the retail sector already play a more important role at the moment than foreign banks.

2. Case studies of cross-border entry strategies

2.1. Allianz’ European acquisitions

2.1.1. Allianz’ strategy of international expansion in Europe: a historical overview

Allianz was founded in 1890 in Berlin and soon after its foundation established international branches in several European countries such as France, the UK, Holland and Italy. In 1913 before the outbreak of the First World War, 20 percent of total premiums were earned outside Germany. After the First World War, Allianz was forced to give up most of its international activities as a result of the Treaty of Versailles. In the interwar period, Allianz set out to rebuild its international activities in particular in Spain, Italy and Holland and several other European countries. Although

the significance of international activities did not approach that before the war, Allianz once again managed to become the German insurer with the largest international portfolio. All international activities were again lost after the Second World War and this time it took longer before the firm made another attempt to rebuild its international activities.

It was not until the end of the 1950s that Allianz enters another European country with a branch in Paris; one year later it enters the Austrian market with a life insurance subsidiary which soon becomes one of the leading firms in the market. In 1966 Allianz enters into a strategic alliance with the British Commercial Union by establishing a cross-shareholding. This shows that such alliances are certainly not a recent innovation.

It was not until the beginning of the 1970s, however, that Allianz enters a phase of a significant internationalisation process. The dramatic impact of this strategy can be assessed when looking at the premium income from foreign activities: these were only 3 percent in 1970, while in 1991 the income from international activities as a proportion of total activities had increased to 48 percent with premiums of ECU11 billion earned abroad, of which more than 80 percent were accounted for by the European countries. In 1992, Allianz belongs to the largest five insurers worldwide with a total premium income of ECU22.5 billion and 75,000 employees. The dramatic expansion of Allianz is reflected in the fact that both total premium volume as well as profits trebled between 1985 and 1991.

Initially, the cross-border entry activities of Allianz were primarily driven by the 'follow the customer' view. As German industrial firms expanded their activities from being predominantly export-oriented to increasing their direct foreign investment, Allianz realised that in order to provide adequate insurance services to the rapidly increasing number of foreign subsidiaries of German industrial firms, it needed to have a local presence in order to be able to perform risk assessment and monitoring activities at lower transaction costs than is possible from the German headquarters.

Subsequently, Allianz' cross-border expansion was increasingly driven by diversification considerations. As is formulated in a strategic review in 1989: "to be dependent on just one market is too dangerous from the point of view of diversifying away economic risk arising from business cycles ... in addition, risk reduction results from the possibility of spreading insurance risk across several national markets. This provides important competitive advantages over those insurers which operate only in their domestic market".

In addition to such a diversification view of cross-border entry activities, Allianz also recognises the advantages which result from the

transfer of product know-how among its subsidiaries. In its annual report of 1989 it notes that "Allianz crosses national borders also because it wants to profit from the rich know-how in insurance and services which can be gleaned from operating in foreign markets ... know-how transfer resulting from international activities guarantees a significant competitive advantage".

In 1974 Allianz started its process of international expansion with a *de novo* entry in the British market. Management and underwriting of the new subsidiary was delegated to Willis, Faber Ltd., a British firm with long-standing experience in managing the British subsidiaries of several foreign insurers. However, this arrangement proved unsatisfactory, since Allianz did not get access to activities on its own account, nor did it gain an insight into management and underwriting activities. A similar *de novo* entry into the US market in 1977 which also led to significant problems leads to the general strategic conclusion that greenfield entry does not lead to the desired position in a foreign market. In the 1989 annual report dealing with the US venture, the company described its encountered problems with *de novo* entry activities. In particular, the lack of local know-how leads to cost disadvantages during the first entering phase: "the entering period into the new market turned out to be extremely difficult ... different customs and mentalities, a different legal system in particular in liability law and the need to establish an agent system entirely from scratch lead to difficulties of an extent not previously experienced".

At the beginning of the 1980s, the Allianz management therefore decided to enter foreign markets by acquisition rather than by *de novo* entry or strategic alliance. The first such large-scale acquisition attempt took place in the UK where Allianz had become increasingly dissatisfied with its marginal presence. In June 1981 Allianz acquired a 28.1 percent of Eagle Star, one of the largest UK insurers. After the management of Eagle Star did not cooperate with Allianz, however, the German insurer made a hostile takeover bid for Eagle Star in October 1983. The takeover bid was the highest ever made for a firm in the UK up to that year. However, soon after the offer, BAT, the third-largest UK conglomerate, stepped in as a white knight and in a competitive race outbid Allianz. The German insurer, when selling its stake in Eagle Star to BAT, made a profit of ECU250 million.

After this failed hostile takeover attempt, Allianz decided in 1986 to acquire Cornhill Insurance in the UK in a friendly takeover for an acquisition price of ECU450 million. Cornhill was the eleventh-largest UK insurer with a special focus on the non-life sector, in particular motor car insurance, accounting for 36 percent of total premiums, where it is one of the market leaders. It had 3,400 employees in 1989 and a premium volume of ECU900 million of which 85 percent come from domestic activities. Cornhill has a reputation for being a product innovator. It was the first

insurer, for example, which introduced the bonus/malus scheme in motor insurance, a scheme which is now commonplace.

In 1984 Allianz had already made a large-scale acquisition in the Italian market. A 51.5 percent stake of Riunione Adriatica di Sicurtà (RAS), the second-largest insurer in the country, was acquired for an amount of ECU560 million. This was by far the largest cross-border acquisition in the financial services sector up to that year. RAS was founded in 1838 and is one of the most internationalised European insurers with half of the premium volume being earned abroad. The main countries of activities of RAS are Austria, Switzerland, France and Spain which constitute a significant strategic complement to Allianz which was not well-represented in these countries with the exception of Austria. In addition, RAS was attractive to Allianz due to its powerful standing in the Italian market which Allianz believed had significant growth potential and where Allianz was represented only with a small subsidiary. After the acquisition Allianz exercised a strategy of restraint concerning the business policy of RAS. It sent only two members to the board of directors of RAS although it would have the right to appoint eleven members. In addition, it did not interfere with the local management in Italy at all, but focused cooperation efforts on joint expansion outside the respective home markets.

Such joint expansion was exercised, for example, in Spain where the subsidiaries of RAS and Allianz were merged and now carry the name 'Allianz-RAS Seguros'. After the merger Allianz became one of the largest insurers in Spain and the largest foreign insurer in the country.

Similarly in France, the RAS subsidiary, Protectrice, was integrated into the Allianz group. However, Allianz was not satisfied with its standing in the French market, a position described as "too big to die, too small to live". After integration of the RAS subsidiary it had a total premium volume of ECU250 million in France in 1987 which gave it only an insignificant market share. In addition, its position in the personal customer sector is clearly underdeveloped. In 1988 Allianz therefore started searching for a potential acquisition target in the French market but only with limited success. The main barrier to cross-border acquisition was the large degree of public ownership in the French market. The 'big three' national insurers are all government-owned, whereas a range of mutual companies cannot be acquired either.

Then, in September 1989 Allianz was approached by the holding company Compagnie de Navigation Mixte (CNM) which was subject to a hostile takeover bid by the national insurer AGF and the large merchant bank Paribas. CNM held a 95.8 percent stake in the insurance group VIA/Rhin et Moselle. Allianz quickly reacted and took over a 50 percent stake in the insurance subsidiary of CNM for a price of ECU930 million, the largest acquisition price paid for a cross-border acquisition until that time.

The VIA/Rhin et Moselle group was the fifth-largest privately-owned insurance company with a total premium volume of ECU1.3 billion and 2,400 employees. It had a market share of 2.2 percent and has a distribution network of 1,300 agents. Its main focus of activities were retail customers and its business portfolio consisted of two-thirds non-life and one-third life insurance.

With its large-scale acquisition programme in the 1980s, Allianz established a sizeable presence in most major European economies. Apart from its European cross-border entry activities, Allianz also entered non-European countries in particular the North-American continent where almost 20 percent of its foreign premiums are underwritten. Most recently, Allianz also entered the Eastern European markets through acquisitions and is so far the insurer with the largest presence in this geographic area. In Hungary, for example, Allianz acquired a 49 percent in one of the two large domestic insurers, Hungaria, which has a market share of 44 percent.

Allianz employs an M-form structure when managing its European subsidiaries. The central headquarters in Munich coordinates international activities and sets return on investment targets for the subsidiaries, while day-to-day management is largely left to local management. The general strategic vision is formulated at headquarters. This includes the supervision of restructuring and integration processes in particular in Spain and France, as well as promotion of international know-how transfer. Such know-how transfer concerns in particular new product ideas, marketing innovations or computer systems solutions. In addition, the internal organisation structure of the European subsidiaries is to some extent harmonised where a customer-focused approach is implemented rather than the traditional functional organisational structure (e.g. fire, motor, life etc.). Allianz started this internal reorganisation in its home market which is now divided into personal customers, small- and medium-sized enterprises and large corporates. This organisational structure, which is certainly not yet common for insurance firms, shall also be implemented in the foreign subsidiaries after sufficient know-how is collected in the German restructuring whose experience can then be transferred to the other countries.

In the next sections, I discuss Allianz' current strategy in some EC countries in greater detail.

2.1.2. Allianz' strategy in Spain

Allianz expanded its presence in Spain primarily through the acquisition of RAS in 1984 which has been active in the Spanish market since 1918 through its subsidiaries Adriatica and Cresa. In addition, a 51 percent stake in the small insurer Ercos was acquired in 1988 which complemented the activities in the personal customer segment. Until that acquisition, Allianz

was only active in the industrial insurance field through its subsidiary in Madrid.

In 1990 all personal customer lines of business were reorganised under the new holding company Allianz-RAS Seguros, SA. The merged company had a premium volume of ECU219 million in 1990 and made a profit after tax of ECU0.2 million, a result which was burdened by an increase in reserves and the restructuring resulting from the merger. The company holds a particularly strong position in the motor insurance market where more than 50 percent of premiums are written. Life business accounts for only 14 percent of total premiums in the insurance sector. As is apparent from table 8.2 life business has had a particularly high growth rate in the Spanish market and is expected to continue to grow at rates above those of other EC countries. Similarly, in the non-life sector Spanish growth rates exceeded the EC average.

Table 8.2: Insurance growth rates in Spain from 1985 to 1989 compared to EC average

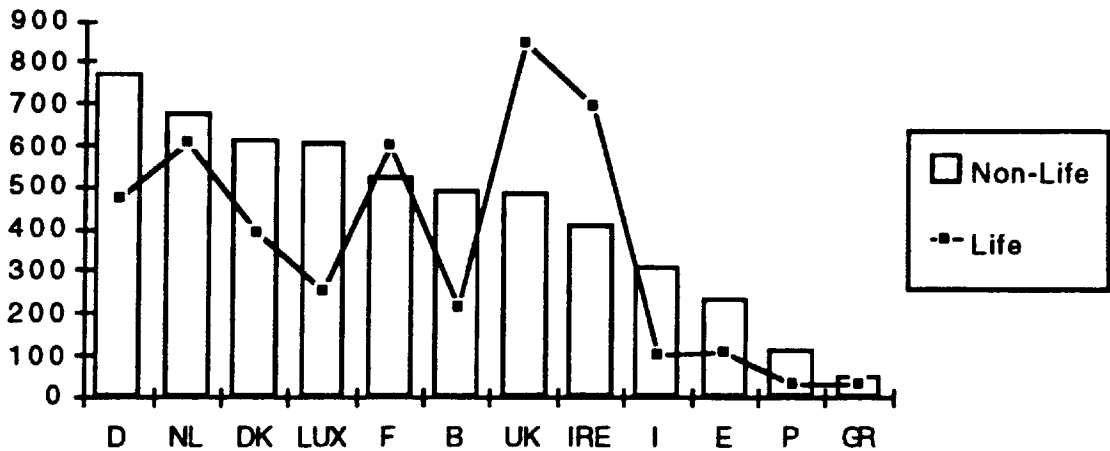
	Life ins.	Life: all EC countries	Non-life	non-life: all EC countries
1986	+67.9%	+16.2%	+14.0%	+8.5%
1987	+7.5%	+16.3%	+23.5%	+7.3%
1988	+70.2%	+15.1%	+12.2%	+5.6%
1989	-48.6%	+13.5%	+14.3%	+3.9%

Source: Sigma, several issues.

As is apparent from figure 8.1, Spain has one of the lowest insurance densities in the EC. Allianz therefore expects significant growth potential in the Spanish market which is only comparable to that of the Italian market which is also characterised by a low insurance density both in life and non-life business.

Figure 8.1: Insurance densities in the twelve EC economies in 1989

Premiums per capita
(\$US)

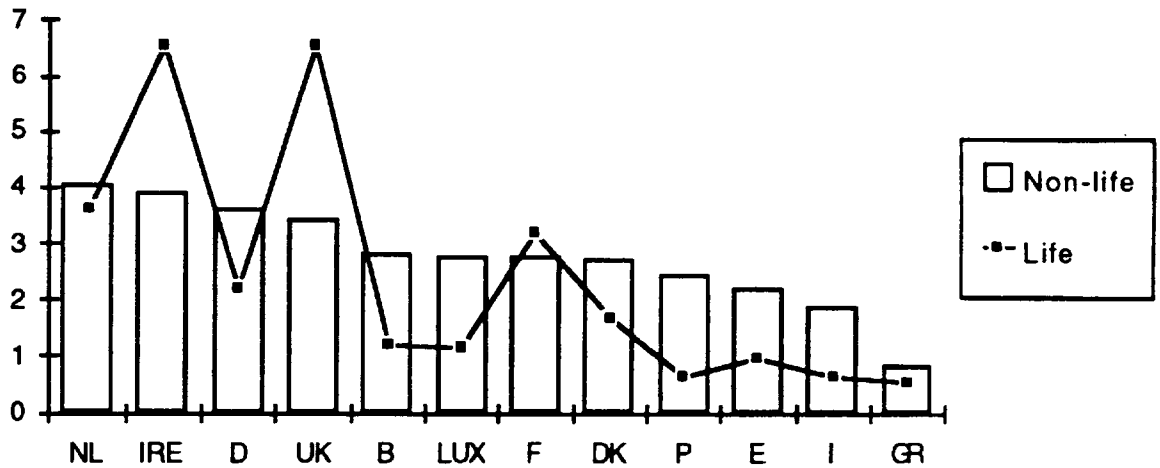


Source: Sigma 2/1991

Figure 8.2 shows similar results concerning insurance density if measured in terms of premiums as a percentage of GDP. Again, Spain and Italy have the lowest insurance density, only ahead of Greece.

Figure 8.2: Premiums as percentage of GDP in the twelve EC economies in 1989

Premiums as %
of GDP
(\$US)



Source: Sigma 2/1991

To expand its position in the high-growth Spanish life-insurance market, Allianz entered a joint venture with Banco Popular Espanol in both life business and pension funds. The two JV companies, Eurovida and Europensiones, which are jointly owned by Allianz and Banco Popular, aim at distributing products which are underwritten by Allianz through the branch network of Banco Popular. In the motor insurance market, which constitutes by far the most important market segment for the group, Allianz-RAS attempts to gain a competitive advantage through introducing innovative products rather than competing on the price and premium level. This corresponds to a general business strategy of the Allianz group which mostly follows a medium- to high-price strategy in the markets in which it is active. In order to justify higher prices, it attempts to provide better service levels than those of competitors. A firm official notes that for the Spanish market

“we aim at providing high service quality rather than competing on the price level. In particular, we want to establish a reputation as an innovator and be the market leader in introducing new products. It is in this area in which we believe to have a competitive advantage due to the possibility of know-how transfers from other European subsidiaries of the Allianz group.”

This strategy appears very similar to that of other European banks and insurers which follow the strategic objective of competing on the level of product or service quality or through innovations rather than by competing only on the price level.

2.1.3. Allianz' strategy in the French market

France was the first EC country in which Allianz became active by establishing a branch in 1959, after having lost all its international activities in 1945. It was not until the 1989 acquisition of a 50 percent stake of the Via/Rhin et Moselle group, however, that Allianz gained a sizeable market share in the French market. As is noted in an annual report, concerning strategy in France:

“it was in France ... that Allianz learned the most important lesson to be applied to its subsequent strategy abroad: that it is almost impossible, in a well-developed insurance market, to set up an efficient organisation for personal insurance business from scratch at reasonable cost.”

In 1990 a new holding company, Allianz Via, S.A. was founded to coordinate all activities of the different group members. In this holding company the interests of the former RAS subsidiaries, Protectrice, are merged with those of Via/Rhin et Moselle and the original subsidiaries of Allianz. Allianz AG holds a majority stake of 65 percent in that group, while Compagnie de Navigation Mixte (CNM), the former majority owner, retains a stake of 34 percent. In turn, Allianz AG is one of the main shareholders of CNM with a stake of around 9 percent.

After these reorganisations which mainly took place in 1990, the French market had become the second-largest European market for Allianz in terms of premium volume (behind Italy). The French insurance market, which is the fifth-largest in the world, has experienced a significant growth rate in the life insurance sector which outstripped the EC average, as is apparent from table 8.3. In the non-life sector, however, there was a lower than average growth rate. Allianz expects these low growth rates to continue in the non-life sector with an average growth rate which equals the GDP plus one to two percent. In the non-life sector, however, Allianz expects continued growth rates of around 11 to 15 percent at least until 1995.

Table 8.3: Insurance growth rates in France from 1985 to 1989 compared to EC average

	Life ins.	Life: all EC countries	Non-life	non-life: all EC countries
1986	+25.7%	+16.2%	+3.3%	+8.5%
1987	+19.4%	+16.3%	+3.4%	+7.3%
1988	+32.6%	+15.1%	+2.4%	+5.6%
1989	+21.9%	+13.5%	+2.2%	+3.9%

Source: Sigma, several issues.

In 1990 the Allianz Via group had a total premium volume of ECU1.44 billion which gave it an overall market share of slightly more than 3 percent in the French market. Of the total premium income, 33 percent fell into the life insurance category, while 60 percent were in the property and casualty insurance sector. In the industrial insurance sector, Allianz Via had a market share of 8 percent which reflects its long-standing focus on this market segment.

Whereas Allianz uses brokers as the main distribution channel in industrial insurance, in the personal sector general agents are used to distribute the firm's products. The group employs 1,500 agents which look after 2 million customers. Competition through non-traditional distribution channels has increased especially in the life insurance sector where the proportion of products distributed through banks increased from 10 percent in 1983 to 41 percent in 1989.

Based on Allianz' general strategic approach of providing high-quality rather than low-price products, its strategy in the French market aims at product innovation and high service standards in order to gain a competitive advantage. Innovative products are introduced both in the life and non-life sectors. In motor insurance, for example, Via introduced the 'Auto Kilomètre' product which provides special rates for those motorists who drive less than a specified number of miles per year.

As an Allianz official notes, know-how transfer takes place from France to Germany rather than the other way around. This results from the fact that the French market is substantially more innovative than the German market and competition in terms of product innovations is actually greater in France than in Germany. Concerning pricing strategy, an Allianz executive notes that the firm currently ranks in the middle in terms of premiums and has no intention of cutting premiums.

2.2. Equity & Law Life Insurance

Equity & Law (E&L), the British life insurer founded more than 140 years ago, was acquired by the French Compagnie du Midi Group in 1987. Compagnie du Midi later merged with the Axa Group to form Axa-Midi, the second-largest European insurer after its 1992 takeover of US Equitable Life. Compagnie du Midi paid an acquisition price of ECU675 million to acquire the British insurer. Only few changes took place after the takeover of E&L by the French group. As a company official notes in a personal interview: "the Axa group believes that strategic issues and day-to-day management should be left to local management. After the takeover by the Axa Group there were therefore no changes in strategy, not even in senior management positions."

The main advantage which E&L sees as being owned by the French group relates to capital raising which is facilitated due to the status of Axa which has a AA+ Standard & Poor rating. This will facilitate E&L's ambitious expansion plans with the aim of belonging to the largest 10 UK life insurers by the end of the 1990s. It currently has a market share of 1.8 percent in the overall market, up from 1.1 percent in 1988 and is the twenty-third-largest life company in the UK. In the market for pension plan products, E&L is currently market leader. Concerning cross-border entry strategies, E&L has been active in the Netherlands where it is the eleventh-largest life company with a market share of 2.3 percent, and Germany where it has been present since the beginning of the 1970s. I discuss E&L's entry strategy in Germany in the next section.

2.2.1. Equity & Law's *de novo* entry strategy in Germany

E&L has been active in Germany since 1974 when it founded a subsidiary in Wiesbaden. Since then it has acquired a significant market share of more than 17 percent in 1991 in the permanent health insurance market which has been the focus of its business strategy since entering the German market. Since the mid-70s, E&L has consistently broadened its product spectrum, however, in order to improve its competitive position in the general life insurance market and to get away from a reputation of being only a specialist insurer.

E&L's role in Germany can best be described as that of a product innovator: all the major products which were introduced into the German market were innovative products which were not offered in that form by any domestic German insurer. This started in 1974 with the entry product being a term life product which was offered only by few German insurers, since most incumbents focused on the more profitable endowment life insurance market. Another entry product was a permanent health insurance product which could be acquired separately from ordinary life insurance. This was a novelty in the German market, as permanent cover was only sold in conjunction with other life products by the major German

incumbents. This innovation made it possible for consumers to acquire insurance coverage against the risk of disability even if no other life insurance products were acquired.

The second major innovative product introduced by E&L into the German market in 1979 was a term life insurance which distributed any valuation gains in regular intervals rather than only in the case of payout. An E&L official notes that competitors were first "surprised and shocked" by the new product. They were then quickly forced to introduce similar products, as E&L rapidly gained market share, since the new valuation system reduced premiums by almost a half. In 1991, E&L still had a market share of almost 6 percent in the term insurance market.

In 1988 E&L introduced as one of the first German insurers the unit-linked endowment insurance which links the value of the asset portfolio to a unit trust. The E&L group benefited from a transfer of know-how from its British operations to the German group, since unit-linked life insurance is the predominant product in the British market. Thus, the E&L group which has accumulated substantial experience in the management and marketing of unit-linked products in the UK market and has therefore progressed significantly along the learning curve, could transfer at least some of this know-how to its German operations. This provided E&L Germany with a significant potential competitive advantage compared to other purely domestic German insurers which had to acquire the product know-how for unit-linked products from scratch. In addition, E&L as part of the AXA group has a total asset portfolio of ECU125 billion and may therefore reap substantial benefits of scale and scope economies in the management of unit trusts to which the life insurance products are linked.

Most recently at the end of 1991, E&L introduced a dread disease insurance product which provides coverage in case of certain specified serious diseases, in addition to being an ordinary endowment life insurance. This product was also first introduced in the UK market and is now being transferred to the German market. Again, E&L is the first insurer which offers this new product. This product also exemplifies the dilemma which E&L faces in the German market: since product innovations in the financial sector are simple for competitors to copy, the product innovator has only little time to establish the product in the market before other firms offer identical products.¹ In the case of E&L's dread disease insurance, competitors such as Volksfürsorge already prepare similar products which are to be launched by the end of 1992. Thus, E&L has about one year to build market share before other firms enter the dread disease insurance market as well.

¹ See, for example, Tirole (1988, p.401-404) for a review of the literature on the strategic adoption of product or process innovations.

Table 8.4 presents some data from the annual reports for E&L Germany for the four-year period from 1987 to 1990.

Table 8.4: Analysis of financial statements of Equity & Law Germany from 1987 to 1990

In ECU million

	Gross Premium Income	Total Operating Expenses	Annual Loss	Number of distribution outlets
1987	44.0	53.1	3.6	2,320
1988	50.9	60.1	4.0	2,665
1989	58.6	69.4	2.2	3,045
1990	68.1	84.2	5.2	3,621

Source: Annual Reports

E&L's main problem concerning its loss-making performance is that its market share in the ordinary endowment life insurance which has by far the biggest share of total business in life insurance is only a minimal 0.09 percent. It accounted for only 7 percent of new business in 1990 with permanent health insurance (PHI) accounting for 27 percent and term insurance for 56 percent. This shows that E&L is strong in the low-margin PHI and term insurance market, while being vastly underrepresented in the endowment life insurance market. The ordinary endowment life insurance market, however, is the main source of profits for life insurance companies in Germany. Even though E&L has introduced an ordinary endowment life insurance product, it had significant difficulties promoting this product, as it could not be considered an innovation compared to the already existing products. This shows that E&L is successful in the market only if it offers innovative products. It is therefore in a constant race to innovate and once it has introduced a new product, to innovate again as competitors are quick to emulate the newly introduced product.

Another significant factor to explain E&L's lack of success in profit terms in the German market is its lack of an indigenous distribution channel. In contrast to the vast majority of domestic German insurers which distribute their products through tied agents, E&L is dependent on the broker network where it is in direct competition with other large insurers.

In a personal interview, an E&L official notes that "we sell our products primarily to the broker rather than the customer". This fact is crucial to understand E&L's pricing strategy in the German market: in order to place its products in the market E&L needs to offer high commissions to the broker, rather than necessarily offering the lowest premiums to the

customer. As the E&L official explains: "we prefer to pay a higher commission to the broker, rather than ranking on top of a consumer group survey of which firms charge the lowest premiums". This view in the management group of E&L is only recent, however, after the firm has gone through years of loss-making and there was a generally perceived need to change the firm's pricing policy. As a firm official explains: "there used to be a 'missionary' attitude in the firm which aimed at providing products to consumers at the least expensive prices. Such a strategy is not sustainable, however, for a firm which has no indigenous distribution channel". Concerning E&L's pricing strategy so far, it still ranks in the lower third in terms of premiums in the German market.

To summarise, Equity & Law which has operated in Germany for almost twenty years now has had a tangible impact on competition in the German insurance market. This resulted above all from its role as product innovator and its strategic policy of transferring product know-how especially from the British to the German market. Other German insurers were forced to adopt similar products to those introduced by E&L which led not only to improvements in product variety but also to tangible premium reductions for consumers.

2.3. Commercial Union's European strategy

2.3.1. CU's entry strategy on the Continent

The Commercial Union (CU) is the third-largest UK non-life insurer with a market share of around 10 percent and the tenth-largest life insurer, accounting for 3 percent of total premiums. It has traditionally had an international focus with premium income from international operations accounting for 60 percent of total operations in 1991. Activities in Continental Europe thereby accounted for 31 percent of total premiums, the most important region right after the UK with 40 percent.

By far the largest EC subsidiary of CU is the Dutch insurer Delta-Lloyd which was acquired as early as 1973 and whose strategy is reported on in the next section. In the Netherlands, CU had a total premium income of ECU561 million in 1991 which exceeded that in the rest of Europe which was ECU379 million. In this section, I analyse CU's operations in the EC countries, excluding the Netherlands which is analysed in the next section.

The biggest operations in the EC of the Commercial Union are in France in particular in the life sector where 42 percent of total European premiums are written (excluding Netherlands). The French life insurance subsidiary, L'Epargne de France which was acquired in 1984, achieved profits of ECU4.8 million in 1991. These profits were more than wiped out by losses in the French non-life sector which amounted to ECU17 million. Since the acquisition of L'Epargne de France, CU decided to enter through greenfield

rather than acquisition. It entered Spain in 1987 and Italy and Greece in 1989, all through de novo start-ups.

In Spain CU wrote premiums of ECU14.6 million in the life sector and ECU36 million in the non-life sector in 1991. Despite a loss of ECU2.5 million resulting from start-up costs, CU sees significant growth potential in the Spanish market. Similar to Eagle Star, CU build a new tied sales agent network from scratch which numbers 650 full-time agents in 1991. Its main strategic objective is to introduce innovative products such as the dread disease policy which it introduced as the first Spanish insurer.

In Italy premiums underwritten amounted to ECU44.2 million and losses before taxation of ECU4.55 million. In the life sector the Italian subsidiary, CU Vita founded in 1990, entered a distribution alliance with Credito Italiano. The JV in which the Italian bank owns 30 percent currently uses Credito Italiano's vast customer base to undertake direct mail solicitations but will increasingly rely on over-the-counter sales in the retail branch network.

Total European operations resulted in a loss before taxation of ECU31 million in 1991. The profit situation has steadily deteriorated since 1987 when CU still made profits of ECU 8 million. This deterioration is partly attributable to start-up costs which inexorably arise during a process of expansion but also reflect the difficulty of establishing a position in a new foreign market.

2.3.2. Significant market share in the Netherlands: Delta-Lloyd

As early as 1973, Commercial Union acquired the Dutch insurer Delta-Lloyd in a competitive bid with the Dutch firm Nationale Nederlanden. Delta-Lloyd was an amalgamation of several Dutch insurers comprising Amstleven, Nedlloyd and Hollandsche Societeit, the oldest Dutch life insurer founded as early as 1807, which had merged at the end of the 1960s. Delta-Lloyd has always had a sizeable market share in the Dutch market, being the third-largest life insurer with a share of total premiums of around 7 percent, and the fourth-largest firm in the non-life sector with a market share of around 5 percent.

As is apparent from figures 8.1 and 8.2, the Dutch insurance market is characterised by one of the highest rates of insurance penetration in the EC. At the same time, it is the least regulated insurance market in the EC together with the UK. Supervision is limited to control of solvency and technical reserve requirements. It has always been open to foreign entry and tariffs and premiums are not subject to regulatory control. Foreign entry is facilitated by the fact that in contrast to the German market, for instance, distribution channels are more readily accessible to new entrants. This

results from the fact that in the life sector 68 percent of insurance sales are made via brokers or multiple agents, while another 15 percent are sold direct. In the non-life sector, 32 percent of sales are made through direct channels, while 39 percent are sold through brokers and multiple agents (Salomon Brothers, 1990, p.62). This allows foreign entrants to gain access to distribution channels more easily than if distribution is primarily through tied agents which confers a greater incumbency advantage, since an entrant has to build an agent network from scratch.

Even though there has been competition between incumbents on premiums, there was also a significant degree of "communication" between firms concerning pricing strategies. For the life-sector there was even an official group which was part of the Dutch Association of Life Insurers which "discussed" premium rates. In a personal interview, a Delta-Lloyd official notes that "this cartel-like group" broke down at the beginning of 1992, as a number of firms dropped out of the cartel. The cartel fell apart as a result of a number of foreign insurers entering the Dutch market. These foreign firms include French UAP which cooperates with the largest Dutch bank ABN-Amro Bank in the distribution of life and pension products. NMB-Postbank, the third-largest Dutch Bank, has a distribution alliance with Austrian Erste Allgemeine, a subsidiary of Italy's Generali, which provides insurance products with NMB design but also handles all claims and trains branch personnel. The main reason why these large banks chose foreign rather than domestic insurers for their distribution alliances was clearly that foreign firms offered lower premiums and higher commissions to the banks, as they did not participate in the Dutch cartel.

In addition to these bank-insurer distribution alliances, a number of foreign insurers also entered the life insurance market by de novo entry. These firms include UK's Eagle Star, Prudential and Germany's DBV which formed a joint venture with a Dutch insurer. The ten foreign life insurers operating in the Dutch market which have their registered office outside the Netherlands had a market share of more than 10 percent in 1989 (Association of Dutch Insurers, 1991, p.35). Since the Dutch market is close to its saturation level concerning insurance density, new entrants have to take away customers from incumbents. Thus, they need to offer significantly better terms than domestic incumbents. This was only possible, however, if foreign entrants were not members of the Dutch cartel. Thus, as foreign entrants drew away business from the domestic incumbents, the discipline of the cartel fell apart, since incumbents saw an increasing need to match the terms of the new foreign entrants so as not to lose market share.²

Delta-Lloyd, even though being a foreign-owned firm, is very much part of the incumbent group in the Netherlands and was an active member of the existing cartel in the life sector. Its pricing strategy is not aimed at

² See also below for an account of Prudential's entry strategy in the Dutch market.

offering better terms than competitors. In fact, as a firm official states in personal interview, "Delta-Lloyd is certainly one of the more expensive insurers in the market with its premium levels being located in the top third of all firms".

In the life insurance sector, Delta-Lloyd mainly draws on its reputation as being the oldest life insurer in the country. It was one of the first firms to introduce unit-linked life insurance products where it could draw on the extensive experience of the Commercial Union in this area. Nevertheless, there is no close cooperation in terms of marketing or product development between Delta-Lloyd and its mother company. Since the Dutch firm is actually older than the CU, there is sometimes even a know-how transfer from Delta-Lloyd to its UK owner.

In the non-life sector, Delta-Lloyd is also in the top range of premiums rather than being a low-price supplier, as a firm official notes in a personal interview.

Table 8.5 reports some data of the financial statements of Delta-Lloyd and compares these with aggregate data for the Dutch insurance market.

Table 8.5: Analysis of Delta-Lloyds financial statemets from 1983 to 1991

in ECU million

	Total premiums in life	% change	% change for all firms	Total premiums in non-life	% change	% change for all firms	% change in pre-tax profits	% change for all firms
1983	431	+15.9	+7.3	335	+3.9	+2.4	-4.7	+6.8
1985	413	-4.1	+15.1	345	+3.0	+7.8	-6.3	+1.3
1987	479	+15.8	+15.2	370	+7.1	+14.7	+5.2	-0.3
1989	570	+18.9	+30.6	398	+7.6	+13.0	+69.7	+72.0
1991	794	+39.4	n.a.	395	-0.7	n.a.	+5.8	n.a.

Source: Annual Reports; Dutch Association of Insurers.

Delta-Lloyd recorded average premium growth rates in the life sector, while falling behind in the non-life sector. All insurers which use agents/brokers as their main distribution channel have to pay significant commissions to the distributors which are around 20 to 25 percent of annual premium volume, increasing costs significantly. Delta-Lloyd which has no direct sales therefore faces higher distribution costs than competitors which use less costly distribution channels. Commissions and expenses as a proportion of premiums remained constant in the non-life sector from 1982 to 1991, while decreasing by 44 percent in the life sector.

