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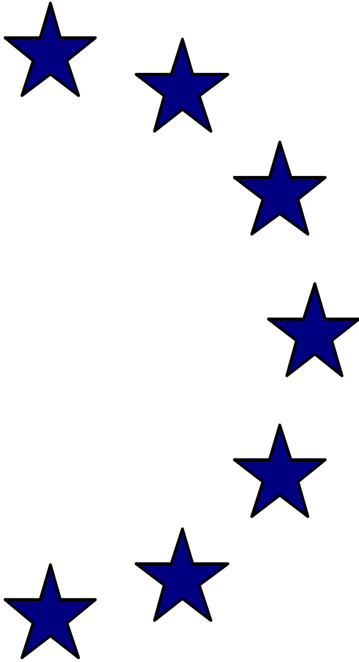

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Integration and consolidation in EU banking - an unfinished business

by
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Integration and consolidation in EU banking - an unfinished business

Christoph Walkner and Jean-Pierre Raes[1]

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Abstract

The objective of this paper is to review the obstacles to cross-border integration and consolidation, which confront banks operating within the EU. Theoretical and empirical evidence supports the view that integration and consolidation in the banking sector can enhance overall economic performance via macroeconomic stabilisation, higher levels of efficiency and consumer welfare. While in recent years only slow progress has been recorded in EU cross-border banking integration, a substantial consolidation in the Member State's national banking sectors has occurred leading to rising domestic concentration ratios implying greater efficiency but potentially limiting welfare gains. The lack of progress in cross-border integration can be attributed to various factors, including national differences in market practices, regulation and taxation. A fairly comprehensive list of existing obstacles is provided and their impact on the main avenues for cross-border banking integration is examined, namely on (i) organic growth in the form of foreign branches and subsidiaries, (ii) cross-border mergers and acquisitions and (iii) cross-border provision of banking services. In addition, the role of institutional factors relating to the framework for prudential supervision is considered, notably in the context of the relationship of home and host country supervisors with each other and with market participants. While the highlighted issues are of general relevance in the context of EU financial integration, they might be of special significance in the context of the recently acceded Member States and their largely foreign owned banking system.

[1] A number of colleagues have commented on various drafts of this paper. John Berrigan provided a number of suggestions for its structure, in addition to making valuable comments on the text. The paper benefited from comments by Delphine Sallard and Patrick Pearson on supervisory issues, by Christine Gerstberger on the banking structure of new EU Member States, and by Jan Host Schmidt, Jürgen Kröger, Massimo Suardi, Roderick Meiklejohn, Gaetan Nicodeme, Arnaud Pecker, Michael Thom and Arto Leppilahti on a number of other issues. Ken Lennan provided suggestions for Section 4 and comments were also made by Magnus Astberg. The help of Daniel Vandewalle and Ramiro Gomez Villalba in relation to data on mergers and acquisitions is gratefully acknowledged. Any remaining errors are solely the fault of the authors. Views expressed represent exclusively the positions of the authors and do not necessarily correspond to those of the European Commission.

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1. Introduction

In the eyes of a parent, a child does not grow older. Often, an outsider is required to point out that the child has already become a young adult. In several respects, the same can be said of the EU financial sector. For those closely involved in the process of EU financial integration, progress always appears slow and incomplete even if the reality may be different. For example, a "reality-check" against a brave vision put forward by The Economist magazine in 1989 confirms the extent to which the EU financial landscape has indeed changed over the years. The vision was summarised as follows:

> *"Cast your mind forward a few years and European finance could look something like this. The share prices of Fiat, Peugeot and Volkswagen flash up side by side on dealing screens from the Republic of Ireland to Athens. Computers click: the deal is done, and ownership is shifted instantaneously from a Belgian seller to a Spanish buyer. Italian investors pour into Dutch mutual funds, while Daimler Benz chooses Crédit Lyonnais to lead-manage its latest D-mark bond issue. Germans take out British life insurance, Danes take out German mortgages, Spaniards open bank accounts in Italy. Aunt Agatha and Tante Emma are as happy as lambs buying here an ecu interest-rate future, there a tempting bond with an equity warrant."*[2]

Fifteen years on, the vision is far from fulfilled but the extent of progress in EU financial integration is undeniable. With the introduction of the euro, pan-EU trading in securities is no longer a far-fetched idea and there are few EU financial sectors more integrated than investment banking. On the other hand, cross-border provision of retail financial products and services, such as mortgages and deposit accounts, is a less common feature – suggesting the persistence of significant gaps in the integration process. This paper examines one such gap - the absence of cross-border integration in the EU banking sector and the persistence of segmented national markets for retail banking services, increasingly dominated by large players.

A long-anticipated surge in the establishment of branches and subsidiaries across borders, international mergers and acquisitions (M&As) and cross-border provision of banking services in the EU has failed to materialise. This failure is striking in view of several apparently catalytic developments – notably the liberalisation of capital movements and efforts to create an internal market in financial services.[3] Expectations of cross-border integration in EU retail banking were especially high in advance of the introduction of the euro, with many commentators predicting a sharp re-orientation towards a pan-EU retail banking sector in the absence of exchange-rate risk. However, cross-border integration have not been major features of developments in EU retail banking in recent years and this latest disappointment suggests that

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[2] The Economist (1989).

[3] The liberalisation of capital movements encompasses also the right (i) of establishment, (ii) of cross-border direct investment and (iii) of a takeover of foreign companies. See Raes (2003).

obstacles – other than exchange-rate risk - have yet to be addressed. Even the implementation of the Financial Services Action Plan (FSAP)[4] - another potential catalyst to cross-border integration in retail banking – may disappoint in this regard. While the necessary degree of regulatory convergence may well be achieved via the FSAP, other fundamental obstacles such as national differences in tax regimes, the practical inability to enforce cross-border collateral pledges and differences in consumer protection requirements are likely to hinder efforts to integrate retail banking at the EU level. In addition, the supervisory framework could be improved to alleviate concerns in the context of the relationship of home and host country supervisors with each other and with market participants.

While the meaning of "integration" may be intuitively obvious, no universally agreed definition exists.[5] This paper avoids entering the debate on an exact definition but focuses on possible avenues to be taken for achieving integration, namely (i) organic growth in the form of foreign branches and subsidiaries, (ii) cross-border mergers and acquisitions and (iii) the offering of services on a cross-border basis and the extent to which such avenues may not be available within the EU retail banking sector.

The remainder of the paper is structured as follows. Section 2 highlights the theoretical and empirical support (i) for banking *integration* in terms of enhanced competition and macroeconomic stability, and (ii) for banking *consolidation* in terms of enhancing the banking-sector's contribution to economic performance. Section 3 considers a range of factors, which facilitate banking integration and cross-border consolidation and assesses the current level of integration and consolidation in the EU banking sector, both within and across national borders. This is followed by an excursus examining the trends toward concentration in domestic retail banking and possible implications for consumer welfare in the absence of a further round of cross-border consolidation. Section 4 looks at the different avenues – and their specific problems - of banking integration inherent in (i) the single license, (ii) cross-border mergers and acquisitions and (iii) the cross-border provision of services. Section 5 focuses on the current EU supervisory framework. Section 6 concludes.

2. Economic significance of banking sector consolidation

2.1. The economic role of banks as financial intermediaries

As financial intermediaries, banks play an essential role in the economy by, *inter alia*, transforming assets, facilitating risk management, financing trade, enabling capital accumulation, and spurring technological innovation. More fundamentally, banks can be said to contribute to economic performance via two important functions which contribute to efficient resource allocation:

[4] After adoption of the relevant EU legislation for the FSAP almost completed, it is now mostly up to Member States to implement the relevant provisions nationally.

[5] For an example of authors offering different definitions see Dermine (2002) and Baele et al. (2004)

- *A monitoring function for investors*: The financial system is characterised by an information asymmetry between those wishing to borrow at the lowest possible cost and those wishing to invest at the highest possible return. This asymmetry creates risk for the investor, as the borrower cannot be relied upon to be entirely transparent about his creditworthiness. Verification of the creditworthiness of each potential borrower is costly and, while it may be feasible for larger-scale investors to undertake their own credit-analysis, the smaller investor typically lacks the required resources. It is in these conditions that a bank fulfils the role of monitoring credit quality on behalf of individual investors and so ensuring the highest possible level of investment.

- *A gatekeeper function for companies*: In the absence of a monitoring intermediary, investors would tend to apply an average value to all possible investment opportunities. This would imply over-investment in lower quality projects and under-investment in higher quality projects. Through their capacity to rank investment opportunities in order of quality, banks ensure that savings are channelled to those projects with the highest (risk-adjusted) rate of return, thereby ensuring an efficient allocation of resources.

These important functions would suggest a positive correlation between banking-sector development and economic performance, although causality could operate in either direction. While theoretical and empirical work in the field of financial development and economic performance is relatively new, evidence would seem to confirm the importance of a developed - hence efficient – banking sector in boosting economic performance.

Using a macro-approach, King and Levine (1993) find a positive correlation between a developed banking sector, productivity growth and output per capita in studies of (i) 80 countries over the period 1960-1989; (ii) the experience of financial sector reforms in five countries; (iii) firm-level evidence on the allocative effects of financial reforms; and (iv) the success of general policy reforms depending on financial development. Levine et al. (2000) demonstrate a strong positive link between financial intermediary development and economic growth, using a range of indicators of intermediation such as overall size of intermediaries and the extent to which financial institutions funnel credit to private sector activities. The authors apply a variety of econometric techniques to a panel dataset of 74 countries covering the period from 1960 to 1995. The possibility of reverse causality is rejected. They further demonstrate that development of financial intermediation is fostered by (i) laws that give a high priority to secured creditors receiving the full present value of their claims against defaulted firms; (ii) legal systems that rigorously enforce contracts; and (iii) high quality accounting standards, which deliver comprehensive and comparable corporate financial statements.[6] Similarly, Beck et al. (2000) find a robust and positive link between financial intermediary development and total factor productivity growth which feeds through to overall GDP growth.

Other empirical analysis using a macro approach broadens the concept of financial development to give financial markets a more prominent role next to intermediaries.

[6] While Leahy et al. (2001) find financial development related to economic growth, they judge the direction of the causation in these relationships to be unclear.

In a broad overview article, Levine (1997) documents a strong positive link between the functioning and development of the financial system as a whole and long-run economic growth. Levine and Zervos (1998) complement their measure of banking sector development (using the value of loans made by commercial banks and other deposit-taking banks to the private sector corrected for GDP) with a proxy for the development of the stock market. The authors show that banking/financial-market development is positively and robustly correlated with current and future economic growth, as capital accumulation and productivity increases. Beck and Levine (2004) find that both banks and stock markets independently boost growth.[7]

In terms of micro-level analysis, Rajan and Zingales (1998) focus on the theoretical channels through which financial development might affect economic growth by looking at more disaggregated data. This approach is also an attempt to refute suggestions that correlations between economic growth and financial development are related to another, unobserved variable. The authors begin from the hypothesis that industries, which are more dependent on external financing (as opposed to financing from retained profits), will have relatively higher growth rates in countries that have more developed financial markets. Utilising a proxy for financial dependence on a sample of publicly listed companies, the authors find that financial development influences economic growth rates via the reduction of the cost of external finance to financially dependent firms. In that context, the paper suggests that a developed financial system may play a crucial role in the rise of new firms, while a lack of financial development may favour incumbent firms - able to fund themselves through retained profits - over new entrants.

2.2. The effects of bank integration

Competition

Foreign bank entry forces domestic banks to compete and improve their services. Claessens et al. (2001), using 7900 observations from 80 countries for the 1988-1995 period, observe that for most countries a larger foreign ownership share of banks is correlated with a reduction in profitability and margins of domestically owned banks. Another finding of the paper is that foreign bank entry matters more in terms of *numbers* of foreign bank entries, rather than in terms of foreign bank *market share* suggesting that the impact of foreign competition is felt immediately upon foreign bank entry, with domestically owned banks reacting within a very short period of time. Overall, foreign bank entry seems to enhance client welfare. The result is supported by Levine (2003) who finds in a study of almost 1200 banks in 47 countries that restricting foreign bank entry boosts bank net interest margins.

Lensink and Hermes (2004) note that foreign banks entering a domestic market (i) increase competition, thus lowering the costs for clients and enhance service quality, and (ii) bring with them innovative financial services and practices, which forces the domestically owned banking community to adapt and equally engage in

[7] However, Andrés et al. (1999) do not find a significant growth-financial relationship for developed countries. For a broad overview confirming that financial development is related to economic growth even in industrial countries see Thiel (2001).

innovation, a costly process in the short term. In developing countries, due to the often considerable gap, in terms of financial development, between foreign and domestically owned banks, the latter factor – the so-called spill-over effect - is more significant than the competition effect. In contrast, the spill-over effect pales besides the competition effect in more developed countries and foreign bank entry leads here to overall lower margins, profits and costs.

