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European Banking After the Euro: Progress and Problems

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The introduction of the euro has presented the European banking industry with an opportunity to examine its structure and address its fragmentation. The leaders in European banking will evolve as the efficiencies in a single currency are realized. This article discusses the changes in European banking since the introduction of the euro, providing statistics on mergers and acquisitions and their effects on assets both inside and outside the eurozone. It considers the factors which make cross-border mergers less attractive, the effect of consolidation on costs, and the impact of the euro on foreign exchange earnings, debt markets and cash management systems. It concludes that although banks are becoming more competitive with each other and with other financial services companies, national barriers to further integration of the financial services market remain.

In their earlier article for this journal Templeton and Bond (1999) viewed the introduction of the Euro and the emergence of a single financial market as having important consequences for business strategies and structure of European banking. Keener competition across borders would result in consolidation of the industry, along with reduced costs of operations and new products and services.

The present study extends that analysis to determine to what extent changes have actually occurred in the structure and operations of euroland banking since the advent of the Euro. It finds some progress in the development of a Europe-wide financial services market. The advent of the euro and the continued growth of the Internet have indeed facilitated consolidations and created new products and services. Yet, for many banks cost savings and synergies remain elusive goals. Moreover, some legal and political barriers continue to frustrate efforts for more cross-border financial business.

Competition and Consolidation

The introduction of the euro has presented the European banking industry with an opportunity to examine its structure and address its fragmentation. The introduction of the single currency has served as a catalyst for consolidation. In a recent press conference European Central Bank chairman Duisenberg went on record to state that:

The (ECB) Governing Council is well aware that the current process of consolidation is no longer confined to small and medium-sized banks - as it was in the past - but that now it also covers the larger banks at the national level and cross-border mergers and alliances are on the increase. The role of the Euro as a factor encouraging this process of consolidation via further integration of money and capital markets is important. The consolidation process is welcome in general since it allows efficiency gains to be achieved in the banking sector. On the other hand, it affects the competitive environment in which banks operate, as well as their risk profile.1

The European banking industry has certainly taken his words to heart. Table 1 presents an overview of significant Eurozone bank mergers and acquisitions since the start of 1999. The transactions illustrate the growing global consolidation of the financial services industry as European and US based institutions seek opportunities to extend franchises. Note that this consolidation has occurred mainly within national borders.

The consolidation process has certainly facilitated the growth of major Eurozone banks. Table 2 lists the ten largest Eurozone and non-Eurozone banks by size of assets for 1998 and 1999. They are ranked by asset size. Note that average size of Eurozone bank assets rose 20.5 percent following the introduction of the Euro. In contrast, non-Eurozone bank assets grew only 2 percent over the like period!

The leaders in European banking will continue to evolve as the efficiencies in a single currency are realized. They recognize the need for a global presence. Competition is taking precedence over cartelization.

As both of the above tables reveal, however, the nature of the consolidation movement has been primarily domestic, not the cross-border activity envisioned by a single financial market. The 1999 ABN Amro Annual Report states:

The acceleration in the development of the single market has lowered entry thresholds and forced European banks to redefine their traditional home markets. Consolidation in Europe has so far largely remained a domestic affair. Mergers and acquisitions within a country generally provide the most scope for cost reduction. In larger countries such as Germany, France and Italy, the financial sector is still less concentrated than in smaller countries and local banks still have scope for consolidation at national level. There have been some cross-border takeovers, mainly in smaller countries such as the Netherlands and Belgium where the financial sector is already so highly concentrated that opportunities for consolidation at the national level have almost vanished. In practice, however, cross-border consolidation is often still impeded by the urge to protect national interests. Governments of some European Union member states attach great significance to the development of national champions capable of competing at European and global levels with other major players. Banks are therefore forced initially to take minority stakes in foreign banks, with a view to completing full mergers or takeovers in the future.3

Apparently, old habits die hard. Fiona Haddock (2000) notes that it is one thing to see a major clothing company acquired by a foreign investor. It is a different thing to see a major bank being sold to an outsider. When Spanish giant Banco Santander Central Hispano made a bid for a 40% stake in Mundial Confianca, Portugal's third largest financial group, the government responded swiftly and defensively, favouring the country's own Banco Commercial Portugues. A tussle between Banque Nationale de Paris, Societe Generale, and Paribas had economic nationalism at its core. The French government ignored advances by foreign players, determined to see a strong French bank emerge victorious.