In 1991 Delta Lloyd transferred a total dividend payment of ECU35 million (1990: ECU29 million) to the Commercial Union which contrasted with the overall loss of the Commercial Union Group of ECU10.9 million. This shows that Delta-Lloyd turned out to be a profitable investment for CU. In terms of the impact on domestic competition, however, Delta-Lloyd has been a domestic player which plays by domestic rules and does not upset existing collusive agreements. Its pricing strategy is that of a high-price supplier rather than that of a 'price breaker' and the firm played no role in upsetting the collusive agreements which existed in the Dutch market.

2.4. UAP's and Liberty Life's acquisition of Sun Life

In 1989 the largest French insurer UAP and the South African life insurer Liberty Life each acquired a 27.7 stake in Sun Life Corporation which was sold by Sun Alliance. In 1991/92 this stake was increased to almost 100 percent. A UK holding company for Sun Life, the Rockleigh Corporation, was founded in which each of the two acquirers have a 50 percent stake. The acquirers paid £16.10 per share which resulted in a total acquisition price of ECU771 million. This constitutes the third-largest cross-border acquisition in insurance so far.

Sun Life is the sixth-largest life insurer in the UK market. It had a total premium income of ECU1,206 million and made after-tax profits of ECU29.19 million in 1991. Rather than replacing top management after the takeover, the two acquirers each placed one representative on the board of directors which consists of eleven members. Thus, this takeover was not one for 'corporate control' reasons. According to a company executive "the new shareholders have not exercised significant influence on day-to-day management activities". Although major decisions are coordinated with the two majority shareholders, there is hardly any form of direct influence by either UAP or Liberty Life. In particular, there is no evidence that Sun Life has changed its product or pricing policy after the acquisition.

Concerning cross-border expansion activities, Sun Life will be responsible for developing those markets which are closest to the 'Anglo' markets. These include in particular the Scandinavian markets as well as the Dutch market where currently a range of pension products are being introduced. Sun Life has founded a joint venture in Luxembourg in February 1990 together with UAP, Royal Belge and Banque Internationale which are all members of the UAP group. This joint venture aims at developing life insurance products to be distributed across all the European subsidiaries. This venture actually provides an interesting example of a case of strategic relocation of a firm to the most attractive regulatory environment. As a company official notes it was "the favourable regulatory and tax conditions" which provided the impetus for sourcing life and

investment products through the Luxembourg subsidiary. Products such as single-premium investment funds which are tax-free in Luxembourg are already being sold in the UK market. This example demonstrates that also in the retail sector strategic location decisions will be increasingly influenced by regulatory factors, in particular once the home-country rule will be fully established in the retail sector.

2.5. Victoire's acquisition of Colonia

Colonia, the second-largest insurer in the German market, was acquired by the French group Victoire in 1989 for an estimated acquisition price of more than ECU2 billion for a 52 percent stake. This constitutes the largest cross-border acquisition so far, both in banking and insurance. Only a few weeks after the friendly takeover, Victoire was itself acquired in a hostile takeover by the giant Suez holding company. Colonia and Victoire have had a strategic alliance for more than 20 years which was aimed primarily at jointly developing their foreign activities.

Colonia has a particularly strong position in the non-life sector with a market share of around 4 percent. In the life insurance sector it has a market share of 2.6 percent and also holds stakes in a range of other financial services firms such as reinsurance, building societies and a mortgage bank. 20 percent of its premium income came from foreign operations. Total premiums of the Colonia group were ECU4.7 billion in 1990 and it had 9,600 employees.

After the takeover, group assets of the Colonia group were transferred to a holding company in the Netherlands, Colonia-Victoire Nederland B.V. which is the holding company of all foreign activities of the Victoire group. There were no personnel changes in the Board of Directors, however. Representatives of the new majority shareholder were only appointed to the Supervisory Board. This illustrates the strategic policy of Victoire which has so far not interfered in the management of the Colonia group. Similar to the case of the acquisition of Sun Life by UAP and Liberty Life, there were no changes in pricing or distribution policies after the acquisition. A firm official notes that domestic strategy was unaffected by the takeover and that domestic issues are entirely left to local management. The only change which has taken place is that international committees were established which deal with a variety of issues and are intended to promote the know-how transfer between the two groups. However, as a company official notes, it is perceived to be difficult to find areas where synergy effects between the two groups could be established due to the significant differences in product and distribution structures as well as different regulatory regimes.

Also similar to the case of Sun Life, Colonia and Victoire cooperate mostly in the area of cross-border expansion where foreign activities are

merged and managed either by Colonia or Victoire, depending on whoever has had greater experience in that particular market.

2.6. Prudential's strategy in Italy and the Netherlands

Prudential Corporation is the largest life insurer in the UK with a premium volume of ECU4 billion in 1991. It made a pre-tax profit of ECU186.9 million in 1991. While Prudential has substantial business in particular in the US where 12 percent of premiums were written, in the EC countries it has so far entered only Ireland, Holland and the Netherlands. I review here Prudential's strategy in the latter two countries.

In Italy Prudential initially entered a joint venture in both life and non-life insurance with the Benetton Group in which each of the partners owned 50 percent. In 1989 Benetton sold its stake to the French insurer L'Abeille, part of the Victoire group which also acquired Colonia in Germany. Prudential also increased its stake in the life insurance JV to 60 percent in order to gain control, while reducing its stake in the non-life venture to 40 percent, conceding control to L'Abeille. Total premium volume of Prudential Vita in Italy was ECU11.5 million in 1991 and it achieved high growth rates over the past few years despite still operating from a small base. Concerning Prudential's strategy in the Italian market, a company official notes that there is as yet little scope for product differentiation in the Italian market due to regulatory constraints. However, Prudential attempts to differentiate its life insurance products through superior investment performance. Investment fund management for the Italian market which is performed out of the London headquarters has so far resulted in returns for the Italian policyholders consistently ranking among the top 5 life insurers in the Italian market. As Prudential currently uses only independent brokers and multiple agents as its distribution channel, it needs to provide sufficient incentives for the broker to distribute the products. A company official notes, however, that Prudential does not attempt to "buy" market share by offering significantly above average commissions to brokers.

In Holland, Prudential is much more of a niche player than in Italy. In the Dutch market with its high level of saturation, the company focuses on innovative products and market niches which are not yet served by incumbents. An example of such a product innovation is a unitised annuity which is targeted at the newly retired. Total premium income in Holland was ECU25.9 million and Prudential is not satisfied with the growth performance of the Dutch subsidiary. It is noticeable, however, that Prudential was one of the foreign companies which brought the cartel of Dutch life insurers to a breakdown at the beginning of 1992 by offering substantially lower premiums for a range of life products (see above).

2.7. Eagle Star in Spain, Portugal and the Netherlands

Eagle Star, the fifth-largest UK insurer, has so far entered four Continental European countries. At the beginning of the 1980s, it entered France and Holland, and in 1987/88 it established a presence in Spain and Portugal. All entry activities were de novo start-ups, with the Spanish operations being run from a hotel room during the first phase. In terms of premium revenue, the Spanish and Portuguese operations each accounted for ECU2.5 million in 1990, while the French and Dutch subsidiaries had a volume of ECU3.7 million, all in the life sector. In total, foreign operations accounted for 25 percent of total premium revenue of the Eagle Star Group of which an increasing share comes from the European operations.

Eagle Star's strategic objective when entering other European countries was to introduce a new product which was not available in this form in the host country. In the Netherlands, this product was a universal life plan which was characterised by its link to a unit trust. Unitised products, although originally 'invented' in the Netherlands in the 1950s, were not actually introduced in a marketable product form in this country. Thus, Eagle Star was actually the first firm to introduce a unit-linked life insurance product in the Dutch market and was quickly followed by other companies, among them Delta-Lloyd, as discussed above. After the introduction of this innovative product, Eagle Star introduced a number of other new products to build up its product range and be able to compete with indigenous institutions. The UK firm attempted to differentiate its products from those of competitors by focusing either on innovative niche products, such as a savings plan which parents buy for their children, for example, or by introducing a standard product which has new product attributes, such as the unitised life insurance product.

In Spain and Portugal, Eagle Star followed a very similar strategy by focusing on one innovative product, a unit-linked life insurance, which was a complete novelty in these markets. An Eagle Star official notes in a personal interview that the Iberian markets are "very dogmatic, very slow, and receiving regulatory approval of the new product was a torturous process". Due to regulatory requirements concerning investment of the assets, only a low proportion of total funds of the unit trusts to which the life products are linked are invested in shares, whereas the majority is invested in low-risk government bonds. Such requirements will be harmonised by the Third EC Life Directive. Currently, the Iberian operations are still basically one-product operations but there are plans to introduce other products which are standard in the UK but innovative in the less sophisticated Southern European countries.

Concerning distribution channels, an Eagle Star official notes that it was not necessarily easier to enter the Dutch market with its well-established

brokerage network than the Iberian markets in which a sales agent network had to be established from scratch. This stems from the fact that due to the novelty of the product, it was not difficult to find agents in Spain and Portugal which were eager to distribute Eagle Star's unitised product, as these products offered significant commission potential. However, in order to expand the distribution network of Eagle Star, the firm currently contemplates a distribution alliance with a local bank. Even though the insurance firm would have to share commissions with the cooperating bank, an Eagle Star official notes that it is not evident *per se* that distribution costs will rise, since the costs of actually contacting the customer are reduced due to the frequent-interaction relationship between bank and customer.

Concerning regulatory changes on the EC level, the Eagle Star official notes that these are closely monitored by the firm and actively incorporated into the current strategies. For example, after the UCIT-Directive (concerning mutual funds) took effect in all EC countries, Eagle Star decided to enter the German market and to start the distribution of investment funds through established brokers, based on the freedom of services provision in the EC Directive. Further, it is expected that the home-country rule will also lead to significant pressure on national regulators to harmonise tax regulations. This stems from the fact that it will be possible to relocate to a low-tax country such as Luxembourg, for example, where, unlike in the UK, reserves are not taxed. Thus, all European operations including those in the home country could be channeled through such a low-tax country, making domestic tax regulations basically ineffective.

In summary, Eagle Star has followed a clear strategy of being a product innovator in its foreign markets. It provides a good example of a firm introducing new products into a market which benefits consumers by increasing product variety.

3. Conclusions

In the first part of this chapter, I presented the results of a questionnaire survey which was sent out to the largest 270 banks and insurers in the European Community. The response rates were 31 percent in banking and 34 percent in insurance.

Foreign firms currently play a more significant role and are perceived to be stronger competitors in the retail insurance sector than in retail banking. In banking, foreign firms are at present still considered to be most significant in the wholesale and investment banking sectors, while perceived to become more significant in retail banking. In the retail insurance sector, however, the impact of foreign firms is generally expected to be greater than in retail banking.

Concerning the impact of the internal market programme, around 60 percent of banks and insurers currently take the single financial services passport into account. Not surprisingly, this rate was higher for bigger firms than for smaller firms which operate largely in the domestic market. The vast majority of respondents both in banking and insurance expect an increase in cross-border entry activities in their home market. Spain, Italy and France are expected to be most affected by the changes resulting from the internal market programme in the banking sector, while Germany is additionally listed in the insurance sector.

Concerning the significance of barriers to entry, it is interesting to find that regulatory barriers are not perceived to be all that important in the financial services sector. The most important barriers in insurance are lack of know-how and lack of right distribution channels, while the lack of suitable acquisition targets is additionally listed as a significant barrier in the banking sector.

De novo entry in the personal customer segment is perceived to be a feasible entry strategy by the majority of respondents in insurance, but not in banking. Cross-border provision of services, however, is not considered to be a successful entry strategy in both sectors.

The second part of this chapter presented a number of case studies in the insurance sector, analogous to the approach in the previous chapter. It emerged that in the retail sector there has been a greater scale of cross-border transactions in the insurance than in the banking sector, in particular concerning the size of individual cross-border acquisitions involving firms which have a significant market share in their domestic market. For these large-scale cross-border acquisitions, however, it was noted that the strategic impact of a change in ownership has, so far at least, been negligible. After the takeover by a foreign company, few strategic variables have been changed and these takeovers have certainly not been for corporate control reasons. It seems that the larger the transaction, the less significant the impact on day-to-day management of the acquired firm. The large firms which were acquired are very much domestic players and are unlikely to upset any existing collusive agreements or to suddenly start competing on the price level only because of an ownership change. It seems that foreign acquirers pursue a very cautious approach when integrating the foreign firm and implement a policy of least interference in the domestic affairs of the newly acquired firm.

De novo entries which, in contrast to the retail banking sector, actually exist in insurance seem to have much more of an impact on competition in the host country, as entering firms are forced to provide services either at lower premium levels or introduce new, innovative products. In practice, insurers most frequently choose the second strategy when entering foreign markets and firms like Equity & Law in Germany and Eagle Star in Spain

and Portugal provide good examples of foreign firms which have introduced new products, forcing domestic firms to adapt similar products in order not to lose customers.

Chapter Nine: The Liberalisation of Inter-State Entry in US Banking: a comparative analysis

The process of opening up national financial services markets to foreign competition in the EC may be comparable to the movements in the United States to relax the restrictions on out-of-state entry by banks. I focus in this chapter on banking services rather than retail financial services in general, as this provides the most interesting parallel to the opening up of European financial services market. In particular, regulatory restrictions in the US prevent a similar cross-industry penetration between the insurance and banking sectors as in Europe.

Such a comparative analysis between financial services in the US and in Europe is suggested, for example, by Neven (1990, p.175) who states that "the United States could be a laboratory experiment for European deregulation". Similarly, Santomero (1990, p.438) notes that "as Europe approaches 1992 its financial services industry looks to the United States for some insight into what will happen in its future".¹ In this chapter, I discuss existing parallels and the limits to drawing analogies between the US and the EC.

The focus of the analysis is placed on the two aspects most relevant to our analysis of cross-border entry in Europe, namely that of regulatory competition between state regulators and the impact on state market structure, conduct and performance of out-of-state entry.

The next section gives a brief historical overview of how and why the regulatory structure of interstate banking in the US has evolved as it has. The second section focuses on the question of dynamic regulatory competition between state regulators, while the final section gives an overview of the available evidence about the impact of liberalising interstate banking restrictions on competition in banking markets.

¹ However, as will be explained in this chapter interstate entry in the US is actually more difficult than cross-border entry in the EC, as implemented in the Second Banking Directive. Thus, regulatory efforts to establish freedom of entry have so far been significantly more successful in the EC than in the US.

1. The evolution of interstate banking: gradual lifting of restrictions in the 1980s

Interstate banking was first federally regulated by the 1927 McFadden-Pepper Act, after the National Bank Act of 1863 had established federally chartered banks which were restricted to a single branch. In contrast to general perception, however, the McFadden Act at the time of its passing actually extended rather than limited the scope of branch banking. This stems from the fact that branch banking *per se* was frequently discouraged or even prohibited in the majority of federal states where single-branch banks were the norm. This preference by regulators and legislators for local banks resulted from a deeply-rooted distrust against large powerful banks and the view that community-based banks serve the local clientele most effectively.²

The McFadden Act conferred the power on federally-chartered banks to branch within their home-office cities if state-chartered banks enjoyed the same privilege. The 1933 Banking Act extended branching powers of national banks to the state level (but *only* inside state boundaries) unless state laws prohibited state-wide branching to state-chartered banks. Moreover, the Act established the *state sovereignty* principle which stipulates that all regulatory powers concerning branching rules of both federally and state-chartered banks lie with the state legislators.

The continuing spread of bank holding companies was regulated under the 1956 Bank Holding Company Act which placed the supervision of such holding companies with the Federal Reserve Board. Thus, the Fed was given the right to review and approve any inter-state acquisition by bank holding companies. In addition, the 1957 Douglas Amendment prohibited bank holding companies from acquiring banks in more than one state unless explicitly approved by the state which is to be entered.

Until 1975 no states actually made use of their given powers to liberalise interstate entry. Due to these regulatory restrictions most interstate entry activities in the 1960s and early 1970s took place in non-bank business such as leasing, mortgages or finance companies. In 1975 Maine was the first state to pass a bill which enabled out-of-state banks to acquire domestic banks or set up a *de novo* entity if the entering bank's home state allowed equivalent access to the Maine banks. It was not until 1981, however, that the first actual interstate acquisition took place in Maine. New York and Massachusetts were

² In the 1985 *Northeast Bancorp v. Board of Governors of the Federal Reserve System* case, for example, the Supreme Court noted that "our country traditionally has favored widely dispersed control of banking". These arguments are still powerful in political debates even today and may have been the main reason why the reform proposals to establish full interstate banking failed in 1991.

the next states to adopt reciprocal interstate entry provisions,³ followed by a wave of similar provisions in the whole country, especially after the Supreme Court's 1985 Bancorp decision. By 1991 all but five states had adopted interstate provisions for Bank Holding Companies, as is summarised in table 9.1. In addition, regulatory restrictions on federally chartered Savings & Loan Institutions concerning interstate branching were lifted in May 1992 by the Office of Thrift Supervision.

Table 9.1: Interstate banking laws in the federal states in 1991

Entry from all states allowed with no attached reciprocity provisions	14 states: Alaska, Arizona, Idaho, Maine, Oklahoma, Oregon, Texas, Utah, Wyoming, Nebraska, New Mexico, California, Nevada, Wash. D.C.
Entry from all states allowed if equal access is granted (reciprocity)	15 states: Kennt., Louis., Mich., Ohio, New York, New Jersey, Rhode Island, South Dak., Wash., West Virg., Verm., Delaw., Illinois, Indiana, Colorado,
Entry allowed from same regional area if equal access is granted	16 states: Alab., Arkans., Conn., Florida, Georgia, Maryl., Mass., Minnes., Missouri, New Hampsh., N.C., S.C., Tenn., Virg., Wisc., Penns.,
No interstate entry allowed	5 states: Kansas, Montana, Iowa, North Dakota, Hawaii,

Source: own compilation from Federal Reserve Board Bulletins and American Banker.

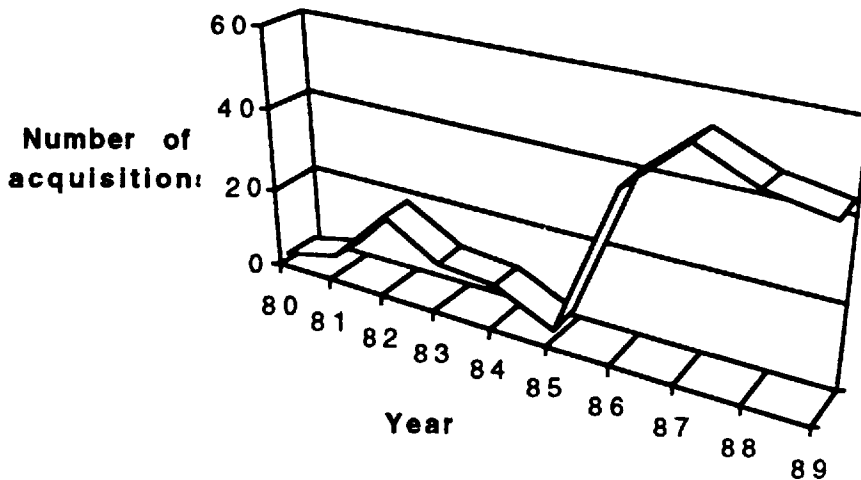
The passing of various interstate banking laws had a significant effect on the number of interstate bank acquisitions. Figure 9.1 shows the number of inter-state acquisitions by Bank Holding Companies (BCHs) in the US from 1980 to 1989. It is apparent that the number of interstate acquisitions has increased dramatically, especially since interstate banking restrictions were partially lifted in most states in 1985.

Nevertheless, one could argue that concerning the large number of commercial banks in the US with still more than 12,000 banks in 1992, the number of interstate acquisitions is comparatively low. Interstate banking laws have facilitated interstate entry but have certainly not yet led to a significant consolidation process in the US.

³ Massachusetts, however, only extended reciprocity provisions to the six New England states, since it wanted to prevent entry from the large money-center institutions based primarily in New York. Such 'selective' reciprocity was upheld to be constitutional by the Supreme Court in its 1985 Bancorp decision.

It is interesting to note, however, that most recently there has been a trend towards 'mega-mergers' between some of the largest banks in the US. These include the mergers between Bank of America and Security Pacific, Manufacturers Hanover and Chemical Bank, and NCNB and Sofran.

Figure 9.1: Number of interstate acquisitions in the US from 1980 to 1989



Note: 1989 data are annualised

Source: Rose (1989, p.10).

The lack of a significant degree of national consolidation between the smaller and medium-sized banks may be the result of continuing barriers to interstate expansion: while interstate banking has been liberalised, interstate branching is still prohibited in all states except Utah, Nevada, Rhode Island, Montana, New York, Oregon and Virginia. Thus, subsidiaries owned by the same BHC still need to be capitalised and incorporated separately in each state and there are restrictions on de novo entry from out-of-state banks. In addition, each subsidiary must have its own board of directors, submit regulatory reports to each of the host state's authorities and maintain separate accounting and computer systems (see Mengle, 1990). These requirements result in potentially significant organisational inefficiencies, as information and transaction costs within the BHC increase compared to a completely integrated organisational form. The 1991 Federal Deposit Insurance Corporation Act did nothing to expand interstate branching powers.⁴ More recently, however, the Office of Thrift Supervision was

⁴ It was argued that the Independent Insurance Agents of America placed pressure on legislators to scrap originally contained expansion of interstate branching due to fears that future nation-wide banks would venture into insurance activities. Thus, the bill actually reduced the ability of state-chartered banks to enter into insurance-underwriting activities which were previously permitted in several states.

charged by the White House to allow interstate branching for savings & loans institutions. Since this may lead to competitive disadvantages for banks, the latter are likely to place pressure on Congress to facilitate interstate branching.

Currently, however, the EC guidelines concerning cross-border branching possibilities actually go further than the US liberalisation of interstate banking. As far as the regulatory environment is concerned, cross-border branching in the EC after 1992 will therefore be easier than interstate branching in the US.

2. Regulatory competition between state regulators: the examples of South Dakota and Delaware

The theory of regulatory competition between regulators as developed in the second chapter can be applied to the case of inter-state competition between legislators in the US.⁵ State legislators have considerable leeway in determining the supervisory and regulatory rules for the financial services firms which are headquartered in their territories and for the local subsidiaries of out-of-state firms. This section discusses the examples of South Dakota and Delaware which were both extremely successful in attracting out-of-state firms in the 1980s.

The main motivation for federal states to seek entry of out-of-state financial services firms is, firstly, the projected increase in employment growth in financial services,⁶ and secondly the prospect of increased tax revenue from firms which locate subsidiaries in the state and channel a significant proportion of their taxable business through the state.

Consider first the example of credit card regulation. Interest rates on credit cards were for a long time regulated by imposing upper 'ceilings' on the permissible rates which may be charged by the credit card providers. In addition, annual fees for credit cards were either entirely prohibited or also subject to maximum limits. Both regulations were enacted and enforced on the state rather than the federal level.

In 1978 the Supreme Court of the United States ruled in its decision *Marquette National Bank v. First of Omaha Service Corporation* that a

⁵ This section draws on Erdevig (1988).

⁶ Concerning employment growth, for example, a study by the US Bureau of Labor Statistics (Kutscher, 1987) predicted an increase in 1.6 million jobs in the financial services sector between 1986 and the year 2000.

federally chartered bank has the right to charge out-of-state customers at the rate which it charges in its home state. In other words, for regulations concerning credit cards the Supreme Court introduced the home-state rather than the host-state rule which makes this case an interesting analogy to the home country rules to be introduced in 1993 by the Second Banking Directive.

In 1980 South Dakota was the first state to introduce legislation targeted at attracting out-of-state credit card operators by abandoning all usury ceilings on consumer loans including credit card facilities. At the same time, it passed a law which permitted out-of-state banks to found a *de novo* entity in the state which operates primarily in the consumer lending area. It is interesting to note that the new legislation imposed severe restrictions on new out-of-state entrants to compete in the intra-state market by limiting out-of-state banks to opening only one branch and restricting them to operations which do not attract customers away from other state banks. While such restrictions were later eliminated in the course of reciprocity provisions with other states, they effectively sheltered state banks from outside competition and thus ensured that the impact of out-of-state entry on state competition was limited.

Let us first analyse how banks reacted to the new legislation. The response by banks to the new legislation which allowed them to charge higher interest rates nationwide by relocating their credit card operations to South Dakota was significant. The first bank which decided to relocate its credit card operations to South Dakota was Citicorp which is the largest issuer of credit cards in the US. By 1987 Citicorp (South Dakota), N.A. had also become the largest commercial bank in the state with a total of 3,500 employees.

Other out-of-state banks followed Citicorp to open banking subsidiaries in South Dakota mainly operating in the credit card market, among them banks from Texas, Nebraska and Minnesota. As a result of this significant entry movement, South Dakota experienced the fastest growth rate in credit card loans between 1980 and 1987 in the US and the second-highest growth rates in total banking assets, total loans and employment. The highest growth rates were achieved by Delaware which is the second example of strategic deregulation to which I turn now.

Delaware is a state which has a well-known reputation for providing a favourable legislative corporate environment including tax, takeover and financial regulations which are explicitly aimed at attracting companies from other states, in particular from the neighbouring state of New York. This favourable regulatory environment has resulted in more than half of the Fortune 500 companies being incorporated in Delaware. In the financial services sector, Delaware followed South Dakota's example of attempting to attract out-of-state firms by providing a favourable regulatory environment.

In 1981 Delaware legislators passed the *Financial Center Development Act* (FCDA) which was very similar to the South Dakota legislation allowing out-of state banks to establish single branch subsidiaries which were not aimed at attracting residents from the state of Delaware. The Delaware FCDA went even further than the South Dakota legislation, however, by abolishing restrictions on charging annual credit card fees as well as eliminating all usury interest rate ceilings on the vast majority of bank loans including consumer credit. In addition, it provided a tax incentive structure characterised by a regressive schedule which made the state attractive for bigger banks. Relocating banks were required to create at least 100 new jobs in the state. Calculations show that the marginal corporate income tax rate in Wilmington, Delaware stands at 4.5 percent compared to 24.2 percent in New York City, for example.

Due to the wider scope of the deregulation which included commercial banking activities, new out-of-state entry was not limited to the case of consumer lending as was the case in South Dakota, but included wholesale activities as undertaken by some of the New York merchant banks such as J.P. Morgan which was the first to open a subsidiary in the state of Delaware under the FDCA. In addition to the FDCA, which played by far the most significant role in attracting out-of-state banks, Delaware also implemented an additional Consumer Credit Banking Act in 1983 specifically targeted at consumer loan business by offering minimal capital requirements, and the International Banking Development Act of 1983 which aimed at attracting foreign banks away from New York City and encouraged the establishment of Edge Act banks by abolishing reserve requirements.

Due to the dual targeting of the Delaware legislation, the state managed to attract both wholesale banks from the New York City area, as well as banks from other states such as Georgia, Maryland, Virginia and Pennsylvania which mainly channel their credit card and consumer lending business through their Delaware subsidiaries. In addition to banks, the state also attracted a number of non-bank financial institutions which do not fall under the restrictions of the 1956 Bank Holding Act because they either do not accept deposits or do not engage in lending activities. These institutions accounted for almost half the growth in new banking employment in the state. By far the largest and best-known non-bank financial services firm which uses Delaware as its base is the retailer Sears which acquired the card processor Greenwood Trust Company and started offering the new and extremely successful 'Discover' credit card in 1985.

Table 9.2 presents some data on the success of the strategic deregulation moves of the two states. It is evident that domestic assets grew significantly more in the two states than the average in the US. For the case of South Dakota this was largely due to the growth in credit card loans which accounted for 90.1 percent of all personal loans in the state in contrast to 32.7

percent for the US average. Delaware was also able to attract a significant amount of commercial and industrial loans which are booked through subsidiaries of out-of-state banks. Similarly, credit card loans account for the vast share of personal loans with 95.6 percent. It is noteworthy that these two states alone accounted for 40 percent of total credit card loans in the whole US in 1989.

Table 9.2: Compound annual growth rates at commercial banks in South Dakota and Delaware between 1980 and 1989

Figures in \$ million

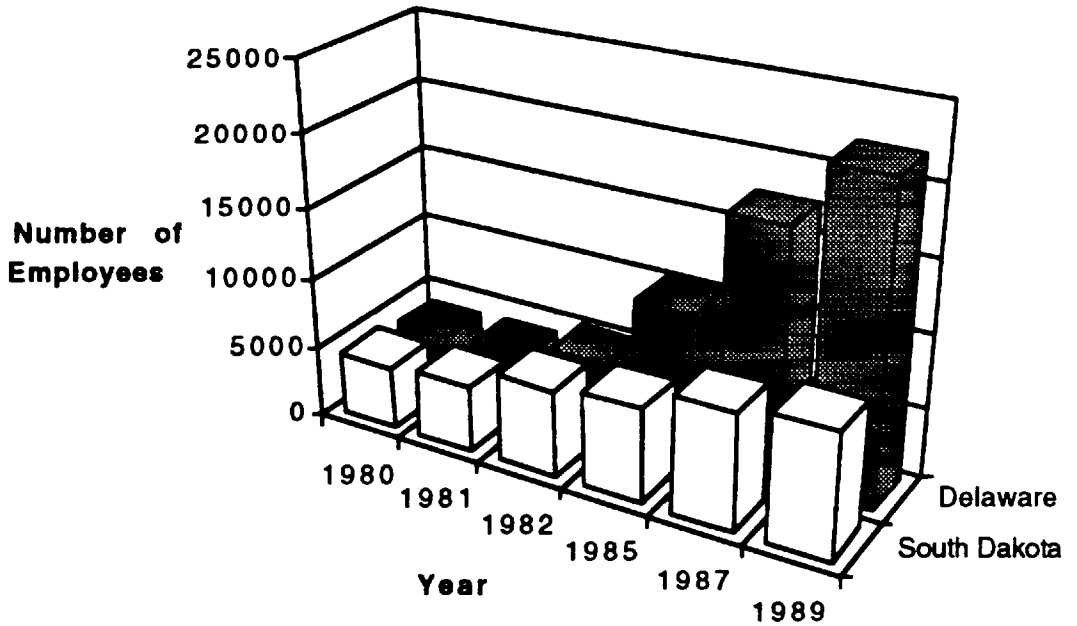
	South Dakota	Delaware	in comparison: all US states
total domestic assets	1980: 5,084,075 1989: 20,118,000 CAGR: +16.5%	1980: 3,685,060 1989: 70,814,000 CAGR: +38.9%	1980: 1,855,687,813 1989: 3,299,026,000 CAGR: +6.6%
personal loans	1980: 498,590 1989: 11,611,000 CAGR: +41.9%	1980: 640,478 1989: 43,760,000 CAGR: +59.9%	1980: 187,375,654 1989: 400,580,000 CAGR: +8.8%
comm. & industr. loans	1980: 667,905 1989: 1,634,000 CAGR: +10.5%	1980: 335,226 1989: 6,476,000 CAGR: +39.0%	1980: 390,930,841 1989: 618,625,000 CAGR: +5.2%

Source: own compilation from several issues of FDIC Bank Operating Statistics and Banking Statistics.

Figure 9.2 analyses the impact of the regulatory moves of the two states on domestic employment in the banking sector. It is obvious that both states could substantially increase their employment. South Dakota managed to double its number of employees in the banking sector from 4,395 in 1980 to 8,801 in 1989 with a compound annual growth rate (CAGR) of 8.1 percent. Banking employment in Delaware increased even more significantly from 3,902 in 1980 to 21,862 in 1989, a CAGR of 21.1 percent.

This contrasts with a constant labour force in US banking where the total number of employees stood at 1.53 million in 1989 which is almost unchanged from 1980.

Figure 9.2: Impact of banking legislation on banking employment in South Dakota and Delaware



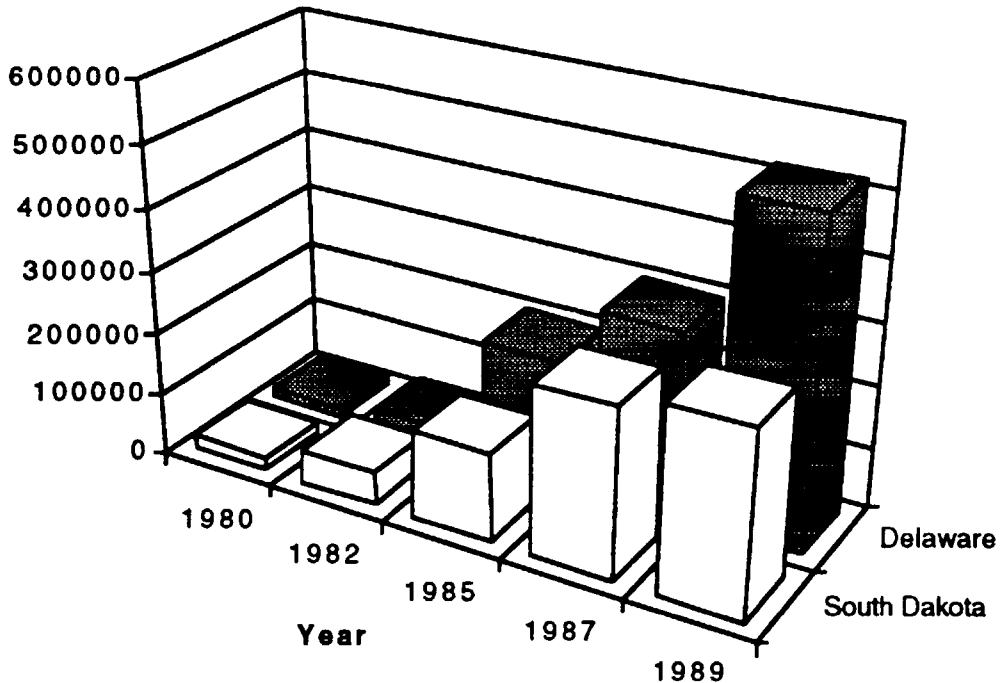
Source: own compilation from several issues of FDIC Bank Operating Statistics and Banking Statistics.