Foreign bank entry seems therefore to improve overall welfare, as long as the reduced profitability of domestically owned banks does not make them more vulnerable to distress. This might be especially dangerous in an environment of weak prudential regulations and supervisory structures (Claessens et al., 2001).

EU banking integration might imply for the recently acceded EU Member States heightened competitive pressure on their banking system, as the comparatively high margins may erode over time. In case this would not be accompanied with cost restructuring, it might lead to stability risks requiring vigilance on the part of supervisors.[8]

Macroeconomic stability

In economies where banks do not cross borders, the fate of an economy and its banks are closely tied as an economic downturn would affect the profitability and stability of the country's banking sector, thereby deepening recessions due (i) to non-financial companies' collateral loss and (ii) banks' capital losses. However, foreign bank entry can have consequences for macroeconomic stability in several respects as foreign bank subsidiaries (or branches) behave not as completely autonomous businesses, but instead as part of a larger bank holding company.

A positive effect on macroeconomic stabilisation can arise as a bank operating in two different countries can import capital to the country where lending opportunities are good, despite eventual bank capital losses in that region, thus protecting national economies against bank specific shocks. In that sense, geographic bank diversification smoothens the respective overall bank holdings' business volatility and thus stabilises borrowing conditions for the respective bank clients. In contrast, another possibility might be that banks cease lending in an environment of economic decline and export their capital to other, more promising, economies, thus aggravating a local economic downturn. Many caution that the latter possibility could become especially relevant in case of financial fragility at the home bank, when a distressed bank holding company re-patriates capital causing lending restrictions for foreign subsidiaries. Another worry is related to the case of cross-border lending which is said to be very volatile. On a *theoretical level*, therefore, foreign bank entry could be either stabilising or de-stabilising for an economy. To obtain greater clarity regarding the net effect in macrostabilisation, a number of authors have turned to *empirical investigations*.

Most empirical papers find a net positive macroeconomic stabilisation effect of foreign bank lending. Following the deregulation of the US banking sector in recent years, where states have opened their borders to non-state banks, Morgan et al. (2003)

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[8] See also European Central Bank (2005), p. 28

finds reduced business volatility as integration allowed banks to diversify against shocks to their own capital. The authors find a de-linking of bank capital growth and employment growth within states, as state banks became increasingly interlinked with non-state banks. In addition, falling state-specific variation in employment and personal income growth is demonstrated, even when taking into account different growth rates or aggregated business cycles. Overall the benefits of bank integration are most pronounced in the least diversified states. The smaller and more correlated state business cycles lead the authors to speculate that banking integration might be one factor behind the recently observed decline in aggregate US economic volatility. Similarly, Hughes et al. (1999) demonstrate that US interstate consolidation improved bank efficiency, particularly when the objective of the consolidation was to diversify macroeconomic risk and so to reduce insolvency risk. Although those papers are mainly drawing on US experiences, the conclusion seems to be that banking integration results in reduced business volatility and enhanced overall macroeconomic stability due to geographical risk spreading. These understandings combined with the often observed large differences in economic cycles across the Member States in the EU, lead to the conclusion that banking integration might have a similar beneficial effect in Europe as well.

De Haas and Van Lelyveld (2003) study whether foreign owned banks have reacted differently than domestically owned banks to prevalent business cycle conditions and host country banking crisis. For this, the authors look at the effects of foreign bank entry into Central and Eastern Europe. Their dataset panel comprises data on more than 300 banks for the period 1993-2000 with detailed bank ownership information. The authors demonstrate that during crisis periods domestic banks contracted their credit and deposit bases, whereas foreign banks did not. Additional evidence for this thesis comes from Peek and Rosengreen (2000), Crystal et al. (2002) and Goldberg et al. (2000). All three papers – focusing on developments in an emerging market context in Latin America - agree that foreign owned banks were better able to absorb losses when compared with domestically owned banks and have thereby strengthened the financial systems of their host countries.

Another finding of De Haas and Van Lelyveld is that deteriorating home-country conditions lead foreign holding companies to encourage their foreign subsidiaries to increase their lending activities in order to compensate for the lack of profitable investment conditions for their mother banks in the home country. This is taken by the authors as an indication that the parent bank allocates scarce capital among its subsidiaries on the basis of expectations of national risk/return characteristics.

While Peek and Rosengreen (2000), Montgomery (2003) and Clarke et al. (2001) stress the overall stabilisation effects of the presence of foreign banks, the authors find in an emerging market context that the stability of foreign bank lending varies by method of entry with foreign cross-border lending most volatile. In contrast, as suggested by Montgomery, branch lending is more stable and foreign subsidiaries' credit seems to be the most reliable. However, the latter two papers cite limited empirical evidence on this matter and call for further research. An interesting perspective on the issue is offered by Martinez Peria et al. (2002) who seem to suggest that cross-border lending might represent the first phase of a bank's foreign expansion. The authors find more stable lending behaviour as branch and subsidiary lending becomes more important over time. However, the apparently more volatile

off-shore lending might point to a role for banking supervision in maintaining financial stability.[9]

In contrast, a destabilising effect of foreign banks is shown by Peek and Rosengren (1997a) who find that – following the Japanese stock-market decline - binding risk-based capital requirements resulted in a decreased lending by Japanese banks in the United States. While Martinez Peria et al. (2002) confirm that banks transmit shocks from their home countries, an increasing overall exposure of a foreign bank to a host country leads to a decreasing shock transmission effect. Goldberg (2001) finds that US foreign bank claims are highly correlated with US GDP growth, but not with foreign demand conditions of other industrial countries and of emerging Asia. However, lending to Latin America expands in line with US GDP growth.

Although foreign banks' ability to follow different lending cycles than domestically owned banks seem to result in much needed stabilisation effects during crisis time, there is also evidence of destabilising effects, which would suggest a role for efficient and properly designed supervisory and regulatory structures. Overall, though, the presence of foreign banks seems to exert a stabilising effect on the domestic economy. This seems to be confirmed by the recently acceded Member States' experience, where the relatively strong links between their banking systems and those of the "older" Member States seem to have resulted in a more positive than negative experience.[10]

2.3. Consolidation and banking sector performance

A significant consequence of EU banking integration will be consolidation – both domestic and cross-border – reflecting structural adjustments to a more competitive environment and the availability of increased scale and scope economies.[11] The following examines therefore the relevant effects of consolidation on client welfare, operating efficiency, profit efficiency and overall efficiency.

Client welfare

The impact of consolidation on banking-sector performance remains controversial.[12] However, a number of empirical papers indicate that banking consolidation – if successful - increases client welfare by improving lending rates and credit access for borrowers, as well as raising deposit rates but over longer time periods.[13] For example, Bonaccorsi di Patti and Gobbi (2002) show that bank consolidation

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[9] Caution might be recommendable before applying those results too literally in an EU context, which is so fundamentally dissimilar in institutional, economical and political terms when compared with off-shore lending to emerging markets.

[10] On this see Section 3.2 of this paper and European Central Bank (2005).

[11] Integration and cross-border consolidation are expected to coincide, although – theoretically – it would be possible to observe the one without the other.

[12] For example Schenk (2000) declares most banking mergers to be economic failures.

[13] Banking fees are not a focus of the analysis for most papers.

improves the availability of credit for (high-quality) corporate borrowers. Using a set of Italian banks with a high number of small and privately held companies as clients, Sapienza (2002) discovers that in-market mergers (involving banks operating previously in the same geographical area) benefit borrowers if such mergers involve the acquisition of banks with small market shares, as rates charged by the consolidated bank decline. However, this effect is reversed if the merged banks increase their combined market share significantly, possibly due to competition problems. The positive interest rate effect is equally found in out-of market mergers (involving banks previously operating in another geographical area), but to a lesser extent.

In contrast, some analyses, e.g. the just cited Sapienza (2002), indicate that smaller borrowers are disadvantaged by bank consolidation to the extent that long-standing bank-client relationships and lending policies are disrupted, and the transfer of information from the target institution to the acquiring bank is not smooth. Moreover, evidence suggests that the problems for small borrowers increase with the size of the acquiring bank, with larger acquiring banks tending to cut off many more small borrowers. In an emerging market context, Berger et al. (2001) find large size and foreign ownership of banks as being statistically significant barriers for providing relationship lending services in Argentina. The effect seems to be most pronounced for small businesses with delinquencies in repaying loans. In surveying a sample of small US firms in the mid-1990s, Scott and Dunkelberg (2003) find that banking consolidation has no significant effect on small firms' ability to obtain loans. However, they seem to increase non-price loan costs (e.g. service fees) as well as leading to a deterioration in service quality and an increase in the frequency of small companies changing banks.

Peek and Rosengren (1997b) argue that bank consolidation need not always curtail small business lending. The authors state that an acquiring bank tends to recast the target bank in its own image, which leads the new consolidated bank to have a similar portfolio composition of small business clients to that of the acquiring bank. In this respect, bank consolidation would be problematic for smaller enterprises if the acquiring bank was not already a significant lender to such enterprises. However, the authors point out that in roughly half of the commercial and savings bank mergers in the United States, the acquirer had a larger small business loan portfolio than the target bank. In addition, the most common acquirer of a small bank had been another small bank. Consequently, bank consolidation may actually promote small-business lending because acquirers are almost as likely to have larger as well as smaller shares of small business loans in their portfolios, when compared to their targets. Karceski et al. (2000) assess the impact of bank consolidation on borrower's welfare by analysing share price reactions of corporate borrowers to the merger announcement using a Norwegian data set. They find that small borrowers of target banks seem to benefit from small banking mergers, as reflected in a share price gain, while their share prices fall when two large banks merge.

With respect to deposit-holders, Focarelli and Panetta (2002) find strong evidence that banking consolidation leads to rising deposit rates in the long run, thus overcoming possible adverse price changes immediately following a merger or acquisition. It is worth noting, however, that retail banking markets are overwhelmingly local and evidence suggests that strongly rising local bank concentration rates tend to be

associated with lower interest rates on deposits (e.g. Simons and Stavins, 1998). Similarly, Prager and Hannan (1998) demonstrate that a more pronounced decline in deposit rates is observable in those local markets where substantial horizontal banking mergers have taken place when compared to other markets where no such mergers have occurred. Corvoisier and Gropp (2001) fail to find higher bank margins in savings and time deposits in a European context, but find higher margins on loan interest rates and demand deposits.[14] Therefore, a disproportionate domestic consolidation may impact negatively on client welfare due to rising national banking concentration rates and consequently rising prices. Cross-border bank consolidation in segmented markets, though, could strengthen competition to the extent that market entry is facilitated (See Excursus following Section 3 for further discussion).

Operating efficiency

While the balance of evidence suggests that - in the absence of strongly concentrated banking markets - consolidation leads to welfare gains for clients, evidence of efficiency gains within consolidated banks seem to be much less clear-cut. In a meta-examination, Rhoades (1994) considers thirty-nine empirical studies of bank consolidation and efficiency that were undertaken between 1980 and 1993. About half of the studies use an "operating-performance" approach, thus observing the financial performance of banks following a merger or acquisition. The other half comprises "event" studies, measuring the reaction of stock prices of acquirer and target banks, subsequent to a merger or acquisition announcement. The findings of the operating-performance studies point to a lack of improvement in bank efficiency or profitability as a result of mergers, while results of the event studies fail to find rising stock prices – when prices of bidders and targets are combined - in response to mergers. In a more recent overview, Pilloff and Santomero (1997) fail to establish statistically significant post-merger gains, either in share value gains or in an improvement in performance indicators as derived from accounting data. Investigating bank consolidation benefits for various industrialised countries, Amel et al. (2002) find economies of scale mainly for mergers and acquisitions involving smaller banks, while convincing evidence for economies of scope or gains in managerial efficiency is not found.

The absence of observed efficiency gains from bank consolidation may be explained by various efficiency barriers in bank mergers and acquisitions. In respect of cross-border EU merger and acquisitions, Vander Vennet (2002) points out that the typical deal is characterised by the takeover of a poorly performing bank by a relatively efficient foreign bank. The paper finds evidence of an increase in realised profits, but not in operational efficiency, at least in the short term. The author explains these findings by reference to different legal and tax systems, which prevent the full exploitation of synergies in cross-border bank consolidation. A slightly differentiated picture is presented by Hughes et al. (2003), where the key for successful banking mergers is said to be efficient bank corporate governance structures. The analysis finds that an increase in acquired assets improves the financial performance of banks with less entrenched management – defined as a low proportion of the bank owned by management. On the other hand, an increase in acquired assets tends to worsen performance of banks with a more entrenched management, which may prefer to

[14] Akhavein et al. (1997), though, do not find significant price changes for loans and deposits following mergers in their sample.

