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The Impact of Technology and Regulation on the Geographical
Scope of Banking

by

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**DISCUSSION
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**The Impact of Technology and Regulation on
the Geographical Scope of Banking**

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The Impact of Technology and Regulation on the Geographical Scope of Banking

Abstract

We review how technological advances and changes in regulation may shape the (future) geographical scope of banking. We first review how both physical distance and the presence of borders currently affect bank lending conditions (loan pricing and credit availability) and market presence (branching and servicing). Next we discuss how technology and regulation have altered this impact and analyse the current state of the European banking sector. We discuss both theoretical contributions and empirical work and highlight open questions along the way.

We draw three main lessons from the current theoretical and empirical literature: (1) Bank lending to small businesses in Europe may be characterized both by (local) spatial pricing and resilient (regional and/or national) market segmentation; (2) Because of informational asymmetries in the retail market, bank mergers and acquisitions seem the optimal route of entering another market, long before cross-border servicing or direct entry are economically feasible; (3) Current technological and regulatory developments may to a large extent remain impotent in further dismantling the various residual but mutually reinforcing frictions in the retail banking markets in Europe. We conclude the paper by offering pertinent policy recommendations based on these three lessons.

Keywords: geographical scope, banking, lending relationships, technology, and regulation.
JEL: G21, L11, L14.

I. INTRODUCTION

Spectacular advances over the last decades in information processing and communication technology as well as continued deregulation of the financial marketplace on both sides of the Atlantic may have dramatically expanded the geographical reach of financial institutions and their clients. Bankers, consultants, and financial journalists alike now envision a future world in which consumers and businesses seek and access bank services 24/7 (i.e., 24 hours a day, 7 days a week) from any physical location on the wired part of the planet.

Yet (and notwithstanding all the hype) the daily grind of obtaining financing for most businesses still seems strikingly different from a world where “distance is about to die”. For example, the median small US business reports in the 1998 National Survey of Small Business Finance (NSSBF) that it is located a mere 8 kilometres (5 miles) away from its lending bank (though it should be noted that this distance has been increasing steadily over the last decades). In addition, small businesses in the US still communicate predominantly in person with their lending bank (Petersen and Rajan (2002)).

European small firms are possibly located even closer to their lenders. For example in Degryse and Ongena (2004) we document how the median entrepreneur borrowing from a large Belgian bank in 1997 travelled only 2 ¼ kilometres (1.4 miles) to the bank branch granting the credit. This very short distance has actually increased by only 30 meters (0.02 miles) per year over the last three decades. Other work has also highlighted the lack of integration of (European) retail banking markets. Different measures of integration show that retail banking markets are not (yet) integrated in Europe (Baele, Ferrando, Hordahl, Krylova and Monnet (2004)), in contrast to for example corporate bond and equity markets that have integrated rapidly since the early 1990s.

Why is proximity to a bank branch still very important for most borrowing European small and medium sized enterprises (SMEs)? And how does geography affect lending conditions and the structure and operation of European retail banking markets? Will technological developments and regulations shape and alter this impact? Will distance only “die another day” in European retail banking markets?

We summarize answers given to these questions by recent banking research. Reviewing contemporary contributions naturally leads us to highlight open issues and pinpoint unanswered questions. We also provide some recommendations with respect to competition policy in banking and banking supervision towards the end of the paper.

We start by distinguishing between *distance* and *borders*. While intimately related, these concepts are often usefully separable when assessing the geographical scope of financial markets.¹ *Distance* pertains to physical proximity that can be bridged by traditional modes of transportation, say car or train travel. In other words, by spending some distance-related costs banks or their clients can overcome the distance and engage in transactions with one another. For given locations of banks and borrowers, distance *per se* is exogenous and bridging it (i.e., the lender visiting the borrower and/or the borrower visiting the lender) may be adequate to deal with informational problems for the lender concerning its decision about granting and pricing the loan. As a result, given location, banks play no (or a rather mechanical) role in theoretical competition models featuring only distance.

Borders, on the other hand, are not merely bridgeable by car or train travel, or even more modern technological ways of interacting. Borders result as an artefact of exogenous

regulation or endogenously arise through the actions of the competing lenders. We think of borders as being tightly interrelated with informational problems that cannot be easily resolved or ameliorated by technological developments. The national borders of the countries in Europe often coincide with the cultural, informational, and/or regulatory borders that are relevant in this respect (we classify and discuss borders in Section II).

Bank lending to small firms in Europe, we contend in this review, remains confined by both distance and borders (Figure 1). In contrast, large multinationals issue corporate bonds on a pan-European market anchored in London, Frankfurt, or Luxembourg. In the corporate bond market neither distance nor borders are relevant any longer. The same can probably be said about European investment / wholesale banking and interestingly enough also about venture capital markets as documented by Mayer, Schoors and Yafeh (2004) (for simplicity reasons we did not include all these markets in Figure 1). Consumer credit cards are an interesting intermediate case. In quite a few European countries banks compete nationwide to enlist credit card users; distance plays no role anymore. However no banks we know of target yet credit card customers across national borders.