Figure 9.3 analyses the second strategic target variable of state regulators: the amount of local and state income taxes paid by resident banks. The increase in tax revenue for the states is dramatic: South Dakota increased its tax revenue from \$21.7 million in 1980 to \$296.1 million in 1989 at a compound annual growth rate of 33.1 percent, while Delaware had a tax revenue of \$13 million in 1980 which rose to \$520.2 million in 1989 at a CAGR of 49.9 percent.

This contrasted with a CAGR for the whole of the US of only 7.5 percent.

Figure 9.3: Income tax revenue from banks in South Dakota and Delaware

Tax revenue in \$thousands



Source: own compilation from several issues of FDIC Bank Operating Statistics and Banking Statistics.

In the second chapter I have argued that competing regulators are unlikely to stand by idly and see their domestic employment and tax revenue reduced, while domestic banks relocate to other states which offer a more attractive regulatory environment. Especially where such tax and employment losses are likely to be significant when relocation is not limited to the mere opening of 'brass-plate' subsidiaries in other states but involves actual transfer of capital and labour, regulators are likely to emulate or even outbid other states' moves to prevent the loss of domestic business.

Exactly such a process of strategic regulatory liberalisation could be observed after South Dakota and Delaware had enacted their more permissive banking rules. In particular, near-by states felt the need to relax if not match the new regulations, since banking institutions either threatened or actually moved operations abroad. Only seven months after the South Dakota legislation took effect, New York emulated its moves by also

eliminating usury interest rate ceilings as well as allowing annual fees. Nevertheless, the legislation came too late to prevent Citibank from changing its plans to move to South Dakota. Competition against the neighbouring state of Delaware was even more difficult as the latter state offered a corporate tax rate which New York could not match without losing substantial tax revenues in other sectors.

Similarly Nebraska, the southern neighbouring state of South Dakota, abolished all remaining interest rate restrictions and allowed the imposition of an annual services charge for credit cards in April 1983 after its largest state bank, First National, had acquired a bank just across the border to South Dakota and threatened to channel its credit card operations through that state. Almost an identical story can be told of Virginia, close to Delaware, which deregulated its interest rate ceilings in April 1983 and passed legislation similar to that of South Dakota to attract single branch out-of-state banks.

But not all states responded in the same way. Both Maryland and Pennsylvania were much slower to respond to the regulatory challenges posed by South Dakota and Delaware. Recall from chapter two that the regulator maximises a social welfare function which consists of industry profits, consumer surplus and financial stability. As banks raise interest rates, industry profits increase, whereas consumer surplus decreases with no adverse effect on financial stability. Thus, if a regulator attaches a greater weight to consumer surplus than to industry profits, she may decide not to follow other states' legislation to deregulate interest rates entirely in order to keep domestic interest rates below a certain level, an action which may benefit consumers.⁷ Indeed, the pressure of consumer groups in both Maryland and Pennsylvania prevented the states' regulators from matching the more permissive regulatory regimes of other states. In Maryland, the interest rate ceiling was raised to a higher maximum limit in July 1982 rather than abolishing it altogether, while annual fees and other restrictions continued to be prohibited. This policy of 'restrained deregulation' did not work, however: the original idea of state legislators was to keep interest rates of *domestic* banks low which were then able to retain their domestic customers, since consumers would prefer these institutions over out-of-state banks which asked for higher rates. Domestic banks, however, did not react according to the legislators' expectations: the four major banks of the state decided to relocate their credit card operations to Delaware in the course of 1982. Finally, in July 1983 state regulators gave up their hesitant approach to credit card deregulation when they adopted legislation similar to that of neighbouring Delaware.

⁷ Similar arguments were recently put forward by Congressmen who wanted to reimpose usury interest rate ceilings on credit cards in order to boost consumer spending. After the stock market reacted with a significant slump after the announcement due to the fact that such ceilings would eliminate one of the last profitable business lines of the troubled US banking industry, these plans were quickly abandoned.

What conclusions can be drawn from this example of strategic deregulation? First, let us note that the ease by which banks were able to relocate their credit card and consumer loan business was facilitated by recent improvements in communication and information technologies which made long-distance information processing less costly. Electronic data transmission, funds transfer and payment processing make it increasingly possible to locate back-office bank facilities in areas which may be remote from the actual customer. Thus, lines of business which do not require immediate contact with the customer can be more easily transferred to the most favourable regulatory environments.

In addition, it has become clear that once one of the competing legislators has started to introduce a more favourable regulatory environment which attracts non-domestic institutions, other regulators are required to follow suit if they want to stem the tide of domestic institutions leaving their territories. They are more likely to do so when there are actually adverse effects on domestic parameters such as industry profits, tax revenues or employment, and domestic financial stability is not adversely affected by the deregulatory moves. As both conditions were fulfilled for the case of interest rate regulations, state regulators responded in the way predicted. Attempts by state regulators to abstain from the process of strategic deregulation failed entirely, as banks quickly abandoned domestic terrain in favour of more permissive regulatory environments. For the case of interest rate ceilings domestic financial stability is not adversely affected such as in the case of capital requirements, for example, where state legislators may be a lot more hesitant to engage in a competitive race. Thus, as was stressed in the second chapter, whether or not strategic deregulation ensues, depends very much on the specific regulation under scrutiny and its significance for maintaining financial stability.

3. The impact of lifting interstate banking restrictions on intrastate competition

Increasing interstate penetration may be expected to lead to greater competition, very much like in the case of European cross-border entry. As was discussed in chapter four, such increased competition may manifest itself in lower prices for consumers, spoiling of collusive domestic equilibria, introduction of new services or greater quality of services.

Unfortunately, there are only few research studies on the actual impact of interstate entry on domestic competition, as most existing studies deal with the quantitative extent of interstate entry or analyse the stock market reaction to merger announcements. Frieder and Petty (1991, p.13), for example, note that the "recent interstate bank merger phenomenon has

received little attention in the literature". I review here the existing evidence which may provide some indication about the impact of interstate entry.

Evanoff and Fortier (1986) analyse the impact on competition of abandoning unit-branching restrictions in a range of US states. The elimination of such *intrastate* branching restrictions is comparable to the derestriction of *interstate* banking. In their study, the authors find that customers in states where statewide branching is allowed, as distinct from those states where banks are only allowed to maintain a single branch, are offered a wider range of services and improved service accessibility. They conclude that the impact of the liberalisation of geographic restrictions is "to increase competition and the array of services, improve credit availability and service accessibility, and more efficiently allocate financial resources". In a similar spirit, Baer and Scheld (1986) present a statistical analysis of prices for banking services in unit branching states and compare these with states where statewide branching is permitted. They find that banks in states where statewide branching is allowed charge significantly lower service charges and lower interest rates on real estate loans than banks in states with unit banking regulations. This provides some evidence that price competition increases as geographic branching restrictions are abandoned.⁸

Laderman and Pozdena (1991) analyse the impact of changing legislation concerning interstate entry on publicly quoted banks' share prices. They hypothesise that if increased interstate entry leads to increased competition then banks from the state which is opened to out-of-state entry may experience negatively abnormal returns. This will be the case only if the increase in competition in the home state more than wipes out potential increases in profits from being given the opportunity to enter new states. In their regressions they find a highly significant reduction in the banks' share prices in states where interstate banking laws were passed in the preceding quarter. This provides strong evidence that financial markets associate an increase in competition with the opening up of state markets to out-of-state competition which outweighs any expected increase in bank profits due to greater entry and profit opportunities for the banks of the home state which has passed the interstate law.⁹

⁸ Interstate entry takes place especially in the retail area. Rose (1989b) finds that banks making interstate acquisitions are characterised by a stronger retail orientation than those which are not active in interstate banking.

⁹ A similar approach is pursued by Chong (1991) who finds an increase in banks' profits around announcement dates of interstate banking laws, in contrast to Laderman and Pozdena. However, his model differs from the latter authors in three respects: first, he uses daily rather than quarterly stock return data. Second, Chong does not analyse stock returns around the date at which the law actually takes effect as distinct from the passing of the bill and thirdly, he does not differentiate between different types of laws concerning reciprocity, for example.

Perhaps the most significant industry development after liberalisation of interstate banking regulations has been the emergence of the so-called 'superregionals', BHCs with an extended retail branch presence across one particular region of the US. Examples include the Bank of Boston in the Northeast, NCNB in the Southeast and Banc One in the Midwest. At the same time, the moneycenter banks have expanded their branch network to cover an increasing number of states in addition to their home state. Examples include Bank of America's acquisitions in the Western states, Chemical's acquisition of Texas Commerce Bank and Citicorp which has a widespread retail presence in several states. There is substantial evidence that such interstate entry has led to increased pressure on the local state banks to offer more competitive services in order to match the entrants' terms and conditions. As one observer notes, "the entry of large banks into local markets - particularly in their current retail orientation - generates intense competition and puts considerable strain on smaller institutions" (Duffy, 1990, p.20). Examples include Citibank's mortgage programme which prompted local banks and thrifts to reduce the time for mortgage processing from several weeks to only a few days in order to be able to match Citibank's automated and much quicker decision process.

Remaining barriers to interstate expansion have led to a shift in delivery systems away from the traditional branch-based distribution to technology-based systems. Santomero (1990), for example, notes that

"Telecommunications and electronics began to replace brick and mortar as a delivery system of retail products ... on the consumer side the telephone became a substitute for location in retail deposit gathering. Home banking, wire transfer and the mail box slowly replaced the teller line".

These developments are interesting also for the European case. They show that despite the lack of a branch network in the host country it may be possible to enter the retail market through card-based products, home banking or telephone banking facilities. Such technology-based entry strategies may be very successful as the example of Citibank's credit cards shows which have the largest market share in the US despite the fact that Citicorp is represented in only a small number of US states. Direct mailings, as well as telephone and home banking serve as a substitute for branches.

Another development which will almost certainly be paralleled in Europe is the increase in financial services competition due to entry of 'non-bank' financial services groups which either do not accept deposits or do not give out loans. Due to the lack of a bank status these institutions do not fall under the regulatory scope of the Banking Acts and can therefore branch freely as well as offer all financial products without being restricted by

product line restrictions.¹⁰ Such non-bank financial institutions include the major car producers which offer consumer loans, the retail companies such as Sears with its Discover credit card which has become the credit card with the second-largest nationwide distribution, or J.C. Penney which has acquired the low-commission brokerage firm Dean Witter which has distribution outlets in the retailer's stores. Similarly, AT&T introduced its "Universal" phone charge card which at the same time serves as a VISA credit card. Ford Motor Company which acquired First Nationwide Bank actively solicits savings deposits through nationwide advertising, a network of 'account representatives' and nationwide access to ATM machines. Eisenberg (1988, p.28) notes that at the end of the 1970s "only visionaries spoke of a 'financial services industry'. Now the term is commonplace."

An interesting case of actual *foreign* entry into a state market is that of Japanese banks in the Californian banking market. In fact, this example may be the most successful and significant case of cross-border entry in the retail banking area which has so far occurred. In contrast to the British banks which acquired Californian banks only to divest them later on due to lack of success, the Japanese banks are highly successful and now capture 25 percent of total banking assets in California and almost thirty percent in the commercial loan market with a total number of branches of 424 in 1988 (Zimmerman, 1989).¹¹ They not only operate in the corporate market but also in the retail banking area with a similar retail deposit funding base as the indigenous institutions. Thus, the Japanese banks apparently managed to overcome possible barriers resulting from a 'foreign' name, as some of them maintain their Japanese name (e.g. Sanwa Bank California and Sumitomo Bank of California). There is some evidence that Japanese banks pursued aggressive pricing strategies in order to attract customers (Tschoegl, 1982). The success of the Japanese banks shows that the retail market is not necessarily "closed to foreign banks", as is frequently argued by many European bankers, but can be successfully penetrated by foreign banks.

4. Conclusions

In this chapter an analysis of interstate entry in the US was undertaken to shed light on aspects of cross-border entry in the EC. Rather than undertaking a full-fledged analysis of regulatory issues in US banking in comparison to the EC, this chapter concentrated on the two issues which

¹⁰ In the US this regulatory 'loophole' has been closed. Existing non-bank financial institutions were allowed to continue to exist, however.

¹¹ In 1984 Mitsubishi paid \$242.5 million to acquire BanCal Tri-State Corp., in 1986 Sanwa Bank paid \$263 million to buy Lloyds Bank California and in 1988 Bank of Tokyo paid \$750 million to purchase Union Bank.

form the focal point of this thesis: regulatory competition and the impact on competition of entry from abroad.

A brief review of the liberalisation process of interstate banking in the US has shown that despite the movement towards opening state markets to out-of-state entry, significant regulatory entry barriers remain which actually exceed those in the EC. Thus, the number of interstate mergers and acquisitions in the US has remained comparatively low, despite the increase in transactions since 1985. This stems largely from the fact that for interstate acquisitions approval by the Federal Reserve Bank was required which, until recently, was difficult to obtain.

Concerning regulatory competition, the examples of South Dakota and Delaware show that state regulators have successfully used strategic regulation to attract out-of-state banks. By relaxing restrictive credit card regulations, both states achieved vastly overproportional growth in credit card loans booked through subsidiaries of out-of-state banks. This mainly resulted from the fact that credit card services can be easily transferred to the most favourable regulatory environment, since they do not require a presence close to the customer. At the same time, both states significantly increased their income tax revenue from banks as well as increasing banking employment. These effects were obtained despite the fact that most other states were quick to emulate the more permissive regulations of the two states. This seems to indicate a first-mover advantage for those regulators who are first to introduce less restrictive regulations. Such a first-mover advantage may stem from transaction costs which prevent a firm from moving back to its original location even if that state has passed an equally competitive legislation. This example makes clear that regulators are not able to maintain a more restrictive regulatory environment if firms can easily move business into another legislation. Thus, for financial services where personal interaction is not required and which can therefore be moved to the location with the lowest net regulatory burden, regulations across states or countries are likely to equalise.

Concerning the impact of out-of-state entry on domestic competition, the empirical evidence is scarce so far. Studies of the liberalisation of statewide branching show that credit availability rises, new products and services are introduced and prices for at least some products tend to fall as competition increases. In addition, financial markets seem to expect a significant increase in competition, as states pass and enact more liberal regulations concerning out-of-state entry.

The continued restrictions on interstate branching have led to a stronger focus on distribution channels which increasingly rely on telephone, mail and computer support rather than the traditional branch network. This example shows that it is possible to make significant inroads even into mass retail financial services without the need to maintain a large

branch network. One may expect similar developments and distribution methods to become increasingly important in Europe as well. Equally interesting is the increasing involvement of non-bank firms to enter traditional financial services. These firms include telephone companies, retailers and automobile concerns which all have a substantial customer franchise and thus a potentially powerful base to which they can sell financial services. It is likely that such entry activities of non-banks will also rise in significance in Europe.

Finally, the example of the Japanese banks which have acquired 25 percent of banking assets in California shows that foreign banks can successfully enter even the retail banking market and capture a significant market share. Although such a development is unlikely in Europe in the near future as was argued in chapter four, it demonstrates that foreign banks can become a significant force even in retail banking.

Chapter Ten: Cross-Border Entry in Retail Financial Services: Policy Implications

This chapter presents some public policy conclusions which can be derived from the theoretical reasoning and the empirical evidence presented in the preceding chapters. In particular, it looks at the implications for European competition policy and develops some policy proposals for preserving financial stability in a European retail financial services market increasingly characterised by cross-border activities. For the latter question, it focuses on the question of home country versus host country provision of deposit insurance and lender of last resort facilities which are the two main regulatory tools to attempt to make financial systems 'run-proof'.

1. Competition policy and cross-border transactions

What are the policy conclusions with respect to competition issues related to cross-border entry? More specifically, does cross-border entry in retail financial services lead to a danger of a reduction in competition as European financial services 'giants' emerge which may possess undesirable market power? The two major academic studies of European financial services integration seem to have such a scenario in mind: Vives (1991, p.24) states that "mergers, acquisitions and cross-participations agreements will tend to soften competition". In a similar spirit, Neven (1990, p.176) concludes his study by stating that:

"given that mergers and acquisitions are often difficult to realise because of managerial, cultural and organisational problems, one is left rather agnostic about the benefits of cross-border mergers in banking, apart from market power. Hence, from a public policy perspective, it does not seem that such mergers should be encouraged".

This study does not support these policy conclusions for three main reasons: first, it was seen that cross-border acquisitions do not display the organisational problems of industrial transactions. This results from the fact that unlike industrial combinations, expectations concerning scale and scope economies in financial services are usually low anyway and thus do not lead to post-merger disappointments. The main reason for cross-border

acquisitions is to share into domestic profits rather than to achieve significant synergy effects.

Second, as was argued in the fourth chapter, the definition of the relevant market in retail financial services is mostly national and may even be regional or local. Thus, concentration indices need to be calculated on a national, regional or even local basis and cross-border acquisitions, as distinct from domestic mergers, are unlikely to increase market power, since they are likely to leave these concentration indices unchanged. Only where competition is on a European scale such that concentration indices also need to be calculated on a European basis is there a danger of increased market power due to cross-border combinations. This is unlikely to be the case for retail financial services for a long time to come, however.

Third, and most importantly, cross-border mergers are most likely to *increase* the level of domestic competition and thus *reduce* the market power which can be exercised by domestic institutions. Even though domestic social welfare may decrease in particular circumstances when the loss in producer surplus outweighs the gain in consumer surplus, such cases are likely to be rare. Thus, our policy conclusion would be diametrically opposed to Neven's: rather than restricting cross-border acquisitions, they should be encouraged through public policy means as an effective means of increasing the level of domestic competition.

Drawing such policy conclusions, one should carefully distinguish between cross-border acquisitions and domestic mergers. The latter category needs to be assessed on a different scale than the former. In particular, the threat of cross-border entry may induce domestic institutions to increase concentration in order to deter foreign entry. If such entry deterrence is successful then the threat of cross-border entry may not be sufficient to ensure an adequate level of competition. In particular, the relationship between prices and concentration seems to be positive in the relevant geographic markets, as shown by Berger and Hannan (1989) who examine a sample of US banking markets and find a statistically significant negative relationship between money market deposit interest rates and market concentration. This supports the view that greater concentration allows financial services firms to operate with higher margins. A similar result is obtained by Neuberger and Zimmerman (1990) who regress a range of explanatory variables against deposit rates and find a statistically significant relationship at the 1 percent level between local market concentration and deposit rates. Thus, competition policy intervention may be required where domestic concentration increases significantly. As national regulators have little incentive to intervene in such domestic concentrations and sometimes actually encourage them, the assessment of large-scale domestic concentrations may have to be delegated to a supra-national authority such as

the Commission of the EC, in particular for cases in countries which do not have effective merger control regulations.¹

2. Financial services regulation in the Internal Market

This section analyses the implications of cross-border entry and increased internationalisation of European financial services for preserving financial stability in the internal market. In chapter two it was argued that the possibility of runs inflicting negative externalities on the economy was one of the two major market failures which justify public regulation of financial services. Two main tools exist to limit the risk of negative externalities posed by contagious bank runs by means of public regulation: deposit insurance schemes, official or *de facto* lender-of-last-resort facilities by the Central Bank providing financial aid in liquidity crises.² In the next two sections I focus on deposit insurance and lender of last resort facilities and analyse how these need to be adapted with increased cross-border entry in the internal financial services market.

2.1. EC deposit insurance schemes in an international context

Deposit insurance schemes with differing degrees of coverage operate in most Western countries. Their purpose is to provide protection for deposits and thus to calm depositor panic in case of liquidity problems of a financial institution.³ I first discuss the properties of actual deposit insurance schemes in the EC. A second section then analyses the implications of increasing internationalisation on the operation of national deposit insurance systems and analyses the proposed EC Directive.

¹ Such delegation to a supra-national authority may be in conflict with the subsidiarity principle in the EC, however, which stipulates that decisions with predominantly domestic consequences should be taken by the relevant national authorities.

² Jacklin (1987, 1990) points out that if current accounts are money market funds then runs will not occur and deposit insurance is only required to cover fraud, since demand deposits will be backed by marketable securities which are not characterised by asymmetry of information concerning their current value. In this scenario, bank loans would be backed by non-demand deposits such as long-term debt, equity or CDs or may even be bundled together and securitised.

³ Friedman (1959, p. 38), for example, stresses the signalling function of a deposit insurance scheme when stating that "... (US) federal deposit insurance has performed a signal service in rendering the banking system panic-proof" and further adds that the introduction of deposit insurance was "the most important structural change in (the US) monetary system in the direction of greater stability since the post-Civil War tax on state bank notes" (*ibid.* p.21). Kareken and Wallace (1978) dispute the notion that deposit insurance is required to ensure a safe banking system. For their results to obtain, however, it is necessary that depositors have complete and perfect information about banks' portfolios. This assumption is obviously unrealistic, however, since complete monitoring is precluded by the informational asymmetries between banks and customers which lie at the heart of financial intermediation.

2.1.1. Deposit insurance in the EC

Table 10.1 reports the type and coverage of deposit insurance schemes in the EC in 1991.

Table 10.1: Deposit insurance schemes for commercial banks in the EC in 1991

Country	Coverage in ECU	Type of Scheme	Year of Establish.	Participation	Deposit Funds	Amount of Funds in million ECU*
UK	75% of deposits, maximum of 21,700	Public	1979	Compuls.	Funded	between 4.34 and 8.69
France	100% up to ceiling of 57,800	Private	1979	Voluntary**	Unfunded	144.09
Germany	100% up to a limit of 30% of bank's equity capital per depositor	Private	1966	Voluntary	Funded	n.a.
Spain	Deposits up to 11,700	Semi-public	1977	Compuls.	Funded	n.a.
Netherl.	100% up to ceiling of 17,200	Public	1979	Compuls.	Unfunded	n.a.
Belgium	100% up to ceiling of 11,800	Semi-public	1974	Compuls.	Funded	106.15
Italy	100% up to a ceiling of 130,625, 75% up to 522,500	Private	1987	Voluntary	Unfunded	2612.65
Luxemb.	100% up to 11,800	Private	1989	Compuls.	Unfunded	n.a.
Denmark	31,000 ECU	Public	1987	Compuls.	Funded	240.50
Ireland	80, 70 and 50% up to 13,000 max. pay out	Public	1989	Compuls.	Funded	240.25
Portugal	Under discussion					
Greece	Under discussion					

* For unfunded schemes the amount required to be paid in at the first request in case of call commitments is listed.

** While voluntary in theory, the French scheme is de facto compulsory, since all members of the French Bankers Association are required to be members of the deposit protection scheme.

Source: DG 15, EC Commission.

First, it becomes apparent from the table that compared to the Federal Deposit Insurance Corporation in the US which was established in 1933 as a response to the large number of bank failures during the Great Depression, deposit insurance schemes in the EC have been introduced only recently. The only two EC countries which do not yet have deposit insurance schemes, Portugal and Greece, currently contemplate their introduction. All schemes have limited coverage either by imposing an absolute maximum pay-out amount or by covering less than 100 percent of deposits.⁴ The operation of

⁴ In Germany there is next to complete coverage with the exception of very large depositors. For a bank with one billion ECU equity capital, for example, the fund covers up to 333 million ECU for any individual depositor.

deposit insurance schemes, however, is widely unknown in the European countries and even intendedly so, as regulators avoid to widely publicise their existence. In France and Luxembourg deposit insurance funds actually operate as 'secret' arrangements where participating banks are legally prohibited to publicise their membership. Membership in the funds is not always compulsory.⁵ Finally, all schemes in the EC have flat-rate insurance premiums rather than premiums which depend on a bank's asset risk.⁶

Similar to the deposit insurance scheme, it seems useful to establish guarantee funds for the insurance sector. So far, in the EC only the UK has such a scheme which was established in 1975 under the Policyholders Protection Act. The Policyholders Protection Board serves a similar function as the deposit insurance schemes in banking. The scheme is designed exclusively to protect personal policyholders and excludes companies or other business organisations. In the case of insurer insolvency it pays the full liability to the insured and third parties for compulsory insurance and for other general insurance services it covers 90 percent of liabilities. For the case of long-term insurance such as life, the Board transfers the policy to another insurer or pays out 90 percent of value to the policyholder. In addition, the Board has the right to intervene if the insurance company is in financial difficulties which may go as far as transferring its business to another firm.

In chapter two it was argued that negative externalities in the case of runs are not limited to the banking sector but may equally occur in the insurance sector. Solvency requirements alone do not seem sufficient, however, for maintaining financial stability as they do not exclude the possibility of firm failure. It therefore seems necessary to provide an additional safety net just like the deposit insurance schemes in banking. Since only the UK has so far established such a scheme in the insurance sector, it seems recommendable to introduce an EC Directive which requires insurance guarantee funds, modelled according to the UK example.

The absence of insurance guarantee schemes in Europe contrasts with the existence of insurance "Guaranty Funds" in 47 US states. Most of these were formed on the basis of the 1969 "Post-Assessment Property and Liability Insurance Guaranty Association Model Act" which was adopted as a response to a number of insurer failures in the 1950s and 1960s. The US guaranty funds

⁵ In practice, however, the vast majority of banks are in fact members in the national deposit insurance schemes. Nevertheless, since it requires only a few bank failures to shake depositors' confidence and since depositors may have only imperfect information on which banks participate in the scheme and which do not, it seems preferable to make participation legally binding.

⁶ The Italian Fondo Interbancario di Tutela dei Depositi, however, provides for the insurance agency to monitor efficiency, liquidity and solvency ratios. Banks whose ratios exceed or fall below the required standards are given up to two years to rectify the situation under the threat of expulsion from the fund. This solution comes very close to risk-based premiums, since high-risk banks will be penalised by expulsion and their license may even be withdrawn.

operate on very similar principles as deposit insurance schemes. In contrast to the US deposit insurance scheme, however, they are organised and monitored by the states rather than on the federal level. Their function is to guarantee liabilities of both first-party and third-party claims in case of insurer insolvency up to a limit on maximum pay-outs per policyholder which ranges from \$100,000 to \$1,000,000. All guaranty associations are funded by the insurance industry itself. Over the past two decades, the state guaranty funds became active in more than 200 insurer insolvencies and paid out more than \$3.3 billion (see Spencer, 1991). Recent strains on the fund by the failure of multi-state operators have led to calls for federal regulation of the insurance guaranty fund, however (Semaya, 1991).

2.1.2. The implications of increasing internationalisation on deposit insurance

As barriers to cross-border entry in EC financial services decrease, it is likely that there is an increasing number of branches and subsidiaries owned by foreign firms. What are the implications for deposit insurance schemes? In particular, should foreign branches and subsidiaries be covered by host-country or home-country deposit insurance? While I discuss these questions for the case of banking, the basic thrust of the argument applies equally to insurance guarantee funds which may eventually be set up.

Consider first the host-country rule where national insurance schemes cover both domestic and foreign institutions operating under domestic rules of conduct. This solution has the advantage that it reduces possible competitive distortions between domestic and foreign banks and establishes a clear and easily-understood rule for depositors. The problem with the rule is, however, that foreign banks cannot be controlled by the domestic insurance agency or regulator as far as prudential rules are concerned. It is therefore fundamentally at odds with the home-country rule of supervision of the Second Banking Directive. Furthermore, under the host-country rule domestic regulators could be tempted to undertake lax supervision of the foreign branches and subsidiaries of domestic banks, since in the case of failure the foreign deposit insurance has to cover the costs.

Consider next the suggestion that the domestic deposit insurance scheme should also cover the foreign branches and subsidiaries of domestic banks but that they are not covered by the insurance system of the host country. This would be analogous to the home-country principle concerning supervision and adherence to prudential regulations of foreign branches and subsidiaries. It therefore has the advantage of being consistent with the general home country approach to supervision adopted in the Second Banking Directive. In addition, it guarantees equal treatment of depositors of a (failed) multinational bank in different EC countries. The home country principle may also lead to confusing situations, however, and confer an unjustifiable competitive advantage on either the domestic or foreign institution. Suppose that a domestic insurance scheme exists, but that foreign

banks are only partially insured by their home country deposit insurance or not covered at all (non-EC banks). Domestic depositors may then prefer domestic banks purely because they offer a lower probability of deposit loss. Foreign banks may therefore be disadvantaged because they do not participate in a deposit insurance scheme. The reverse holds if only foreign institutions are covered. In addition, there may be confusion among domestic depositors of which banks are covered and which are not, since it is not always easy to find out whether a bank is owned by a foreign parent. The EC Deposit Insurance Directive to be discussed in the next section ingeniously solves this problem by permitting banks to voluntarily join the host-country scheme if they wish to supplement the coverage provided by their home-country scheme. A bank will decide to join the host-country scheme if it perceives the benefit of being able to provide a greater level of safety to its depositors to outweigh the additional costs of contributing to a second deposit insurance scheme.

Table 10.2 depicts the characteristics of current deposit insurance schemes concerning the extent of coverage of foreign branches and subsidiaries.

Table 10.2: Coverage of multinational banking under domestic deposit insurance schemes in 1991

Country	Coverage of foreign branches/ subsidiaries in domestic country	Coverage of domestic banks' foreign activities	Coverage of foreign currency deposits
UK	Yes	No	No
France	Yes	No	No
Germany	Yes, if foreign banks participate	Yes	Yes
Italy	Yes	Only if no scheme exists in host country or branch does not participate	Yes
Spain	Yes	No	Yes
Netherl.	Yes	No	Yes
Belgium	Yes	Only if no scheme exists in host country	No
Luxemb.	Yes	No	Yes
Ireland	Yes	No	No
Denmark	Yes	Only if no scheme exists in host country	Yes

Source: DG 15, EC Commission.

It becomes obvious that the vast majority of schemes are characterised by the host country principle where foreign branches are covered by the host

country deposit insurance. However, there is no dominating principle concerning coverage of foreign currency deposits.

2.1.3. *The proposed EC Directive on deposit insurance*

The operation of effective deposit insurance schemes in the EC countries was targeted as early as 1984 by the Commission of the EC as forming part of the core of regulatory measures which should be subjected to minimum harmonisation.⁷ A Commission Recommendation was adopted on 22 December 1986.⁸ Concerning the question of participation of branches of foreign credit institutions, Article 1(b) of the Recommendation clearly suggests the host-country principle where depositors of branches of foreign banks should be included in the coverage of the scheme.

Over the past years, the Commission has changed its view on the host-country principle, however. The Directive proposed in 1992 which is to be implemented by January 1994 has shifted to the home-country principle. The arguments which have led to this 180 degree shift are illustrated in the statement by the Banking Advisory Committee of the Commission of the EC. The main argument for the home-country principle for deposit insurance is consistency with the principles of the Second Banking Directive. As the Committee (1991, p.2) formulates: "a breach of the home country approach in an area so closely linked to banking supervision as {deposit protection schemes} would set a potentially dangerous precedent in the creation of the Single Market for banking supervision". The argument that the operation of a home country scheme may lead to competitive distortions where banks operating in the same country are covered by different schemes, is countered by the observation that "regulatory competition is a necessary, and intended, consequence of the principle of minimum harmonisation" (p.4).

Nevertheless, there is a difference between regulatory competition in the area of certain prudential rules and that of deposit insurance. In the latter area it is the depositor rather than the bank who needs to respond to regulatory differences. Thus, for regulatory competition to be effective the depositor needs to be fully informed about the different schemes of deposit insurance in the home country of the deposit-taking foreign branch. This requires public awareness of the existence, role and functioning of deposit insurance schemes. In order to successfully implement a home country approach, it therefore seems mandatory to improve the level of public information concerning membership and coverage of the bank's deposit

⁷ See the Commission's White Paper on the 'Completion of the Internal Market' (COM 85, 310, 14 June, 1985, Annex, p. 31) where deposit insurance was targeted to be subject of a recommendation.

⁸ OJL 33 4 February 1987, p.16/17.

insurance scheme.⁹ Since such information is crucial in blocking the incentive for a bank run in the case of firm failures, it appears that the resistance of banks and regulators to publicise the existence of deposit insurance schemes is not justifiable on economic grounds. In particular, as depositors have a choice of credit institutions across the EC countries, it seems imperative that they are able to assess and compare the extent of the differing insurance coverage under the respective national system.¹⁰ One may have some doubts, however, whether deposit insurance will ever receive the kind of attention to make 'regulatory competition' in this area work effectively.

Other features of the deposit insurance system proposed in the Directive include coverage up to a level of ECU15,000 and compulsory membership. Member States are free, however, to implement higher amounts of coverage or to provide co-insurance with 90 percent coverage. In the latter case which was included on account of the UK scheme, the minimum coverage is increased to ECU18,750.

There are two rationales for limiting total coverage of insurance schemes: when depositors are faced with a residual loss even when their funds are protected under the scheme, it is argued that they increase their monitoring activities. However, one may argue that since the existence of insurance schemes is currently not widely known in public, depositors' monitoring behaviour is unlikely to change even if limited coverage is introduced. Second, the combination of deposit insurance schemes with lender of last resort facilities leads to the general impression that deposits are 'made safe' by the central bank and larger institutions are almost certain to be bailed out. In fact, there have been only few bank failures where personal depositors actually suffered losses. Thus, the threat of partial deposit losses in case of incompletely insured deposits suffers from a serious credibility problem, as actual losses are highly unlikely. The recent failure of the Luxembourg-incorporated Bank of Credit & Commerce International, however, may be an example of depositors suffering actual losses. At the same time, this case illustrates that depositors' monitoring behaviour is at best incomplete: it was publicly known even before the failure that at least part of the bank was subject to fraud and criminal money laundering activities but this fact did not lead to tangible changes in the behaviour of depositors.