"build empires" rather than seek the most valuable acquisitions. The analysis suggests that acquisitions might allow an entrenched management to increase its consumption of agency goods (defined as perks) and also to avoid effort and risk.[15] The authors explain their result by suggesting that managers owning banks are better able to resist the pressure of market discipline, while a large share of outside owners can have an incentive to monitor management performance more strictly.

A number of analyses argue that efficiency gains from bank consolidation are understated due to measurement problems. Unlike most studies which use financial data or estimates of managerial efficiency, Haynes and Thompson (1999) examine the impact of acquisitions on building society banks' productivity over the period 1981-1993 using a Cobb-Douglas production function approach. The authors find evidence of productivity gains from consolidation, whereby the effect is steadily *increasing* over a period of six or more years subsequent to an acquisition. This is explained by the gradual dismissal of initial retained staff, which had received employment assurances for an immediate post-acquisition period. This observation shows also that a short-term orientated assessment – such as possibly reflected in share price changes - might not always take longer term efficiency effects into account.

Another reason for understating gains from banking-sector consolidation in US studies might be found in accounting rules, as discussed in a study by Kwan and Wilcox (1999). Two methods exist in the US General Accepted Accounting Principles (GAAP) to account for banking mergers and acquisitions - purchasing accounting and pooling-of-interest. In purchasing accounting, the difference between the (usually higher) purchasing price and the book value of the target's bank equity (including its premises and equipment) is recorded as goodwill, an intangible asset. As intangible assets must be amortized and expensed, the consolidated bank's depreciation charge and amortization expense will rise instantly, even if there is no change in performance of the consolidated bank after the merger. On the other hand, in pooling-of-interest accounting, the reported assets of the new consolidated bank would be equal to the sum of the reported assets of the two merging banks. The authors argue that a significant use of the purchasing accounting approach for reporting results and rising share prices after M&As (as was the case in the 1990s) would aggravate the negative effect on reported expenses. With data corrected for these factors, evidence is established of significant efficiency gains and reduced operating costs, both in terms of labour costs and other expenses. Finally, the analysis finds evidence of efficiency gains from bank consolidation. Huizinga et al. (2001) find improving cost efficiency for consolidating banks, both for large and small bank mergers, often especially pronounced when both banks portray poor pre-merger cost efficiency.

Profit efficiency

Cost efficiency is defined as a cost reduction per unit of output for a given set of output quantities and input prices. However, Akhavein et al. (1997) investigate profit efficiency, which is taking cost considerations *and* revenue considerations into account. Profit X-inefficiency is the failure of producing the highest value of output for a given set of input quantities and output prices. One example would be a profit X-

[15] A similar point is made by Bertrand and Mullainathan (2003) who observe that managers prefer to have a quiet live if they are insulated from takeovers.

inefficient firm which produces too few outputs for given inputs or is inside its production possibilities frontier.[16] Another example would be a profit inefficient firm operating on the production possibilities frontier but responding inadequately to relative prices and therefore producing too little of a high-priced output and too much of a low-priced output. In case customers prefer services (i) that can only provided by a larger firm or (ii) that are complementary to each other (one-stop shopping), profit efficiency can also be the function of scale or scope economics. For overall economic welfare an increase in the value of output – associated with higher profits - is equally beneficial than a decrease of costs. In their data set, merging banks tend to shift their output mixes towards high profit products, possibly because the new consolidated bank may have improved risk diversification opportunities allowing for a higher loan/asset ratio. Consequently, the authors demonstrate that their sample of merged banks significantly improved profit efficiency on average. Two alternative hypotheses - on why profit efficiency goes up following bank mergers - are advanced on the basis of available evidence. First, the *relative efficiency hypothesis* which states that the acquiring bank tends to bring the acquired bank towards its own level of efficiency, and the *low efficiency hypothesis* where the merger event would act like a "wake-up event" (possibly also used as an excuse), causing substantial restructuring and efficiency improvements to increase the profitability of both parts of the combined institution.

Overall efficiency

Banking mergers can also improve the sector's overall efficiency and resilience to economic shocks. Beck et al. (2003) look at banks in 70 countries from 1980 to 1997 and find a higher resilience to economic shocks in more consolidated banking systems with better diversified banks, which are also easier to monitor. On the other hand, too concentrated banking system might be subject to other forms of idiosyncratic risks undermining the financial system such as in case of scandals or fraud.

One area where consolidation can clearly bring efficiency gains is in the elimination of excess capacity, particularly as the alternative method is through bank defaults. As DeYoung and Whalen (1994) find that failed banks are significantly less efficient than their peers, consolidation can be a means to eliminate relatively inefficient banks.

3. Banking integration and consolidation

3.1. Factors facilitating banking sector integration and consolidation

Consistent with the economic rationale outlined above, several factors have combined to facilitate integration and consolidation within the EU banking sector over the past quarter of a century. These include (i) the globalisation of the international financial system due to the liberalisation of international capital movements and financial deregulation within countries; (ii) major technological advances, particularly in the field of data processing; (iii) improvements in the cross-border regulatory environment linked to the Single Market Programme and the introduction of the euro,

[16] The concept of X-efficiency has been introduced by H. Leibenstein.

which has eliminated exchange risk in the bulk of financial flows within the EU; and (iv) a diminishing effect of so-called natural barriers such as language and culture.

Globalisation is a broad phenomenon, encompassing social, cultural and technological integration. Economic factors – notably the consensus on the benefits to international trade and investment - have played a major part in promoting the globalisation process. In a narrower context, the liberalisation of capital movements - to finance the growth of international trade and investment – has had a specific impact in integrating the international financial system (IFS). An important feature of integration in the IFS has been the internationalisation of the banking sector. In consequence, an increasing number of banks have chosen to hold significant assets outside of their home jurisdiction.[17] To some extent, this internationalisation of balance sheets has been achieved by cross-border mergers and acquisitions.

Globalisation of the IFS has been associated with a shift from bank-centred to market-based financing. This shift has been reflected in the asset composition of banks, as higher-rated borrowers have turned to direct financing via the markets for commercial paper and corporate bonds. The result has been a dramatic change in the income profile of banks, with the proportion of interest income declining relative to income from more fee-based activities. On the liability side, a search for yield has prompted an outflow of depositor funds from banks to a range of competing financial products. The relative decline in banks' core business areas, combined with an increasing focus on shareholder value, has encouraged banks to look for attractive consolidation opportunities both domestically and abroad.

Technological change has fostered bank consolidation, particularly to the extent that advances in information technology have led to declining costs for information collection, storage, processing and transformation. An obvious consequence of advanced information technology for banking has been the substitution of paper-based methods with computer and powerful telecommunication systems. The resulting centralisation of many services has yielded significant cost savings - not only in the back office but also in trading, brokerage etc. Internet and automated lending technologies have shaped new electronic delivery channels, enabling banks to enlarge their delivery capacity, and thereby facilitate the distribution of a wider array of products/services to a larger number of clients over a wider geographical area.[18] In addition, the harnessing of information technology has allowed tailored products to be targeted directly at specific clients.

As technology has extended the range of services provided by the banking sector, distinctions between various service categories have become blurred (e.g. between banks and payment providers) and banks have increasingly engaged in non-traditional activities and non-banking institutions and securities firms have been able to make

[17] In a study published in 2000, 38 out of the top 50 international banks are found to have at least 30 per cent of their assets abroad. See: The Banker, internet edition, published 1 February 2000.

[18] Berger (2003) finds that technological advances have increased productivity and scale economies in processing electronic payments and have as well reduced costs, in some cases by more than 50 percent. One notable feature seems to be in that respect the adoption of small business credit scoring technology, which has enabled banks to lend to "marginal applicants" that might otherwise not have received bank credit.

inroads into traditional banking activities (e.g. loans, brokerages). In consequence, new technologies are said to have increased the optimum bank size, providing a powerful rationale for consolidation.

Another key factor facilitating banking integration and consolidation has been regulatory reform. In the 1980s, there was a marked shift in government attitudes toward banking, which had long been treated as mercantilist industry and subject to considerable public-sector interference. The move away from a "government knows best" approach led to a relaxation in many constraints on the banking sector. Market discipline and risk-based capital guidelines were the hallmarks of the new era, replacing the extensive focus on safety concerns and protective regulations.[19] The new regulatory style supported a re-orientation towards more efficiency through competition, and encouraged a relaxation of a number of barriers previously hindering banking consolidation.[20] Moreover, efforts to promote an EU internal market in financial services intensified from the mid-1980s onwards, holding out the prospect of a much larger and more liquid "domestic" market for banks operating in the EU. In that respect, the introduction of home country supervisory control and the single licence raised hopes for EU banking sector integration and consolidation (see Sections 4 and 5). The introduction of the euro – together with the accompanying infrastructure such as TARGET - signalled a step change in financial integration and, by eliminating exchange rate risk on the bulk of intra-EU financial flows, created the potential for economies of scale and scope within the financial sector - and more specifically banking.[21] This development might have also enhanced the attractiveness of the EU as a banking market for third country banks.

So-called "natural" barriers to banking consolidation emerge in the form of national-based market differences, which relate to language, cultural preferences and considerations of geographical proximity. While such barriers are very difficult to overcome completely, developments in recent years have mitigated their effect. For example, barriers related to geographical distance or a high cost of cross-border information and communication have been eased by advances in information technology (e.g. wider Internet access) and by lower telecommunication prices due to liberalisation. In this way, many natural barriers now represent management challenges rather than insurmountable obstacles.[22]

[19] It is noteworthy that the coming implementation of the Basel agreement (Basel II) would allow some banking institutions to use less capital for their operations, allowing therefore the freed-up capital to be used for other activities, including for a renewed focus on Mergers and Acquisitions.

[20] For example Stiroh and Strahan (2003) argue that in competitive environments, like manufacturing and in the telecommunication industry, capacity has the tendency to go to high productivity plants, making thus the overall sector more productive. The study provides evidence that deregulating banking markets may have had a similar effect on US banks with the link between performance and market share increasing significantly over time.

[21] See for a discussion Kleimeier and Sander (2002) and Cabral et al. (2002).

[22] Berger and DeYoung (2000) suggest that efficient organisations can overcome distance effects and there may be no optimal geographic scope for banking institutions.

3.2. Consolidation in the EU banking sector

Bank consolidation has progressed rapidly in the Member States of the EU 15 since the introduction of the euro, however, cross-border consolidation is lagging behind. Domestically-owned banks continue to dominate their domestic banking sector, except for some retail market integration movements which achieved integration on a limited scale, such as in the Benelux and Nordic countries.[23]

Consolidation within Member States

An examination of trends in consolidation within Member States reveals a sharply declining number of credit institutions. Between 1997 and 2003, the number of credit institutions fell by almost 35% in Germany, by over 25% in France and the Netherlands and in excess of 20% in the United Kingdom. In Belgium the number of institutions has declined by more than 17%. Running counter to this generalised trend, the number of credit institutions in Ireland increased by almost 13%, while the respective numbers advanced as well in Greece (7,3%) and in Finland (5,2%). Calculating EU and euro-area aggregates based on these national numbers, the number of credit institutions declined by 23,7% in the euro area and by more than 22% in the EU15 according to the most recent data available (see Table 1).

Table 1: Number of credit institutions, change in %

Country/Year	1997	1998	1999	2000	2001	2002	2003	97-03 change in %
Belgium	131	123	117	118	112	111	108	-17,6
Denmark	213	212	210	210	203	178	203	-4,7
Germany	3420	3238	2992	2742	2526	2363	2225	-34,9
Greece	55	59	57	57	61	61	59	7,3
Spain	416	404	387	368	366	359	348	-16,3
France	1258	1226	1158	1099	1050	989	939	-25,4
Ireland	71	78	81	81	88	85	80	12,7
Italy	909	934	890	861	843	821	801	-11,9
Luxembourg	215	212	211	202	194	184	172	-20,0
Netherlands	648	634	616	586	561	539	481	-25,8
Austria	928	898	875	848	836	823	814	-12,3
Portugal	238	227	224	218	212	202	200	-16,0
Finland	348	348	346	341	369	369	366	5,2
Sweden	237	223	212	211	211	216	222	-6,3
UK	537	521	496	491	452	451	426	-20,7
Euro area 12	8637	8361	7954	7521	7218	6906	6593	-23,7
EU 15	9624	9337	8872	8433	8084	7751	7444	-22,7

Source: European Central Bank (2004): Table 1, own calculations.

Further evidence of bank consolidation can be found by examining the number of local banking units (branches). Here, the number of banking units declined by 46% in the Netherlands, by over 32% in Belgium, and by slightly more than 25% in Germany. In contrast, the number of local units increased significantly in Greece

[23] Unlike wholesale market activities like inter-bank and investment banking activities which are more integrated.