Nevertheless, some cross-border alliances are being made. In 1999, for example, Commerzbank invested el.2 billion in 1999 in three geographically diverse financial services/banking firms.

The dramatic transition in the European Banking sector is also evident in the variety of alliances that have been formed outside of the traditional banking industries. Bancassurance, in which a bank joins with an insurer, has gained favour as a way of cross selling (Haddock, 2000). The changing competitive environment is also illustrated by Deutsche Bank's alliance with Mannesmann AG to support an E-commerce initiative to offer online banking services. Also, after its purchase of US life insurer ReliaStar for $6.1 billion and its announced intention to acquire US Aetna Financial Services for $7.7 billion, ING will be first in US life and annuity premiums and up to 11th from its 19th position in terms of global asset managers. It will have the biggest broker/dealer network in the US and be sixth in assets under management at $111 billion.

Cost Structures in the Banking Industry

Certainly a major reason behind the merger movement is the potential for cost savings. But are they being attained? The evidence suggests that in the short run the benefits are limited. Banks have typically overestimated their synergies. In fact some banks have even experienced increased costs associated with the introduction of the Euro. Commerzbank (1999) has reported that overall operating expenses rose a significant 23.9% in 1999. It cites the Euro as a major reason for increased costs.4 For DG Bank the overall costs of the switch to the Euro were around DM 100 million.5 Rabobank notes that "...estimates on the cost of implementing the single currency are expected to amount to around Fl.300m."6 Credit Lyonnais attributes a 2.1% rise in expenses as being chiefly due to Euro and year 2000 related costs.

In addition to the costs of preparing their systems for the Euro banks face significant expenses in the actual distribution and handling of new notes and coins scheduled for introduction in January 2002. The European Central Bank forecasts the number of Euro bank notes, which need to be printed before the launch date of Jan 1, 2002 is for 14.5 billion in notes, compared with last year's estimate of 13 billion.

Among other major barriers to achieving cost efficiencies are strong unions and strict labour laws in many continental European countries. When banks do merge there is little room to cut staff. Haddock (2000) quotes Gary Jenkins of Barclays Capital:

If you have two large branch-based networks in the United Kingdom with a lot of overlapping, you would see a lot of people potentially out of work. In Europe it is more a matter of not hiring too many new people and letting people go as they reach retirement age. It takes time for that to happen. In Germany and France, it is difficult to be aggressive about staff numbers in the same way as in the United States or the United Kingdom. As a result the economies of scale in continental Europe banking mergers is not being realized.

This is largely why UK banks have avoided cross-border mergers. They are already more consolidated and efficient and enjoy significantly higher returns than Continental banks. Lloyds-TSB, in particular, boasts a remarkably high return on equity of 30%. Toss in problems involved with different cultures and languages, it becomes hard to justify acquisitions of banks in other countries, a process, which will inevitably dilute earnings.

Nevertheless, in the long run, potentials for cost savings do exist. At the retail level, as evidenced by a Bank of International Settlement report on comparative cost structures for the banking European banks have a significantly higher number of branches than their global competition.7 Eurozone banks have about one branch for every 2000 inhabitants. This figure compares with one branch for every 3000 in the United States and one branch for every 5000 residents in Japan. While the near term effect of the single currency is to increase operating costs, in the longer term the attendant consolidation of the industry offers opportunities to lower costs through the reduction of branch offices and the use of more automatic banking machines.