⁹ The current lack of public information on deposit insurance schemes in the EC countries and the apparent resistance of both regulators and banks to advertise their existence is in stark contrast to the operation of the Federal Deposit Insurance Corporation (FDIC) in the US. In contrast to their European counterparts, banks in the US can actually advertise by displaying an 'FDIC-Member' sign in their branches.

¹⁰ This issue is currently being discussed and will be decided only by the Council of Ministers in the final Directive.

Finally, the proposed Directive imposes flat-rate rather than risk-related premiums. The main reason why deposit insurance schemes are characterised by flat-rate rather than risk-related premiums are administrative and theoretical problems of how to measure banks' asset risks. Flat-rate premiums may lead to significant moral hazard problems, however.¹¹ As banks are not penalised for taking higher risks, they have no incentive to follow a prudent asset portfolio strategy: formulating the bank's asset allocation problem in the mean-variance framework of portfolio theory (see, for example, Pyle, 1971; Hart and Jaffee, 1984), it is easily shown that if the return is not reduced proportionately by variable risk premiums the bank will always choose the riskiest asset portfolio. Thus, to avoid such adverse moral hazard effects it is clearly theoretically preferable to implement a scheme with risk-related premiums.

There may, however, be significant practical obstacles to implementing such a risk-based scheme. The main problem lies in assessing banks' portfolio risk. A similar problem exists when determining capital adequacy ratios. Concerning capital adequacy, however, some central banks have most recently switched to assessing banks' assets on a risk basis.¹² Equally, the EC Solvency Ratio Directive uses a range of risk weights to determine the necessary minimum capital-assets ratio.¹³ In addition, there have been theoretical advances in linking risk measures to the theory of finance to design sounder risk measures (e.g. Shaeffer, 1987, 1990).¹⁴

Apart from practical and administrative concerns, two economic reasons may speak against risk-related premiums: first, banks may seek to avoid those asset allocations which are penalised by higher risk premiums. Instead they may attempt to invest in areas which are not (yet) adequately priced by the premiums (e.g. new off-balance sheet activities, new forms of options) in

¹¹ Kareken and Wallace (1978) show that if bank liabilities are insured at a premium which is uncorrelated to the bank's portfolio risk then banks lack an incentive to restrain risk and "hold the riskiest portfolios they are allowed to hold". In fact, Kareken and Wallace argue that the half-hearted regulation of banks before the Great Depression and the lack of correlation between insurance premiums and portfolio risk was mainly responsible for the high number of bank failures.

¹² The Bank of England, for example, determines a risk asset ratio by dividing assets into seven risk categories which are then weighted according to their riskiness. Notes and coins receive the lowest weight and property lending is considered to be the most risky asset allocation. See Shaeffer (1987) for a criticism of this somewhat *ad hoc* approach.

¹³ Article 6 of the Directive classifies five categories of risk weights which need to be assigned to different assets to determine the denominator of the solvency ratio.

¹⁴ Merrick and Saunders (1985) depict a socially optimal deposit insurance premium p for any particular bank as taking the following form: $p = l(\emptyset) + c(\mu) + e$, where $l(\cdot)$ is the expected loss of the insurance fund in case of bank failure which is an increasing function of \emptyset , the riskiness of bank assets, $c(\mu)$ is the cost function of the deposit insurance agency, and e is the externality cost of a bank failure (e.g. interrupting otherwise profitable production). Possible measures of \emptyset are discussed, for example, in Shaeffer (1987).

order to minimise their premium payments. To address such a strategy of minimising insurance premiums, flexible rules of assessing asset risk should be implemented which can be easily modified to take account of new financial instruments and innovations. Since such flexibility is already required for updating the rules concerning asset risk assignment in the context of capital adequacy, no additional administrative effort is needed.

A second more serious objection to risk-related premiums is that they aggravate the financial situation of troubled banks and thus merely increase their probability of insolvency, rather than contributing to financial stability. In particular, a bank attempting to recover from temporary difficulties is penalised by higher insurance premiums, hindering its recovery efforts. This stems from the fact that for a variable rate system to be effective, the variance of premiums needs to be significant to result in sufficient incentive effects. To address such concerns, there should be a possibility of replacing *ex ante* premiums by some form of *ex post* mechanism. Thus, the insurance agency may decide on a temporary moratorium in exceptional circumstances where a bank is aiming to recover from financial difficulties. If the bank then follows a prudent low-risk strategy it would be rewarded *ex post* by lower insurance premiums.

The fact that no country has so far established a risk-based deposit insurance scheme may speak for the fact that there are formidable practical obstacles to designing and administering such a scheme, however. Recent research in the US on deposit insurance has taken as a starting point the premise that it is nearly impossible to design a practical risk-adjusted deposit insurance scheme.¹⁵ Thus, while a risk-based system is clearly theoretically preferable, it may not be obtainable in practice.

2.2. Lender of last resort in an international context

2.2.1. *The lender of last resort: theoretical considerations*

The lender of last resort function (LLR) refers to financial aid granted to illiquid but solvent institutions.¹⁶ It is usually performed by the Central Bank, although there are also private institutions set up by the banking sector

¹⁵ See, for example, the contributions in the 1991 special issue of the *Journal of Banking and Finance* on deposit insurance.

¹⁶ A bank is insolvent if its liabilities exceed its assets. It experiences liquidity problems when it is not able to meet its short-term cash obligations while still maintaining positive net worth. This distinction goes back to Bagehot (1873) (see Humphrey, 1989, for a historical analysis). As noted by Goodhart (1985, p.35), however, in practise, this distinction is not always clear-cut, since valuation problems may blur the line between illiquidity and insolvency and the necessity to take quick action makes full-fledged balance sheet evaluations impossible.

which fulfill a similar role.¹⁷ In the case of symmetric and perfect information between the bank and the capital market there would be no need for lender of last resort facilities, however, as the illiquid bank could always obtain funds on the market (possibly at above the market rate). In practice, informational asymmetries preclude such a market solution since potential lenders are unable to evaluate perfectly the financial status of the troubled bank. Thus, lenders face a residual risk that the bank is actually insolvent rather than just illiquid and they are therefore likely to ration credit rather than increase the interest rate. Market equilibria may therefore obtain at a level of lending insufficient to cover the troubled bank's liquidity needs and therefore public intervention is required to prevent bank failures of illiquid but solvent banks.

As is the case with flat-rate deposit insurance schemes, lender of last resort facilities may lead to moral hazard problems as banks may be induced to pursue a less prudent liquidity management strategy.¹⁸ To optimise its assets and liabilities management, a bank equates the marginal return of individual assets to the expected marginal cost of adjusting reserves by borrowing the required funds in case of illiquidity. Hence, when lender of last resort facilities are certain, the expected costs of illiquidity are lowered and the opportunity costs of holding additional reserves increases. Banks are therefore induced to lower reserve holdings, increasing the likelihood of liquidity problems.

Two possibilities exist to reduce such moral hazard effects. First, the LLR may charge a penalty rate for its funds.¹⁹ The rate needs to be high enough to make reliance on LLR funds sufficiently unattractive for banks. On the other hand, it must not be higher than the cost of selling illiquid assets since in this case it would not be taken up by the bank. Since the bank expects to draw on LLR funds only for short periods of time, however, whereas the opportunity costs of holding higher liquid reserves are continuously compounded, it is likely that the penalty rate required to reduce moral hazard problems exceeds the asset liquidation rate (see Guttentag and Herring, 1987). Thus, imposing a penalty rate for LLR funds is unlikely to have much of an effect on banks' liquidity management.

¹⁷ Such as the 'Liquiditäts-Konsortialbank' in Germany, for example, which was set up as a joint venture between private banks and the Central Bank in response to the Herstatt bank failure, providing financial aid of up to almost DM 1 billion for banks in liquidity crises. Its capital was doubled in 1991. The Bundesbank continues to act as the true lender of last resort, however.

¹⁸ Kindleberger (1978, p.163) summarises the predicament facing public authorities in the case of a bank failure: "Central banks should act one way (lending freely) to halt the panic, but another (leave the market to its own devices) to improve the chances of preventing future panics".

¹⁹ As suggested by Bagehot (1873).

The second possibility to reduce moral hazard problems is to make LLR assistance discretionary rather than certain. This is the solution most often used in practice. Banks and depositors then face the problem of assessing the probability of liquidity aid by the LLR. Since the LLR's objective is to minimise the social costs of bank failures and the risk of contagious bank runs and these are likely to be greater the bigger the bank, discretionary intervention results in large banks being protected with a high probability, whereas smaller banks have a lower chance of being rescued by the LLR (the 'too big to fail' doctrine). Obviously, this may lead to competitive distortions as larger banks are able to operate with lower reserves than smaller banks, since the latter face higher expected costs of illiquidity and depositors demand higher rates to compensate for the higher risk of default.

In practise, liquidity crises are comparatively uncommon in European countries. In particular, compared to the US there have been few crises in Europe. In few cases has there been a failure of the domestic LLR to provide liquidity assistance and therefore LLR assistance can be considered to be almost a certainty especially when larger institutions are concerned.²⁰

2.2.2. The LLR for multinational banks: home-country or host-country responsibility?

As scale and significance of multinational banking increases, there are a number of questions concerning the applicability and competence of national LLRs for foreign branches and subsidiaries. In our discussion we have to distinguish between LLR functions for foreign branches and those for subsidiaries. As the latter are legally separate institutions, the parent bank has no obligation to provide liquidity aid in cases of financial crisis. Branches, however, are legal parts of the parent institution and therefore the latter holds ultimate responsibility for the liabilities of the branch.

To see why there may be regulatory ambiguities in the case of multinational banks, consider a country with a domestic LLR and several multinational banks, i.e. foreign banks which have branches and subsidiaries in the country. Thus, some depositors and lenders are located abroad and these may be assigned less weight in the LLR's social welfare function. The LLR is assumed to maximise a social welfare function of the following type: $W(a\Pi, bCS, S)$, where Π is industry profits, a is the percentage of profits that

²⁰ Such as Credit Lyonnais which experienced a liquidity crisis in 1973 and was actively supported through lending by the Bank of France. When the subsidiary of Al Saudi Bank in France experienced liquidity problems in 1988 there was a cooperative rescue effort by French banks (similar for Germany's Schröder, Münchmeyer, Hengst in 1982), so that the central banks did not have to intervene. Johnson Matthey in the UK though technically insolvent was rescued by a cooperative effort of the large UK clearers due to fears of depositors losing confidence, while British & Commonwealth Merchant Bank though only illiquid rather than insolvent was not rescued by the Bank of England. The latter example illustrates the discretionary nature of the LLR. German Herstatt Bank was allowed to go under by the Bundesbank in 1974.

remain in the country, CS is consumer surplus, b is the share of consumer surplus which accrues to domestic consumers and S is financial stability. Suppose a foreign-owned subsidiary which is not covered by the home LLR experiences liquidity problems. The domestic LLR has to decide whether or not to provide emergency liquidity assistance. The net domestic damage (NDD) of failure of the subsidiary is given by

$$NDD = cD + \delta L + Pd + Sa$$

where c is the percentage of domestic residents who lose their deposits (D), δ is the share of domestic firms who are engaged in a long-term credit relationship with the subsidiary and may lose their reputational capital and Pd and Sa stand for the detrimental impact on the domestic payments system and financial stability. The LLR is assumed to balance the NDD against the social costs of providing liquidity assistance. These costs are given firstly by the potential loss of funds in case the foreign subsidiary defaults and secondly by the adverse effect on future monitoring activities which may increase moral hazard problems (see above). In its optimising decision the LLR provides liquidity assistance up to the point where the marginal benefit of reducing the NDD just equals its marginal social cost. The former is likely to be greater the higher the values of c and δ and the greater the expected adverse impact of not granting assistance to the subsidiary on the domestic payments system and financial stability. If the benefit of reducing the NDD is low the domestic LLR is more likely not to provide liquidity assistance to the troubled subsidiary since the social costs of failure are largely borne by non-residents.

Thus, in the case where the host-country LLR holds responsibility for foreign subsidiaries no incentive problems arise if the subsidiary pursues mostly domestic activities, as is likely to be the case in retail financial services, since the NDD of failure is similar to that of domestic banks. Only if the foreign subsidiary deals mostly with foreign clients, has the domestic LLR little incentive to provide liquidity assistance. The host-country rule of LLR assistance is somewhat inconsistent with the home-country rule of supervision of the Second Banking Directive, however. This results from the fact that the LLR needs to have a certain degree of familiarity with the troubled institution in order to distinguish illiquidity from insolvency. This familiarity is best achieved when the LLR is at the same time the prudential and supervisory regulatory authority of the institution. The Second Banking Directive, however, assigns these functions to the home-country authorities.

To improve consistency with the Second Banking Directive, the LLR function for foreign subsidiaries could therefore be exercised by the home-country authorities. While this has the virtue of according with the home-country principle of supervision and thus establishing a clear-cut and consistent rule, it encounters problems if the NDD is low, as it is likely to be for most foreign subsidiaries with mainly foreign activities, since the home country authorities have little incentive to bail out a subsidiary if the social

welfare reduction occurs mainly in another country. In practice, foreign subsidiaries are likely to be bailed out by the parent institution, since the latter may otherwise suffer irreparable reputational damage if it lets one of its subsidiaries go under without having undertaken everything possible to pursue its rescue.

In summary, it therefore appears to be preferable to retain the host country principle for the LLR function of foreign subsidiaries, primarily because the social welfare effects are most likely to occur in the host country especially in retail financial services, and the central bank has a greater incentive to provide liquidity assistance.

3. Conclusions

In this chapter I have reviewed the public policy implications which can be derived from the theoretical and empirical analysis of the previous chapters. Concerning competition policy aspects, I have argued that cross-border acquisitions are likely to increase rather than decrease competition in financial services. This conclusion is diametrically opposed to those of previous academic studies of cross-border acquisitions in financial services. However, it was argued that one must carefully distinguish between cross-border and domestic transactions. The latter may reduce the level of domestic competition in particular in those countries which do not have effective merger control regulations and where regulators actively support such domestic consolidation efforts. In these cases, intervention on the EC level may be required, as domestic regulators have no sufficient incentive to ensure an effective level of competition.

The two main policy tools to reduce the risk of contagious bank runs both operate under second-best principles. Deposit insurance as implemented in the EC countries is aimed primarily at protecting small investors, rather than preventing bank runs. To reduce the problem of moral hazard, coverage is comparatively low, in particular comparing it to the deposit insurance scheme in the US. Concerning the coverage of foreign branches, it suggests the home-country principle which although consistent with the Second Banking Directive may lead to confusion among depositors which need to assess the coverage of different insurance schemes when making their choice between domestic and foreign banks.

Concerning lender of last resort facilities, the discretionary nature of liquidity assistance by the central bank is supposed to reduce possible moral hazard problems. At the same time, it provides an argument for exempting LLR facilities from the home country approach, since home country regulators may have little incentive to provide assistance to a foreign subsidiary of a domestic bank if the detrimental welfare effects largely occur in the host country, as is likely to be the case in retail financial services. Thus, assignment of foreign subsidiaries to the host country LLR may be preferable to home country responsibility.

Conclusions

In this last section, I briefly review the questions tackled in this thesis, the methodology adopted to address these issues and the conclusions which emerge from the preceding theoretical and empirical analysis. I follow the conclusions of the individual chapters of the thesis.

The first chapter introduced the basic definitions of the financial services industry and markets. Rather than following the traditional divide between banking and insurance, I introduced a customer-oriented definition. This makes economic sense, since due to increasing decompartmentalisation an institutional classification no longer provides a sufficient basis for evaluating financial services competition, most especially in the retail sector. I defined retail financial services as comprising the mass personal and small- and medium sized business market. Cross-border entry takes place when a firm follows the strategic objective of expanding operations to foreign markets through a range of possible entry vehicles including *de novo* entry over acquisitions, strategic alliances, joint ventures or exporting.

A brief overview of the historical evolution of cross-border banking in Europe has shown that significant foreign penetration started only around the beginning of the 1960s and was predominantly in the area of wholesale and investment banking, rather than in the retail sector. In contrast, in the insurance sector there was a significantly higher degree of cross-border entry also in the retail sector.

In chapter two, I briefly reviewed the main economic reasons for regulating retail financial services and assessed the changing regulatory approach of financial services regulation on the EC level. Capital liberalisation constitutes the *conditio sine qua non* for increased cross-border penetration in financial services, as it allows agents to obtain the optimal risk-return tradeoff across the EC countries, as well as purchasing financial products in those countries which offer the best conditions. The Second EC Banking Directive and the Third EC Insurance Directives establish a regulatory regime which allows cross-border provision of services and freedom of establishment under the home-country rule. Despite some ambiguities concerning the boundary between home country regulation and host country supervision of "rules of conduct", it seems certain that foreign financial services firms will be able to operate under home country regulatory rules for most of their activities and will therefore no longer have to deal with several different supervisory agencies when operating internationally.

The new regulatory regime on the EC level characterised by minimum harmonisation, home-country supervision and mutual recognition is predicted to lead to a process of strategic deregulation where national regulators or policy-makers aim to provide domestic financial institutions with competitive advantages abroad or attract foreign firms to the home country. In order to analyse this prediction, I developed a simple game-theoretic model. It became clear that once objective functions and strategies are fully specified, regulators or policy-makers have no interest to deregulate *ad infinitum*, since this would jeopardise financial stability in their home country. In addition, they are able to 'free-ride' on the deregulatory moves of other national regulators. It is therefore by no means evident that regulatory competition results in lax supervision or leads to neglect of the original economic objectives of alleviating market failures, as predicted by some academic commentators.

Several areas which may nevertheless be affected by strategic regulation were identified. In the banking sector these include minimum reserve requirements, deposit rate regulation, taxation of interest rate earnings and line of business restrictions. In these areas it is likely that domestic banks will place pressure on their regulators or policy-makers to abolish restrictions which place them at a competitive disadvantage compared to foreign institutions. In the insurance sector the impact of enforced deregulation will be felt most in those countries which have so far relied on a material control system of supervision with premium and profit regulation. These countries will be forced to replace this approach by a deregulated system of unrestrained competition on premiums where regulators control only solvency and reserve requirements.

In order to explain the process of cross-border entry in retail financial services, I developed a theory of cross-border entry activities in chapter three. I argued that traditional trade theory which focuses on comparative cost differences cannot provide a satisfactory explanation for cross-border entry in financial services. A firm-level approach to the theory of cross-border entry is needed. I developed such a theory on the basis of the eclectic paradigm of multinational enterprises which builds on an analysis of corporate-level competitive advantages transferrable to foreign markets and locational factors inducing cross-border entry. The eclectic paradigm starts from the premise that foreign firms suffer from a cost disadvantage. I argued that foreign banks may have higher costs due to a reputation which has yet to be established, a lower position on the learning curve and fewer transactional relationships which make the basic intermediation function more costly. Similarly, foreign insurers face cost disadvantages, as they may not be able to perform the risk pooling function as effectively as domestic firms due to the operation of the law of large numbers. In addition, foreign insurers have less experience with risk assessment and may also face reputational disadvantages.

To the degree that foreign banks and insurers face a cost disadvantage they need some competitive advantage to compensate for this. Concerning firm-level competitive advantages, I argued that the follow-or-lead the customer hypothesis is not only applicable to the largest corporate customers but also to medium and small-sized firms and even to some extent to personal customers who travel extensively across Europe. The second potential source of a firm-level advantage is product know-how resulting in learning economies which can be transferred to foreign markets at low marginal costs.

The second source of potential competitive advantages are locational factors. These include in particular high oligopoly profits in foreign markets which may attract foreign entry. However, expectations of domestic incumbents' reaction to foreign entry are crucial for determining such a locational advantage. A second potentially important locational explanation results from diversification advantages which achieve risk reduction at constant returns if risks in these markets are less than perfectly correlated.

Concerning the mode of entry, I argued that cross-border provision of services will play only a marginal role in retail financial services, as the vast majority of services require at least some degree of personal interaction between customer and supplier. De novo entry faces the problem of building up a distribution and customer network entirely from scratch. In retail financial services, acquisitions or strategic alliances are therefore likely to be the most likely entry routes. While large firms are likely to prefer acquisitions, medium-sized institutions may opt for alliances or joint ventures due to lack of financial resources to undertake large-scale acquisitions.

The extent of cross-border penetration depends on the significance of barriers to cross-border entry in retail financial services which I examined in chapter four. Two main sources of entry barriers were identified: first, barriers arising from the regulatory environment which are attacked by the EC internal market programme. Second, entry barriers which I called 'market-inherent' arising from the particular market structure or product characteristics. These are likely to persist - though becoming less severe - even after the integration of European financial markets.

Concerning regulatory entry barriers, it was noted that regulatory resistance to takeovers of domestic firms by foreign institutions is greater in banking than in insurance, as the banking sector is considered to have a strategic role for domestic economic policy. Moreover, the lack of a corporate control market in the EC may be especially severe in the banking sector resulting from the large extent of public ownership in some EC countries.

Market-inherent barriers to cross-border entry are unlikely to result from size economies which do not appear to be significant in most areas of

financial services. In contrast, incumbency advantages arising from firm reputation and switching costs may constitute the most significant barriers to entry in the retail financial services sector. Thus, price differentials do not necessarily induce a switch from one supplier to another, allowing incumbents to exercise a certain degree of market power. Barriers to entry arising from switching costs are likely to be greater in banking than in insurance which is partly due to the fact that the latter industry is characterised by less-frequent interaction. In addition, reputational factors may be less significant in insurance than in banking. Finally, there are fewer joint products in insurance such that individual products are separable. This further facilitates entry in insurance where a foreign firm can enter only one particular product market. In banking, however, there are fewer stand alone products. Thus, the insurance sector is characterised by fewer barriers to foreign entry than retail banking.

Faced with the threat of increased foreign entry, domestic regulators and institutions may attempt to implement entry-detering strategies, in particular in retail banking. These include especially domestic consolidation which has increased significantly in some EC countries. Further, domestic banks may attempt to exclude foreign banks from domestic networks such as ATMs or clearing systems. Finally, branch proliferation by domestic banks may have the objective of closing potentially profitable locational niches to foreign entrants.

In chapter five, I have analysed the potential impact of foreign entry on domestic competition in retail financial services. I showed that for the simple case of Cournot competition in deposit markets both cross-border acquisitions and de novo entry lead to higher deposit rates and thus to an increase in consumer surplus. As domestic firms lose market share to foreign entrants, however, domestic producer surplus decreases and this decrease may outweigh the increase in consumer surplus. In addition to stimulating price competition, cross-border entry may spoil domestic collusive equilibria such as (tacit) agreements not to compete on deposit rates or agreements to fix insurance premiums. Further, foreign financial services firms can bring new expertise to the market in the form of introducing new products or may increase quality competition by offering existing products at a higher quality level. Finally, if foreign entrants are more cost-efficient than domestic firms this may induce a restructuring of domestic firms and reduce X-inefficiency.

As the Price Waterhouse study is characterised by some insufficiencies concerning statistical sampling, I decided to gather additional data on price differences in retail banking across six EC countries. It became obvious that there are significant differences in the pricing structure of retail products. Differing degrees of cross-subsidisation are likely to come under intense scrutiny when competition intensifies. I also showed that there is substantial evidence for X-inefficiency in some countries, as well as differing quality levels concerning products and services.

In chapter six, I provided an aggregate overview of cross-border entry activities in the EC. Cross-border provision of services currently constitutes only a fairly insignificant amount of total services trade. I decided to construct an original database of cross-border entry activities of the largest sixty European banks and the largest forty insurers for the period from 1986 to the beginning of 1992. A comparison of cross-border acquisition activity in financial services with that of other industries in the EC revealed that the financial services industry is particularly active in this area with the number and disclosed value of transactions exceeding those in other industries.

An analysis of acquisitions in EC financial services since 1975 suggests that there has been a significant increase in transactions, especially since 1986. The most recent decrease in cross-border acquisitions seems to suggest that most firms have already undertaken their European expansion plans in preparation of the internal market, however.

Joint ventures play a less significant role than cross-border acquisitions but account for a similar proportion of total cross-border entry activities as in other industries. Strategic alliances have been a common form of cross-border cooperation for some time, especially in the banking sector. Recent evidence suggests that such agreements have become increasingly popular, as a less costly alternative to a majority acquisition. Finally, *de novo* entry activities still account for a large number of cross-border entry activities of European banks but almost exclusively in the area of corporate and investment banking.

Entry by non-EC institutions into the EC market has been concentrated in the market for large corporates. Neither US nor Japanese firms are likely to play a significant role in European retail financial services in the foreseeable future.

In chapter seven, I first provided some evidence from a range of interviews with banks on the general impact of the regulatory changes in the context of the internal market programme. Most practitioners agree that the impact of 1992 is likely to be minimal in the market for large corporates and institutions. Retail banking is seen to be more affected but it may well take another ten years before greater cross-border penetration in this sector is achieved.

I undertook a number of in-depth case studies for cross-border acquisitions and alliances in the banking sector. For cross-border acquisitions it became apparent that post-acquisition strategies vary significantly for individual cases. While for some cases a hands-off approach is pursued by the acquirer, other acquisitions are actively integrated into the group following a unified European strategy. It appears that acquired banks do not follow a strategy of consistently undercutting indigenous institutions on

prices. However, they frequently do offer better conditions on selected products such as deposit interest rates, like CC-Bank and Citibank in Germany or Barclays in Spain, or credit cards such as Citibank and Barclays in Germany and may therefore force domestic competitors to follow suit. In addition, it seems that foreign institutions frequently compete on quality and efficiency of services. In addition, foreign banks are frequently forced to rely on technology-intensive distribution methods in order to compensate for the lower number of branches. Thus, they may introduce new distribution methods such as home banking and advanced ATMs, as Citibank has done in Germany, which may eventually be copied by domestic competitors. Thus, foreign banks are frequently competing on service quality and efficiency of distribution rather than merely on prices.

Does actual or potential foreign entry in retail banking place constraints on domestic firms and reduce their ability to exercise market power? Our empirical evidence seems to suggest that foreign banks in the retail area compete on the price level only in selected areas. This may concern the area of interest rates on deposit accounts, for example, where foreign banks are often the first banks to offer significantly positive or above average rates. Possibly more importantly, foreign banks frequently compete on the quality and efficiency level. Firstly, this probably results from the simple fact that price cuts can be immediately matched by domestic competitors, whereas a technological edge requires more time to be imitated by competitors. More importantly, foreign banks are to some extent forced to compete on efficiency, technology, and quality levels, as they cannot compete with domestic banks in terms of the extent of the retail branch network. Innovations in the field of product-delivery methods may bring considerable benefits to the consumer, as they are likely to facilitate the communication and interaction with banks. In particular, new distribution methods introduced by foreign banks may be copied by domestic institutions.

In general, it seems clear, however, that in the retail area the impact of foreign banks on domestic competition is limited. In contrast to investment banking, geographic expansion in the retail sector entails large fixed costs, as product delivery still necessitates a large number of distribution outlets. Only when communication technology has progressed so far as to make non-branch based distribution methods widely acceptable, will foreign banks be able to make a greater impact on domestic competition in the retail banking sector.

The impact of strategic alliances on competition does not seem to be significant, in general. As the example of Royal Bank of Scotland and Banco Santander shows, however, such an alliance can bring significant benefits in the retail area where technological cooperation between two large branch networks leads to a simplification of cross-border transactions.

In chapter eight I reported the results of a questionnaire survey which was sent out to the largest 270 banks and insurers in the European Community. The results showed that foreign firms currently play a more significant role and are perceived to be stronger competitors in the retail insurance sector than in retail banking. In banking, foreign firms are at present still considered to be most significant in the wholesale and investment banking sectors, while perceived to become more significant in retail banking. In the retail insurance sector, however, the impact of foreign firms is generally expected to be greater than in retail banking. Concerning the impact of the internal market programme, around 60 percent of banks and insurers currently take the single financial services passport into account. Spain, Italy and France are expected to be most affected by the changes resulting from the internal market programme in the banking sector, while Germany is additionally listed in the insurance sector.

Concerning the significance of barriers to entry, it is interesting to find that regulatory barriers are not perceived to be all that important in the financial services sector. The most important barriers in insurance are lack of know-how and lack of right distribution channels, while the lack of suitable acquisition targets is additionally listed as a significant barrier in the banking sector.

De novo entry in the personal customer segment is perceived to be a feasible entry strategy by the majority of respondents in insurance, but not in banking. Cross-border provision of services, however, is not considered to be a successful entry strategy in both sectors.

In the second part of chapter eight, I presented a number of case studies for the insurance sector. It emerged that in the retail sector there has been a greater scale of cross-border transactions in the insurance than in the banking sector, in particular concerning the size of individual cross-border acquisitions involving firms which have a significant market share in their domestic market. For these large-scale cross-border acquisitions, however, it was noted that the strategic impact of a change in ownership has, so far at least, been negligible. After the takeover by a foreign company, few strategic variables have been changed and these takeovers have certainly not been for corporate control reasons. It seems that the larger the transaction, the less significant the impact on day-to-day management of the acquired firm. The large firms which were acquired are very much domestic players and are unlikely to upset any existing collusive agreements or to suddenly start competing on the price level only because of an ownership change. It seems that foreign acquirers pursue a very cautious approach when integrating the foreign firm and implement a policy of least interference in the domestic affairs of the newly acquired firm.

De novo entries which, in contrast to the retail banking sector, actually exist in insurance seem to have much more of an impact on competition in

the host country, as entering firms are forced to provide services either at lower premium levels or introduce new, innovative products. In practice, insurers most frequently choose the second strategy when entering foreign markets and firms like Equity & Law in Germany and Eagle Star in Spain and Portugal provide good examples of foreign firms which have introduced new products, forcing domestic firms to adapt similar products in order not to lose customers.

In chapter nine, I undertook an analysis of interstate entry in the US in order to test the view whether predictions can be derived from the US experience for the EC. A brief review of the liberalisation process of interstate banking in the US showed that despite the movement towards opening state markets to out-of-state entry, significant regulatory entry barriers remain which actually exceed those in the EC. Even though the number of interstate mergers and acquisitions has increased, no significant consolidation process has so far taken place with the possible exception of large-scale mergers between the bigger banks.

Concerning regulatory competition, the examples of South Dakota and Delaware show that state regulators have successfully used strategic regulation to attract out-of-state banks. By relaxing restrictive credit card regulations, both states achieved vastly overproportional growth in credit card loans booked through subsidiaries of out-of-state banks. This resulted in a significant increase in income tax revenue from banks as well as increasing banking employment. Strategic deregulation was successful despite the fact that other state regulators quickly emulated the more permissive regulations.

Concerning the impact of out-of-state entry on domestic competition, studies of the liberalisation of statewide branching show that credit availability rises, new products and services are introduced and prices for at least some products tend to fall as competition increases. Continued restrictions on interstate branching have led to a stronger focus on distribution channels which increasingly rely on telephone, mail and computer support rather than the traditional branch network. This example shows that it is possible to make significant inroads even into mass retail financial services without the need to maintain a large branch network. One may expect similar developments and distribution methods to become increasingly important in Europe as well.

In chapter ten, I reviewed the public policy implications which can be derived from the theoretical and empirical analysis of the previous chapters. Concerning competition policy aspects, I argued that cross-border acquisitions are likely to increase rather than decrease competition in financial services. This conclusion is diametrically opposed to those of previous academic studies of cross-border acquisitions in financial services. However, I argued that cross-border acquisitions are quite different from domestic mergers. The

latter may reduce the level of domestic competition in particular in those countries which do not have effective merger control regulations.

I finally discussed the two main policy tools to reduce the risk of contagious runs on financial institutions. A deposit insurance scheme as envisaged in the EC Directive aims primarily at protecting small investors in the case of bank failure, rather than preventing bank runs *per se*. Since firm failures and runs with potentially harmful effects may also occur in the insurance sector, as recent examples from the US illustrate, guarantee funds should be set up also for insurers which may be modelled according to the institutions which already exist in most US states.

Concerning lender of last resort facilities, the discretionary nature of liquidity assistance by the central bank provides an argument for exempting LLR facilities from the home country approach, since home country regulators may have little incentive to provide assistance to a foreign subsidiary of a domestic bank. This results from the fact that in retail financial services the detrimental welfare effects largely occur in the host country. Thus, assignment of foreign subsidiaries to the host country LLR may be preferable to home country responsibility.

In summary, it emerges from this study that the impact of cross-border entry in retail financial services on domestic competition is less significant than what is predicted in the Cecchini report. It will be interesting to undertake a similar study like the present one in about five years time to analyse the changes which have actually taken place in the European retail financial services sector.

Appendix 1: Database of Cross-Border EC Bank Acquisitions, Cooperative Agreements, Joint Ventures and De Novo Entry Activities for largest EC and non-EC banks

The following ranking lists the largest 60 EC banks and the largest US, Japanese and other European banks by size of their Tier-1 capital in 1990, as defined by the Cooke Committee which includes equity (both ordinary and preference shares) as well as retained earnings. A ranking of banks according to this criterion is published annually in *The Banker*. The first column contains the bank's name, its country of origin, and its capital size in US dollar (in 1990).

For each bank, its acquisitions from 1986 to the beginning of 1992 are listed. The second column lists the year of the transaction, the name of the acquisition target, followed by its country of operation and, where known, the equity capital of the acquisition target, the percentage stake of the acquisition and the area of activity of the target bank.

The third column lists joint ventures (JV) between the bank and any other EC bank. After the year of the transaction, the names of the participants of the JV are given, followed by the name of the joint venture, the stakes which the banks hold in the JV and a comment about the area of activity of the JV and its objectives pursued.

The fourth column lists cooperative agreements (and strategic alliances) between the bank and any other EC bank and again gives the year of the agreement, the names of participants and the type and objectives of the alliance.