(31,5%), Italy (19,1%) and in Portugal (14,6%). For the euro area and EU15 the number of branches declined by 7,4% and 8,0% respectively.

Table 2: Number of local banking units, change in %

Country/Year	1997	1998	1999	2000	2001	2002	2003	97-03 change in %
Belgium	7358	7129	6982	6616	6168	5550	4989	-32,2
Denmark	2283	2291	2294	2365	2376	2128	2118	-7,2
Germany	63186	59929	58546	56936	53931	50867	47351	-25,1
Greece	2510	2779	2850	3004	3134	3263	3300	31,5
Spain	38039	39039	39376	39311	39024	39021	39762	4,5
France	25464	25428	25501	25657	26049	26162	25789	1,3
Ireland	942	1026	977	880	970	926	924	-1,9
Italy	25601	26748	27134	28177	29270	29926	30502	19,1
Luxembourg	318	324	345	335	274	271	269	-15,4
Netherlands	6800	6787	6258	5983	5207	4610	3671	-46,0
Austria	4691	4587	4589	4570	4561	4466	4395	-6,3
Portugal	4746	4947	5401	5662	5534	5390	5440	14,6
Finland	1289	1254	1193	1202	1257	1267	1252	-2,9
Sweden	2521	2197	2140	2059	2040	2040	2061	-18,2
UK	16344	15854	15387	14756	14554	14392	14186	-13,2
Euro area 12	180944	179977	179152	178333	175379	171719	167644	-7,4
EU 15	202092	200319	198973	197513	194349	190279	186009	-8,0

Source: European Central Bank (2004): Table 2; own calculations

The reduction of local banking units per 100.000 inhabitants is even slightly more pronounced (see Table 3).

Table 3: Number of local banking units per 100.000 inhabitants, change in %

Country/Year	1997	1998	1999	2000	2001	2002	2003	97-03 change in %
Belgium	72	70	68	65	60	54	48	-33,3
Denmark	43	43	43	44	44	40	39	-9,3
Germany	77	73	71	69	65	62	57	-26,0
Greece	23	26	26	28	29	30	30	30,4
Spain	97	99	99	98	97	96	97	0,0
France	43	42	42	42	43	43	42	-2,3
Ireland	26	28	26	23	25	24	23	-11,5
Italy	45	46	47	49	51	52	52	15,6
Luxembourg	76	76	80	76	62	61	60	-21,1
Netherlands	44	43	40	38	32	29	23	-47,7
Austria	59	58	57	57	57	55	54	-8,5
Portugal	47	49	53	55	54	52	52	10,6
Finland	25	24	23	23	24	24	24	-4,0
Sweden	28	25	24	23	23	23	23	-17,9
UK	28	27	26	25	25	24	24	-14,3
Euro area 12	60	59	59	58	57	56	54	-10,0
EU 15	54	53	53	52	51	50	49	-9,3

Source: European Central Bank (2004): Table 3; own calculations

Trends in cross-border consolidation

An examination of trends in cross-border bank consolidation reveals a rather mixed picture at the wholesale level (bank-to-bank or bank-to-large companies) but very little evidence of consolidation at the retail level.[24] No truly "Pan-European bank" has emerged at the retail level and the market share of foreign branches and subsidiaries in other Member States is low, except in the case of some smaller Member States such as the Benelux and the Nordic region. Evidence of fragmentation in the retail market is found in the dispersion of company loan and household interest rates, although the dispersion has trended downwards in recent years (with the exception of consumer loans). Differences in bank profitability across countries are another indication of fragmentation. Direct cross-border provision of traditional banking services remains small in absolute terms and seems relevant only for large customers.

Foreign banks in recently acceded EU Member States[25]

Most of the recently acceded EU Member States are special in that they exhibit an elevated level of foreign-owned banks. Although foreign ownership of banks in the new Member States has occurred outside the current Community framework for financial integration a combination of factors (some of them one-off) seem to explain the phenomenon of a high market share of foreign owned banks.[26]

Banks previously operating under a centrally-planned regime were ill-prepared to meet the challenges of the transition to a market-based economy, lacking the necessary risk management skills and a capacity for effective scrutiny of lending. In consequence, many governments decided to embark on major privatisation processes by inviting foreign institutions to enter the market - bringing with them the necessary know-how and experience. In addition, the relatively strong economic performance of these Member States, partly due to a catching-up process, transformed them into an attractive market for foreign banks. Anticipation of EU membership might have played a role as well.

The resulting share of foreign-owned banks is especially high in Estonia (97,3%), the Czech Republic (96%), Slovakia (96,3%) and Lithuania (95,6%). The market share of foreign-owned banks amounts to 83,3% in Hungary, 67,8% in Poland and 67,6% in Malta. In contrast, the share of foreign banks is below 50% in Latvia (47,2%), Slovenia (36,0%) and Cyprus (12,3%).

[24] See European Commission (2004a and 2004b). Other Papers discussing EU banking integration would be for example: Baele et al. (2004), Cabral et al. (2002), Corvoisier and Gropp (2001), Dermine (2002), Kleimeier and Sander (2002) and Vander Vennet (2002). For a short survey see Manna (2004).

[25] The figures on asset shares of foreign-owned banks are based on European Central Bank (2005).

[26] This might also explain the relative high level of concentration in the recently acceded EU Member States. On concentration values see European Central Bank (2005).

Excursus: Rising concentration ratios and consumer welfare

As the demand side of EU retail banking remains largely fragmented between Member States, national concentration ratios are a useful guide for measuring competition. Here, the consequence of the rapid pace of domestic consolidation and the absence of cross-border consolidation is a rise in concentration ratios at the national level as measured in asset terms of the 5 largest domestic banks (see Table 4).[27] Since 1997, the rise in domestic concentration ratios has been notable in Belgium (+29), Portugal (+17), Spain (+12) and Greece (+11). Only three Member States (Denmark, Finland and Sweden) experienced a decline in their respective concentration ratios, although one of them, Finland, exhibits a still very high concentration rate. Similarly, the degree of concentration is already very high in some of the Member States not witnessing a sharp advance in concentration ratios, such as for example in the Netherlands with an index level of 84.

Table 4: Asset share of 5 largest banks and change

Country/Year	1997	1998	1999	2000	2001	2002	2003	97-03 change
Belgium	54	63	76	75	78	82	83	+29
Denmark	70	71	71	60	68	68	67	-3
Germany	17	19	19	20	20	20	22	+5
Greece	56	63	67	65	67	67	67	+11
Spain	32	35	41	46	45	44	44	+12
France	40	41	43	47	47	45	47	+7
Ireland	41	40	41	41	43	46	44	+3
Italy	25	25	25	23	29	31	27	+2
Luxembourg	23	25	26	26	28	30	32	+9
Netherlands	79	82	82	81	83	83	84	+5
Austria	44	42	41	43	45	46	44	0
Portugal	46	45	44	59	60	60	63	+17
Finland	88	86	86	87	80	79	81	-7
Sweden	58	56	56	57	55	56	54	-4
UK	24	25	28	28	29	30	33	+9

Source: ECB (2004), Table 6, own calculations.

Another way of examining concentration ratios in the domestic banking sector is by using the Herfindahl index for bank's total assets. The index, which is here defined as the sum of the squares of the asset shares of each individual bank, can range from a number close to 0 (atomic competition) to 10.000 (a single monopolistic firm). According to those numbers, only Denmark (-317) and Sweden (-70) witnessed an

[27] Although the few banks created through cross-border M&As might be included in some national concentration ratios, it would seem that foreign bank entry <u>on a large scale</u> should drive concentration ratios downward or have at least a neutral effect: First, one might point out that in a fully integrated EU market customers would have many more options when compared with the current segmented domestic markets. As a consequence, an integrated EU market (a larger market) would very likely exhibit lower concentration ratios. This reflection is also supported on *an empirical level* by the observation that larger EU Member States seem to have clearly lower concentration ratios when compared with smaller Member States. Second, even if the EU retail market is segmented nationally, the difference between domestic and cross-border M&As is that the latter do not *change* the concentration ratios, while domestic M&As do.

index decline, while all other EU 15 Member States experienced index increases, whereby especially strong advances are noted in Belgium (+1366), but also to a lesser extent in Portugal (+467), Greece (+245), Spain (+236) and Finland (+270). Equally noteworthy are the relatively high index levels in Finland (2420), Belgium (2065) and in the Netherlands (1744). In contrast, the index level of Germany (173) and Italy (240) are relatively low.

Table 5: Herfindahl index for bank's total assets and index change

Country/Year	1997	1998	1999	2000	2001	2002	2003	97-03 index change
Belgium	699	909	1518	1506	1587	1905	2065	+1366
Denmark	1431	1442	1499	863	1119	1145	1114	-317
Germany	114	133	140	151	158	163	173	+59
Greece	885	1165	986	1122	1113	1164	1130	+245
Spain	285	329	441	581	551	529	521	+236
France	449	485	509	587	606	551	597	+148
Ireland	500	473	480	486	512	553	562	+62
Italy	201	210	220	190	260	270	240	+39
Luxembourg	210	222	236	242	275	296	315	+105
Netherlands	1654	1802	1700	1694	1762	1788	1744	+90
Austria	515	515	511	548	561	618	557	+42
Portugal	577	575	566	986	991	963	1044	+467
Finland	2150	2120	1960	2050	2240	2050	2420	+270
Sweden	830	790	790	800	760	800	760	-70
UK	208	221	250	264	282	307	347	+139

Source: ECB (2004), Table 7, own calculations.

While the evidence on pricing power does not indicate a widespread problem with competition, concentration in domestic banking sectors could imply that the benefits of consolidation fail to filter down to the consumer. Some have even suggested that the rationale for the large amount of domestic M&As when compared to cross-border M&As derives from the fact that domestic M&As increase market power while cross-border M&As do not.

It is also often claimed that another consequence of the lack of an integrated EU banking environment might be that competition policy would limit the capacity of banks in smaller Member States to achieve sufficient size to compete on a regional or global level – as domestic consolidation would more rapidly lead to problems of excessive market share. The cited interaction of competition policy and consolidation within domestic markets might therefore indirectly favour banks in larger Member States relative to their counterparts in smaller Member States (Hyvärinen, 2002).[28]

[28] However, critics of that assertion contend that this "critical mass" argument is overstated and that intensive ex-ante domestic M&A activity could make international expansion even more difficult due to the additional debt burden and reorganisation effort that M&A activities usually entail.

4. Avenues for cross-border bank consolidation within the EU

Integration of the EU banking sector can proceed along three different avenues, namely through (i) organic growth in the form of foreign branches and subsidiaries; (ii) consolidation via cross-border mergers and acquisitions; and (iii) the provision of services on a cross-border basis, allowing customers to choose banking products freely from their country of choice. This section examines the extent of obstacles to integration along each of these avenues.

4.1. Organic growth in the form of foreign branches and subsidiaries

Current EU legislation on banking aims to facilitate organic growth by granting each bank a license valid in all of the Member States, enabling them to establish a foreign branch which is subject to home-country supervision.[29] The objective is to allow a bank from one Member State to enter the domestic market of other Member States without the need to report to multiple supervisors. As a bank operating across borders via subsidiaries is subject to host-country supervision in each and every Member State - in addition to home-country supervision on a consolidated basis, it would be expected that organic growth across borders would occur mainly via branches and not subsidiaries. In fact, cross-border bank integration has taken place substantially through the establishment of subsidiaries. The number of subsidiaries of other European Economic Area Countries (EEA, involving EU Member States plus Iceland, Norway and Lichtenstein) in EU Member States reached 333 in 2002 with a market share (based on assets) of 19 % when compared with overall GDP in 2001 (latest figure available for EU15); and 23 % in the euro area (already figures for 2002 available). While the corresponding number of cross-border branches in the EU is clearly higher at 571, the market share in terms of assets amounted to only 24 percent of GDP, only slightly above the share recorded for subsidiaries.[30]

The relatively even split between the use of foreign-based branches and subsidiaries is surprising, given the apparent advantages of a branch-based structure in terms of supervisory compliance costs. Several factors may explain this outcome. For example, Dermine (2002) presents a list of possible explanatory factors, such as, among others, (i) that the creation of a subsidiary would help to insulate the mother company from business risk avoiding therefore investor worries about risk shifting towards far-away places; (ii) that the probability of a consolidated branch defaulting would be lower when compared to a subsidiary structure; a subsidiary structure would therefore allow for exploiting the deposit insurance put option in case a subsidiary was to face difficulties; (iii) the possibility of a separate stock market listing.