Why do we observe this remarkable diversity in geographical scope of financial and banking markets in Europe? Part of the explanation may reside in the different informational requirements in each of these markets. Small and young businesses often lack publicly accessible accounting statements, an observable repayment track record, or assets that can serve as acceptable collateral (called “hard” information in Petersen (2002) and Stein (2002)). Hence the assessment by the lending bank’s loan officer of the skills and character of the firm’s management and the quality of the firm’s business vision (called “soft” information) will play a key role in the lending decision. “Handshakes”, *in situ* monitoring, and repeated interaction will create trust in the borrowing firm and foster a bank-firm relationship, but may require physical proximity to be economically viable.

In contrast, corporate bond issuers are mostly large and well-known international firms that can easily be assessed by many investors and banks located across Europe on the basis of accounting statements and public track record. Hence corporate bond markets integrated rather rapidly as regulatory impediments dissolved and a common currency was introduced. Credit cards are intermediate in this regard. Consumers can be readily scored on the basis of observable characteristics such as age, income, and marital status and card balances can be pooled and securitized, making distance within each country increasingly irrelevant. However consumer characteristics, preferences, and regulatory protection still differs substantially across European countries making cross-border bank forays more complex.

What are the consequences of a geographical scope determined by both distance and borders for the conditions and structure in the retail banking markets in Europe?

Previewing the main lessons we draw in this paper, recent work suggests that:

- (1) Bank lending to small businesses in Europe may be characterized both by (local) spatial pricing and resilient (regional and/or national) market segmentation;
- (2) Because of informational asymmetries in the retail market, bank mergers and acquisitions seem the optimal route of entering another market, long before cross-border servicing or direct entry are economically feasible;
- (3) Current technological and regulatory developments may to a large extent remain

impotent in further dismantling the various residual but mutually reinforcing frictions in the retail banking markets in Europe.

We organize the rest of the paper as follows. Section II reviews the theoretical predictions and empirical findings regarding the geographical scope of banking. Section III discusses the impact of technology and regulation on the geographical scope while Section IV assesses the current state of the banking sector in the Europe. Section V provides some policy recommendations and concludes.

II. GEOGRAPHICAL SCOPE OF BANKING

(i) Distance versus Borders

To structure our analysis, we commence by distinguishing between *lending conditions* and *market presence* as the first dimension and between *distance* and *borders* as the second dimension. These divisions yield a four-celled matrix as in Figure 2. We aim to position the relevant theoretical contributions and empirical findings in the banking literature in one of these four cells. *Lending conditions* naturally concern the offering, pricing and rationing of loans, while *market presence* relates to the location and characteristics of bank branches.

We already introduced our distinction between *distance* and *borders* in the Introduction (Section I). We further follow Buch (2002) in distinguishing between “regulatory” and “economic” borders. *Regulatory borders* may simply prohibit “foreign” banks from engaging borrowers, setting up branches, and/or acquiring local banks. However the Riegle-Neal Act and Second European Banking Directive in effect removed most if not all such Regulatory Borders in the United States and Europe, respectively. Most *economic borders* however remain unaffected by these specific Directives. Take the existing *exogenous economic borders* such as legal origin and system, supervisory and corporate governance practices, political framework, language or cultural differences. We will argue in more detail in Section IV that these borders, in Europe in particular, remain in place and have been almost unaffected by either technological developments or deregulation.

Endogenous economic borders on the other hand are mainly informational and may well be affected by technological developments and deregulation but the extent to which remains unclear. Informational borders arise because of the formation of bank-firm relationships, adverse selection, or information sharing between (a group of) banks. Take the formation of a *bank-firm relationship*. Banks learn about borrowers by privately observing repayment of earlier loans or observing borrower’ type (Sharpe (1990)). It is this informational asymmetry between the ‘inside’ bank and other ‘outside’ banks, which gives the inside bank a competitive edge and almost assures continued interaction, i.e., the existence of a *relationship*, between the bank and its high-quality borrowers. Inside banks make economic rents while outside banks succeed occasionally in “poaching” mostly low-quality borrowers and at best break even (Rajan (1992), von Thadden (2004)), in the absence of other frictions. Hence, relationships arise as an endogenous barrier to entry limiting the number of incumbent inside banks operating in a market (Dell’Ariccia (2001)).

Banks are also faced with *adverse selection*. *De novo* or “foreign” banks screening a particular pool of borrowers for the first time face an adverse selection problem as

incumbent local banks will continue to engage the best customers (Broecker (1990), Shaffer (1998)). The entrants can be expected to end up “fishing in a pretty bad pool”. The harshness of the adverse selection problem faced by the new banks depends on, for example, the banking structure (e.g. number of incumbent banks), the correlation in outcomes of the screening processes by new and incumbent banks, and the investment in screening accurateness made by the incumbents (Gehrig (1998)).