Finally, column five lists any kind of cross-border *de novo* entry of the bank in another EC country. Where known, it also lists the area and type of operation of the newly opened representative office, branch or subsidiary.

Bank

Acquisitions

Joint Ventures

Cooperations

New Entry

1. EC banks

<p>1. Credit Agricole, France, \$11.8 billion</p>	<ul style="list-style-type: none"> • 1988: CAFCO, UK, Mortgage Bank • 1988: Comp. Finanziaria, Italy, \$859 million, 20%, Finance Company • 1989: Nuovo Banco Ambrosiano, Italy, 12%, private banking • 1989: COFIGASA, Spain, 50%, Spain's leading consumer credit cards company • 1990: Agentes de Bolsa Asociados, Spain, 35%, brokerage • 1990: ETEBA (National Investment Bank for Industrial Development, Greece, 10%, investment bank) 	<ul style="list-style-type: none"> • 1986: Espirito Santo, Portugal, Banco Internacional de Credito, 20:80, offers full range of banking services in Portugal, emphasis on corporate clients • 1988: AGF, France, BAMI, Spain; Eurocredito Inmobiliaria: 35:35:30, 	<ul style="list-style-type: none"> • 1988: M&G, UK; to enter mortgage market in UK, M&G markets two of CAs mortgage products • 1989: Rabobank, Netherl., customers able to use the other bank's network, mutual assistance of clients • 1990: Banco Ambrosiano Veneto, Italy, Reciprocal services • 1990: CERA - Savings Bank, Belgium, trade activities, product development 	<ul style="list-style-type: none"> • 1986: Germany, branch, banking • 1988: Spain, upgrade of rep. off. to subs. • 1988: Unibank, Spain, credit cards • 1988: Unibank, Italy, credit cards • 1988: Luxembourg, fund management
<p>2. Barclays Bank, UK, \$10.7 billion:</p>	<ul style="list-style-type: none"> • 1987: BCR Roma Factoring, Italy, 100% • 1989: CFS Finance SYS, Germany, \$32 million, 75%, Credit Cards • 1989: Puget Mahe, France, \$10 million, 75%, Brokerage • 1990: Merck Fink, Germany, 100%, \$200 million, Banking • 1990: L'Europeenne de Banque, France, 100%, \$306 million, Banking 	<ul style="list-style-type: none"> • 1990: Hertie, Germany; OPTIMUS Bank, 49:51, to offer store card to Hertie customers 	<ul style="list-style-type: none"> • member of ABECOR 	<ul style="list-style-type: none"> • 1990: Barclays Commodity, Netherlands
<p>3. National Westminster Bank, UK, \$9.8 billion</p>	<ul style="list-style-type: none"> • 1987: Banco de Asturias, Spain, 90%, Banking • 1988: Banque de L'Union Europeenne, France, FF 877 million, Banking • 1989: Banco Nat West Merch, Spain, \$126 million, increase of stake from 49% to 83.6%, Banking • 1989: Sellier, France, 100%, Brokerage, FF12.7 million • 1990: Van Lanschot Bankiers, Netherlands, Dfl.269,239, increase from 40 to 80%, Banking 	<ul style="list-style-type: none"> • 1989: Credito Italiano, Italy, Banca Credit West e dei Comuni Vesuviani: originally Nat West held 30% stake since 1972, then dilution to 19% by taking in Credito Vesuviano, Banking 		
<p>4. Deutsche Bank, Germany, \$8.5 billion</p>	<ul style="list-style-type: none"> • 1988: Banca d'America e d'Italia, Italy, \$366 million, 100%, Banking • 1988: MDM Sociedade de Investimento, Portugal, \$6 million, 100%, Investment Banking • 1988: Bary & Co., Netherl., \$62 million, 100%, Banking • 1989: Banco Comercial Transatlantico, Spain, \$13 million, 72%, Banking • 1989: Morgan Grenfell, UK, \$623 million, 100%, Investment Banking 	<ul style="list-style-type: none"> • 1989: FIAT, Fidis, Italy, introduction of new credit card called FIDIS-card through subsidiary Banca d'America 	<ul style="list-style-type: none"> • member of EBIC 	<ul style="list-style-type: none"> • 1986: DB Finance, Belgium, Finance Company • 1988: DB de Investimento, Portugal, investment bank • 1989: DB M&A, France, mergers & acquisitions advice • 1989: DB Capital Management, UK, fund management of int'l bond & European equity portfolios • 1989: Europäische Hypothekenebank, Luxembourg, Mortgage Bank

Bank Acquisitions Joint Ventures Cooperations New Entry

<p>5. Banque Paribas, France, \$7.0 billion</p>	<ul style="list-style-type: none"> • 1986: Quilter Goodison, UK, \$13 million, 99%, Finance Company. • 1989: Banca Commerciale Italia, Italy, \$3200 million, 2%, Banking • 1990: Unispar, Belgium, \$28 million, 89%, Savings Bank 	<ul style="list-style-type: none"> • 1988: COMIT, Italy, Assicurazioni Generali, Italy; Banca Internazionale Lombarda; 40:20:40, Banking • 1990: Hafnia Holding, Denmark, Cobepa, Belgium; Holnor, 33:33:33, Holnor is to invest in Northern European companies • 1990: Cobepa, Belgium, Executives, India; Paribas, Deelnemingen, NV 68:20:13, Industrial holding company • 1989: James Capel, UK, Shearson Lehman Hutton, US, IBI, Japan; Intermediate Capital Group, focus on MBOs, mezzanine finance, family buy-outs, first in the UK, then France, Italy, Netherl. 	<ul style="list-style-type: none"> • 1989: Kreditanstalt für Wiederaufbau, Germany, Paribas will assist in the allocation of credit facilities for either German investment in the EC or foreign investment in Germany 	<ul style="list-style-type: none"> • 1988: Belgium, branch • 1989: Paribas Futures, UK, Fund Management
<p>6. Banque National de Paris, France, \$6.1 billion</p>	<ul style="list-style-type: none"> • 1987: ARK Sec, UK, 75%, Brokerage • 1988: Chemical Bank Home Loans, UK, 100%, Mortgage Bank • 1989: Banco di Credito y Ahorro, Spain, \$11 million, 100%, Banking • 1989: Credito Romagnolo, Italy, \$784, 2%, Banking • 1990: Bank Nagelmackers Belgium, BFr 589 million, 75%, banking. • 1991: Kleinwort Benson, UK, 5%, merchant banking 	<ul style="list-style-type: none"> • 1988: Naco Borges e Imaro, Portugal, Union des Assurances de Paris, France; BNP Factor, 75:20: 5, overall, fourth factoring company in Portugal • 1991: Dresdner Bank, Germ., OKHB, Hungary, 37:37:26, provision of trade and project finance, privatisation in Hungary 	<ul style="list-style-type: none"> • member of ABECOR • Credito Romagnolo, Italy, • 1989: Dresdner Bank, Germany, strategic alliance, supported by share swaps, exchange of board members. 	<ul style="list-style-type: none"> • 1987: Belgium, Brussels, • 1987: Spain, Pamplona, branch • 1987: Portugal, Porto • 1987: BNP Capital Markets, UK, Investment banking • 1988: BNP Mortgages, UK, Mortgage Bank

Bank

Acquisitions

Joint Ventures

Cooperations

New Entry

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
7. Credit Lyonnais, France, \$5.6 billion	<ul style="list-style-type: none"> • 1987: Slavenburg's Bank, Netherl., \$574, 95%, Banking • 1987: ALCM: UK, 100%, Brokerage • 1987: Astair and Co., UK, \$1 million • 1988: Nederlandse Creditbank, Netherl. 100%, Banking • 1989: Banque de Commerce, Belgium, \$45 million, 100%, Banking • 1988/90: Banco Lombarda di Deposito, Italy, \$38 million, 31%, Banking • 1989/91: Credito Bergamasco, Italy, \$422 million, 53%, Banking • 1989: Regent Trade Finance, UK, Finance Company • 1989: Chase Manhattan Handelsbank (Belgium), branches and subsidiary • 1990: Iberagentes, Spain, 40%, brokerage • 1990: International Bankers Incorporate, FF224 million, Luxembourg, 25%, brokerage • 1990: Woodchester, Ireland, 29.85%, leasing, consumer credit, mortgages • 1990/91: Banco Commercial Espanol, Spain, 97%, FF 2,220 million, banking • 1991: Banco Jover, Spain, majority. • 1991: Eurofactors, Belgium, majority acqu., business factoring 	<ul style="list-style-type: none"> • 1988: Danaise Kreditforeningen, Denmark; Kredit Danmark; 10:90 • 1989: National Bank of Greece, 50:50, French Greek Leasing, Inc., • 1990: GEMINA, Italy; Societa di Intermediazione Mobiliare, 30:70, Merger of Gemini's equity commission house and two brokers based in Milan and Rome 	<ul style="list-style-type: none"> • member of Europartners 	<ul style="list-style-type: none"> • 1988: CL & Co. OHG, Germany, banking • 1989: CL Asset Management, Luxembourg, Fund Management
8. Societe Generale, France, \$5.5 billion	<ul style="list-style-type: none"> • 1986: Struss Turabull, UK, 29.9%, brokerage • 1988: SGST Securities, UK, \$11 million, 60%, Brokerage • 1989: Ingversen and Co. Netherl., 55%, Brokerage • 1989: Touche Remnant Hold, UK, \$25 million, 100%, Fund Management • 1990: Companhia Financiara internac. sociedade Corretora, Portugal, 20%, brokerage • Interdealers, Spain, 40%, brokerage • 1990: Barclays Bank Consumer Credit, Italy, 100% 		<ul style="list-style-type: none"> • member of EBIC 	

Bank Acquisitions Joint Ventures Cooperations New Entry

<p>9. Dresdner Bank, Germany, \$5.4 billion</p>	<ul style="list-style-type: none"> • 1988: Thomson & Co., UK, \$3 million, 70%, Fund Management • 1989/90: Banque International de Placement, France, \$66 million, 64%, Investment Bank • 1991: La corporacion Banesto, Spain, 5%, holding company of Banesto Bank 	<ul style="list-style-type: none"> • 1987: FIDIS, Italy, Cassi di Risparmi di Verona e Vicenza e Belluno, Credito di Padova/Rovi, Erzel; Comeba, 10:26:15:30:19, Merchant bank to provide corporate finance to small and medium-sized Italian firms • 1990: London and Manchester Group, UK; London and Manchester Mortgages, 40:60, Mortgage company, • 1990: BNP, France; OKHB Bank, Hungary; 37:37:26, BNP-KH-Dresdner Bank Rt, 	<ul style="list-style-type: none"> • member of ABECOR • 1989: BNP, France, strategic alliance, supported by share swaps, exchange of board members, 	<ul style="list-style-type: none"> • 1988: Europa Bank, Luxembourg, Holding • 1989: DB Asset Management, Luxembourg, Fund Management • 1989: Ireland, branch, Fund Management
<p>10. Rabobank, Netherlands, \$5.3 billion</p>	<ul style="list-style-type: none"> • 1989: Banco Popular, Spain, \$711 million, 1.25%, Banking • 1989: ADCA-Bank, Germany, increase in stake from 84% to 100% 		<ul style="list-style-type: none"> • 1989: Banco Popular Espanol, Spain, agreement to serve each other's customers and use each other's branch network, supported by mutual shareholdings • 1989: Credit Agricole, France, similar agreement as with Banco Popular Espanol 	<ul style="list-style-type: none"> • 1988: Luxembourg, subsidiary
<p>11. Banco Bilbao Vizcaya, Spain, \$4.7 billion</p>	<ul style="list-style-type: none"> • 1987: Hambros, UK, \$440 million, 6%, Investment Bank • 1989: Banque Credit Commercial, Belgium, \$9 million, 100%, Banking • 1989: Credit Universel, France, \$22 million, 98%, Banking • 1990: Lloyd's Bank Portugal, 100% 		<ul style="list-style-type: none"> • 1990: Credit Communal/Gemeentekredit Belgium, Cooperation in different sectors such as real estate acquisitions in Spain • 1989: Hambros, UK, M&A activities 	<ul style="list-style-type: none"> • 1988: BBV Sociedade de Investimentos, Portugal, Investment Banking • 1988: Netherl., branch
<p>12. Cariplo, Italy, \$4.5 billion</p>	<ul style="list-style-type: none"> • 1987: Co. International de Banque, France, \$10 million, 65%, Banking • 1988: Banco de Santander, Spain, \$686 million, 0.8%, Banking • 1989/90: Bankhaus Lobbbecke & Co., Germany, \$59 million, 89%, Private Banking • 1989: Banco Jover, Spain, \$49 million, 30%, Banking • 1990: Banco Comercial Portugues, Portugal, 1.5% (share swap) 	<ul style="list-style-type: none"> • 1991: TSB, UK, Caisse Nationale de Prevoyance, France; Carivita, 60:20:20, project led by TSB, Cariplo provides technical support and branch network 	<ul style="list-style-type: none"> • 1988: Banco Santander, Spain, 30% swap of stakes in subsidiaries Istituto Bancario Italiano and Jover • 1989: Caisse de Depots & des Consignations, France, marketing various financial services especially outside EC • 1990: Banca Jover, Spain, to offer services to Italian companies in Spain, especially in Catalonia 	<ul style="list-style-type: none"> • 1986: Spain, Madrid, rep. off. • 1989: Germany, Frankfurt, upgrade rep. off. to branch
<p>13. Midland Bank, UK, \$4.3 billion</p>	<ul style="list-style-type: none"> • 1986: Northern Bank, Ireland, majority acqu. • 1988/91: Euromobiliare, Italy, \$4.5%, Investment Bank • 1989: BNP (Corporate Business), Spain, Corporate banking 			<ul style="list-style-type: none"> • 1988: Netherl., branch. • Banque Immobiliere de Credit, France, Mortgage Bank
<p>14. Banca Naz. del Lavoro, Italy, \$4.2 billion</p>	<ul style="list-style-type: none"> • 1989: Bankhaus Hesse Neumann, Germany, \$45 million, 100%, Banking • 1990: Bank Leumi, France, Paris branch only, 			<ul style="list-style-type: none"> • 1989: Spain, subsidiary, focus on life insurance and pension funds

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

15. Banco Central, Spain, \$3.9 billion				
16. Abbey National, \$3.9 billion	<ul style="list-style-type: none"> • 1990: Ficofrance, France, 42%, Finance Company real estate 	<ul style="list-style-type: none"> • 1988: Corgroup, Spain, Winterthur, Switzerl.; Abbeycor Nacional Hipotecario, 67:23:10, mortgage specialist (70% endowment mortgages) to open in Barcelona 	<ul style="list-style-type: none"> • 1990: Monceau, France, launching of real estate loans and life insurance 	
18. Groupe de Caisses d'Epargne Ecureuil, France, \$3.9 million			<ul style="list-style-type: none"> • 1988: Caja de Madrid and Caja de Barcelona, Spain, renouncing of opening of branches in host country, cooperation in retailing products • 1989: ICCRI, Italy, representing 78 savings bank in Italy, mutual representation agreement • 1990: reciprocal representation agreements, technical and distribution cooperation with Dutch, German and Belgian Savings Banks Associations, 	
19. Commerzbank, Germany, \$3.8 billion	<ul style="list-style-type: none"> • 1987: Cholet Dupont, France, 5%, Brokerage 	<ul style="list-style-type: none"> • 1989: AIB Investment Management (Allied Irish Bank), 75:25, CICM Ireland Ltd., fund capital of IRP 500 million expected from institutional investors • 1991: Banco Hispano Americano, Spain; Hispano Commerzbank Gibraltar, 50:50, to specialise in portfolio and asset management 	<ul style="list-style-type: none"> • member of Europartner group including Banco Hispano Americano, Credit Lyonnais and Banco di Roma • 1989: specific alliance with Banco Hispano Americano, Spain, focusing on retail banking: planned to offer joint cheque books, ATM cards, savings accounts, unified computer system, mutual renouncement of opening branches in each other's markets 	<ul style="list-style-type: none"> • 1989: Italy, Milan, rep. off.
20. Istituto Bancario San Paolo di Torino, Italy, \$3.7 billion	<ul style="list-style-type: none"> • 1986/91: Hambros, UK, 17%, Investment Banking • 1987: Comp. Financiere de Suez, France, \$4882, 1%, Finance Company • 1987: Banque Indosuez, France, \$627 million, 4%, Banking • 1988: Banque Vernes, France, \$64 million, 100%, Banking • 1988: Credit Commercial de France, France, \$381 million, 1%, Banking • 1988: ODDO, France, \$40 million, 10%, Brokerage • 1989/90: Hambros, UK, \$440, 14%, Investment Banking • 1989: Banque Francaise Commerciale, France, \$22 million, 100%, Banking • 1990: Eurosic, France, 20.4%, Finance Company • 1990: Abel Matutes, Banco de Ibiza, Spain, 40%, banking 	<ul style="list-style-type: none"> • 1987: Hambros, UK, Saa Paolo Hambros, 60:40, investment fund JV£ 100 million under management • 1989: Banque Indosuez, France, Assurances Generales de France, Uniphenix, 30:40:30, real estate financing and credit • 1990: Hambros, UK, Nicco, India; Hambros-Nicco Financial Services, 12.5:12.5:75, Merchant banking services between Europe and India 	<ul style="list-style-type: none"> • 1986: Hambros, UK, mutual stakes, exchange of board members, general cooperation • 1989: Caisse des Depots & des Consignations, France, provision of project finance for infrastructural work especially in Southern Europe • member of Inter-Alpha group 	<ul style="list-style-type: none"> • 1989: Spain, branch

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

21. Monte dei Paschi di Siena, Italy, \$3.6 billion	<ul style="list-style-type: none"> • 1989: Grindlays Bank, UK, \$562 million, 14 retail branches in France • 1989: Banque de Vizille of Lyon, France, 10.1%, Banking • 1990: Bankhaus H. Aufhauser, Germany, 14% banking • 1990: Sindibank, 24%, banking. 			<ul style="list-style-type: none"> • 1989: Belgium, branch
22. Algemene Bank Nederland, Netherl., \$3.6 billion	<ul style="list-style-type: none"> • 1988: Aicon, Borsmaeglerskab, Denmark, 50%, Brokerage • 1988: Dufour, France, 16%, Brokerage 		<ul style="list-style-type: none"> • member of ABECOR 	<ul style="list-style-type: none"> • 1988, Luxembourg, branch • 1988: Belgium, Antwerp, branch • 1988: ABN Financial Services, Ireland, Finance Company • 1989: Portugal, branch
23. Lloyds Bank, UK, \$3.5 billion	<ul style="list-style-type: none"> • 1984: Schröder, Münchmeyer, Hengst, Germany, 95%, private banking • 1987: Finance Plus, France, 30%, Brokerage 			<ul style="list-style-type: none"> • 1989: Portugal, Agency
24. Banco Espanol de Credito, Spain, \$3.5 billion	<ul style="list-style-type: none"> • 1989: Banco Totta e Acores, Portugal, 11% banking • 1989: Lombardia & Lacaci Securities, Italy, 30%, brokerage 			
25. Amro Bank, Netherl. \$3.5 billion	<ul style="list-style-type: none"> • 1988: Massonau, France, \$20 million, 52%, Brokerage • 1989: Generale Bank, Belgium, 10%, Banking • 1990: Frankfurter Kreditbank, Germany, \$122 million, 100%, Banking • 1990: CM Capital Markets, Spain, 20%, brokerage • 1990: Banque Sudameris, France, banking 	<ul style="list-style-type: none"> • 1989: Cetelem, France: Le Card, 60:40, Focus on private label credit cards, i.e. those to which retailers can attach own logo and facilities • 1990: Generale Bank, Belgium and Banque Indosuez, see there 	<ul style="list-style-type: none"> • member of EBIC 	
26. Banca Commerciale Italiana, Italy, \$3.4 billion	<ul style="list-style-type: none"> • 1986: Mercury International, UK, \$680 million, 2.2%, Investment Banking • 1989: Banque Paribas, France, \$1063 million, 2%, Banking • 1990: Banque Sudameris, France, 100%, FF250 million, Banking 		<ul style="list-style-type: none"> • member of EBIC 	<ul style="list-style-type: none"> • 1988: Germany, upgrade of rep. off. to branch • Comit Sociedade de Investimentos, Portugal, Finance Company
27. Istituto Mobiliare Italiano, Italy, \$3.2 billion		<ul style="list-style-type: none"> • 1990: Invesco MIM (Britannia Arrow), UK, IMI MIM International Asset Management, pan-European investment managem. group, seeks investment from outside Europe 	<ul style="list-style-type: none"> • 1989: Instituto de Credito Oficial, Spain, collaboration in Italo-Spanish venture capital and mutual funds management 	<ul style="list-style-type: none"> • 1989: Germany, branch

Bank Acquisitions Joint Ventures Cooperations New Entry

<p>28. TSB Group, UK, \$3.1 billion</p>		<ul style="list-style-type: none"> • 1989: Cariplo, Italy, see there 	<ul style="list-style-type: none"> • 1991: strategic alliance of merchant bank subsidiary Hill Samuel with Cariplo, Italy to cooperate in corporate finance 	<ul style="list-style-type: none"> • 1987: Luxembourg, TSP Private Bank International,
<p>29. Westdeutsche Landesbank, Germany, \$3.1 billion</p>	<ul style="list-style-type: none"> • 1989: Standard Chartered (European branches, except CH, D), Banking, ECU 500 million 	<ul style="list-style-type: none"> • 1989: Standard Chartered, UK, Chartered WestLB Holdings, 50:50, merchant bank resulting from merger between SC merchant bank and WestLB corporate finance departm. • 1990: Standard Chartered, UK; CWB Capital Partners, to invest in European LBOs 	<ul style="list-style-type: none"> • 1989: Standard Chartered, UK, preferred correspondents, SCB can use former European branches, WestLB can use SCB's Far East network 	<ul style="list-style-type: none"> • 1989: Italy, Milan, rep. off. • 1989: Spain, Madrid, rep. off
<p>30. NMB Postbank Group, Netherl., \$2.8 billion</p>			<ul style="list-style-type: none"> • member of Inter-Alpha group 	
<p>31. DG Bank, Germany, \$2.7 billion</p>	<ul style="list-style-type: none"> • 1987: London & Continental Bankers, UK, 78.6%, Banking, • 1989: Philippe de Graaff, Netherl. 75%, Brokerage 	<ul style="list-style-type: none"> • 1989: JV with 24 regional cooperative banks in Spain to form Banco Cooperativo 	<ul style="list-style-type: none"> • 1990: Istituto Nazionale di Credito Edilizio, Italy, the latter owns majority of Banca di Novara (largest coop. bank in Italy), DG Mortgage Bank can use its retail network to offer its own products 	<ul style="list-style-type: none"> • 1990: DG Finance, France, Banking
<p>32. Bayerische Hypotheken bank, Germany, \$2.7 billion</p>	<ul style="list-style-type: none"> • 1987: Banca Trento e Bolzana, Italy, 15%, \$65 million, Banking • 1988: Richard Ellis Fin. Services, UK, 25%, \$9 million, Mortgage Financing • 1989: Foreign & Colonial Management, UK, 50%, \$8 million, Fund Management • 1989: Banco Popular Espanol, Spain, 1.7%, \$711 million, Banking • 1990: Banco Commercial Portugues, Portugal, 3%, banking • 1990: Interbanca, Italy, 41%, banking 	<ul style="list-style-type: none"> • 1989: Banco Popular Espanol, Spain, to establish two joint companies, Europea Hypotecaria and Hipotecaria de Leasing using BPE's distribution network and Hypo's know-how • 1989: Richard Ellis, UK: Richard Ellis Financial Services, 25:75, to lead manage syndicates, underwrite & finance transactions up to £25 million 	<ul style="list-style-type: none"> • Banco Popular Espanol, Spain, exchange of board members, 	<ul style="list-style-type: none"> • 1986: Bayernhypo Finance, Netherl. Finance Company, • 1988: Hypo Property Fin. Capital Management, Ireland, Fund Management • 1989: Hypo Property Fin. Capital Management, Luxembourg, Fund Management
<p>33. Credito Italiano, Italy, \$2.6 billion</p>	<ul style="list-style-type: none"> • 1989: Bank CIC Union Europeene AG, Germany, 35%, \$53 million, Banking • 1989: Compagnie Fiduciaire, France, 30%, Finance Company 	<ul style="list-style-type: none"> • 	<ul style="list-style-type: none"> • 1989: Commercial Union, UK, CU can distribute its life and non-life insurance products through Credito Italiano's branch network • 1990: Banco Portugues do Atlantico, Portugal, 	<ul style="list-style-type: none"> • 1988: Spain, branch • 1989: Germany, Munich, rep. off.
<p>34. Groupe de Banques Populaires, France, \$2.6 billion</p>	<ul style="list-style-type: none"> • 1988: Banque de Credit Liegeois, Belgium, 51%, \$11 million, Banking 			<ul style="list-style-type: none"> • 1988: Banque Pop. Luxembourg

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

<p>35. Bayrische Vereinsbank, Germany, 2.5 billion</p>	<ul style="list-style-type: none"> • 1987: Rome and Milan branches of First National Bank of Chicago, banking 	<ul style="list-style-type: none"> • 1989: Caisse Centrale des Banques Populaires, France, Banque Internationale de Credit & Gestion, 51:49, Private Banking in Monaco • 1989: Credit Nationale, France, Crediop, Italy, Hambros bank, UK; Euro Synergies, 20:40:20:20, to provide finance for medium/large companies to finance expansion through acquisitions • 1989: Credit Lyonnais, Banca Commerciale Italiana and others; International Moscow Bank • 1990: Credit Foncier de France; CFF-BV Immobilier, 34:64, specialises in French-German real estate transactions 	<ul style="list-style-type: none"> • 1989: Gruppo Arca Nordest, Italy, mortgage business and cross-border M&A • 1989: Credit Foncier de France, planned creation of JVs in real estate • 1990: Banco de Sabadell, Spain, focus on financial operations and credit 	<ul style="list-style-type: none"> • 1988: Italy, branch • 1989: Greece, branch
<p>36. Royal Bank of Scotland, UK, \$2.3 billion</p>	<ul style="list-style-type: none"> • 1988: Credit du Nord, Belgium, 50% • 1988: CC-Bank, Germany, 50% • 1990: Banco de Comercio e Industria, Portugal, 19.9%, £48.8 million 	<ul style="list-style-type: none"> • 1989: Banco Santander, Spain, RBS Gibraltar, 50:50, to provide offshore and expatriate services in Gibraltar, 	<ul style="list-style-type: none"> • 1988: Banco Santander, Spain, general alliance (see chapter 6) • member of Inter-Alpha group 	
<p>37. Generale Bank, Belgium, \$2.1 billion</p>	<ul style="list-style-type: none"> • 1988: AMRO Bank, Netherl. 10%, banking • 1989: Banco Totta e Acores, Portugal, banking • 1990: Banque Parisienne de Credit (BPC), France, banking 	<ul style="list-style-type: none"> • 1990: Banque Indosuez, see there • 1990: La Cie de Suez, France; Banque Parisienne de Credit, 45:55, to focus on the Northern French region 		<ul style="list-style-type: none"> • 1987: Germany, branch • 1988: UK, branch
<p>38. Banco di Roma, Italy, \$2.1 billion</p>	<ul style="list-style-type: none"> • 1987: Cholet Dupont, France, brokerage 	<ul style="list-style-type: none"> • 1990: SOVAC (subs. of Lazard), France, Romacredit, 51:49, initially distributes car loans, 	<ul style="list-style-type: none"> • member of Europartners 	<ul style="list-style-type: none"> • 1989: Germany, upgrade of rep. off. into branch,
<p>39. Banco Santander, Spain, \$2.0 billion</p>	<ul style="list-style-type: none"> • 1987: CC Bank, Germany, 50%, \$87 million, banking • 1988: Credit du Nord, Belgium, 50%, \$31 million, banking • 1988: RBS, UK, 10%, \$2152 million, banking • 1989/90: Banco de Comercio e Industria, Portugal, 29.9%, \$70 million, banking 	<ul style="list-style-type: none"> • 1989: Landesgirokasse Stuttgart, Berliner Bank, Germany, B&S Visa card Services, 30:25:25, processing company replacing Banco Santander Visa card services, ADAC and regional banks offered 10% each 	<ul style="list-style-type: none"> • 1988: Royal Bank of Scotland, UK, general alliance, see chapter 6 • 1988: Cariplo, Italy (see there) 	
<p>40. CIC Group, France, \$1.9 billion</p>	<ul style="list-style-type: none"> • 1990: Banque Transatlantique, Belgium, 20%, FF 160 million, banking. 			
<p>41. Bayrische Landesbank, Germany, \$1.9 billion</p>	<ul style="list-style-type: none"> • 1990: Credito Commerciale, Italy, 5%, banking 			

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

42. Bank of Ireland, Ireland, \$1.8 billion	<ul style="list-style-type: none"> • 1987: Bankamerica Finance, mortgage bank, • 1988: E. Davy, Spain, 49%, brokerage 			
43. Banque Indosuez, France, \$1.8 billion	<ul style="list-style-type: none"> • 1987: W.I. Carr, UK, 100%, brokerage • 1990: Gartmore Investment Management, UK, 100%, fund management, • 1990: Kitex & Aitken, UK, brokerage, 100% • 1991: Bankhaus Marcard Stein, Germany, 100% Private Banking 	<ul style="list-style-type: none"> • 1989: Mapfre, Spain; Mapfre Indosuez, to provide financial services through Mapfre's retail network, focus on small investors • 1990: Generale Bank, Belgium, Amro Bank, Netherl. Societe Generale de Belgique; European Turkish Investment Bank, 40:25:25:10, merchant bank focusing on foreign investors 	<ul style="list-style-type: none"> • 1987: Guinness Peat Aviation, Ireland, Aircraft Leasing Co., 	<ul style="list-style-type: none"> • 1988: SEFIS, Portugal, Finance Company • 1989: Synerlease, Belgium, leasing
44. Crediop, Italy, \$1.7 billion				<ul style="list-style-type: none"> • 1989: Crediop Finance, UK,
45. Caja de Madrid, Spain, \$1.7 billion			<ul style="list-style-type: none"> • 1988: Groupe Ecurieul (see there) 	
46. Den Danske Bank, af 1871, Denmark, \$1.7 billion			<ul style="list-style-type: none"> • 1990: Kreditanstalt für Wiederaufbau, Germany, access to KfW's government supported programmes 	<ul style="list-style-type: none"> • 1988: Spain, branch • 1988: UK, upgrade rep. off. in branch • 1989: Germany, Hamburg, branch
47. Banco Hispano Americano, Spain, \$1.6 billion	<ul style="list-style-type: none"> • 1989: Commerzbank, Germany, 5%, banking • 1988: Continental Bank, Belgium, banking, 75% 	<ul style="list-style-type: none"> • 1990: FIDIS, Italy; Prime Hispano, fund and investment managem. and merchant banking 	<ul style="list-style-type: none"> • member of Europartners 	
48. Norddeutsche Landesbank, Germany, \$1.5 billion				

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

49. Bank of Scotland, UK, \$1.5 billion	<ul style="list-style-type: none"> • 1989: Equity Bank, Ireland, 85%, £2.1 million • 1990: Dorian Bank, Greece, 30% 	<ul style="list-style-type: none"> • 1991: Quelle Bank, Germany, processing credit cards in Nuremberg 		
50. Standard Chartered UK, \$1.5 billion			<ul style="list-style-type: none"> • 1989: Westdeutsche Landesbank, Germany (see there) 	
51. Credit Commercial de France, France, \$1.5 billion	<ul style="list-style-type: none"> • 1987: Foster & Braithwaite, UK, Finance Company, 100% • 1988: Irish Bank of Commerce, Ireland, 100% • 1988: Laurence Prust, UK, Brokerage, 81% • 1990: Fida Holding, Italy, Finance Company, 20% • 1990: Framlington Holdings, UK, fund management, 25%, £18.75 million 	<ul style="list-style-type: none"> • 1987: Interfinanz, Germany, CCF Interfinanz, M&A • 1988: National Home Loans, UK; to offer mortgage finance in France 	<ul style="list-style-type: none"> • member of Inter-Alpha group 	
52. Kredietbank, Belgium, \$1.4 billion	<ul style="list-style-type: none"> • 1987: Bank van der Hoops offers, Netherl., banking 100% • 1989: Bankverein Bremen, Germany, banking, 17% • 1989: Banque Joire, Pajot Martin, France, banking • 1990: Berisford Leasing, Ireland, 85%, £5.8 million 		<ul style="list-style-type: none"> • member of Inter-Alpha group 	
53. SDS Bank, Denmark, \$1.4 billion	<ul style="list-style-type: none"> • 1985: London Interstate Bank, UK, 100% banking 			
54. Banca Popolare di Novara, Italy, \$1.4 billion	<ul style="list-style-type: none"> • 1988: Banque de L'union maritime et financiere, France, 80%, banking. • 1990: SFE Bank, UK, banking 			
55. BfG Bank, Germany, \$1.2 billion	<ul style="list-style-type: none"> • 1987: Hollandse Koopmansbank, NL, 50%, banking 		<ul style="list-style-type: none"> • 1990: Banque Herve, France, exchange of board members, coop. in commercial banking & capital markets. BfG can use Herve's branch network to sell insurance products • 1990: Banco Pastor, Spain, focus on cross-border services in commercial transactions and capital market operations 	<ul style="list-style-type: none"> • 1987: UK,