The inability of a bank to consolidate after a cross-border merger or acquisition is likely to act as another obstacle to the creation of a European banking groups,

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[29] A branch is understood to be a legally dependent part of a credit institution (a bank, for the purpose of this paper), fully allowed to carry out all or some of the transactions inherent in the business of banks. It is worth noting that any number legally dependent parts set up in the same Member State by a single non-domestically authorised credit institution is regarded as a single branch.

[30] European Commission (2004b).

although the European Company Statute may offer a partial remedy in this regard (see the discussion on "Restrictions deriving from company law" in Section 4.2.).

More fundamentally, however, the idea that banks would rush to establish branches in other Member States may have been illusory in view of the fact that banks require local knowledge for screening clients, resulting in the need of a proprietary information accumulation.[31] As each loan applicant presents a specific adverse selection problem, banks already active in a specific market have an informational advantage over new entrants, not only in respect of potential clients but also in respect of local market characteristics. Supporting those arguments, economic research suggests that foreign banks tend to have lower interest margins, lower profitability than their domestic rivals (Claessens et al., 2001).[32] Banks would, therefore, be expected to hesitate in establishing greenfield operations in other Member States – especially for retail clients - and may prefer to enter a foreign banking market through mergers or acquisitions.[33] However, numerous obstacles lie along this avenue also.

4.2. Cross-border consolidation

Cross-border mergers and acquisitions are another possible avenue for integration in the EU banking sector. Mergers can be defined as the combination of two organisations (with comparable size) into one legal entity. Acquisitions are transactions where one firm purchases a controlling stake of another one, without necessarily combining the involved firm's assets. According to the available data, cross-border mergers and acquisitions have not been a major feature of the EU banking sector. In terms of numbers, mergers and acquisitions among domestic credit institutions represent about 80 percent of total consolidation activity in the EU in each year since 1992[34] (see Graph 1). The only clear pickup in cross-border mergers and acquisitions is evident in the run up to the creation of the single market in 1992, when the share of domestic mergers fell to about 60 per cent. However, cross-border mergers and acquisitions have never come close to exceeding domestic mergers and acquisitions.

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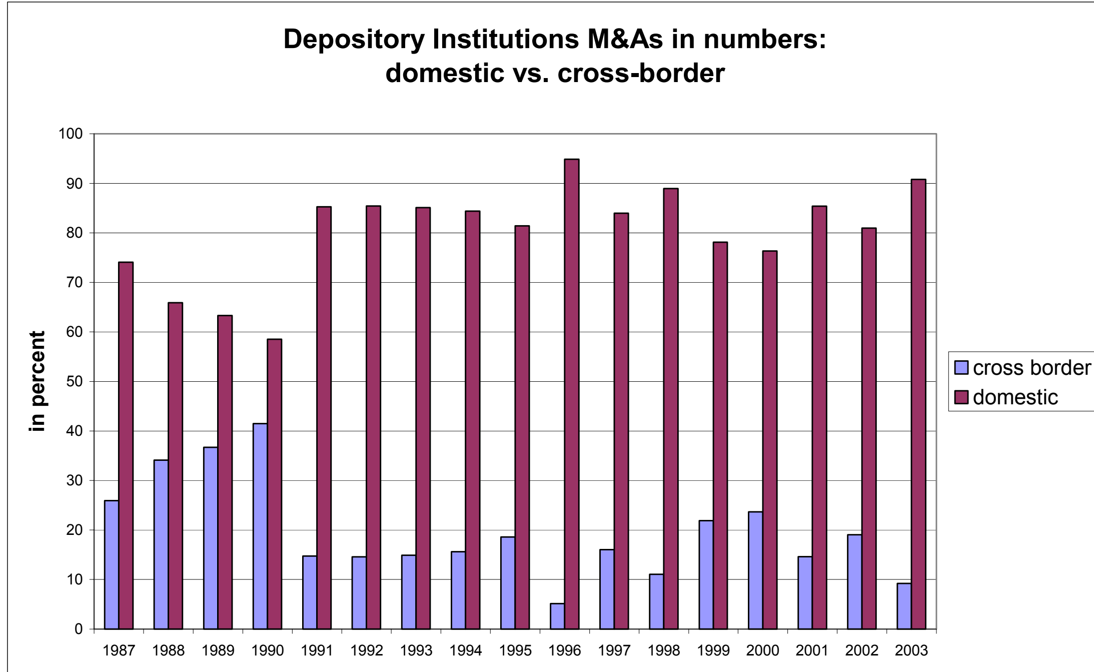
[31] See Marquez (2002) and also Kaas (2003) models on bank entry.

[32] While the reverse seems to be the case for foreign banks in developing countries.

[33] The banking group Nordea provides an interesting – and unusual - example as it pursued first cross-border M&As and has been only at a latter stage trying to convert the Group's legal structure through a Societas Europeae into branches (Nordea, 2003).

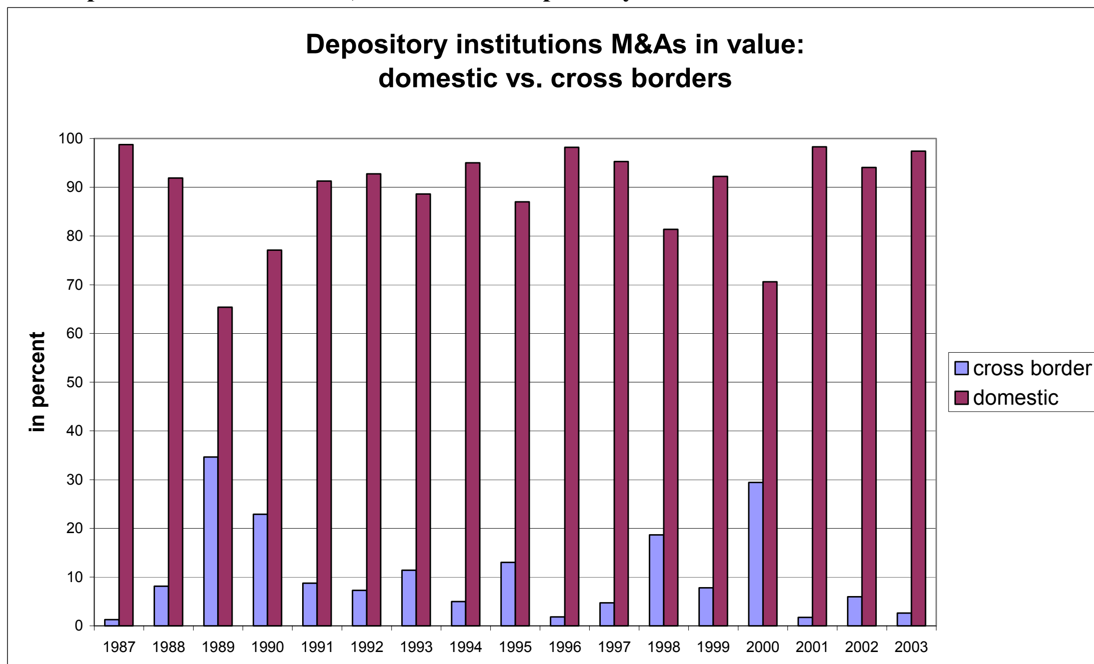
[34] Source of graph 1 and 2: Competition Databases: General Statistics on Mergers and Acquisitions; extraction 3 March 2004; DG Ecfin E2; data comprise completed as well as announced M&As; Data include all EU financial firm mergers from any of the following sectors as bidders into the depository banks as target sector: depository institutions, nondepository institutions and security and commodity brokers; Own calculations. A number of sources confirm a low level of banking cross-border M&As, for example in Schich and Kikuchi (2003) and Buch and DeLong (2001).

Graph 1: share of domestic, cross-border depository institutions on overall M&As in numbers



The dominance of domestic consolidation in total is even more remarkable in terms of value (see Graph 2), accounting for a share of about 90% or more in thirteen out of the last seventeen years and falling below 70% only in 1989. A possible explanation for the different outcomes in terms of numbers and value may be that EU banks pursue modest cross-border value deals in order to escape the involvement of national politicians and regulators.[35]

Graph 2: share of domestic, cross-border depository institutions on overall M&As in value



[35] Wall Street Journal, 2003.

The divergence between bank consolidation at the domestic and cross-border levels is striking in light of the fact that factors facilitating consolidation seem to be present at both levels. Accordingly, it is likely that offsetting obstacles exist at the cross-border level linked to different market evolutions in terms of different market practices, taxation systems, accounting procedures, legal issues etc. Another aspect would be that national banking systems may have evolved differently due to deeply rooted cultural and political preferences, possibly preventing full EU banking integration even in the absence of any kind of barriers. On the other hand, one cannot rule out the possibility that some obstacles have been erected with the specific purpose of preventing cross-border consolidation (see Box).

Box: Rationale for cross-border banking M&A barriers

Banking-sector consolidation can be controversial, with proponents stressing the benefits of increased synergies and cost-savings and opponents warning of job losses and the regularity of failed business strategies. Cross-border consolidation can be particularly controversial because of the inevitable foreign dimension in any transfer of ownership. While concerns relating to cross-border bank consolidation may be legitimate, the existence of "hidden national agendas" cannot be excluded. For example, some have argued that economic openness and international financial integration pose a threat to the domestic corporate establishment, which is able to finance most of its projects through retained earnings and so does not need a competitive banking system.[36] It has also been suggested that domestic banks may oppose foreign entry in an effort to limit competition. As government authorities are involved in the banking sector – often as bank owners and more often as supervisors – national vested interests cannot be excluded as a possible obstacle. In this context, some observers have pointed to "state-induced" barriers to integration, such as explicit and implicit rules against foreign competitors which are sometimes accompanied by strategies to create national champions.[37] [38] One observer sums up the EU situation in the banking sector with the following words (Boot, 1999):

"The domestic banks in Europe were – and are – protected as domestic flagships. A fundamental belief that financial institutions should not be controlled by foreigners has (so far) almost prevented any cross-border merge ...central banks, ministries of finance and the banks operate in close concert. This is not very surprising: a very homogenous group of executives is in charge of the financial sector, central bank and government ministries guaranteeing a clear national identity of domestic institutions.

[36] See Rajan and Zingales (2001, 2003)

[37] See Berger et al. (2000).

[38] See for example Standard & Poor's (2001), stating on page 5: "The influence of domestic … regulators should not be underestimated. Political intervention has played a big part in countries such as Italy, Portugal, and France, where governments have intervened to block outside predators. In these countries, the priority remains the emergence of national champions, strong enough to compete on an international basis."

In countries with explicit government involvement....foreign control over domestic institutions is even more unlikely...unless banks become so inefficient and weak that involvement of foreigners becomes almost inevitable."

Barriers to cross-border mergers and acquisitions

In this section, three broad categories of barriers to cross-border bank integration and consolidation are identified: investment restrictions, differences in taxation and a lack of common financial reporting.[39]

4.2.1. Investment restrictions

Inward investment restrictions are one of the most obvious examples of government intervention to protect national companies and thus potentially impede cross-border consolidation. These restrictions can take several forms, the most important of which are:

Special public control rights of Member States

Wide-ranging restrictions on investments in the Member States were replaced in the 1990s by narrower and more subtle investment restrictions, which focus on liberalised sectors and, more generally, on privatised companies. While the latest generation of restrictions does not formally discriminate against foreign investors, the predominance of domestic actors in privatisations and in mergers and acquisitions over the past ten years provides circumstantial evidence of a possible bias in favour of domestic consolidation. Further evidence is to be found in adopted laws, which have incorporated often admissible exceptions to the Treaty provisions on freedom of capital movements such as 'defence', 'public security', 'public order', or the concept of 'general interest' established by the European Court of Justice (ECJ).[40] The intention would be to ensure that national restrictions are deemed compatible with the Community framework.

Although 'defence'-related considerations were clearly definable, the exact scope of the other exceptions was much more difficult to determine. In this respect, many Member States drew their inspiration from the wave of privatisations in the United Kingdom during the 1980s, when 'golden shares' were heavily used and usually

[39]All barriers affect banking cross-border mergers directly, although some hinder uniquely the banking sector, while others apply to broader sectors of the economy doing cross-border business. The focus is on the cross-border aspect of those barriers. Other obstacles, such as stifling labour law restrictions, possibly complicating post-M&A restructuring are not mentioned as those kind of barriers are equally relevant for purely domestic M&As. The listed barriers might to varying degrees equally be relevant for other sectors of the economy as well, not just the banking sector.

[40] More precisely, the ECJ refers in its rulings to "overriding requirements of the general interest linked to strategic imperatives and the need to ensure continuity in public services".

justified by the need to protect vital national interests.[41] In its rulings on such restrictions, the ECJ has confirmed that some specific economic activities fall within the ambit of a legitimate public interest (e.g. energy supply, telecommunication services). However, commercial banking activities in the traditional sense would not and so impediments to cross-border banking sector consolidation cannot be justified by 'general interest' considerations. Accordingly, some Member States have already been condemned and been required to remove existing investment restrictions affecting specific banks (see box).