New Products and Services

Overcapacity and growing competition from nonbanks for both deposit and lending business has led to pressure on interest margins. As foreign exchange earnings have declined banks have responded by expanding the range of other financial products and services they offer. As the 1998 Annual Report of the West Landesbank indicates:

Banks are now challenged to align their range of products and services to accommodate the changing requirements of their clients, who are increasingly operating on an EMU-wide basis. Banks offering comprehensive systems and products at marketable conditions across Europe will be best placed to make use of competitive opportunities.8

Foreign Exchange

With the introduction of the Euro, industry observers anticipated a decline in foreign exchange earnings for European Banks. Although separate reporting of foreign exchange earnings is not standard, the financial impact on performance has been cited by a number of institutions in their annual reports. Typical is the notation in Commerzbank's 1999 Annual Report: "Foreign exchange at 79 million Euros produced less than half the income of the previous year; however, this decline was virtually inevitable after the introduction of the Euro and the limited opportunities for trading in European currencies which this entailed."9 A Rabobank report cites that, "...the loss of foreign exchange business.. is estimated at around fl.70 million per annum."10 The Banks for International Settlement reports that:

In the last two years foreign exchange markets have been affected by significant structural change, including the introduction of the Euro, consolidation among market players and the growth of electronic banking. These changes have been accompanied by a general reduction in trading activity and some rise in exchange rate volatility, although it is still too early to ascertain their effect on volatility and liquidity.11

A number of European financial institutions report that their hedging business declined after the bilateral exchange rates of prospective EMU members were locked together in May 1998. Overall, however, profitability has improved as banks increase their earnings in underwriting/securities while their income from foreign exchange transactions has declined. Isolating the effect of the Euro introduction on profitability in specific areas has proven a difficult task.

Ironically, the impact of the introduction of the Euro in global financial markets has been less than in the European Foreign Exchange market. The Bank for International Settlements reports:

"An analysis of spot and forward foreign exchange (FX) trading volumes suggests that the introduction of the Euro has not to date caused major changes in FX market activity. Results from an informal survey among market participants and information from electronic brokers indicate that the importance of the new currency in FX trading roughly matches that of the Duetsche mark before 1999. In particular, the reported share of trading in Euros against dollars in October 1999 was about the same as that of dollar/mark trading in April 1998. Furthermore, the share of Euro/yen trading still accounts for only a small part of the total market. In emerging market countries, the role of the Euro so far seems similar to that of the mark, being confined mainly to Eastern Europe."13

European Bond Market

Historically, European firms have depended upon syndicated bank loans for financing, rather than using the securities markets to issue equity shares or debt. Such financing is still the preferred way to find European mergers and acquisitions. However, Wolswijk (2000) has found that the process of disintermediation, whereby companies rely less on bank credit and more on the public market has accelerated. In addition, the consolidation in European banking has increased the demand from borrowers for debt denominated in Euros. Subsequent to the introduction of the Euro, the currency's share of international bond issues increased from 35% in 1998 to 45% in 1999. The West Landesbank Annual Report cites:

The commencement of EMU has given rise to the world's second-largest bond market with a volume of some e3.8 trillion. Accounting for over 60% of the market, government bonds will continue to dominate. The euro bond market will, however, form a broad range of investments involving issuers of different sizes and credit standing. Among other things, this will be spurred by mounting demand on the part of institutional investors such as insurance companies and pension funds, which are gaining an importance due to the on-going "institutionalization" of saving."14

As corporate borrowing preferences change from syndicated loans to credit markets, the transition in European banking has encouraged the development of new products and services that add underwriting to bank services. However, the European institutions have encountered significant global competition from US institutions. This competition has encouraged the consolidation of the industry beyond the domestic or even European wide markets. This need for consolidation became evident in Deutsche Bank's acquisition of US-based Bankers Trust. Shearlock (1999) notes that despite the competition, through October 1999 the three leading German banks, plus ABN Amro and Paribas, together ran the books on more than a third of all Euro-denominated bond issues.

Throughout 1999 the European debt markets continued to evolve as barriers declined. For example, legal barriers to the issue of commercial paper that existed in Germany have been lifted. In addition to the development of a commercial paper market the European corporate debt market has expanded to include high-yield bonds and derivative products.

Analyzing actual income from securities underwriting for European banks is difficult due to differences in accounting standards. For example, under German accounting rules, banks have a variety of opportunities to defer tax on start-up assets, write down future losses and net off costs against revenues. Thus, it is difficult to determine the impact of the shift in lending practices on a bank's profits. Nevertheless, for the leading European banks reporting, net commission income increased 22.6 percent from 1998 to 1999. This increase appears to be primarily the result of securities transactions and asset management.