Bank

Acquisitions

Joint Ventures

Cooperations

New Entry

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
56. Landes-kredit-bank Baden-Württemberg, Germany, \$1.2 billion				
57. Allied Irish Bank, Ireland, \$1.2 billion	<ul style="list-style-type: none"> • 1990: UVW Germany, 80% leasing 		<ul style="list-style-type: none"> • member of Inter-Alpha group 	
58. Banco Amrosiano Veneto, Italy, \$1.2 billion			<ul style="list-style-type: none"> • 1990: Banco Espanol de Credito, Spain, provision of reciprocal banking services including loans) 	
59. Bank Brussels Lambert, Belgium, \$1.2 billion	<ul style="list-style-type: none"> • 1987: Credit Europeene, Luxembourg, 99%, banking. • 1987: Banque Paribas, France, 10% • 1989: Banque Dreyfus, France, 100%. 			
60. Copenhagen Handelsbank, Denmark, \$1.2 billion				

2. United States

<p>1. Citicorp, \$7.3 billion</p>	<ul style="list-style-type: none"> • 1983: Banco de Levante, Spain, banking, renamed Citibank Espana • 1985: Banca Centro Sud, Italy, 100% \$130 million, banking, renamed Citibank Italia • 1985: Banque Soficam, France, 90%, FF200 million • 1985: Banque Sud Belge Belgium, banking • 1985: Seccombe, Marshall & Campion, UK, brokerage • 1985: Diner's Club UK franchise acquired from Nat West • 1987: Compagnie Generale de Banque, France, banking • 1986: Vickers Dacosta, UK, brokerage, merged with Citibank 			
<p>2. Bank America Corp., \$5.6 billion</p>	<ul style="list-style-type: none"> • 1986: divestment of Banca d'America e d'Italia to Deutsche Bank • 1986: divestment of 20% holding in Lisbon Leasing to Banco Bilbao • 1987: divestment of BancAmerica Finance, UK to Bank of Ireland • 1987: divestment of Bankhaus Centrale Credit, Germany to Banco de Santander • 1988: divestment of CC-Bank, Germany to RBS and Banco Santander • 1989: Interpayment Services, UK, traveller cheques • 1991: divestment of Luxembourg branch to Royal Belge 			
<p>3. J.P. Morgan, US, 4.7 billion</p>	<ul style="list-style-type: none"> • 1987/90: Nivard-Flornoy, France, 100% brokerage, renamed Soc. de Bourse J.P.Morgan 			
<p>4. Security Pacific, 3.6 billion</p>	<ul style="list-style-type: none"> • 1984: WIFAG Bank, Germany, banking • 1984: Bankhaus Brohl & Co., Germany, banking • 1985: Baumeister Kreditbank, Germany, banking • 1986: Anglo Factoring Services, UK, factoring • 1987: Hoare Govett, UK, brokerage, 100% • 1991: divestment of Security Pacific Eurofactors, Belgium to Credit Lyonnais 			

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

5. Chase Manhattan, \$3.6 billion	<ul style="list-style-type: none"> • 1985: Banco de Finanzas, Spain, 91%, banking, ESP 6360 million, resumed Chase Manhattan, Espana • 1985: German branch of Nederlandse Creditbank • 1989: divestment of Le Chase Banque de Commerce to Credit Lyonnais • 1991: divestment of Chase Espagne to Caixa Geral 		<ul style="list-style-type: none"> • 1989: sale of Belgian subsidiary to Credit Lyonnais 	
6. Banc One Corp., \$3 billion				
7. Manufacturers Hanover, \$2.7 billion	<ul style="list-style-type: none"> • 1986: Manufacturers Hanover Nordique, France, banking, 100% • 1988: divestment of Luxembourg branch to Bankers Trust • 1991: divestment of German branch to Caisse de Depots et Consignations 			<ul style="list-style-type: none"> • 1988: Portugal change from branch to subsidiary • 1989: France, Paris, branch
8. Chemical Bank, \$2.4 billion	<ul style="list-style-type: none"> • 1987: divestment of Italian branch to Banca della Provincia di Napoli • 1988: divestment of Chemical Bank Home Loans Group, UK to BNP • 1988: divestment of Spanish branch to Bancapital • 1989: divestment of Transbanque, France to LaFarge 			

3. Japan

1. Sumitomo Bank, 15.7 billion	<ul style="list-style-type: none"> • 1987: Ligresti, Italy; FIDA, fund management 			<ul style="list-style-type: none"> • 1988: Germany, subsidiary incorporated as GmbH • 1988: France, Paris, upgrade of rep. off. to branch
2. Dai-ichi Kangyo Bank, 14.8 billion				<ul style="list-style-type: none"> • 1987: France, branch, corporate finance & lending • 1988: Germany, Munich, rep. off. • 1989: Spain. • 1989: Italy, upgrade of rep. off. to branch • 1989: Germany, subsidiary incorporated as AG

Bank	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

3. Fuji Bank, 13.8 billion				<ul style="list-style-type: none"> • 1987: Germany, Munich, rep. off. • 1988: Italy, Milan, upgrade of rep. off. to branch • 1989: Germany, Frankfurt, branch • 1989: Netherl., Amsterdam, rep. off.
4. Sanwa Bank, 13.4 billion	• 1990: Robert Fleming & Co., UK, private banking division only			<ul style="list-style-type: none"> • 1987: UK, Manchester, rep. off. • 1988: France: upgrade of rep. off. to branch • 1989: Germany, Munich, rep. off. • 1989: subsidiary incorporated as AG • 1991: Sanwa Business Credit, UK
5. Mitsui Taiyo Kobe Bank, 12.2 billion				<ul style="list-style-type: none"> • 1987: Spain, branch • 1988: Luxembourg, subsidiary • 1989: Italy: rep. off.
6. Mitsubishi Bank, 11.8 billion				<ul style="list-style-type: none"> • 1986: Spain, branch • 1988: UK, Birmingham, rep. off. • 1988: Germany, Düsseldorf, branch • 1989: Italy, Milan, upgrade rep. off. into branch
7. Industrial Bank of Japan, 9.6 billion				<ul style="list-style-type: none"> • 1988: Germany, Düsseldorf, branch • 1988: Italy, Milan, rep. off. • 1989: Spain, Madrid, upgrade of rep. off. to branch
8. Tokai Bank, 7.8 billion				<ul style="list-style-type: none"> • 1989: upgrade of rep. off. to branch
9. Long-Term Credit Bank of Japan, 7.4 billion	• 1990: Marceau Investissements, France, 62%, Finance Company	• 1988: Foreign & Colonial Asset Management, UK,		<ul style="list-style-type: none"> • 1989: Italy, Milan, rep. off. • 1989: Spain, branch
10. Bank of Tokyo, 6.9 billion	• 1989: Touche Remnant Asset Management, 100%, fund management.	• 1984: Touche Remnant, UK		

4. Other European banks

1. UBS, Switzerl. 13.2 billion	<ul style="list-style-type: none"> • 1986/89: Banco di Roma per la Svizzera, 100%, banking • 1989: Banca Internazionale, Lombardia, Italy, 20%, banking • 1985: Deutsche Länderbank, Germany, banking 			
2. Swiss Bank Corporation, Switzerl. 9.0 billion	<ul style="list-style-type: none"> • 1987/89: Banque Stern, France, 100%, banking • 1987: Ducatel Duval, France, brokerage. • 1989: M&A Societa, 70%, Italy, M&A • 1989: Banesto, Spain, 2% 			
3. Credit Suisse, Switzerl. billion	<ul style="list-style-type: none"> • 1984: Buckmaster & Moore, UK, brokerage. • 1985: Grundig Bank, Germany, banking. 			<ul style="list-style-type: none"> • 1989: Spain, branch
4. Union Bank of Finland, billion				
5. Svenska Handels- banken, Sweden, billion	<ul style="list-style-type: none"> • 1988: Thestrup, Borsmaegterskelskap, Denmark, brokerage. 			<ul style="list-style-type: none"> • 1989: UK, Manchester, rep. off. • 1989: Germany, Frankfurt, branch
6. PK Banken, Sweden, billion	<ul style="list-style-type: none"> • 1986: English Trust Group, UK, investment banking • 1987: L'Omnium Bancaire et Commerciale, France, 20% 			

Sources: own compilation from several sources including telephone and personal interviews, press clippings, annual reports, EC Commission DG15, Faßbender and Leichtfuß (1990), EFIMA-database, Acquisitions Monthly, The Bankers' Almanac.

Appendix 2: Database of EC Insurance Acquisitions, Cooperative Agreements, Joint Ventures and De Novo Entry Activities for largest European insurers

The following ranking lists cross-border transactions for the largest European insurance companies. Insurance firms were listed by their market capitalisation in the year 1991, as published in the Financial Times supplement on the largest European companies on January 13, 1992.

For each firm, its acquisitions from 1986 to 1991 are listed. The second column lists the year of the transaction, the name of the acquisition target, followed by its country of operation and, where known, the percentage stake of the acquisition, the area of activity of the target firm and its premium size, revenues or capital.

The third column lists joint ventures (JV) between the firm and any EC firm. After the year of the agreement, the names of the participants of the JV are given, followed by a comment about the area of activity the JV falls into and its objectives pursued. The fourth column lists cooperative agreements between the firm and any EC firm and again gives the names of participants and objectives of the agreement. Finally, column five lists any kind of cross-border *de novo* entry of the firm in any EC country. It also lists the area and type of operation of the newly opened representative office, branch or subsidiary.

1. EC Insurers

<p>1. Allianz Holding, Germany, \$21.5 billion</p>	<ul style="list-style-type: none"> • 1986: Affiliated Legal Protection, UK, 79.9%. • 1986: Corahill Insurance, UK, £305 million, 100% • 1987: Riunione Adriatica di Sicurtà (RAS), Italy, 51.5%, 1,100 million DM • 1988: Banco Popular Espanol, Spain, 5% • 1989: Ercos de Seguros & Reaseguros, Spain, 51%, purchase price: PTA 3 billion • 1989: Ergobank, Greece, 20% • 1989: Compagnie de Navigation Mixte, France, 10%. • 1989: Rhin & Moselle, France, 50%, together with Navigation Mixte, purchase price: FF6.53 billion • 1989: Via Assurances, France, 50%, together with Navigation Mixte 	<ul style="list-style-type: none"> • 1989: Banco Popular Espanol; Eurovida, Spain 51:49, selling life insurance in Spain • 1989: Banco Popular Espanol, Europensiones, 49:51, pension fund management in Spain • 1990: Compagnie de Navigation Mixte, France, Allianz/CNM Holding, 66:34. • 1990: Ergobank, Greece, to offer life insurance products in Greece 		
<p>2. Generali, Italy, \$11.9 billion</p>	<ul style="list-style-type: none"> • 1987: Northern Star Insurance, UK, 98%. • 1989: Interpayment Services, UK, traveller cheques • 1989: Compagnie du Midi, France, 17%. • 1989: Les Patrons Reunis, Belgium, 70%. • 1989: Union des Assureurs de Bruxelles, Belgium, 98% 	<ul style="list-style-type: none"> • 1986: Credit Bank, Greece, General Life, 60:40, life insurance • 1988: BNP, France, pension fund management in Spain 	<ul style="list-style-type: none"> • 1989: Compagnie du Midi, strategic alliance 	<ul style="list-style-type: none"> • 1990: Generali Krankenversicherung, Munichcapital: DM4 million
<p>3. Prudential, UK, \$8.2 billion</p>	<ul style="list-style-type: none"> • 1990: Prudential Vita, Italy, 60%. 	<ul style="list-style-type: none"> • 1987: Benetton, Italy; Prudential Italy, 50:50 	<ul style="list-style-type: none"> • 1989: Credit Agricole, France, cooperation on mortgage offerings in the UK 	
<p>4. Compagnie Financiere de Suez, France, \$7.8 billion</p>	<ul style="list-style-type: none"> • 1988: Societe Generale de Belgique, Belgium, 50.6% • 1989: Baltica Holding, Denmark, 23%, purchase price: DKR 4.2 billion • 1989: Colonia, Germany, 50.5%, total premia: DM3140 million (through holding in Victoire) • 1989: Nieuw Rotterdam, Netherl., maj. stake, capital: Hfl. 719 million, fifth-largest Dutch insurer 	<ul style="list-style-type: none"> • 		

Firm	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

<p>5. U.A.P., France, \$7.7 billion</p>	<ul style="list-style-type: none"> • 1987: Interamerican, Greece, 40% • 1987: New Ireland Assurance, 82%, chiffre d'affaires: FF1.5 billion • 1987: Royal Belge, Belgium, 34.1% • 1988: merger of UAP Portugal with Garantia to become sixth-largest insurer in Portuguese market • 1989: Allsecures, Italy, 90%, reveaues of Lit 170 billion, 10% are held by Toro Ass. • 1990: General Europea, Spain, 73%, purchase price: FF40 million • 1989/90: Sun Life Insurance, UK, 27.6% • 1990: Vasco Navarra, Spain, 30% • 1991: together with Liberty Life (S.A.) acquires 59% of Sun Life and transfers shareholding to jointly owned Rockleigh Corp. • 1991: Alianza Seguradora, Portugal, 45% 	<ul style="list-style-type: none"> • 1989: Royal Belge, Garantie Belge Protection Juridique, Belgium, 20:80, legal protection insurance • 1991: Sun Life, UK, Royal Belge, Belg., BIL, Lux.; Pan Euro Life, 30:20:20:20, first pan-European life insurance company 	<ul style="list-style-type: none"> • 1990: Banco Central, Spain, distribution alliance 	
<p>6. GAN, France, \$6.7 billion</p>	<ul style="list-style-type: none"> • 1987: Minster Insurance, UK, 100% • 1989: General Portfolio, UK, 51%, purchase price: £119 million (already represented in UK since 1984 through acquisition of Minster Insurance) • 1989: Societa Assicuratrice Industriale, Italy, 10% • 1990: Alianza Aseguradora, Spain, 98% • 1991: Uniseguros, Spain, 49%, purchase price: \$30 million 			
<p>7. Internationale Nederlande Group, Netherl.\$ 6.0 billion</p>	<ul style="list-style-type: none"> • 1990: Medisure Marketing & Management, UK, 75% 			
<p>8. Axa, France, \$ 5.1 billion</p>	<ul style="list-style-type: none"> • 1986: Mare Nostrum, Spain, • 1987: Equity and Life, UK, 100% • 1987: Lloyd Europeen, Belgium, total premia: FB 900 million • 1989: Ahorro Familiar, Spain, • 1990: Assurlux, Luxembourg, 100% • 1991: Assurlux, Lux., 100% 	<ul style="list-style-type: none"> • 1989: ICCRI, Italy, Casse di Risparmio de Italiane, Italy, 30:31:39, Italian savings banks distribute Axa's products 		
<p>9. Lloyds Abbey Life, UK, \$ 5.1 billion</p>				

Firm

Acquisitions

Joint Ventures

Cooperations

New Entry

Firm	Acquisitions	Joint Ventures	Cooperations	New Entry
10. AGF, France, \$ 4.9 billion	<ul style="list-style-type: none"> • 1985: Saarbrueck. Sachvers. 62% und Krankenvers. , 55.5%, Germany. • 1986: Sofibanque, Belgium, 25.1% • 1986: Popular de Seguros (capital: FF134 million) and Fenix Peninsular capital: FF89 million), Spain, 100% • 1986: Omnia, Spain, 100% • 1987: City of Westminster Assurance, UK. • 1987: Seantry, UK, 100%, • 1987: Cosmos, Greece, • 1988: Asubel Life Insurance, Belgium, 51% • 1989: Alianza Seguradora, Portugal, 3.9% • 1990: Mutual and General Insurance Ass. UK, • 1990: Insurance Corp. of Ireland. purchase price: Ir£ 107 million (AGF also holds 27% percent stake in Church and General, Irel.) • 1990: Milano Assicurazione, Italy, • 1990: L'Escaut de De Schelde, Belgium, maj. acqu., purchase price: Bfr. 9.4 million • 1991: Aachener & Muechner, Germany, 25 percent, purchase price: DM 1billion • 1991: Irish Life, 5% 	<ul style="list-style-type: none"> • 1989: Banco Atlantico, Spain; AGF Atlantico, personal and group pension schemes • 1991: Istbank, Italy; 8 other Italian banks; CBA, 30:70, to offer life insurance products in Italy 		<ul style="list-style-type: none"> • 1989: London, subsidiary to offer general damage coverage
11. Sun Alliance, UK, 4.6 billion	<ul style="list-style-type: none"> • 1987: Fenix Latino, Spain, • 1991: Royal Insurance Belgium, maj.acqu. 			
12. Allianz Leben, Germany, \$4.6 billion				
13. General Accident, UK, \$4.0 billion	<ul style="list-style-type: none"> • 1987: Seven Provinces, Netherl. • 1990: Assecura Holding, Luxembourg, 40%, 			
14. Alleanza, Italy, \$4.0 billion				

Firm	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

15. Commercial Union, UK, \$3.8 billion	<ul style="list-style-type: none"> • 1986: Rawes & Pinto Basto Lda., Portugal, 70%. 	<ul style="list-style-type: none"> • 1990: Credito Italiano, Italy; Commercial Union Vita, 70:30 • 1990: Akros, Italy, 60:40 	<ul style="list-style-type: none"> • 1989: Credito Italiano, Italy, distribution of CU's products through the Italian bank's branch network 	<ul style="list-style-type: none"> • 1989: Commercial Union Assicurazioni, Italy, subsidiary • 1989: Commercial Union Life, Greece.
16. Legal & General, UK, \$3.5 billion				
17. Royal Insurance, UK, \$3.0 billion	<ul style="list-style-type: none"> • 1983: Velazquez, Spain, 99% • 1989: Lloyd Italico, Italy, 90%. • 1989: Systema Terra, Italy. 		<ul style="list-style-type: none"> • see Aachener und Münchner 	<ul style="list-style-type: none"> • 1989: Royal Life, Spain
18. Fortis, Belgium/Netherl. \$2.9 billion	Fortis group was created in 1990 as cross-border merger between Groupe d'Assurances, Belgium and AMEV, Netherl.			
19. Guardian Royal Exchange, UK, \$2.7 billion	<ul style="list-style-type: none"> • 1989: Cidas, Italy, 51%. • 1989: New PMPA, Spain. • 1989: Polaris Vita, Italy, 49%. • 1989: Sipea, Italy, 51% 	<ul style="list-style-type: none"> • 1989: Istituto Bancario San Paolo di Torino, Italy; Polaris Vita, 49:51; Sipea, 51:49; Cidas, 51:49 		<ul style="list-style-type: none"> • 1988: Guardian Vie, France life insurance
20. Aegon, Netherl. \$2.7 billion	<ul style="list-style-type: none"> • 1986: Union Levantina de Seguros, Spain. • 1989: Aspis Pronia, Greece. • 1987: Union Previsora, Spain, 90%, revenues: Hfl.100 million • 1991: Precam, Belgium, maj.acqu., capital: Bfr. 2 billion • 1991: Regency Life, UK, maj. acqu., capital: Hfl.: 118 million 			
21. Aachener & Muenchner Holding, Germany, \$2.3 billion	<ul style="list-style-type: none"> • 1987: Groupement Francais d'assurances, France, 80%. • 1990: GAIC, Italy. • 1991: International Hellas, Greece, 65%. 		<ul style="list-style-type: none"> • 1991: strategic alliance with Royal Insurance, UK and Fondiaria, Italy. 	

Firm	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

22. Fondiaris , Italy, \$2.3 billion	<ul style="list-style-type: none"> • 1987: Dominion Insurance, UK, 50%. • 1988: Volksturnsorge, Germany, 25%. • 1988/90: Aachener & Munchner, Germany, 26%. 		• see Aachener und Munchner	
23. Willis Corroon, UK, \$2.1 billion				
24. Victoria Holding, Germany, \$2.0 billion				
25. RAS, Italy, \$2.0 billion	• acquired by Allianz, Germany (see there)			
26. Toro Assicur., Italy, \$1.8 billion	• 1987: Le Continent, France, 100%, total premia: FF1.65 billion			
27. Royale Belge, Belgium, \$1.8 billion	• 1990: Gelderland, Netherl. 39%.			
28. Sedgwick Group, UK, \$1.7 billion		• 1989: Colonia, Germany, Nordstern, Germany, Colonia-Nordstern Schadeverzekerung 10:54:36; marine insurance		• 1988: Sedgwick Financial Services, Sa. France
29. SAI, Italy, \$1.6 billion	<ul style="list-style-type: none"> • 1989: GAN International, France, 9%. • 1990: Kairos Seguros, Spain, 10%. 	• 1990: Friends Provident, UK; Fineuras, Italy, 55:45,		
30. Baltica Holding, Denmark, \$1.4 billion	<ul style="list-style-type: none"> • 1989: Colonia Victoire, France, 7.6%. • 1989: Compagnie de Suez, France, 3% 			

Firm	Acquisitions	Joint Ventures	Cooperations	New Entry
------	--------------	----------------	--------------	-----------

31. Wuerttem bergisch. Versicher ung, Germany, \$1.3 billion		• 1986: Fraser & Co. NL, Allg. Rentenanstalt, Germany; Erasmus Leven, NL., 60:10:30, to offer life insurance products in Netherl.		
32. Sun Life Corp. UK, 1.3 billion	• 1991: Sun Life is majority-owned by Liberty Life (S.A.) and UAP, France			
33. Mapfre, Spain, \$1.3 billion	<ul style="list-style-type: none"> • 1988: Progress Insurance, Italy, 40%. • 1988: Union Assicurazioni, Italy. • 1989: CIAR, Belgium, 52.5% • 1989: Etoile Commerciale, France, 10%. 	• 1989: Banque Indosuez, France; Mapfre Indosuez, to distribute financial products through retail network of Mapfre in Spain	• 1989: Gothaer Versicherung, Germany, distribution alliance	
34. Codan Group, Denmark, \$1.1 billion				
35. Britannic Assurance , UK, \$1.1 billion				
36. Deutsche Beamtens ers. Germany, \$1 billion	• 1989: Ambrosiana Assicurazioni, Italy, 80%, purchase price: Lit 28 billion.			
37. Assitalia, Italy, \$1 billion				
38. Aachener u. Muenchne r Leben, Germany, 0.9 billion				

Firm

Acquisitions

Joint Ventures

Cooperations

New Entry

<p>39. Volksfuer sorge, Germany, 0.8 billion</p>	<ul style="list-style-type: none"> • 1990: GAIC, Italy. • 1987: Unial, Spain, 40%. 			
<p>40. Hafnia Holding, Denmark, \$0.8 billion</p>	<ul style="list-style-type: none"> • 1989: Prolific Group, UK, 100%, purchase price: £90.6 million 			

2. Non-EC Insurers

<p>1. Zurich Insurance Switzerl., 5.0 billion</p>	<ul style="list-style-type: none"> • 1987: Astorg Vie et Accident, France, minority holding • 1987: Caudal Sa de Seguros y Reaseguros, Spain. • 1986: Minerva, Italy, 65%, total premia: Lit.245 billion • 1988: Union Iberamericana Ca de Seguros y Reaseguros, Spain, 50%, total premia: PTA.33 billion • 1991: merger of Zurich International France (capital: FF350 million) with Satiel Assurances, France (capital: 708 million). 		<ul style="list-style-type: none"> • Sydbank, Denmark, general alliance 	
<p>2. Swiss Reinsuran ce, Switzerl., 3.7 billion</p>	<ul style="list-style-type: none"> • 1989: Dansk Caution, Denmark. • 1988: Lloyd Adriatico, Italy, 53%. • 1989: Rhin et Moselle, France, 11% • 1988: Societa Italiana Cauzioni, Italy, 31%. • 1988: Union Reinsurance Co., UK, 85%. 			
<p>3. Winterthu r Versicher ung, Switzerl. 3.3 billion</p>	<ul style="list-style-type: none"> • 1988: Intercontinentale Assicurazioni, Italy, 100%, premia: Lit.463 billion • 1987: Nordstern Versicherung, Germany, 37%. • 1989: Transatlantische Allg. Versicherung and Telecon Versicherung, Germany, total premia of DM 200 million • 1990: Wand AG, 74.9%, total premia: DM 65 million 			
<p>4. Skandia Forsakrin g, Sweden, 2.4 billion</p>	<ul style="list-style-type: none"> • 1986: Copenhagen Re, Denmark. • 1989: National Insurance & Guarantee, UK, purchase price: £150 million • 1989: Royal Chartered, Denmark, increase in stake from 53 % to 79%, purchase price: Dkr. 480 million 			

Firm Acquisitions Joint Ventures Cooperations New Entry

5. Trygg- Hansa SPP Holding, Sweden, 1.5 billion				
---	--	--	--	--

Sources: own compilation from Annual Reports; interviews with firm officials; newspaper clippings, EFIMA-database, EC Commission DG 15.

Appendix 3:

Questionnaire

for Study on

Cross-Border Entry in European Insurance

Address of Respondent:

Firm-Name: _____

Address: _____

Name: _____

Unit: _____

Telephone: _____

Please return questionnaire, if possible before 16 April 92, to:**Tobias Hoschka
Hohle Gasse 12
D - 53 Bonn 2**

1. The Impact of the Single European Financial Services Market

1.1. In which insurance sectors do you expect intensified international competition in Europe after 1992?

Please assess the impact on a scale from 1-4: (1 = big impact, 2= sizeable impact, 3 = little change, 4 = no change)

	1	2	3	4
Life	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Property (fire, disaster)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Motor vehicles	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Health	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Personal Liability	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

.....

.....

1.2. In which market segments do you expect intensified international competition in Europe after 1992?

Please assess the impact on a scale from 1-4: (1 = big impact, 2= sizeable impact, 3 = little change, 4 = no change)

	1	2	3	4
Personal Customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Small and Medium Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Large Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Multinationals	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

1.3.a) In which three EC markets do you expect the greatest impact of the Single Market for financial services?

b) In which three countries is cross-border entry in insurance most likely?

	a)	b)
Belgium	<input type="checkbox"/>	<input type="checkbox"/>
Denmark	<input type="checkbox"/>	<input type="checkbox"/>
France	<input type="checkbox"/>	<input type="checkbox"/>
Germany	<input type="checkbox"/>	<input type="checkbox"/>
Greece	<input type="checkbox"/>	<input type="checkbox"/>
Ireland	<input type="checkbox"/>	<input type="checkbox"/>
Italy	<input type="checkbox"/>	<input type="checkbox"/>
Luxembourg	<input type="checkbox"/>	<input type="checkbox"/>
Netherlands	<input type="checkbox"/>	<input type="checkbox"/>
Portugal	<input type="checkbox"/>	<input type="checkbox"/>
Spain	<input type="checkbox"/>	<input type="checkbox"/>
United Kingdom	<input type="checkbox"/>	<input type="checkbox"/>

Further Comments:

.....

.....

.....

1.4. In which three EC countries do you see the greatest market potential for your firm, concerning possible or actual international expansion?

- 1.....
- 2.....
- 3.....

1.5. Why do you consider these three countries to be most interesting for your firm?

country: 1..... 2..... 3.....

relatively untouched by foreign insurers	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
significant market potential	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
competitive advantage compared to domestic insurers	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
high margins	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
important for domestic customers	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
.....	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Further Comments:

.....

.....

.....

.....

1.6. The Second and proposed Third Insurance Directives introduce the so-called "single passport" in insurance: a firm which is licensed in one EC country can open branches in all other EC countries without requiring an additional licence. In addition, foreign branches are regulated under the home country principle. Which consequences does this regulatory change have in your opinion?

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

b) Do you take the 'single insurance passport' into account in your strategic planning of European activities?

yes no

If yes, how did you incorporate it into your strategy?

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

.....

2. Foreign Insurers in your Domestic Market

2.1. In which insurance sectors and market segments do you consider foreign insurers to be competitors?
(Foreign insurers are: 1=Strong competitors, 2=significant competitors, 3=moderate competitors, 4=no significant foreign competitors)

INSURANCE SECTORS:

	1	2	3	4
Life	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Property (fire, disaster)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Motor vehicles	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Health	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Personal Liability	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

MARKET SEGMENTS:

Personal Customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Small and Medium Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Large Enterprises

Multinationals

Others:

Comments:.....

.....
.....

2.2. Do you know of examples where foreign insurers have introduced new or modified products in the domestic market or have offered particular services at a significantly lower price than domestic competitors?

yes

no

If yes, which insurer and which products?

firm

product/comment

.....
.....
.....
.....
.....

2.3. Which strategy do foreign insurers mainly follow in your home market ?

aggressive price strategy

innovative strategy

adjusting to established domestic strategies

further comments:.....

.....
.....
.....

2.4. Do you expect an increase in cross-border entry activities in your domestic market after 1992?

Yes

No

If yes, in which sectors and segments in particular?

(foreign entry is: 1=very likely, 2=likely, 3=not very likely, 4=unlikely)

INSURANCE SECTORS:

	1	2	3	4
Life	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Property (fire, disaster)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Motor vehicles	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Health	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Personal Liability	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

MARKET SEGMENTS:

Personal Customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Small and Medium Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Large Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Multinationals	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Comments:.....
.....
.....

2.5. Does increased foreign entry in your opinion lead to downward pressure on domestic prices, as the level of competition increases?

yes

no

Further Comments:

.....
.....

.....

.....

.....

3. Current EC Activities of your Firm

3.1. In which segments and countries are the main activities of your cross-border EC insurance activities (for example:Spain/Personal Customers/Life Insurance)?

Countries:	Market segments/Insurance Sectors:
.....
.....
.....
.....
.....
.....
.....
.....
.....
.....
.....

Further Comments:

.....

.....

.....

.....

3.2 In which EC countries did you first enter?

Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:
Country:	Year of entry:	Form of Entry:

3.3. Is there a unified "European" strategy which your firm follows in all EC countries where it is present?

Yes

No

Comments:.....

.....
.....
.....
.....
.....

3.4 What strategy do you pursue to make your firm attractive for customers who currently maintain a business relation with competitors in the foreign EC countries in which you are active? How do you attempt to overcome switching costs associated with changing an established insurance relationship?

.....
.....
.....
.....
.....
.....
.....
.....
.....

3.5. What does your firm offer which other indigenous firms in the foreign EC countries in which you are present do not offer in the same way or at the same conditions?

.....
.....
.....
.....
.....
.....
.....
.....
.....
.....

3.6. Do you know of examples where your firm has introduced new or modified products or services in the foreign EC countries in which you are present or has offered particular services at a significantly lower price than competitors?

yes

no

If yes, which country/ies and which products/services?

.....
.....
.....
.....
.....
.....
.....
.....
.....
.....
.....
.....
.....

3.7. Does your firm offer products/services at a lower price than competitors in the host country?

yes

no

If yes, please give an example, if no, please explain why not:

.....
.....
.....
.....
.....
.....
.....
.....
.....
.....

3.8 a) Do you see synergy effects from operating Europe-wide?

yes

no

b) If yes, please explain in which areas you attempt to exploit synergy effects between different international operating units? If no, please explain why not.

.....
.....
.....
.....
.....
.....

c) Do you see scale or scope economies from operating Europe-wide?

yes

no

d) If yes, in which areas and segments?.....

.....
.....
.....
.....
.....
.....
.....
.....
.....

3.9.a) Are there products/services which are distributed across several European countries in which you operate?

yes

no

if yes, which:

.....
.....
.....
.....
.....
.....
.....
.....

b) Is there cooperation in technological areas between the EC subsidiaries/branches?

yes

no

If yes, in which areas?

.....
.....
.....
.....

Further Comments:

4. Concepts of Cross-Border Entry Activities

4.1. Where do you see the main barriers for cross-border penetration in insurance in other EC countries?

Please assess the significance of the listed barriers on a scale from 1-4: (1 = very important, 2 = important, 3 = not so important, 4 = unimportant)

	1	2	3	4
regulatory barriers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of intimate knowledge of foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of right distribution channels	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of suitable acquisition targets in foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of a level playing field for cross-border takeovers in the EC	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
difficulty to acquire customers in foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
difficulty to establish a reputation in the foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
competitive disadvantage compared to local firms	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
in the foreign host market due to smaller scale of operation	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of a level playing field for cross-border takeovers in the EC	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
collusive behaviour of local firms in the foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
aimed at hindering foreign entry	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

4.2. Where do you see the main disadvantages of foreign insurers during the first phase of entering a market?

Please assess the significance on a scale from 1-4: (1 = very important, 2 = important, 3 = not so important, 4 = unimportant)

	1	2	3	4
insufficient infrastructure (branches etc)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
acceptance by customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
being "foreign"	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
difficulty of establishing a reputation	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of know-how of local market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

.....

.....

4.3. In order to analyse possible competitive advantages of foreign insurers, a range of factors is now listed which may convey firm-level or locational advantages on a foreign insurer. Please assess the importance of each of the following factors for the foreign EC activities of your firm:

Please answer according to the following scale: 1= very important, 2= important, 3= not so important, 4= unimportant

a) firm-level advantages:	1	2	3	4
"Follow the Customer": established customer base in home country which expands into host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Positioning in host country, which will gain in importance for domestic customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Qualified personnel, which has special know-how transferable to host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Learning economies which can be transferred to foreign markets	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Established reputation in particular markets	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Network effects resulting in informational advantages from wide international presence	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....				
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....				

Further Comments:

.....

.....

.....

.....

b) locational advantages:

Please answer according to the following scale: 1= very important, 2= important, 3= not so important, 4= unimportant

	1	2	3	4
Lower Funding costs in the home country which permit to offer better conditions in the host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Host country as source of lower funding costs	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Tax factors which lead to advantages in the host country or which can be transferred to home country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Presence in the currency of the host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Foreign regulatory factors which make a presence in the host country attractive for other markets (such as in offshore markets)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Domestic regulatory factors which convey a competitive advantage on the firm in the host country (esp. under new home country rule)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Lower efficiency of the financial services system in the host market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
High margins in host country which make entry profitable	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Less competition in the host country leading to higher margins	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Diversification advantages resulting from operations in several geographic markets	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....				

Further Comments.....