Box: Investment Restrictions for Specific Banks – some recent examples

In Portugal, the Framework Law on Privatisation N° 11/90 of 5 April 1990 provided powers to set limits on foreign participation in companies that were being privatised, while Decree-Law 65/94 fixed in 1994 a ceiling of 25% on the participation of foreigners in already privatised companies. Several Decree-Laws implementing the above provisions applied to specific Portuguese banks: *Banco Totta & Açores, Credito Predial Português, Banco Fonsecas & Burnay, Banco Espírito Santo & Comercia de Lisboa, Sociedade Financeira Portuguesa,* and *Banco Português do Atlântico*. Although the above legislation was declared illegal by the ECJ in its ruling of 4 June 2002, the case is not yet been resolved insofar as Portugal has not removed these restrictions so far.

In Spain, the Privatisation Law N° 5/1995 of 23 March 1995 applied to firms in which the State owned more than 25% of the shares in 1995. When the participation of the State in these undertakings is either reduced, via a sale of 10% or more, to less than 50%, or becomes less than 15%, prior authorisation can be required for dissolution, sale of assets, change in business aims, and the acquisition by any investor of 10% of the share capital. Such a procedure had been introduced for a limited duration in six privatised companies, and in particular in *Corporación Bancaria de España SA (Argentaria)*. The ECJ declared the above legislation illegal in its ruling of 13 May 2003 (the authorisation mechanism of Argentaria had elapsed in the meantime).

Restrictions deriving from company law

The inability of firms to consolidate after a successful cross-border merger or acquisition – either because certain operations are impossible (i.e. not foreseen by national company law) or because they result in a costly and time consuming winding-up – acts as another obstacle to the creation of European banking groups. In this respect, the European Company Statute offers a partial remedy. The Statute, which was established in 2001 and entered into force in 2004, gives companies operating in more than one Member State the possibility of establishing as a single company, with a single management and reporting system as well as a single set of

[41] While the United Kingdom chose to enforce its control rights over privatised companies through specific legal means (i.e. the attachment of special rights to one share of the company's capital), other Member States opted for the insertion of such privileges in provisions of public law.

rules.[42] [43] However, several issues are not covered by the Statute and remain subject to national law (e.g. insolvency, intellectual property, taxation). Problems with cross-border operations may persist also because of national differences in inserting the EC regulation governing the statute in their legislative framework.[44] Finally, companies established in Member States, where employee participation is not required, may be deterred by the mandatory negotiations with employee representatives that are contained in the Statute.[45]

Removing restrictions deriving from company law has also been the focus of the Directive on Takeover Bids, which was adopted at the end of 2003. However, serious doubts have been expressed about the effectiveness of the Directive, since national authorities are given ample scope to deviate from the central rules. For example, the Directive embodies the principle of reciprocity, whereby Member States are *allowed* to exempt domestic companies – without obliging them to do so - from the ban on anti-takeover devices when the bidding company comes from a jurisdiction permitting their use.[46]

It should be pointed out that these different layers of optional exemptions - at Member State and company level - actually favour a further fragmentation of the market instead of its integration. Each Member State will have its own policy in this area and, within each Member State, companies will have the option to define their own policy with respect to takeover bids. This means implicitly that any takeover plan will have to be preceded by a preliminary assessment of the legal background applicable on the target company and on the bidding company. Moreover, since the "reciprocity principle" implies a comparative assessment of measures which have been drafted at national level by different Member States, it could be argued that substantial legal uncertainty will remain, even in the case where 'integration friendly' options would have been chosen.

[42] Council Regulation (EC) N° 2157/2001 of 8 October 2001 on the Statute for a European Company (SE).

[43] A similar harmonisation process for cooperative societies led to the adoption of the statute for a European Cooperative Society in 2003, complemented by employee involvement provisions, entering into force by mid-2006. For the European Corporative Society Council Regulation (EC) N° 1435/2003 of 22 July 2003 and Council Directive 2003/72/EC of 22 July 2003 supplementing the Statute regarding the involvement of employees.

[44] In addition, some corporate groups maintain separate subsidiaries in various jurisdictions for tax reasons and might be reluctant to put these benefits at risk by creating a European Company.

[45] Council Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees.

[46] This concerns restrictions on securities transfers and voting rights as well as the right of the board of the target company to issue shares, without prior shareholder authorisation ("poison pills"). Directive 2004/25/EC of the European Parliament and the Council of 21 April 2004 on takeover bids.

Restrictions deriving from prudential considerations

The Community legislation on the control of concentrations between undertakings[47] states that Member States may take appropriate measures to protect several categories of legitimate interests. In particular, prudential rules are regarded as legitimate interests. Therefore, a Member State can adopt measures with regard to a concentration of community dimension in order to protect prudential interests without previously requesting approval by the Commission.

However, the term "prudential interests" has a specific meaning in Community law implying implicitly that Member States have to ensure that interests they consider as being prudential are also recognised as such by Community legislation. In particular, the Council interpreted that prudential interests would cover measures aimed at ensuring the good repute of individuals managing such undertakings, the honesty of transactions and the rules of solvency. Furthermore, these fairly broad concepts should be further interpreted in the light of the ongoing process of harmonisation of prudential rules at EU level.[48] Therefore, while a Member State has a right of initiative with respect to the adoption of prudential rules in the context of concentrations between undertakings, it is also responsible for ensuring the compliance of the detailed measures adopted with Community legislation. As far as the banking sector is concerned, it can be argued that in the past decade several Member States have misused their right of adopting prudential measures in order to fend off unwanted foreign interests in national banks (see Box).

Box: An illustrative example

A well-known illustration of the trend of fending off unwanted foreign interests in national banks was displayed when the Spanish Banco Santander Central Hispano (BSCH) tried to acquire a reference stake in the Portuguese financial group Champalimaud (1999-2000). The group Champalimaud was majority owner of insurance company Mondial Confiança S.A., and the latter owned more than 50% of the capital of several Portuguese banks (Banco Pinto & Sotto Mayor; Banco Totta & Açores; Banco Chemical Finance; Crédito Predial Português). In this particular case, the Portuguese authorities held out for so long against the break up of the Champalimaud group that Commission involvement had been necessary to guarantee the application of the freedom of establishment and the free movement of capital.

The initial negative decision of the Portuguese authorities referred essentially to alleged prudential considerations. In particular, due to the lack of clarity and transparency of the group resulting from the operation, negative repercussions for the stability of the insurance undertaking in question and the financial group depending on it was often cited. In addition, the possibility of an appropriate supervision of the group had been questioned. However, the decision of the Portuguese authorities failed to explain or justify why this operation would have such damaging consequences. As

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[47] Council Regulation (EEC) N° 4064/89 of 21 December 1989 on the control of concentrations between undertakings

[48] Notes on Council Regulation 4064/89

far as the supervision argument is concerned, this would have been especially difficult since BSCH was a well-known financial entity which controlled then already two banking subsidiaries in Portugal, duly authorised by the Portuguese authorities.

The above appears to demonstrate a typical reasoning followed by Member States when confronted with the possibility of intra-EU cross-border mergers and acquisitions in the banking sector. On the one hand, the creation of national champions is informally encouraged by the government. On the other hand, attempts at acquisition by foreign operators are challenged on the basis of relevant competences which remain, at least partially, in Member States' hands, such as prudential rules. Although Community law and, if needed, Commission involvement should ultimately guarantee the full implementation of the right of establishment of the free movement of capital, the prospect of lengthy negotiations with the authorities of the target country may lead some acquiring banks to renounce their cross-border acquisition plans or at least amend them.

4.2.2. Taxation issues

Corporate taxation remains a national responsibility and conflicting (or unclear) national tax systems can lead to uncertainty with respect to the applicable tax jurisdiction and to double taxation. Even when such difficulties can be avoided, the administrative burden due to specific and diverging compliance requirements can be prohibitive. The tax-related barriers, which are most relevant in terms of hampering cross-border bank consolidation, are:

Income flows between associated companies

Income flows between company groups - mainly dividends, interest rate payments and royalties - are not subject to double taxation, if covered by EU Directives. However, the narrow scope of the Directives and implementation problems at Member State level often render the provisions inapplicable, thereby undermining incentives for cross-border consolidation. For example, the "Parent-Subsidiary Directive" aims to avoid the double taxation of dividends, but dividends are only covered by the Directive if the recipient company holds at least a direct 25% capital stake in the foreign company, with indirect holdings not taken into account.[49] If the recipient company is not incorporated as one of the eligible legal forms, dividends do not fall under the Directive's scope. This leaves out legal company forms created after 1990 or omitted from the list by the time of adoption (e.g. Belgian co-operative societies, some Irish banking companies). In addition, it is often said that some Member States interpret the foreseen "anti-abuse" clause (built-in to deny the Directive's application to non-EU held entities) excessively, which led the ECJ to declare as discriminatory some derived national provisions. In mid-2003, the Commission has proposed to extend the list of eligible legal company forms and

[49] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

lowering the threshold from 25% to 10% for the status of parent and subsidiary company.[50]

Starting from January 2004 onwards, interest and royalties payments are covered by another Directive; however similar provisions as in the Parent-Subsidiary Directive would suggest that its application is likely to suffer similar problems.[51] Here too, the Commission has made a proposal to expand the list of eligible company forms.[52]

Cross-border restructuring operations

In order to guarantee the same treatment as in a domestic context, the fiscal treatment of cross-border restructuring operations following mergers and acquisitions is partially harmonised at EU level through the "Merger Directive". However, diverging national merger rules, a narrow scope and transposition problems hamper its application. The Merger Directive prohibits charging capital gains tax on initially tax exempt assets such as provisions and reserves and ensures that cross-border restructuring are subject to the same tax rules as those applied to similar domestic operations.[53] Furthermore, the Directive prohibits the taxation of share exchanges, although Member States may get tax profits generated by a subsequent share sale. However, the list of eligible companies is limited and important tax types are not covered, [54] for example transfer taxes on immovable property (e.g. land registration taxes) as well as some taxes on restructuring operations (e.g. the centralisation of activities initially located in several Member States into a single Member State). The Commission has recently made a proposal to rectify some of the identified problems, which would also expand the Directive's scope to include as well a partial company division ("split off"), where the transferring company continues to exist.[55]

Loss-compensation

In a domestic context, a company can consolidate its profits and losses at group level and pay only taxes on the remaining surplus. This is not always possible on a cross-

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[50] To include as well banking sector relevant cooperatives, mutual companies, certain non-capital based companies, saving banks, funds and associations with commercial activity, adding 'European Company' and 'European Cooperative Society'.

[51] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

[52] Commission proposal of 30 December 2003 for a Council Directive amending Directive 2003/49/EC (COM(2003) 841 final).

[53] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States.

[54] The positive effects of the "Merger Directive" can only be felt once national legislation allows companies to be absorbed or divided by foreign companies. At present, only cross-border transfers of assets or exchanges of shares can be undertaken in all Member States.

[55] Commission proposal of 17 October 2003 for a Council Directive amending Directive 90/434/EEC of 23 July 1990 (COM(2003) 613 final).

border level. While losses incurred by foreign branches may usually be offset at the level of the parent company (subject to special conditions and maximum thresholds), an offset from subsidiaries is often not allowed. In addition, diverging national loss-compensation rules generate even in the case of branches interpretational divergences detrimental to their recognition by tax authorities.[56]

The calculation of transfer prices

Transfer pricing is significant for tax authorities as it affects the tax allocation between different jurisdictions. Companies encounter several problems with the concept in practice. In 1995, the OECD developed guidelines for "Transfer Pricing" which proposed a standardised way for allocating tax revenues for companies operating across borders.[57] The proposed pricing methods are all based on the "arm's length principle", which treats transactions between a company group for tax purposes as if the transaction would have been conducted at market prices, and therefore comparable to conditions of transactions between independent parties. Member States have increased their auditing activities in order to avoid that companies use transfer pricing as a tax avoidance tool (shifting profits from high tax to low tax jurisdictions). This approach seems to entail high administrative costs deriving from complex national documentation requirements and companies face the risk of an eventual dispute with or between Member States' tax authorities, which can involve lengthy and expensive procedures.

In October 2002, the Commission established a Joint Transfer Pricing Forum (involving representatives from tax authorities, industry and consultancy). The Forum works on the basis of consensus to examine possible non-legislative solutions to the practical problems related to the application of the transfer pricing rules in the Internal Market and to those related to the implementation of the Arbitration Convention.[58] The objective is to make the EU Arbitration Convention the prevailing dispute settlement mechanism within the EU for the relief of double taxation resulting from differences in transfer pricing methods in Member States. To achieve this, the Arbitration Convention should provide for appropriate mechanisms to allow double taxation relief quickly and efficiently in as many cases as possible and with the lowest possible costs for business and tax administration. At present, this is far from being the case.