Cash and Asset Management

The introduction of the Euro had been expected to increase the demand for cash management services by European banks for corporate customers. Indeed, as cross-border barriers have fallen banks have recognized the need to develop more integrated cash management systems that operate across borders. The ability to consolidate working capital balances provides corporate treasuries with more efficient cost management. The ING Group reports that:

The introduction of a single currency has further enhanced the importance of international funds transfer and optimal cash management. `With the Euro Navigator, we assist our corporate clients in their European funds transfer and in their cash flows throughout Europe in the most efficient way,' says Hans van der Noordaa, who was the first general manager of International Cash Management."

The market consolidation climate has led corporate customers to seek cash management accounts that deliver increased efficiency. Negative balances in one Eurozone country can be consolidated and balanced against the positive balances in other countries improving cash management and liquidity. European banks have developed European cash management systems to take advantage of technological advances and regulatory changes accompanying the introduction of a single currency.

As European cross-border transactions have increased, banking services dealing with asset management have also changed. The development of a continent wide investment focus has spawned a significant increase in assets under management. Thus, the distinctions between commercial and investment banks are becoming less clear.

Currently, it is estimated that global custodians have custody of e3,000 billion in assets for European mutual funds. This amount is expected to rise to e8,000 billion by 2005. Some $90 billion went into European equity funds in 1999, marking a 32-percent increase. European financial institutions are responding to the changes in the fund management business. Investment banks and insurance companies manage over three-quarters of institutional funds under management. The development of this business has provided European banks with new opportunities. ING reports that assets under management for third parties increased 50 percent in 1999 with mutual fund assets increasing 63 percent. ABN Amro Mellon has picked up contracts to run multinational pension schemes. The exact impact of the asset management business is difficult to determine due to the lack of separate financial reporting. However, Deutsche Bank notes that 20 percent of the group's net profit in the first half of 1999 came from asset management services. Fee generation was a critical issue behind the announcement of UBS's plan to purchase Paine Webber for $10.8 billion.16

What's Next?

It is clear that the Eurozone banking industry has made some progress in the past two years. Banks have merged and acquired, restructured and rationalized their industry. They are becoming competitive, not only among themselves, but with non-bank financial services companies.

But the benefits of cross-border mergers and attendant cost savings will not be fully realized until the European market for financial services is more integrated than it is today. The problem remains protectionism - a fear that once the floodgates are open US and British bankers will dominate financial services. Turf wars abound, both within the European Commission and among the member nations. The enemy is the time it takes to draw up and refine European legislation, or promote a common code of conduct, and then enforce it.

Shireff (1999) finds that it is still not possible to have a pan-European bank account. Retail bank charges for intereuro business remain excessive. Conversions average 5%, while cross-border transfers cost 8.4%.

ABN-Amro has been trying for years to establish a bank account usable across Europe. The problem is a legal and political one, not a technical one. Spokesman Jaap Kamp, head of ABN's European Union office in Brussels, notes that "Registering is difficult, there are different reporting requirements, there are different set-off and bankruptcy laws and solvency ratios. This sort of thing was not discussed when Europe went headlong into monetary union."

Wholesale markets are also trapped behind national barriers. Legal obstacles remain before this business becomes freely cross border. Agreement must be reached on such matters as title to collateral, bankruptcy and set-off, variations in takeover codes.

The European Union, through its Directorate-General for Internal Market and Financial Affairs has sought to deal with these problems. In 1999 it launched its programme "Financial Services: Implementing the Framework for Financial Markets Action Plan." The director, however, had to admit that progress on market liberalization was being held hostage by another committee seeking progress on tax coordination. Horse-trading and politics are still strong factors in the administrative process.

EU directives can be difficult to negotiate, but they represent a long-term solution to harmonization. UK representatives are playing a role in shaping these rules. But administrative wheels grind slowly. UK bankers may not be remiss to take a "wait and see" attitude before taking the plunge into cross-border activities. The advent of the Euro has catalyzed the ongoing trend towards financial sector consolidation, but has yet to transform its mainly domestic character.

Endnotes

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