5. Choice of Entry into the Foreign Market

5.1 What kind of cross-border entry have you pursued in the EC (if not already answered in question 3.2 above)?

Where, when and with whom?

De novo entry

.....
.....
.....
.....
.....
.....

Majority acquisition

.....
.....
.....
.....

Strategic alliance

.....
.....
.....
.....

Joint Venture

.....
.....
.....

Exporting (cross-border provision of services from home country)

.....

Other:.....

.....
.....

5.2 Do you think it is possible to successfully enter the personal customer market through de novo entry or exporting?

yes	no
<input type="checkbox"/>	<input type="checkbox"/>

De novo entry:

yes	no
<input type="checkbox"/>	<input type="checkbox"/>

Exporting:

Further Comments:

.....

.....

.....

.....

.....

5.3 a) Are strategic alliances for you an alternative to acquisitions to enter a foreign market?

b) Which factors influence the decision between majority acquisition and alliance?

.....

.....

.....

.....

.....

c) Where do you see disadvantages of such alliances?

Please assess the degree of the disadvantages on a scale from 1-4 (1= significant disadvantage, 2= disadvantage, 3= not a significant disadvantage, 4= no disadvantage at all):

	1	2	3	4
degree of profit potential	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate culture	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate identity	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences in management attitudes	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
coordination of strategic planning	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

5.4 a) In which areas do you see opportunities for cross-border joint ventures?

research & development

offering of common services/products

marketing

distribution

Others:

Others:

Further Comments:

.....

.....

b) In which areas do you see disadvantages of Joint Ventures?

Please assess the degree of the disadvantages on a scale from 1-4 (1= significant disadvantage, 2= disadvantage, 3= not a significant disadvantage, 4= no disadvantage at all):

	1	2	3	4
degree of profit potential	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate culture	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate identity	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences in management attitudes	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
coordination of strategic planning	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

5.5. Do you plan any (further) cross-border entry activities in the future?

yes

no

if yes, in which countries and segments (e.g. life insurance/personal customers/Spain)?

Country:

Segment:

.....
.....
.....
.....
.....

Further Comments:

.....
.....
.....

Thank you very much for your cooperation!

Appendix 4:

Questionnaire

for Study on

Cross-Border Entry in European Banking

Address of Respondent:

Bank-Name: _____

Address: _____

Name: _____

Unit: _____

Telephone: _____

Please return questionnaire, if possible before 25 March 92, to:

**Tobias Hoschka
Hohle Gasse 12
D - 53 Bonn 2**

1. The Impact of the Single European Financial Services Market

1.1. In which segments do you expect intensified international competition in Europe after 1992?

Please assess the impact on a scale from 1-4: (1 = big impact, 2= sizeable impact, 3 = little change, 4 = no change)

	1	2	3	4
Investment Banking	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Retail Banking	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Small and Medium Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Large Enterprises	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Multinationals	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

.....

.....

1.2.a) In which three EC markets do you expect the greatest impact of the Single Market for financial services?

b) In which three countries is cross-border entry most likely?

	a)	b)
Belgium	<input type="checkbox"/>	<input type="checkbox"/>
Denmark	<input type="checkbox"/>	<input type="checkbox"/>
France	<input type="checkbox"/>	<input type="checkbox"/>
Germany	<input type="checkbox"/>	<input type="checkbox"/>
Greece	<input type="checkbox"/>	<input type="checkbox"/>
Ireland	<input type="checkbox"/>	<input type="checkbox"/>
Italy	<input type="checkbox"/>	<input type="checkbox"/>
Luxembourg	<input type="checkbox"/>	<input type="checkbox"/>

1.5. The Second EC Banking Directive introduces the so-called "banking passport" on 1 January 1993: a bank which is licensed in one EC country can open branches in all other EC countries without requiring an additional licence. In addition, foreign branches are regulated under the home country principle. Which consequences, if any, does this bank passport have in your opinion?

.....

.....

.....

.....

.....

.....

.....

.....

b) Do you take the banking passport into account in your strategic planning of European activities?

yes

no

If yes, how did you incorporate it into your strategy?

.....

.....

.....

.....

.....

.....

.....

.....

2. Foreign Banks in your Domestic Market

2.1. In which segments do you consider foreign banks to be competitors?

- Investment Banking
- Retail Banking
- Small and Medium Enterprises
- Large Enterprises
- Multinationals
- Others:

Comments:.....
.....
.....

2.2. Do you know of examples where foreign firms have introduced new or modified products in the domestic market or have offered particular services at a significantly lower price than domestic competitors?

- yes
- no

If yes, which bank and which products?

bank	product
.....
.....
.....
.....
.....
.....
.....

2.3. Which strategy do foreign banks mainly follow in your home market ?

- aggressive price strategy
- innovative strategy
- adjusting to established domestic strategies

others:
.....
.....
.....

2.4. Do you expect an increase in cross-border entry activities in your domestic market after 1992?

Yes No

If yes, in which segments in particular?

- Investment Banking
- Private Retail Banking
- Small and Medium Enterprises
- Large Enterprises
- Multinationals
- Others:

Further comments:
.....
.....

2.5. Does increased foreign entry in your opinion lead to downward pressure on domestic prices, as the level of competition increases?

yes no

Further Comments:
.....
.....
.....
.....

3.3. Is there a unified "European" strategy which your bank follows in all EC countries where it is present?

Yes

No

Comments:.....
.....
.....
.....
.....

3.4 What strategy do you pursue to make your bank attractive for customers who currently maintain a business relation with competitors in the foreign EC countries in which you are active? How do you attempt to overcome switching costs associated with changing an established banking relationship?

.....
.....
.....
.....
.....
.....
.....
.....

3.5. What does your bank offer which other indigenous banks in the foreign EC countries in which you are present do not offer in the same way or at the same conditions?

.....
.....
.....
.....
.....
.....
.....
.....

3.6. Do you know of examples where your bank has introduced new or modified products or services in the foreign EC countries in which you are present or has offered particular services at a significantly lower price than competitors?

yes

no

if yes, which country/ies and which products/services?

.....
.....
.....
.....
.....
.....
.....
.....
.....
.....

3.7. Does your bank offer products/services at a lower price than competitors in the host country?

yes

no

If yes, please give an example, if no, please explain why not:

.....
.....
.....
.....
.....
.....
.....
.....
.....
.....

3.8 a) Do you see synergy effects from operating Europe-wide?

yes

no

b) If yes, please explain in which areas you attempt to exploit synergy effects between different international operating units? If no, please explain why not.

.....
.....
.....
.....

c) Do you see scale or scope economies from operating Europe-wide?

yes

no

d) If yes, in which areas and segments?.....

.....
.....
.....
.....
.....
.....
.....

3.9.a) Are there products/services which are distributed across several European countries in which you operate?

yes

no

if yes, which:

.....
.....
.....
.....
.....
.....
.....

b) Is there cooperation in technological areas between the EC subsidiaries/branches?

yes

no

If yes, in which areas?

.....
.....
.....
.....

Further Comments:

.....
.....

4. Concepts of Cross-Border Entry Activities

4.1. Where do you see the main barriers for cross-border penetration in insurance in other EC countries?
 Please assess the significance of the listed barriers on a scale from 1-4: (1 = very important, 2 = important, 3 = not so important, 4 = unimportant)

	1	2	3	4
regulatory barriers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of intimate knowledge of foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of right distribution channels	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of suitable acquisition targets in foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of a level playing field for cross-border takeovers in the EC	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
difficulty to acquire customers in foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
difficulty to establish a reputation in the foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
competitive disadvantage compared to local firms	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
in the foreign host market due to smaller scale of operation	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of a level playing field for cross-border takeovers in the EC	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
collusive behaviour of local firms in the foreign market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
aimed at hindering foreign entry	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

4.2. Where do you see the main disadvantages of foreign banks during the first phase of entering a market?

Please assess the significance on a scale from 1-4: (1 = very important, 2 = important, 3 = not so important, 4 = unimportant)

	1	2	3	4
insufficient infrastructure (branches etc)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
acceptance by customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
being "foreign"	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
difficulty of establishing a reputation	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
lack of know-how of local market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

.....

.....

4.3. In order to analyse possible competitive advantages of foreign banks, a range of factors is now listed which may convey firm-level or locational advantages on a foreign bank. Please assess the importance of each of the following factors for the foreign EC activities of your firm:
Please answer according to the following scale: 1= very important, 2= important, 3= not so important, 4= unimportant

a) firm-level advantages:	1	2	3	4
"Follow the Customer": established customer base in home country which expands into host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Positioning in host country, which will gain in importance for domestic customers	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Qualified personnel, which has special know-how transferable to host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Learning economies which can be transferred to foreign markets	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Established reputation in particular markets	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Network effects resulting in informational advantages from wide international presence	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:

.....

.....

.....

.....

b) locational advantages:

Please answer according to the following scale: 1= very important, 2= important, 3= not so important, 4= unimportant

	1	2	3	4
Lower Funding costs in the home country which permit to offer better conditions in the host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Host country as source of lower funding costs	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Tax factors which lead to advantages in the host country or which can be transferred to home country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Presence in the currency of the host country	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Foreign regulatory factors which make a presence in the host country attractive for other markets (such as in offshore markets)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Domestic regulatory factors which convey a competitive advantage on the firm in the host country (esp. under new home country rule)	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Lower efficiency of the financial services system in the host market	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
High margins in host country which make entry profitable	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Less competition in the host country leading to higher margins	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Diversification advantages resulting from operations in several geographic markets	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
.....				

Further Comments.....
.....
.....

5. Choice of Entry into the Foreign Market

5.1 What kind of cross-border entry have you pursued in the EC (if not already answered in question 3.2 above)?

Where, when and with whom?

De novo entry

.....
.....
.....
.....
.....
.....

Majority acquisition

.....
.....
.....
.....

Strategic alliance

.....
.....
.....
.....

Joint Venture

.....
.....
.....

Exporting (cross-border provision of services from home country)

.....
.....

Other:.....

.....
.....

5.2 Do you think it is possible to successfully enter the personal customer market through de novo entry or exporting?

De novo entry: **yes** **no**

Exporting: **yes** **no**

Further Comments:

.....

.....

.....

.....

.....

5.3 a) Are strategic alliances for you an alternative to acquisitions to enter a foreign market?

yes **no**

b) Which factors influence the decision between majority acquisition and alliance?

.....

.....

.....

.....

.....

c) Where do you see disadvantages of such alliances?

Please assess the degree of the disadvantages on a scale from 1-4 (1= significant disadvantage, 2= disadvantage, 3= not a significant disadvantage, 4= no disadvantage at all):

	1	2	3	4
degree of profit potential	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate culture	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate identity	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences in management attitudes	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
coordination of strategic planning	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:
.....
.....

5.4 a) In which areas do you see opportunities for cross-border joint ventures?

research & development

offering of common services/products

marketing

distribution

Others:

Others:

Further Comments:
.....
.....

b) In which areas do you see disadvantages of Joint Ventures?

Please assess the degree of the disadvantages on a scale from 1-4 (1= significant disadvantage, 2= disadvantage, 3= not a significant disadvantage, 4= no disadvantage at all):

	1	2	3	4
degree of profit potential	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate culture	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences of corporate identity	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
differences in management attitudes	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
coordination of strategic planning	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
Others:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Further Comments:
.....
.....

5.5. Do you plan any (further) cross-border entry activities in the future?

yes

no

if yes, in which countries and segments (e.g. retail banking/personal customers/Spain)?

Country:

Segment:

.....
.....
.....
.....
.....

Further Comments:

.....
.....
.....

Thank you very much for your cooperation!

Bibliography:

- Adolf, R., Cramer, J. and Ollmann, M. (1991), 'Banking mergers: a realistic assessment of synergy effects', *Die Bank*, 1/91, 4-9
- Aerthoj, O. (1990), 'The European insurance industry and the impact competition from banks will exert on it', in: D. Fair and C. de Boissieu (eds.), *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer Academic Publishers
- Albert, M. (1987), 'How to ensure the security of reinsurance in spite of economic and social insecurity', *Quarterly Letter of NRG* (May), p.5-13
- Akerlof, G. (1970), 'The market for lemons: quality uncertainty and the market mechanism', *Quarterly Journal of Economics*, 84, 488-500
- Alchian, A. and Demsetz, H. (1962), 'Competition, monopoly, and the pursuit of pecuniary gain', in: *Aspects of Labor Economics*, Princeton: National Bureau of Economic Research
- Alchian, A. and Demsetz, H. (1972), 'Production, information costs and economic organisation', *American Economic Review*, 62, 777-95
- Alexander, J. and Greeve, G. (1991), 'State-owned banks in France', *The Banker*, February, 8-10
- Aliber, R. (1976), 'Toward a theory of international banking', Federal Reserve Bank of San Francisco, *Economic Review*, Spring issue, 5-8
- Aliber, R. (1984), 'International banking', *Journal of Money, Credit and Banking*, 16, 661-678
- Areeda, P. and Turner, D. (1975), 'Predatory pricing and related practices under section 2 of the Sherman Act', *Harvard Law Review*, 88, 697-733
- Arrow, K. (1962a), 'The economic implications of learning by doing', *Review of Economic Studies*, 29, 153-173
- Arrow, K. (1962b), 'Economic welfare and the allocation of resources for inventions', in: R. Nelson (ed.), *The Rate and Direction of Inventive Activity*, Princeton University Press
- Arrow, K. and Debreu, G. (1954), 'Existence of equilibrium for a competitive economy', *Econometrica*, 22, 265-90
- Artis, M. (1988), 'Exchange controls and the EMS', *European Economy*, 36, 163-181
- Association of Dutch Insurers (1991), Annual Report 1990
- Atrus, P. (1990), 'Comment on de Boissieu: The French banking system in the light of European financial integration', in: J. Dermine, (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Athanasios, G., Subhash, C. and Miller, S. (1990), 'Returns to scale and input substitution for large U.S. Banks', *Journal of Money, Credit and Banking*, 22, 94-107

- Aumann, R. (1959), 'Acceptable points in general cooperative n-persons games', in: A. Tucker and R. Luce (eds.), *Contributions to the theory of games*, Princeton: Princeton University Press
- Ausubel, L. (1991), 'The failure of competition in the credit card market', *American Economic Review*, 81, 50-81
- Baer, H. and Scheld, K. (1986), 'Interstate banking and intrastate branching: summing up' in: *Toward Nationwide Banking*, Federal Reserve Bank of Chicago
- Bagehot, W. (1873), *Lombard Street*, reprinted in 1962 by Richard D. Irwin, Illinois: Homewood
- Bailey, E. and Friedlaender, A. (1982), 'Market structure and multiproduct industries', *Journal of Economic Literature*, 20, 1024-1048
- Bain, J. (1956), *Barriers to New Competition*, Cambridge, MA: Harvard University Press
- Balakrishnan, S. and Koza, M. (1989), 'Organisation costs and a theory of joint ventures', Working Paper, INSEAD
- Baltensperger, E. (1980), 'Alternative approaches to the theory of the banking firm', *Journal of Monetary Economics*, 6, 1-37
- Baltensperger, E. and Dermine, J. (1987), 'Banking deregulation in Europe', *Economic Policy*, 4, 64-109
- Baltensperger, E. and Dermine, J. (1990), 'European Banking: prudential and regulatory issues', in: *European Banking in the 1990's*, J. Dermine (ed.), Oxford: Basil Blackwell
- Bank for International Settlements (1987), 'Committee on banking regulations and supervisory practise, *Proposals for international convergence of capital measurement and capital standards*, December
- Bank of England (1977), *A Guide to United Kingdom exchange control*, London: Bank of England, H.M. Stationary Publications
- Bank of England (1981), 'The effects of exchange control abolition on capital flows', *Quarterly Bulletin of the Bank of England*, September
- Banking Advisory Committee of the EC (1988), 'Report of the Chairman, 1985-1988', DG15, Commission of the EC,
- Banking Advisory Committee of the Commission of the EC (1991), 'Opinion on an EC Directive on Deposit Protection Schemes for Credit Institutions', mimeo, DG15, Commission of the EC
- Bakker, T. (1991), 'Dutch banking: into the fast lane', *The Banker*, February
- Baumol, W. (1977), 'On the proper cost tests for natural monopoly in a multiproduct industry', *American Economic Review*, 67, 809-22
- Baumol, W., Panzar, J. and Willig, R. (1982), *Contestable Markets and the Theory of Industry Structure*, New York: Harcourt Brace Jovanovich
- Bebear, C. (1990), 'The AXA Group strategy', *Geneva Papers on Risk and Insurance*, 15, 359-363
- Benston, G. (1965), 'Branch banking and economies of scale', *Journal of Finance*, 20, 312-331

- Benston, G., Hanweck, G. and Humphrey, D. (1982), 'Scale economies in banking: a restructuring and reassessment', *Journal of Money, Credit and Banking*, **14**, 435-456
- Bell, F. and Murphy, N. (1968), 'Economies of scale and division of labour in commercial banking' *Southern Economic Journal*, October
- Berger A., Hanweck, G. and Humphrey D. (1987), 'Competitive viability in banking: scale, scope and product mix economies', *Journal of Monetary Economics*, **20**, 501-520
- Berger, A. and Hannan, T. (1989), 'The price-concentration relationship in banking', *Review of Economics and Statistics*, **71**, 291-99
- Berger, A. and Humphrey, D. (1991), 'Measurement and efficiency issues in banking', in: *Output Measurement in the Services Sector*, NBER, Chicago: University of Chicago Press
- Berghe, L. van den, (1990), '(De) regulation of insurance markets', in: Henri Louberge (ed.), *Risk, Information and Insurance*, Boston, MA: Kluwer Academic Publishers
- Berle, A. and Means, G. (1932), *The Modern Corporation and Private Property*, New York: Commerce Clearing House
- Berlin, M., Saunders, A. and Udell, G. (1991), 'Deposit insurance reform: what are the issues and what needs to be fixed?', *Journal of Banking and Finance*, **15**, 735-752
- Bernanke, B. (1983), 'Non-monetary effects of the financial crisis in the propagation of the Great Depression', *American Economic Review*, **73**, 257-276
- Bernheim, D. and Whinston, M. (1990), 'Multimarket contact and collusive behaviour', *Rand Journal of Economics*, **21**, 1-26
- Bester, H. (1985), 'Screening versus rationing in credit markets with imperfect information', *American Economic Review*, **75**, 850-55
- Bester, H. (1987), 'The role of collateral in credit markets with imperfect information', *European Economic Review*, **31**, 887-99
- Black, F. (1986), 'Presidential address to the American Finance Association', *Journal of Finance*, 529-543
- Blinder, A. (1991), 'Why are prices sticky? Preliminary results from an interview study', *American Economic Review*, May, 89-96
- Bresnahan, T. and Salop, S. (1986), 'Quantifying the competitive effects of production joint ventures', *International Journal of Industrial Organisation*, **4**, 155-175
- Brimmer, A. and Dahl, F. (1975), 'Growth of American international banking: implications for public policy', *Journal of Finance*, **30**, 341-63
- British Bank Association (1988), *Comment on the Second EC Banking Directive*, London: British Banking Association
- Brittan, Sir Leon (1991), 'Financial Services and Financial Markets: a European Perspective', Speech held on 14 January 1991 before the American Chamber of Commerce, New York, mimeo, DG15, Commission of the EC
- Broecker, T. (1990), 'Credit-worthiness tests and interbank competition', *Econometrica*, **58**, 429-52

- Bruni, F. (1990), 'Banking and financial reregulation towards 1992: the Italian case', in: J. Dermine, (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Bryan, L. (1990), 'The role of banking in society', *McKinsey Quarterly*, 26, No.3, 113-126
- Bryan, L. and Allen, P. (1988), 'The changing world of banking: geographic strategies for the 1990s', *McKinsey Quarterly*, 52-71
- Boissieu, C. de (1990), 'Recent developments in the French financial system: an overview', in: C. de Boissieu, *Banking in France*, London: Routledge
- Boissieu, C. de (1990b), 'The French banking system in the light of European financial integration', in: J. Dermine, (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Bolton, P. (1990), 'Renegotiation and the dynamics of contract design', *European Economic Review*, 34, 303-310
- Bonano, G. (1987), 'Location choice, product proliferation and entry deterrence', *Review of Economic Studies*, 54, 37-46
- Bordo, M. (1986), 'Financial crises, banking crises, stock market crashes and the money supply: some international evidence, 1870-1933, in: F. Capie and G. Wood (eds.), *Financial Crises and the World Banking System*, London: MacMillan
- Burgess, D. (1990), 'Services as intermediate goods: the issues of trade liberalisation', in: R. Jones and A. Krueger (eds.), *The Political Economy of International Trade*, Oxford: Basil Blackwells
- Caminal, R., Gual, J. and Vives, X. (1990), 'Competition in Spanish banking', in: J. Dermine, (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Capie, F. and Wood, G. (1990), 'Banking structure and banking stability after 1992', in: D. Fair and C. de Boissieu (eds.), *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer Academic Publishers
- Casson, M. (1990), 'Evolution of multinational banking: a theoretical perspective', in: *Banks as Multinationals*, G. Owen (ed.), London: Routledge
- Caves, R. (1982), *Multinational Enterprise and Economic Analysis*, Cambridge: Cambridge University Press
- Caves, R. (1989), 'Mergers, takeovers and economic efficiency', *International Journal of Industrial Organisation*, 7, 151-174
- Chamberlin, E. (1933), *The Theory of Monopolistic Competition*, Cambridge, MA: Harvard University Press
- Chandler, A. (1962), *Strategy and Structure: Chapters in the History of Industrial Enterprise*, Cambridge, MA: MIT Press
- Chandler, A. (1982), 'The M-form: industrial groups, American style', *European Economic Review*, 19, 3-23
- Clark, J. (1988), 'Economies of scale and scope at depository financial institutions: a review of the literature', *Economic Review*, Federal Reserve Bank of Kansas City, 73, 16-33

- Coase, R. (1937), 'The nature of the firm', *Economica*, 4, 386-405
- Commission of the EC (1991), *Twentieth Annual Report on Competition Policy*, Luxembourg: Office for Official Publications of the European Communities
- Commons, J. (1934), *Institutional Economics*, Madison: University of Wisconsin Press
- Chong, B. (1991), 'The effects of interstate banking on commercial banks' risk and profitability', *Review of Economics and Statistics*, 78-84
- Cowling, K. et al. (1980), *Mergers and Economic Performance*, Cambridge: Cambridge University Press
- Cummins, J. (1991), 'Statistical and financial models of insurance pricing and the insurance firm', *Journal of Risk and Insurance*, 58, 261-302
- Darby, M. and Karny, E. (1973), 'Free competition and the optimal amount of fraud', *Journal of Law and Economics*, 16, 67-88
- Dasgupta, P. and Stiglitz, J. (1988), 'Learning-by-doing, market structure, and industrial and trade policies', *Oxford Economic Papers*, 40, 246-68
- Dassesse, M. and Isaacs, S. (1985), *EEC Banking Law*, London: Lloyds of London Press
- Davidson, C. and Denercke, R. (1984), 'Horizontal mergers and collusive behaviour', *International Journal of Industrial Organisation*, 2, 117-132
- Davidson, C. and Denercke, R. (1985), 'Incentives to form coalitions with Bertrand competition', *Rand Journal of Economics*, 16, 473-486
- Davis and Lewis, M. (1987), *Domestic and International Banking*, London:
- Demsetz, H. (1983), 'The structure of ownership and the theory of the firm', *Journal of Law and Economics*, 26,
- Demsetz, H. (1982), 'Barriers to entry', *American Economic Review*, 72, 47-57
- Dennig, U. (1990), 'Die europäische Sparkassen-Reformbewegung aus ordnungspolitischer Sicht', *Österreichisches Bankarchiv*, 12/90, 971-983
- Dermine, J. (1989), 'The specialisation of financial institutions, the EEC model', Working Paper, Paris: INSEAD
- Dermine, J. (1991), 'Discussion on Vives', in: A. Giovannini and C. Mayer (eds.), *European Financial Integration*, Cambridge: Cambridge University Press
- Dermine, J. and Röller, L. (1991), Economies of Scale and Scope in the French Mutual Funds (SICAV) industry, mimeo, Paris: INSEAD
- Dewratipont, M. (1988), 'Commitment through renegotiation proof contracts with third parties', *Review of Economic Studies*, 55, 377-90
- Diacon, S. and Carter, R. (1990), *Success in Insurance*, London: John Murray
- Diamond, D. (1984), 'Financial intermediation and delegated monitoring', *Review of Economic Studies*, 51, 393-414

- Diamond, D. (1989), 'Reputation acquisition in debt markets', *Journal of Political Economy*, 97, 828-62
- Diamond, D. and Dybvig, P. (1983), 'Bank runs, deposit insurance and liquidity', *Journal of Political Economy*, 91, 401-419
- Dueser, J. (1990), *International Strategies of Japanese Banks: the European Perspective*, Basingstoke: Macmillan
- Dufey, G. and Giddy, I. (1981), 'Innovation in the International Financial Markets', *Journal of International Business Studies*, Fall issue, 33-51
- Duffy, H. (1990), 'Bundling is key to retail banking', *Bank Management*, March, 18-23
- Dunning, J. (1977), 'Trade, location of economic activity and the MNE: a search for an eclectic approach', in: Ohlin, Hesselborn and Wijkman (eds.), *The International Allocation of Economic Activity*, New York: Holmes and Meier,
- Dunning, J. (1980), 'Towards an eclectic theory of international production: some empirical results', *Journal of International Business Studies*, 11, 9-31
- Dunning, J. (1988), 'The eclectic paradigm of international production: some empirical results', *Journal of International Business Studies*, 1-31
- Dunning, J. and Rugman, A. (1985), 'The influence of Hymer's dissertation on the theory of foreign direct investment', *American Economic Review*, 75, 228-
- Eaton, B. and Lipsey, R. (1977), 'The theory of market preemption: the persistence of excess capacity and monopoly in growing spatial markets', *Econometrica*, 47, 149-158
- Enderwick, P. (1989) 'Some economics of service-sector multinational enterprises', in: P. Enderwick (ed.), *Multinational Service Firms*, London: Routledge
- Eisenberg, M. (1988), 'The current status of the regulation of financial services and products in the United States: developments and trends', in: M. de Cecco (ed.), *Changing Money*, Oxford: Basil Blackwell
- Erdevig, E. (1988), 'Small states teach a big banking lesson', *Chicago Fed Letter*, Federal Reserve Bank of Chicago, June 1988
- Evanoff, D. and Fortier, D. (1986), 'Geographic expansion in commercial banking: inferences from intrastate activity', in: *Toward Nationwide Banking*, Federal Reserve Bank of Chicago
- Fairburn, J. and Kay, J. (1989), 'Introduction', in: J.A. Fairburn and J. Kay (eds.) *Mergers and Merger Policy*, Oxford: Oxford University Press
- Fama, E. (1980), 'Agency problems and the theory of the firm', *Journal of Political Economy*, 88, 288-307
- Farny, D. (1990), 'Fourth Geneva Lecture: Corporate strategy of European insurers', *Geneva Papers on Risk and Insurance*, 57, 372-389
- Farrell, J. (1986), 'Moral hazard as an entry barrier', *Rand Journal of Economics*, 17, 440-449
- Farrell, J. and Saloner, G. (1985), 'Standardization, compatibility, and innovation', *Rand Journal of Economics*, 16, 70-83

- Farrell, J. and Shapiro, C. (1988), 'Dynamic competition with lock-in', *Rand Journal of Economics*, 19, 123-137
- Farrell, J. and Shapiro, C. (1990), 'Horizontal mergers: an equilibrium analysis', *American Economic Review*, 80, 107-126
- Faßbender, H. and Leichtfuß, R. (1990), 'Banking in the new Europe: an interim assessment', *Die Bank*, May
- Fecher, F., Perelman, S. and Pestieau (1991), 'Scale economies and performance in the French insurance industry', *Geneva Papers on Risk and Insurance*, 16, 315-326
- Finsinger, J. and Pauly, M. (1986), 'Introduction', in: Finsinger, J. and Pauly, M. (eds.), *The Economics of Insurance Regulation*, New York: St.Martin's Press
- Finsinger, J. (1986), 'A state-controlled market: the German case', in: Finsinger, J. and Pauly, M. (eds.), *The Economics of Insurance Regulation*, New York: St.Martin's Press
- Fitchew, G. (1990), 'Overview: European financial markets - the Commission's proposals', in: *European Banking in the 1990's*, J. Dermine, ed. Oxford: Basil Blackwell
- Fitchew, G. (1990b), 'The European regulatory and supervisory framework', in: D. Fair and C. de Boissieu (eds.), *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer Academic Publishers
- Follak, K. (1991), 'European mortgage business and distribution: a German mortgage bank's perspective'. *Österreichisches Bankarchiv*, 1/91, 29-33
- Franks, J. and Harris, R. (1989), 'Shareholder wealth effects of UK takeovers: implications for merger policy', in: J.A. Fairburn and J. Kay (eds.) *Mergers and Merger Policy*, Oxford: Oxford University Press
- Franks, J. and Mayer, C. (1990), 'Capital Markets and Corporate Control: a study of France, Germany and the UK', *Economic Policy*, 10, 189-231
- Frieder, L. and Petty, P. (1991), 'Determinants of bank acquisition premiums: issues and evidence', *Contemporary Policy Issues*, 9, 13-24
- Friedman, M. (1953), 'The methodology of positive economics', in: *Essays in Positive Economics*, Chicago: Chicago University Press
- Friedman, M. (1959), 'The control of money', in: *A Program for Monetary Stability*, Bronx, N.Y.: Fordham University Press
- Friedman, J. (1971), 'A non-cooperative equilibrium for supergames', *Review of Economic Studies*, 28, 1-12
- Fudenberg, D. and Tirole, J. (1983), 'Learning by doing and market performance', *Bell Journal of Economics*, 14, 522-530
- Gardener, E. (1992), 'Banking strategies and 1992', in: A. Mullineux (ed.), Oxford: Basil Blackwell
- Geroski, P. (1989), 'Domestic and foreign entry in the UK: 1983-84', Working Paper, revised May 1989, London Business School
- Giddy, I. (1985), 'Domestic regulation versus international competition in banking', *Kredit und Kapital*, Special Supplement No. 8

- Gilbert, R. (1990), 'On the delegation of pricing authority in shared ATM networks', Working Paper, revised October 1990, University of California at Berkeley
- Gilbert, R. and Vives, X. (1986), 'Entry deterrence and the free-rider problem', *Review of Economic Studies*, 53, 71-83
- Gilligan, T. and Smirlock, M. (1984), 'An empirical study of joint production and scale economies in commercial banking', *Journal of Banking and Finance*, 8, 67-76
- Gilligan, T., Smirlock, M. and Marshall, W. (1984), 'Scale and scope economies in the multi-product banking firm', *Journal of Monetary Economics*, 13, 393-405
- Giovannini, A. and Hines, J. (1991), 'Capital flight and tax competition: are there viable solutions to both problems?', in: A. Giovannini and C. Mayer (eds.), *European Financial Integration*, Cambridge: Cambridge University Press
- Goldberg, L. and Saunders, A. (1981), 'The growth of organisational forms of foreign banks in the United States', *Journal of Money, Credit and Banking*, 13, 365-74
- Goodhart, C. (1985), *The Evolution of Central Banks*, London: London School of Economics
- Goodhart, C. (1989), *Money, Information and Uncertainty*, London: Macmillan
- Goto, A. (1982), 'Business groups in a market economy', *European Economic Review*, 19, 53-70
- Greene, M. and Trieschmann, J. (1988), *Risk and Insurance*, Cincinnati, OH: South-Western Publishing Company
- Greenwich Associates (1988), *Europe 1992: Less Change Than Anticipated*, Connecticut: Greenwich
- Greenwich Associates (1990), *Bankverbindungen Deutscher Großunternehmen 1990*, Connecticut: Greenwich
- Grossman, S. and Hart, O. (1980), 'Takeover bids, the free-rider problem and the theory of the corporation', *Bell Journal of Economics*, 11, 42-64
- Grossman, S. and Hart, O. (1986), 'The costs and benefits of ownership: a theory of vertical and lateral integration', *Journal of Political Economy*, 94, 691-719
- Grubel, H., (1977), 'A theory of multinational banking', *Quarterly Review*, Banca Nazionale del Lavoro, December, 349-64
- Grubel, H. (1989), 'Multinational banking' in: P. Enderwick (ed.), *Multinational Service Firms*, London: Routledge
- Guttentag, and Herring, R. (1987), 'International LLR...', in: R. Portes and A. Swoboda (eds.) *Threats to International Financial Stability*, Cambridge: Cambridge University Press
- Hannah, L. and Kay, J. (1977), *Concentration in Modern Industry*, London: Macmillan
- Hannan, T. and Rhoades, S. (1987), 'Acquisition targets and motives: the case of the banking industry', *Review of Economic and Statistics*, 67-74
- Hart, O. and Holmstrom, B. (1987), 'The theory of contracts', in: *Advances in Economic Theory, Fifth World Congress*, Cambridge: Cambridge University Press