Shortcomings in double taxation treaties

Member States have concluded a number of agreements with the aim of avoiding double taxation of companies operating on a cross-border basis. However, this goal is not always achieved. Article 293 of the EU Treaty requires Member States to negotiate the abolition of double taxation within the EU. Consequently, a network of

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[56] For instance, since the determination of the taxable base and taxable income varies in every Member State, no common "loss" definition exists in the EU. Similar problems arise with the consolidation of profits and losses in the few countries which extend this possibility to potential cross-border losses.

[57] OECD (1995).

[58] Convention on the elimination of double taxation in connection with the adjustment of profits and associated enterprises (COM 90/436/EC).

bilateral double taxation treaties has emerged. However, due to the variety of applicable national tax systems, the complexity of double taxation situations as well as interpretational divergences, the treaties seem to fail in their quest to eliminate double taxation in all cases. For example, complex anti-abuse clauses and a number of exceptions on withholding tax exemptions and on offsetting foreign tax payments make it difficult for corporate groups to determine their treaty benefits. In addition, the very concept of "permanent establishment" – essential for double taxation treaties – has undergone a change in recent years in the face of technological progress (internet) and due to the evolution of corporate group structures.[59]

4.2.3. The absence of common financial reporting

Although the EU has introduced a number of steps towards common reporting for banks,[60] different national accounting standards make the comparison of balance sheets difficult and may, therefore, constitute a barrier for potential bidders in the context of cross-border banking consolidation. For example, a recent report from Standard & Poors describes the difficulties in comparing the quality of credit decisions and the adequacy of provisioning between banks in Western Europe as being "exacerbated ...by the diverse regulations and management practices relating to asset quality accounting." The report goes on to say that "there are major differences between the definitions of impaired, non-performing, and doubtful loans, and related to this, policies on interest accrual vary. There are also significant differences in provisioning and write-off policies applied in light of the prevailing regulation in the individual countries in Europe."[61]

A partial remedy to this situation might come through the application of the International Accounting Standards (IAS). From 2005 onwards, all EU listed companies – including banks and other financial institutions - will be required to prepare their accounts in accordance with IAS, developed by the International Accounting Standards Board (IASB), an independent privately-funded body. This will allow EU banks to base their financial reporting on harmonised rules, and depart therefore from their specific national reporting traditions. The IASB approach is based on the adoption of fair value accounting principles (FVA) instead of the hitherto practiced historical cost accounting (HCA). The FVA method values tradable assets and liabilities in the balance sheet at market (rather than historical) values, while resorting to a model-based valuation in the case of a non-tradable asset. Although the Commission has already endorsed most of IAS, it has so far refrained from doing the same for some portions of IAS 39 (Financial Instruments: recognition and

[59] Bilateral treaties based on the OECD Model Double Taxation Convention seem often not to solve many of the identified instances of double taxation, such as those resulting from cross-border loss-compensation or transfer pricing disputes. In addition, double taxation treaties with non-EU countries are highly divergent, which results in EU companies being able to avoid double taxation when being located in some Member States but not in others.

[60] See for example the Directives 86/635/EEC, 2001/65/EC and 2003/51/EC.

[61] See Standard & Poors (2003).

measurement) - which would apply FVA to most financial instruments as the ECB, national supervisors and many banks have expressed concerns.

The major deviations from the standards as originally proposed by the IASB concern the liability element in the so-called “fair value option”. One rationale for this decision has been the reflection that a rating *downgrade* might lead to *increased* profits. On the other hand, the asset side of the fair value *option* has remained, enabling different companies to value one and the same asset not held for trading at fair value *or* at historic costs and thereby diluting somewhat the original aim of arriving at a transparent and harmonised financial reporting system. Another removed provision relates to hedge accounting, where a number of banks have expressed concerns that this provision would constitute an obstacle for allowing portfolio hedging of core deposits on a fair value measurement basis.

4.3 Provision of cross-border banking services

If banks were able to supply products and services on an EU-wide basis, the EU banking market could become integrated from the consumer side. However, apart from bank-to-bank transactions and services offered by investment banks, this avenue for integration has not been exploited significantly to date. The following section examines the barriers to the cross-border provision of banking products and services under two headings: (i) the absence of European private law and (ii) differences in national consumer protection laws.

4.3.1 Lack of European private law

Due to divergences in European contract law, firms active in the Single Market are required to use different standard contracts in each Member State, which in turn makes it impossible to use the same business model for the entire market. This creates legal uncertainty, while increasing the cost of cross-border transactions, and is likely to discourage firms from seeking to operate on pan-EU basis. Such impediments to cross-border provision of services derive essentially from mandatory rules applied in accordance with national legislation. Mandatory rules are found either in contract law itself or in a variety of other laws applying to international transactions (e.g. consumer law, bankruptcy law, securities law, corporate law).

The importance of European private law to the functioning of a Single Market in banking services has been well established in the academic literature.[62] So far, the method for creating European private law in this field has been via Community legislation, with EU consumer protection a particular focus (see directives on doorstep selling, consumer credit, unfair terms in consumer contracts, etc.). However, the content of private law in EU directives is still very limited. As a result, cross-border transactions remain difficult when relating to credits and for operators in securities markets. Granting cross-border credit is often only possible if the corresponding collateral is enforceable. The analysis of the validity of the cross-border transfer of securities necessitates costly in-depth legal expertise, which may discourage such

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[62] Smits (1998)

transactions. It is also generally observed that operators in cross-border securities markets suffer a significant risk resulting from the divergence of legal rules on securities.[63]

4.3.2 Consumer protection

A prominent manifestation of the absence of European private law is in the area of consumer protection. Diverging national consumer protection rules hamper the provision of pan-EU retail banking products and thus hinder the exploitation of potential economies of scale on a cross-border basis.[64] As EU legislation on retail consumer protection is limited in scope, Member States assemble their own consumer protection rules and require non-domestic financial providers to comply with them. In that context, Member States refer frequently to the "general good" concept.[65] According to the rulings by the ECJ, the following are legitimate motives for invoking this concept.

- The need and extent of consumer protection-inspired exceptions depends on the relation between the risk level and the complexity of the financial service on the one hand, and the degree of vulnerability of the recipients of the service on the other. While professional clients (e.g. financial institutions, institutional investors, large enterprises) are able to assess risks associated with specific banking services properly, this may not be the case for individual consumers, which may constitute an acceptable 'general good' motive.[66]

- The risks and complexity of some financial products may justify restrictive rules on advertising, selling methods and price transparency for financial services. The need is here to ensure fairness in commercial transactions.

- The significance of consumer confidence in the product quality and in the involved intermediaries allows for measures aiming at the protection of financial market integrity at the firm level.[67]

- The ECJ has also acknowledged that the coherence of the fiscal system[68] is equally a 'general good' motive for justifying restrictions on cross-border financial services. Broadly, ECJ rulings in this area have fixed the limits of Member States' competence in the field of direct taxation in the context of the free movement principles guaranteed by the EC Treaty. This refers to the

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[63] Some of the examples are also covered in a Commission Action plan in the area of contract law presented in 2003.

[64] Thus equally hampering the incentives for pursuing the other two banking integration venues.

[65] As provided for by Article 153(5) of the Treaty on 'Consumer Protection'.

[66] See Case C-222/95 *Parodi*

[67] See Case C-204/90 *Bachmann*, Case C-80/94 *Wielockx*, Case C-484/93 *Svensson and Gustavsson*

[68] See Case C-250/95 *Futura Participations and Singer*

fundamental right of Member States (enshrined in Article 58 of the Treaty) to differentiate the treatment of taxpayers in accordance with their place of residence or the place where their money is invested. However, another provision of the same article provides that Member States may not differentiate to such an extent that the applied fiscal rules would actually constitute an arbitrary discrimination or disguised restriction on the free movement of capital (these provisions apply on capital movements and by extension on financial services as well). Obviously, there is a thin line between an acceptable differentiation and an unacceptable discriminatory treatment and it is the ECJ's responsibility to weed out acceptable from unacceptable practice. "Coherence of the fiscal system" was acknowledged in the nineties as a possible justification, but the ECJ seemed to resort to a stricter interpretation in more recent years.[69]

- Finally, the effectiveness of fiscal supervision may demand the enforcement of measures restricting cross-border trade in financial services. According to ECJ case law, Member States should, in the exercise of their fiscal competencies, comply with the fundamental freedoms of the Treaty, which implies the obligation to maintain only those fiscal supervision measures which, if they produce restrictive effects on free movement, are objectively necessary to ensure the effectiveness of fiscal supervision. However, the establishment of this principle by the ECJ does not imply that Member States may enjoy an unlimited freedom in that regard.

The *diversity* of these 'general good' inspired national consumer protection regulations reduces the capacity of banks to offer products and services on an EU-wide basis.[70] Consequently, banks are unable to exploit economies of scale in offering pan-EU pension or mortgage products or economies of scope by offering products from their home Member State in addition to those available in the host Member State. The diversity and uneven level of consumer protection legislation – rather than consumer protection as such - acts therefore as a brake on cross-border banking consolidation.

One way of remedying this situation could be financial service legislation at the EU level, which would replace the 'general good' exceptions at Member State level. Recently, there have been several forces working in this direction. For example, there is increasing interest in consumer protection on the part of the European Parliament. In addition, the European Commission has adopted a consumer policy strategy [71] for the period 2002-2006. The rationale underlying this strategy is the need for common (or at least convergent) rules ensuring at the same time sufficient protection of consumer interests and the elimination of regulatory obstacles and competitive distortions in the Internal Market. One goal of this strategy is to implement a high

[69] See also Case C-315/02 Lenz and Case C-319/02 Manninen

[70] See Heinemann and Jopp (2002).

[71] Commission from the Commission to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, Consumer Policy Strategy 2002-2006, COM(2002) 208final.

common level of consumer protection across the EU, which covers all aspects of consumer economic interests, and gives consumers the necessary confidence to conduct transactions anywhere in the Internal Market. In particular, this principle applies on the retail market for financial services. While many actions have already been undertaken in the framework of the Financial Services Action Plan, complementary actions are provided by this strategy in order to increase confidence in cross-border transactions. Overall, Directives governing specific types of financial services are to be revised and updated while new directives should also be adopted. The list of planned actions covers, among others, a Directive on consumer credit[72], as well as Directives on market abuse, prospectus, investment services, and transparency obligations of quoted companies.

In terms of market reaction to the proposals, public consultations showed that most voices supported a future harmonisation of consumer protection legislation and/or fair commercial practices based on “full harmonisation” which would help in creating a level playing field. However, some questioned the level of protection, which the Commission aims to establish.

The Commission’s consumer policy strategy provides also for other actions targeting the general legislation on consumer economic interests (which, by definition, covers also the financial services sector). In particular, one aim is to further harmonise existing rules on commercial practices in accordance with the options set out in the Green Paper on European Union Consumer Protection[73], which aims to progressively adapt the existing framework from minimum harmonisation to full harmonisation measures (so as to effectively address the main differences in national rules on commercial practices). In particular, these options include the update of directives on, respectively, misleading advertising, price indications, terms in consumer contracts, contracts negotiated away from business premises, distance selling contracts. Moreover, the Commission adopted in 2001 a Communication on European Contract Law[74], which launched a consultation process on potential problems for the internal market and the uniform application of Community law resulting from the divergence of national contract laws. Furthermore, the 2002-2006 strategy targets also the effective enforcement of consumer protection rules and the proper involvement of consumer protection organisations in EU policies.

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[72] Council Directive 87/102/EEC of 22 December 1986 for the approximation of the laws, regulations and administrative provisions of the Member States concerning consumer credit, as amended by Directive 90/88/EEC of 22 February 1990; European Parliament and Council Directive 98/7/EC of 16 February 1998.

[73] COM(2001) 531 final

[74] COM(2001) 398 final

5. The EU supervisory framework

5.1. Current arrangements for EU cross-border supervision

The EU supervisory framework is designed to facilitate integration of the banking system. Directive 89/646/EEC, the so-called "Second Banking Directive", and similar legislative texts entered into force in 1993 and were consolidated in a single Directive in the year 2000 (2000/12/EC). This Directive provides one of the most important pillars for banking supervision in the Internal Market.[75] The Directive states that a credit institution (a bank for the purposes of this paper) is allowed to open branches in the other EU Member States, so long as it is authorised to do so by its home-country supervisor. In this way, a single banking licence opens the possibility for the bank to do business throughout the EU while the home-country supervisor retains responsibility for its financial health. The home-country supervisor has the power to scrutinise the adequacy of the institution's administrative structure and financial situation and, if appropriate, to prohibit the bank from opening branch in another Member State. However, the justification for any negative decision must be disclosed, allowing the bank to contest the supervisor's decision in court.