- Hart, O. and Tirole, J. (1988), 'Contract renegotiation and Coasian dynamics', *Review of Economic Studies*, 55, 509-540
- Hart, O. and Moore, J. (1990), 'Property rights and the nature of the firm', *Journal of Political Economy*, 98, 1119-1158
- Hawawini, G. and Rajera, E. (1990), 'The transformation of the European financial services industry: from fragmentation to integration', Working Paper, Paris: INSEAD
- Hawawini, G. and Jacquillat, B. (1990), 'European equity markets: towards 1992 and beyond', in: J. Dermine, (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Hay, G. (1976), 'Sequential entry and entry-detering strategies', *Oxford Economic Papers*, 28, 240-257
- Heffernan, S. and Sinclair, P. (1990), *Modern International Economics*, Oxford: Basil Blackwell
- Heckscher, E. (1949), 'The effect of foreign trade on the distribution of income', in: H.S. Ellis and L.A. Meltzer, (eds.), *Readings in the Theory of International Trade*, Philadelphia, PA: Blackiston
- Hellwig, M. (1991), 'Banking, financial intermediation and corporate finance', in: (eds.) , *European Financial Integration*,
- Helm, D. (1989), 'Mergers, takeovers and the enforcement of profit-maximisation', in: J.A. Fairburn and J. Kay (eds.) *Mergers and Merger Policy*, Oxford: Oxford University Press
- Helpman, E. and Krugman, P. (1985), *Market Structure and Foreign Trade*, Cambridge, MA: MIT Press
- Hennart, J. (1988), 'A transaction costs theory of equity joint ventures', *Strategic Management Journal*, 9, 361-374
- Henrot, F. and Levy-Lang, A. (1990), 'Markets and products in the banking sector', in: C. de Boissieu (ed.), *Banking in France*, London: Routledge
- Hertner, P. (1990), 'German banks abroad before 1914', in: G. Jones (ed.), *Banks as multinationals*, London: Routledge
- Hicks, J. (1935), 'The theory of monopoly: a survey', *Econometrica*, 3, 1-20
- Hicks, J. (1974), *The Crisis in Keynesian Economics*, Oxford: Basil Blackwell
- Hindley, B. and Smith, A. (1984), 'Comparative advantage and trade in services', *The World Economy*, 7, 369-389
- Hirshleifer, J. (1976), 'Comment on Peltzman (Toward a more general theory of regulation)', *Journal of Law and Economics*, 29,
- Holmstrom, B. and Tirole, J. (1989), 'The theory of the firm', in: R. Schmalensee and R. Willig (eds.), *Handbook of Industrial Organisation*, Vol. 1, Elsevier Science Publishers B. V.
- Hornstein, A. and Prescott, E. (1989), 'On measuring the output of insurance business', Research Department Working Paper 342, Federal Reserve Bank of Minneapolis
- Huertas, T. (1990), 'US multinational banking: history and prospects', in: G. Jones (ed.), *Banks as multinationals*, London: Routledge

- Hughes, A. (1989), 'The impact of merger: a survey of empirical evidence for the UK', in: J.A. Fairburn and J. Kay (eds.) *Mergers and Merger Policy*, Oxford: Oxford University Press
- Humphrey, D. (1984), 'The US payments system: costs, pricing, competition and risk', *Monograph Series in Finance and Economics*, New York: Salomon Brothers Center for the Study of Financial Institutions
- Humphrey, D. (1990), 'Why do estimated of scale economies differ?', *Economic Review*, Federal Reserve Bank of Richmond, September/October, 38-50
- Humphrey, D. (1991), 'Productivity in banking and effects from deregulation', *Economic Review*, Federal Reserve Bank of Richmond, March/April, 16-28
- Humphrey, T. (1989), 'Lender of last resort: The concept in history', *Economic Review*, Federal Reserve Bank of Richmond, March/April, 8-16
- Hunter, W. and Timme, S. (1986), 'Technical change, organisation form and the structure of bank production', *Journal of Money, Credit and Banking*, 18, 152-166
- Hunter, W., Timme, S. and Yang, W. (1990), 'An examination of cost subadditivity and multiproduct production in large U.S. banks', *Journal of Money, Credit and Banking*, 22, 504-525
- Huveneers, C. and Steinherr, A. (1990), 'Universal banks: the prototype of successful banks in the integrated European market? A view inspired by German experience', European Investment Bank
- Hymer, S. (1976), *The International Operations of National Firms: a Study of Direct Foreign Investment*, Cambridge, MA: MIT Press (originally 1960)
- Imfeld, D. (1991), 'Economies of scale in the insurance industry', Swiss Reinsurance Company, *Sigma*, 4/91
- Jacklin, C. (1987), 'Banks and risk sharing: instabilities and coordination', in: S. Bhattacharya and N. Wallace (eds.), *Financial Markets and Incomplete Information*, Rowman & Littlefield Publishers
- Jacklin, C. (1990), 'Demand equity and deposit insurance', Research Paper No.1062, Graduate School of Business, Stanford University
- Jacklin, C. and Bhattacharya, S. (1988), 'Distinguishing panics and information-based bank runs', *Journal of Political Economy*, 96, 568-592
- Jacquemin, A. (1989), 'Horizontal merger policy', *European Economy*, May 1989
- Jacquemin, A. (1990), 'Horizontal concentration and European merger policy', *European Economic Review*, 34, 539-550
- Jacquemin, A. and Slade, M. (1989), 'Cartels, collusion, and horizontal merger', in: R. Schmalensee and R. Willig (eds.), *Handbook of Industrial Organisation*, Vol.1, Elsevier Science Publishers B. V.
- Jaffee, D. (1989), 'Symposium on Federal Deposit Insurance for S & L institutions', *Journal of Economic Perspectives*, 3, 3-9
- Jaffee, D. and Russell, T. (1976), 'Imperfect information and credit rationing', *Quarterly Journal of Economics*, 90, 651-66

- Jensen, M. (1988), 'Takeovers: their causes and consequences', *Journal of Economic Perspectives*, 2, 21-48
- Jensen, M. and Meckling, W. (1976), 'Theory of the firm: managerial behaviour, agency costs and ownership structure', *Journal of Financial Economics*, 3, 305-60
- Joerges, C. (1991), 'Markt ohne Staat? Die Wirtschaftsverfassung der Gemeinschaft und die Renaissance der regulativen Politik', Working Paper, Department of Law, European University Institute, Florence, Italy
- Jones, G. (1990a), 'Banks as multinationals' in: G. Jones (ed.), *Banks as multinationals*, London: Routledge
- Jones, G. (1990b), 'Competitive advantages in British multinational banking since 1890', in: G. Jones (ed.), *Banks as multinationals*, London: Routledge
- Jones, R. and Ruane, F. (1990), 'Appraising the options for international trade in services', *Oxford Economic Papers*, 42, 672-687
- Judd, K. (1985), 'Credible spatial preemption', *Rand Journal of Economics*, 16, 153-166
- Kane, E. (1987) 'Competitive financial reregulation: an international perspective', in: R. Portes and A. Swoboda (eds.), *Threats to International Financial Stability*, Cambridge: Cambridge University Press
- Kane, E. (1989), 'The high cost of incompletely funding the FSLIC's shortage of explicit capital', *Journal of Economic Perspectives*, 3, 31-47
- Kareken, J. (1983), 'The first step in bank deregulation: what about the FDIC?', *American Economic Review*, Papers and Proceedings, 198-203
- Kareken, J. and Wallace N. (1978), 'Deposit insurance and bank regulation: a partial equilibrium exposition', *Journal of Business*, 51, 413-438
- Katz, M. and Shapiro, C. (1985), 'Network externalities, competition, and compatibility', *American Economic Review*, 75, 424-440
- Katz, M. and Shapiro, C. (1986a), 'Technology adoption in the presence of network externalities', *Journal of Political Economy*, 94, 822-841
- Katz, M. and Shapiro, C. (1986b), 'Product compatibility choice in a market with technological progress', *Oxford Economic Papers*, 38, 146-165
- Kaufman, G. (1988), 'The truth about bank runs', in: C. England and T. Huertas (eds.), *The Financial Services Revolution*, Boston: Kluwer Academic Publishers
- Kay, N. (1991), 'Industrial collaborative activity and the completion of the internal market', *Journal of Common Market Studies*, 14, 347-362
- Kaye, G. (1991), 'Economies of scale in UK life insurance companies: an empirical approach', *Geneva Papers on Risk and Insurance*, 16, 302-314
- Kessides, I. (1990), 'Towards a testable model of entry: a study of the US manufacturing industries', *Economica*, 57, 219-238
- Kierzkowski, H. (1987), 'Recent advances in international trade theory: a selective survey', *Oxford Review of Economic Policy*, 3, 1-19

- Kim, H. (1986), 'Economies of scale and economies of scope in multiproduct financial institutions: further evidence from credit unions', *Journal of Money, Credit and Banking*, 18, 220-226
- Kim, S. and Miller, S. (1983), *Competitive Structure of the International Banking Industry*, Lexington and Toronto
- Kindleberger, C. (1969), 'The theory of foreign direct investment', in: C. Kindleberger (ed.), *American Business Abroad: Six Lectures on Direct Investment*, New Haven, Conn.: Yale University Press
- Kindleberger, C. (1978), *Manias, Panics and Crashes: A History of Financial Crises*, New York: Basic Books
- King, M. (1990), 'International harmonisation of capital market regulation', *European Economic Review*, 34, 569-77
- Klein, M. (1971), 'A theory of the banking firm', *Journal of Money, Credit and Banking*, 3, 205-218
- Klein, B., Crawford, R. and Alchian, A. (1978), 'Vertical integration, appropriable rents, and the competitive contracting process', *Journal of Law and Economics*, 21, 297-326
- Klemperer, P. (1987a), 'Entry deterrence in markets with consumer switching costs', *Economic Journal*, 97, 99-117
- Klemperer, P. (1987b), 'Markets with consumer switching costs', *Quarterly Journal of Economics*,
- Klemperer, P. (1989), 'Price wars caused by switching costs', Discussion Paper No. 40, Oxford: Nuffield College
- Klemperer, P. (1990), 'Product line competition and shopping costs: why firms may choose to compete head-to-head', Discussion Paper No.55, Oxford: Nuffield College
- Kogut, B. (1989), 'The stability of joint ventures: reciprocity and competitive rivalry', *Journal of Industrial Economics*, 28, 183-198
- Kopper, H. (1989), 'Europe 1992: strategic implications for financial services', speech held at the 1989 International Monetary Conference in Madrid, Spain, mimeo, Deutsche Bank AG, Frankfurt
- Kopper, H. (1990), 'Strategische Ausrichtung einer Universalbank auf einen gemeinsamen EG-Finanzmarkt', *Österreichisches Bankarchiv*, 2/90
- Kreps, D. (1990), 'Corporate culture and economic theory' in: J. Alte and K. Shepsle (eds.), *Rational Perspectives on Positive Political Economy*, Cambridge: Cambridge University Press
- Kreps, D. and Wilson, R. (1982), 'Reputation and imperfect information', *Journal of Economic Theory*, 27, 253-279
- Krugman, P. (1989), 'Industrial organisation and international trade', in: R. Schmalensee and R. Willig (eds.), *Handbook of Industrial Organisation*, Vol.1, Elsevier Science Publishers B. V.
- Kuerble, G. (1990), 'The exodus of the American life insurers from Germany - the Tontine and the developments prior to 1894', *German Journal of Insurance*, 583-623

- Kutscher, R. (1987), 'Projections 2000: overview and implications of the projections to 2000', *Monthly Labor Review*, 100, 3-9
- Kwoka, J. (1985), 'The Herfindahl index in theory and practise', *Antitrust Bulletin*, 30, 915-947
- Kwoka, J. (1989), 'The private profitability of horizontal mergers with non-Cournot and maverick behaviour', *International Journal of Industrial Organisation*, 7, 403-411
- Laderman, E. and Pozdena, R. (1991), 'Interstate banking and competition: evidence from the behaviour of stock returns', *Economic Review*, Federal Reserve Bank of San Francisco, Spring, 32-47
- Lane, D. (1991), 'Banks in Italy: Much ado about something', *The Banker*, August
- Leamer, E. (1980), 'The Leontief paradox reconsidered', *Journal of Political Economy*, 88, 495-503
- Leibenstein, H. (1966), 'Allocative efficiency vs. X-inefficiency', *American Economic Review*, 56, 392-415
- Leibenstein, H. (1975), 'Aspects of the X-inefficiency theory of the firm', *Bell Journal of Economics*, 6, 580-606
- Leibenstein, H. (1987), *Inside the Firm: the Inefficiencies of Hierarchy*, Cambridge, MA: Harvard University Press
- Leland, H. (1979), 'Quacks, lemons and licensing: a theory of minimum quality standards', *Journal of Political Economy*, 87, 1328-1346
- Leland, H. and Pye, D. (1977), 'Information asymmetries, financial structure and financial intermediation', *Journal of Finance*, 32, 371-387
- Leontief, W. (1953), 'Domestic production and foreign trade: the American capital position re-examined', *Proceedings of the American Philosophical Society*, 37, 322-49
- LeRoy, S. (1989), 'Efficient capital markets and martingales', *Journal of Economic Literature*, 27, 1583-1621
- Levich, R. (1990), 'The Euromarkets after 1992', in: J. Dermine, (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Levy, H. and Sarnat, M. (1970), 'International diversification of investment portfolios', *American Economic Review*, 60, 668-75
- Llewellyn, D. (1989), 'Financial services and competition', *Banking World*, September, 28-34
- Llewellyn, D. (1990), 'Competition, diversification and structural change in the British financial system', in: D. Fair and C. de Boissieu (eds.), *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer Academic Publishers
- Llewellyn, D. (1992), 'Banking and financial services', in: D. Swann (ed.), *The Single European Market and Beyond*, London: Routledge
- Manne, H. (1965), 'Mergers and the market for corporate control', *Journal of Political Economy*, 73, 693-706

- Mariti, P. and Smiley, R. (1983), 'Cooperative agreements and the organisation of industry', *Journal of Industrial Economics*, 31, 437-451
- Markowitz, H. (1959), *Portfolio Selection: Efficient Diversification of Investments*, New York: Wiley
- Marris, R. (1963), 'A model of the managerial enterprise', *Quarterly Journal of Economics*, 77, 185-209
- Martin, S. (1989), 'Sunk costs, financial markets, and contestability', *European Economic Review*, 33, 1089-1113
- Martin, S. (1989b), 'Product differentiation and market performance in oligopoly', Working Paper No. 89/385, European University Institute, Florence, Italy
- Martin, S. (1992), *Advanced Industrial Economics*, Oxford: Basil Blackwell
- Martin, S. (1992b), 'Engogenous firm efficiency in a Cournot principal-agent model', to be published in *Journal of Economic Theory*
- Masera, R. (1990), 'Issues in financial regulation: efficiency, stability, information', in: D. Fair and C. de Boissieu (eds.), *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer Academic Publishers
- Mayer, C. (1988), Discussion of Kay and Vickers: 'Regulatory reform in Britain', *Economic Policy*, October, 285-343
- Mayer, C. (1990), 'The regulation of financial services: lessons from the United Kingdom for 1992', in: *European Banking in the 1990's*, J. Dermine, ed., Oxford: Basil Blackwell
- Mayer, C. and Neven, D. (1991), 'European financial regulation: a framework for policy analysis', in: A. Giovannini and C. Mayer (eds.), *European Financial Integration*, Cambridge: Cambridge University Press
- McDowell, B. (1989), *Deregulation and Competition in the Insurance Industry*, New York: Quorum Books
- McGee, J. (1980), 'Predatory pricing revisited', *Journal of Law and Economics*, 23, 289-330
- McKinsey (1990), 'Bridging the uncertainty gap with creative M&A: a tool for Eurobankers', Paper presented at the Annual Conference of the European Banking Practise, Copenhagen, 26 November 1990
- Meeks, G. (1977), *Disappointing Marriage: A Study of the Gains from Merger*, Cambridge: Cambridge University Press
- Mehr, R. (1986), *Fundamentals of Insurance*, Homewood IL: Irwin
- Melitz, J. (1990), 'Financial deregulation in France', *European Economic Review*, 34, 394-402
- Melvin, J. (1989), 'Trade in producer services: a Heckscher-Ohlin approach', *Journal of Political Economy*, 97, 1180-1196
- Mengle, D., (1990), 'The case for interstate branch banking', *Economic Review*, Federal Reserve Bank of Richmond, November
- Merrick, D. and Saunders, A. (1985), 'Bank regulation and monetary policy', *Journal of Money, Credit and Banking*, 17, 691-717

- Mester, L. (1987), 'A multiproduct cost study of Savings and Loan Associations', *Journal of Finance*, 42, 423-445
- Metais, J. (1990), 'International strategies of French banks', in: C. de Boissieu (ed.), *Banking in France*, London: Routledge
- Michalet, C.A. and Sauviat, C. (1981), 'L'internationalisation des banquiers: le cas français', in: C.A. Michalet (ed.), *Internationalisation des banques et des groupes financières*, Paris: Editions du CNRS
- Micossi, S. (1988), 'The single European market: finance', *Quarterly Review*, Banco Nazionale del Lavoro, 217-35
- Milgrom, P. and Roberts, J. (1982), 'Predation and entry deterrence', *Journal of Economic Theory*, 27, 280-312
- Milgrom, P. and Roberts, J. (1986), 'Prices and advertising signals of product quality', *Journal of Political Economy*, 94, 796-821
- Monti, M. (1971), 'A theoretical model of bank behaviour and its implications for monetary policy', *L'Industria*, 2, 3-29
- Morgan Guarantee Trust (1988), 'Financial markets in Europe: towards 1992', *World Financial Markets*, New York: Morgan Guaranty Trust
- Moser, C. and Kalton, G. (1979), *Survey Methods in Social Investigation*, Hants: Gower
- Mueller, D. (1989), 'Mergers - causes, effects and policies', *International Journal of Industrial Organisation*, 7, 1-10
- Murray, J. and White, R. (1983), 'Economies of scale and economies of scope in multiproduct financial institutions: a study of British Columbia credit unions', *Journal of Finance*, 38, 887-902
- Nelson, P. (1970), 'Information and consumer behaviour', *Journal of Political Economy*, 78, 311-29
- Nelson, R. (1971) 'Branching, scale economies, and banking costs', *Journal of Banking and Finance*, 9, 177-191
- Nelson, R. (1988), 'Optimal banking structure: implications for interstate banking', *Contemporary Policy Issues*, 6, 13-23
- Neuberger, J. and Zimmerman, G. (1990), 'Bank pricing of retail deposit accounts and the California rate mystery', *Economic Review*, Federal Reserve Bank of San Francisco, Spring 1990, 3-16
- Neven, D. (1985), 'Two-stage (perfect) equilibrium in Hotelling's model', *Journal of Industrial Economics*, 33, 317-325
- Neven, D. (1990), 'Structural adjustment in European retail banking: some views from industrial organisation', in: J. Dermine (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell
- Nonhoff, D. (1991), 'Lebensversicherung im EG-Binnenmarkt - Wechselwirkung im Hinblick auf Produkt- und Marktverfassung', *Zeitschrift für die gesamte Versicherungswirtschaft*, September 1991, 235-265

- O'Brien, C. (1991), 'Measuring the output of life assurance companies', *Geneva Papers on Risk and Insurance*, 16, 207-235
- Odagiri, H. and Hase, T. (1989), 'Are mergers and acquisitions going to be popular in Japan too?', *International Journal of Industrial Organisation*, 7, 49-72
- Ohlin, B. (1967), *Interregional and International Trade*, revised edition: London: Oxford University Press
- OECD (1983), *The Internationalisation of Banking*, Paris: OECD Publications
- OECD (1989), *Competition in Banking*, Paris: OECD Publications
- OECD (1991), *Bank Profitability*, Paris: OECD Publications
- Onado, M. (1990), 'Competition in banking services and its implications: the Italian case', in: D. Fair and C. de Boissieu (eds.), *Financial Institutions in Europe Under New Competitive Conditions*, Dordrecht: Kluwer Academic Publishers
- Outreville, J. (1990), 'Price regulation and segmented insurance markets', in: Henri Louberge (ed.), *Risk, Information and Insurance*, Boston, MA: Kluwer Academic Publishers
- Padoa-Schioppa (1987), *Efficiency, Stability and Equity*, Oxford: Oxford University Press
- Panorama of EC Industry (1990), Luxembourg: Office for Official Publications of the European Communities
- Panzar, J. and Willig, R. (1977), 'Economies of scale in multi-output production', *Quarterly Journal of Economics*, 91, 431-93
- Panzar, J. and Willig, R. (1981), 'Economies of Scope', *American Economic Review*, 71, 268-272
- Penrose, E. (1959), *Theory of the Growth of the Firm*, Oxford: Basil Blackwell
- Perry, M. and Porter, R. (1985), 'Oligopoly and the incentive for horizontal merger', *American Economic Review*, 75, 219-227
- Phlips, L. (1988), *The Economics of Imperfect Information*, Cambridge: Cambridge University Press
- Phlips, L. (1989), 'Time-series and cross-sectional studies of industrial structure', *European Economic Review*, 33, 321-324
- Poitevin, M. (1989), 'Financial signalling and the deep-pocket argument', *Rand Journal of Economics*, 20, 26-40
- Pool, B. (1990), *Towards an Internal Market in Insurance*, Luxembourg: Office for Official Publications of the EC
- Postlewaite, A. and Vives, X. (1987), 'Bank runs as an equilibrium phenomenon', *Journal of Political Economy*, 95, 485-491
- Prescott, E. and Visscher, M. (1977), 'Sequential location among firms with foresight', *Bell Journal of Economics*, 8, 378-393
- Prescott, E. and Visscher, M. (1980), 'Organisational capital', *Journal of Political Economy*, 88, 446-71

- Price Waterhouse (1988), *The Costs of Non-Europe in Financial Services, Cecchini-Report*, Vol. 9, Luxembourg: Office for Official Publications of the European Communities
- Prosperetti, L. (1991), 'Economies of scale in Italian life-insurance', *Geneva Papers on Risk and Insurance*, 16, 282-292
- Ravenscraft, D. and Scherer, F. (1987), *Mergers, Sell-Offs, and Economic Efficiency*, Washington, D.C.: Brookings Institution
- Ravenscraft, D. and Scherer, F. (1989), 'The profitability of mergers', *International Journal of Industrial Organisation*, 7, 101-116
- Rees, R. (1985), 'Cheating in a duopoly game', in: P. Geroski, L. Philips, and A. Ulph (eds.), *Oligopoly, Competition and Welfare*, Oxford: Basil Blackwell
- Reynolds, R. and Snapp, B. (1986), 'The competitive effects of partial equity interests and joint ventures', *International Journal of Industrial Organisation*, 4, 141-153
- Ricardo, D. (1971), *The Principles of Political Economy and Taxation*, Harmondsworth: Penguin
- Roell, A. (1987), 'The regulation of takeovers', paper presented at the LSE conference on the economics of takeovers, mimeo, British Library of Economics and Political Science
- Romer, D. (1985), 'Financial intermediation, reserve requirements and inside money: a general equilibrium analysis', *Journal of Monetary Economics*, 16, 175-194
- Rose, P. (1989), *The Interstate Banking Revolution*, Westport, Conn.: Quorum
- Rose, P. (1989b), 'The banking firms making interstate acquisitions: theory and observable motives', *Review of Business and Economics Research*, 25, 1-18
- Ross, T. (1988), 'On the price effects of mergers with freer trade', *International Journal of Industrial Organisation*, 6, 233-246
- Rubinstein, A. (1979), 'Equilibrium in supergames with the overtaking criterion', *Journal of Economic Theory*, 21, 1-9
- Rubinstein, A. (1980), 'Strong perfect equilibrium in supergames', *International Journal of Game Theory*, 9, 13-24
- Salant, S. Switzer, S. and Reynolds, R. (1983), 'Losses from horizontal mergers: the effects of an exogenous change in industry structure on Cournot-Nash equilibrium', *Quarterly Journal of Economics*, 103, 345-356
- Salop, S. (1990), 'Deregulating self-regulated shared ATM networks', *Economics of Innovation and New Technology*, 1, 85-96
- Sampson, G. and Snape, R. (1985), 'Identifying the issues in trade in services', *The World Economy*, 8, 171-182
- Santomero, A. (1984), 'Modeling the banking firm', *Journal of Money, Credit and Banking*, 16, 576-602
- Santomero, A. (1990), 'European banking post-1992: lessons from the United States', in: J. Dermine (ed.), *European Banking in the 1990's*, Oxford: Basil Blackwell

- Sapir, A. and Lutz, E. (1981), 'Trade in services: economic determinants and development-related issues', World Bank Staff Working Paper, The World Bank
- Scharfstein, D. (1988), 'The disciplinary role of takeovers', *Review of Economic Studies*, 55, 185-199
- Scherer, F. (1988), 'Corporate takeovers: the efficiency arguments', *Journal of Economic Perspectives*, 2, 69-82
- Scherer, F. and Ross, D. (1990), *Industrial Market Structure and Economic Performance*, third edition, Chicago: Rand Mc Nally
- Schlesinger, H. and Graf von der Schulenburg, J. (1991), 'Search costs, switching costs and product heterogeneity in an insurance market', *Journal of Risk and Insurance*, 58, 109-119
- Schmallensee, R. (1978), 'A model of advertising and product quality', *Journal of Political Economy*, 86, 485-503
- Schneider, U. (1991), 'Die Harmonisierung des Bankrechts in der Europäischen Gemeinschaft', *Österreichisches Bankarchiv*, 5/91, 312-326
- Schroath, F. (1988), 'Mode of foreign market entry: an analysis of the property and liability insurance industry', *Geneva Papers on Risk and Insurance*, 13, 361-376
- Schroath, F. and Korth, C. (1989), 'Managerial barriers to the internationalisation of U.S. property and liability insurers: theory and perspectives', *Journal of Risk and Insurance*, 56, 630-48
- Schulenburg, J. Graf von der (1989), *Regulation and deregulation of insurance markets in the FRG*, Working Paper, European University Institute
- Schwartz, A. (1986), 'Real and pseudo-financial crises', in: F. Capie and G. Wood (eds.), *Financial Crises and the World Banking System*, London: MacMillan
- Sealey, C. and Lindley, J. (1977), 'Inputs, outputs and a theory of production and cost at depository financial institutions', *Journal of Finance*, 32, 1251-66
- Selten, R. (1978), 'The chain-store paradox', *Theory and Decision*, 9, 127-159
- Semaya, F. (1991), 'State regulation of insurer insolvencies: is there a better alternative?', in: F. Semaya and V. Vitkowsky (eds.), *The State of Insurance Regulation*, Chicago: American Bar Association
- Shaeffer, S. (1987), 'The design of bank regulation and supervision: some lessons from the theory of finance', in: R. Portes and A. Swoboda (eds.), *Threats to International Financial Stability*, Cambridge: Cambridge University Press
- Shaffer, S. (1988), 'A revenue-restricted cost study of 100 large banks', Federal Reserve Bank of New York Research Paper, 8, 1-35
- Shaked, A. and Sutton, J. (1981), 'The self-regulating profession', *Review of Economic Studies*, 48, 217-34
- Shaked, A. and Sutton, J. (1982a), 'Imperfect information, perceived quality, and the formation of professional groups', *Journal of Economic Theory*, 27, 170-181
- Shaked, A. and Sutton, J. (1982b), 'Relaxing price competition through product differentiation', *Review of Economic Studies*, 49, 3-14

- Shaked, A. and Sutton, J. (1990), 'Multi-product firms and market structure', *Rand Journal of Economics*, 21, 45-62
- Shapiro, C. (1983), 'Optimal pricing of experience goods', *Bell Journal of Economics*, 14, 497-507
- Shapiro, C. and Willig, R. (1990), 'On the antitrust treatment of production joint ventures', *Journal of Economic Perspectives*, 4, 113-130
- Sharpe, S. (1990), 'Asymmetric information, bank lending and implicit contracts: a stylized model of customer relationships', *Journal of Finance*, 45, 1069-1087
- Shepherd, W. (1984), 'Contestability versus competition', *American Economic Review*, 74, 572-587
- Shiller, R. (1991), 'Discussion of Blinder (1991)', *American Economic Review*, May, 97-98
- Shleifer, A. and Vishny, R. (1986), 'Large shareholders and corporate control', *Journal of Political Economy*, 94, 461-488
- Simon, H. (1947), *Administrative Behaviour*, New York: Macmillan
- Skogh, G. (1989), 'The transactions cost theory of insurance: contracting impediments and costs', *Journal of Risk and Insurance*, 56, 726-732
- Slade, M. (1989), 'Price wars in price-setting supergames', *Economica*, 56, 295-310
- Sleuwagen, L. and Dehandschutter, W. (1986), 'The critical choice between the concentration ratio and the H-index in assessing industry performance', *Journal of Industrial Economics*, 35, 193-208
- Smith, A. (1776), *The Wealth of Nations*, Cannan Edition, New York: Modern Library
- Spence, M. (1981), 'The learning curve and competition', *Bell Journal of Economics*, 12, 49-70
- Spence, M. (1983), 'Contestable markets and the theory of industry structure: a review', *Journal of Economic Literature*, 21, 981-990
- Spencer, R. (1991), 'Guaranty associations: a look ahead', in: F. Semaya and V. Vitkowsky (eds.), *The State of Insurance Regulation*, Chicago: American Bar Association
- Stein, J. (1988), 'Takeover threats and managerial myopia', *Journal of Political Economy*, 96, 61-80
- Steinherr, A. and Gilibert, P. (1989), *The Impact of Financial Market Integration on the European Banking Industry*, Brussels: Centre for European Policy Studies, Research Report No. 1
- Stigler, G. (1964), 'A theory of oligopoly', *Journal of Political Economy*, 72, 44-61
- Stigler, G. (1968), *The Organisation of Industry*, Homewood, IL: Irwin
- Stigler, G. (1971), 'The theory of economic regulation', *Bell Journal of Economics and Management Science*, 2,
- Stiglitz, J. and Weis, A. (1981), 'Credit rationing in markets with imperfect information', *American Economic Review*, 71, 393-410

- Stiglitz, J. and Arnott, R. (1990), 'The welfare economics of moral hazard', in: Henri Louberge (ed.), *Risk, Information and Insurance*, Boston, MA: Kluwer Academic Publishers
- Stokey, N. (1986), 'The dynamics of industry-wide learning', in: W. Heller, R. Starr and D. Starrett (eds.), *Equilibrium Analysis: Essays in Honour of Kenneth J. Arrow*, Cambridge: Cambridge University Press
- Suret, J. (1991), 'Scale and scope economies in the Canadian property and casualty insurance industry', *Geneva Papers on Risk and Insurance*, 16, 236-256
- Tapp, J. (1986), 'Regulation of the UK Insurance Industry', in: Finsinger, J. and Pauly, M. (eds.), *The Economics of Insurance Regulation*, New York: St.Martin's Press
- Teece, D. (1982), 'Towards an economic theory of the multi-product firm', *Journal of Economic Behaviour and Organisation*, 3, 39-63
- Tirole, J. (1988), *The Theory of Industrial Organisation*, Cambridge, MA: MIT Press
- Tschoegl, A. (1982), 'Foreign bank entry into Japan and California', in: A. Rugman (ed.) *New Theories of the Multinational Enterprise*, London: Croom Helm
- Varian, H. (1988), 'Symposium on takeovers', *Journal of Economic Perspectives*, 2, 3-5
- Veugelers, R. (1990), *Scope Decisions of Multinational Enterprises*, Ph.D dissertation, Catholic University of Louvain
- Vickers, J. and Yarrow, G. (1988), *Privatization*, Oxford: Oxford University Press
- Vives, X. (1990), 'Deregulation and competition in Spanish banking', *European Economic Review*, 34, 403-411
- Vives, X. (1991), 'Banking competition and European integration', in: A. Giovannini and C. Mayer (eds.), *European Financial Integration*, Cambridge: Cambridge University Press
- Waldman (1987), 'Non-cooperative entry deterrence, uncertainty and the free-rider problem', *Review of Economic Studies*, 54, 301-310
- Waldman, M. (1991), 'The role of multiple potential entrants/sequential entrants in non-cooperative entry deterrence', *Rand Journal of Economics*, 22, 446-453
- Weizsäcker, C.-C. von (1984), 'A welfare analysis of barriers to entry', *Bell Journal of Economics*, 11, 399-420
- Wenk, T. (1987), 'Insurer insolvency: causes, effects and solutions', *Journal of Insurance Issues*, 10, 35-48
- Weizsäcker, C.-C. von (1984), 'The costs of substitution', *Econometrica*, 52, 1085-1116
- White, L. (1989), 'The reform of federal deposit insurance', *Journal of Economic Perspectives*, 3, 11-29
- Williams, (1986), 'The EEC Convention on the law applicable to contractual obligations', *International Comparative Law Quarterly*, 35, 1
- Williamson, O. (1967), 'Hierarchical control and optimum firm size', *Journal of Political Economy*, 2, 123-138

- Williamson, O. (1968), 'Economies as an antitrust defense: the welfare trade-offs', *American Economic Review*, 58, 18-31
- Williamson, O. (1975), *Markets and Hierarchies: Analysis and Anti-Trust Implications*, New York: The Free Press
- Williamson, O. (1981), 'The modern corporation: origins, evolution, attributes', *Journal of Economic Literature*, 19, 1537-1568
- Williamson, O. (1984), 'Corporate governance', *Yale Law Journal*, 93, 1197-1209
- Williamson, O. (1985), *The Economic Institutions of Capitalism*, New York: Free Press
- Williamson, O. (1989), 'Transaction cost economics', in: R. Schmalensee and R. Willig (eds.), *Handbook of Industrial Organisation*, Vol.1, Elsevier Science Publishers B.V.
- Williamson, O. (1990), 'Introduction', in: M. Aoki, B. Gustafsson and O. Williamson, (eds.), *The Firm as a Nexus of Treaties*, London: Sage Publications
- Willig, R. (1987), 'Corporate governance and market structure', in: A. Razin and E. Sadka (eds.), *Economic Policy in Theory and Practice*, London: Macmillan Press
- Wilson, J. (1986), *The Chase: The Chase Manhattan Bank, N.A. 1945-1985*, Cambridge, MA: Harvard Business School Press
- Yanelle, M. (1989), 'The strategic analysis of intermediation', *European Economic Review*, 33, 294-301
- Zimmerman, G. (1989), 'The growing presence of Japanese banks in California', *Economic Review*, Federal Reserve Board of San Francisco, Summer 1989, 3-17