Once the home-country supervisor has authorised the bank to open branches in another Member State, the host-country supervisor may not interfere except to require the foreign-owned branches to report periodically on their activities for statistical purposes. The host-country supervisor, however, retains responsibility for supervision of branch liquidity and may interrupt the provision of services by the branch if any legal provisions in this regard are being violated. Moreover, in emergency situations, the host-country supervisor may – subject to ex-post Commission control – take any precautionary measures necessary to protect the interests of depositors, investors and others to whom services are provided. Given this division of responsibility between home and host-country supervisors, close co-operation is required between the two agents. A number of Memoranda of Understanding have been signed to that effect, although none of these is legally binding.

A second possibility for a bank to expand across borders within the EU is via the establishment of a subsidiary in another Member State. As indicated in Section 4.1, this possibility is broadly as popular as expansion via branches. In this case, the foreign-owned subsidiary must report primarily to the host-country supervisor, although the home-country supervisor remains responsible for supervising the subsidiary and its parent bank on a consolidated basis.

5.2. Problems relating to the use of cross-border branches and subsidiaries

The subsidiary structure has been regarded until recently as a convenient means to facilitate market entry without the need for a major change in Member State arrangements. However, a bank operating across borders via subsidiaries is subject to host-country supervision in each and every Member State - in addition to home-

[75] Other Directives would include, for example, the Directive on Financial Conglomerates and on E-Money Institutions.

country supervision on a consolidated basis. A pan-EU bank can therefore be required to deal with a plethora of supervisors from different jurisdictions, each operating in accordance with different rules and distinct procedures. Consequently, supervisory compliance costs - such as different prudential reporting requirements and formats, in particular - can act as a significant barrier to cross-border banking activities conducted via subsidiaries and can interfere with efforts by banks to achieve the most efficient functional organisation on a pan-EU basis. Not unexpectedly, such compliance costs have emerged as a major issue in the debate on further integration of the EU banking sector.

In the case of a bank expansion via branches, the home-country supervisor bears the main cost in supervising the foreign-branch activities of its domestic banks, while the host country receives most of the possible benefits (and risk) in terms of a healthy (or frail) domestic financial system. Consequently, the home-country supervisor may face sub-optimal incentives in performing its duties vis-à-vis the host country. This problem of incentives would be most pronounced in circumstances where the foreign-branch business of the home-country bank is relatively small in terms of its total activity but relatively large in terms of the host country's banking system. In such a situation, financial distress in the bank's foreign branches would have only limited consequences for the home country but would have more significant implications for the financial system of the host county (Schüler 2003).[76]

Another issue might arise if a bank's overall balance sheet is healthy enough to permit further lending, domestically as well as abroad, while considerations related to the business-cycle or the exchange rate would warrant tightening lending conditions in a host country. As a result, a special type of conflict could arise between home country prudential control related to specific banks solvency ratios and host country concerns relating to overall financial stability.

Therefore the responsibilities of a home-country supervisor in relation to foreign branches can be a cause of concern for the host-country supervisor. While the host country retains some emergency powers, these can be used only in extremis, if a spirit of co-operation and trust between home and host supervisor – as well as the confidence of foreign banks operating in the host country – is to be maintained.[77] In these circumstances, the host-country supervisor has very limited possibilities to influence the behaviour of foreign banks within its domestic financial system. Moreover, banks operating through branches across borders link financial stability in various Member States, heightening the contagion risk. Adding to the potential concerns for host country authorities – including the host central banks - would be the possibility for foreign banks to circumvent domestic monetary policy objectives in smaller Member States.

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[76] See also Group of Ten (2001) Chapter III, pp. 152f.

[77] A further complication in the use of those "emergency" instruments would be that banking crisis are often characterised by being both (i) developing and spreading rapidly, making swift supervisory action necessary as well as (ii) opaque and not transparent (even for supervisors). However, quick unilateral pre-emptive actions within an obscure environment might not necessarily allow the host supervisors to clearly demonstrate the actions' justification in an ex-post context;

More specific problems can arise for the host-country supervisor in the operational phase of a cross-border banking M&A, when operational risk and managerial risk can be high. Unintended credit and liquidity risks can arise due to a technical failure, especially in an early transition phase where management might not yet be in full control of a newly-created entity. Risks stemming from operational failures might be relevant in the consolidation of back office operations. Organisational problems in the context of complex mergers and acquisitions can be another hazard, particularly if the management lack experience in some activities of the new entity.

In case of a crisis, the situation would be even more complex as not only the supervisors, but also the central banks and the Ministries of Finance may be involved raising co-ordination issues on the national level as well as cross-border. On the national level, different institutions might be required to co-ordinate and co-operate their actions in a straightforward and rapid way. However, it can be expected that national arrangements are sufficiently well developed to be able to cope with eventual crisis. Therefore co-ordination on the national level would seem relatively easy when compared to cross-border co-ordination between home and host country authorities or between different host country authorities in the case of a subsidiary. Although it can be expected that supervisory authorities would in general share the common goal of redressing a crisis situation effectively, there might be some delicate cases:

- In case a domestic bank has expanded via branches, the home country authorities would be fully responsible for addressing that bank's eventual distress. In a case where the bank's foreign-branch business is large relative to total business, there is a risk that national interests might discourage the home-country supervisor from declaring a bank insolvent as this would put pressure on the home-country tax payers to provide funds for bail-out payments or restructuring costs, while only benefiting the home country in small part. Such logic could encourage cautious home-country authorities to curtail the bank's expansion into other Member States. In case of a pan-European bank, procedures to agree on eventual bank bankruptcy proceedings and/or agreements for eventual banking bailouts might becomes necessary in order to avoid an undue burden on a (possibly small) home country.

- In case of financial difficulties for a large pan-European bank – operating through subsidiaries – a large number of authorities might have to co-ordinate their actions effectively to find quickly an overall response. Here, philosophical and political differences influence national actions in addressing a bank crisis potentially leading to conflicts in case some authorities would favour a bail out of the whole group, while others would be inclined to let the bank subsidiary in their jurisdiction fail.

- Emergency liquidity assistance through a domestic central bank would be another issue, possible involving similar problems. The supranational character of the monetary authority responsible for the euro might raise the additional matter of how diverging views between participating central banks might be resolved.

While the highlighted issues are of general relevance in the context of EU financial integration, they might be of special significance in the context of the recently acceded Member States and their largely foreign owned banking system, where EU

entry might (i) foster additional foreign bank entry due to the single licence, and (ii) open the possibility of a conversion of bank subsidiaries into branches or (iii) the use of the institutional form of the European Company Statute.[78]

5.3. *Proposals to improve EU supervisory arrangements*

EU supervisory co-operation arrangements addressing home and host country arrangements exist, involving information sharing and co-ordination elements. This has been enhanced following the Brouwer report and the Lamfalussy report as the Commission has proposed to extend the four-level approach hitherto used in the securities sector to the banking sector as well.[79] The measures will allow for a much deeper level of co-operation and a much more harmonised approach to day-to-day supervision and regulation but also contribute to crisis management capabilities.

Further banking integration might fuel a possible reform of the EU supervisory framework, possibly propelled by the EU entry of the 10 new Member States, where some banking systems are largely foreign owned. The matter is gaining increased attention from competent political bodies, allowing further progress to be made. It is noteworthy in this context that a number of proposals are discussed for developing the EU supervisory structure further. For example there are calls for a **lead-supervisor** to deal with the split of work between home and host country supervisors, although the exact role and competences are not yet very well defined. In addition, such a model would have to overcome the diverging incentive structures of home and host authorities. A variation would be the delegation of certain powers currently held by a home supervisor to a host supervisor or – in the case of a pan-European operating bank – to delegate supervisory powers to a selected supervisor, or a supervisory network. A second possible modification in current supervisory arrangements would be a **single supervisory authority**, constituted either as a centralised institution or organised in a more de-centralised way. A variation would be a single supervisory authority exclusively devoted to banks operating on a cross-border basis. This ground-breaking idea would seem to be difficult to implement in the current environment.

While the advantages of such a model would be that a unified structure could presumably better overcome the mentioned diverging incentive structures, effective prudential supervision would still be hampered by the unsolved topics of cross-border (i) liquidity assistance and (ii) eventual tax-payer financed bail-outs.[80] As a result, it might be advisable to address those crucial matters first before initiating a full-fledged change of the EU supervisory framework.

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[78] These possibilities are also mentioned in European Central Bank (2005)

[79] Brouwer Report (2000); The four level framework (also in the process of covering banking legislation) foresees on level 1 a framework text agreed to by the Council and Parliament, to be filled later with more detailed provisions by the Commission in level 2, after a vote by the European Securities Committee and following advice of the European Securities Regulators Committee. The later committee works in level 3 together on joint interpretations, guidelines and common standards, peer review and compares regulatory practice to ensure consistent implementation and application. In the level 4, the Commission checks Member States compliance with EU legislation and may take legal action if a breach of Community law is suspected. See Lamfalussy (2001).

[80] More detailed cross-border issues to be addressed in that context would include the provision of bank liquidity provision, emergency liquidity assistance, crisis management, lender of last resort clarification, deposit guarantee schemes as well as bank liquidation.

6. Summary and conclusions

The repeatedly high hopes for a pick-up in EU cross-border banking integration activity - such as at the time of the creation of a single market or the introduction of the euro – have not materialised and progress in that area is lagging behind domestic consolidation. The objective of this paper has been to review obstacles for cross-border EU banking integration from a broader economic perspective, supplemented by an analysis of remaining barriers. In doing so, the paper has provided a fairly comprehensive list of existing obstacles and their impact on the main avenues for cross-border banking integration. In addition, the role of institutional factors relating to the framework for prudential supervision has been considered, notably in the context of the relationship of home and host country supervisors with each other and with market participants.

A number of conclusions can be drawn:

- Due to a number of obstacles – some of which possibly erected with the specific purpose of preventing cross-border integration - EU banking systems are mostly segmented along national borders, at least for smaller customers, both at the corporate and the consumer level. The implication is a loss of welfare related to reduced efficiency, competition and consumer choice.

- Concerning avenues for EU banking integration, the single license – although a laudable step at the time of its introduction - is not a panacea for the future of EU banking integration within the current supervisory and legal framework. In addition, banks would be expected to hesitate in establishing greenfield operations in other Member States and may prefer to enter a foreign banking market through mergers and acquisitions (M&As).

- Possibilities for banking M&As on a cross border basis need to be facilitated through an appropriate legal framework targeting national investment restrictions. While the European Company Statute is a step forward by allowing large corporate groups to complete cross-border M&As, the recently approved takeover Directive opens the possibilities for defensive measures adopted by target companies. Many cross-border barriers still derive from tax legislation, such as – among others - the double taxation applying to income flows between associated companies established in different countries or a restriction of loss-offsets incurred by foreign subsidiaries. In addition, an international framework of rules and regulations on financial reporting is necessary, not least to ensure that the disclosed information by banks is comparable across the EU.

- Another area needing attention is the removal of barriers for the provision of cross-border banking services. The absence of a sufficiently consolidated European private law creates difficulties for enforcing cross-border collateral pledges. A prominent manifestation of this more general problem are the

diverging levels of consumer protection, making the introduction of EU wide retail banking products (mortgages, loans, pension products, saving vehicles) impossible, thus denying banks - operating on a cross-border basis - the possibility to reap economics of scale. A harmonisation of consumer protection rules or mutual recognition of consumer protection provisions for retail banking products might constitute alternative proposals for overcoming this barrier.

- The EU supervisory framework is designed to facilitate integration of the banking system. However, a bank operating across borders via subsidiaries is subject to host-country supervision in each and every Member State - in addition to home-country supervision on a consolidated basis. A pan-EU bank can therefore be required to deal with a plethora of supervisors from different jurisdictions, each operating in accordance with different rules and distinct procedures. In the case of a bank expansion via branches, the home-country supervisor bears the main cost in supervising the foreign-branch activities of its domestic banks, while the host country receives most of the benefits in terms of a healthy domestic financial system. Consequently, the home-country supervisor may face sub-optimal incentives in performing its duties vis-à-vis the host country. In case of a crisis, the situation would be even become more complex as not only the supervisors, but also the central banks and the Ministries of Finance may be involved. Therefore, the current structure would seem only adequate in case of limited financial integration and might require new thinking in a more integrated environment. This issue, which is already relevant in an EU composed of 15 Members, might become even more topical in an EU with 25 Members, where some of the new Member States' banking systems are largely foreign owned.

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