Information sharing between banks, when accessible by outside banks, may lower this endogenous barrier of pre-existing bank-firm relationships. Indeed, the information dissipated through the information sharing network decreases the inside bank’s informational advantage (Padilla and Pagano (1997)), reducing the informational lock-in. Initiatives to start the cross-border sharing of information in Europe may lower the informational economic border. On the other hand information sharing also serves as a collusive device allowing banks to coordinate and be used as a strategic device to soften competition, as it introduces non-information related switching costs (Gehrig and Stenbacka (2001), Bouckaert and Degryse (2004)). If coordination can take place and remain (somewhat) exclusive, information sharing between incumbent banks constitutes another endogenous economic border outside banks need to overcome to enter a market. Alternatively, information sharing introduces other economic borders as switching costs.

(ii) Distance and Lending Conditions: Spatial Pricing

Recent theoretical papers highlight the importance of distance in explaining the availability and pricing of bank loans (the Northwest cell “Distance / Lending Conditions” in Figure 2). As suggested by a number of theories, lending conditions depend on the distance between the borrower and the lender, and the distance between the borrower and the closest competing bank. We borrow from Degryse and Ongena (2004) in our discussion of *spatial pricing* in this section and return to *spatial rationing* in Section (iii). Table 1 summarizes the theoretical predictions regarding spatial pricing.

Transportation Costs for Borrowers

In location differentiation models (Hotelling (1929), Salop (1979)), borrowers incur distance-related transportation costs in the action of visiting a bank. Banks necessarily have to price uniformly if they cannot observe borrower location,² or are prevented from charging different prices to different borrowers. Borrowers pay the same interest rate, but the total transportation costs incurred differ, depending on the firm’s location *vis-à-vis* the lending bank.

However, if banks observe the borrowers’ location and offer interest rates based on that information, they can engage in spatial price discrimination. Banks are often informed about the borrower’s address before even granting or pricing a loan. If borrowers pay for their own transportation, as is mostly likely to be the case, a bank optimally charges a higher interest rate to those borrowers that are located closest to its bank branch (Lederer and Hurter (1986)). The reasoning is that closer borrowers face higher total transportation costs when visiting competing banks (which are located further away than the lending bank), resulting in some market power for the lender over closer borrowers. Similarly, a monopolist bank optimally charges a higher loan rate to close borrowers, as these borrowers incur lower total transportation costs. We summarize these relationships in Table 1.

Monitoring Costs for Lenders

The cost of monitoring a borrower could also be related to physical distance. Total monitoring costs increase with borrower-lender distance, because of extra communication costs or transportation costs incurred by banks visiting the borrowers' premises. Loan rates passing through such costs increase with distance. However, distance-related monitoring costs might also allow for discriminatory pricing.

In Sussman and Zeira (1995), banks face monitoring costs known to be increasing in distance. As a result, lenders extract rents from close borrowers, because more distant competing banks take into account their own higher monitoring costs in their loan rate offers. As indicated in Table 1, spatial price discrimination based on bank monitoring costs again implies a negative (positive) relationship between the loan rate and the borrower-lender (borrower-closest competing bank) distance (for a given number of banks).

Distance and Lender Information

The severity of the asymmetric information problem itself may also increase with distance. Hauswald and Marquez (2003a) for example develop a model in which the precision of the signal about a borrower's quality received by a bank decreases with (informational) distance. Because banks receive more precise signals about close borrowers in Hauswald and Marquez (2003a), competing banks face increasing adverse selection problems when approaching borrowers closer to the most informed bank. Hence, the informed relationship bank can charge higher interest rates to closer borrowers, while the uninformed transactional banks charges higher interest rates to borrowers located farther away (due to the increase in the adverse selection problem). Or to put it differently: the uninformed (transactional) lender charges a higher loan rate to remote borrowers in order to compensate for the adverse selection problem, which intensifies in the vicinity of an informed (relationship) lender. The informed lender accordingly extracts a higher loan rate from closer borrowers. *Ceteris paribus*, Hauswald and Marquez (2003a) derive a negative (positive) relationship between the loan rate and the distance between the borrower and the relationship (transactional) bank. We indicate this result again in Table 1.

We note that the model developed by Hauswald and Marquez (2003a) in effect straddles our "Distance and Borders" categorization. Their model also features "relationship borrowers", whose current borrowing conditions may be determined by past and future borrowing. The transportation and monitoring cost models discussed so far seem mostly relevant for "transactional borrowers", whose current borrowing conditions are unaffected by past or future borrowing. Recent work suggests both type of engagements may coexist in banking markets (Boot and Thakor (2000), Elsas (2004), Degryse and Ongena (2003b)).

Number of Banks

In spatial models, the number of banks in the market is typically positively related to the magnitude of the transportation cost, and inversely related to the distance between the lender and the (closest) competing banks. An increase in the number of banks (harsher competition) increases the likelihood of receiving a lower loan rate offer. A decrease in the fixed set-up costs per bank (in, for example, Sussman and Zeira (1995)) increases the number of banks, decreases the distance between any two neighbouring banks, and

decreases the loan rate for each bank-borrower distance combination.³

On the other hand, an increase in the number of banks aggravates an adverse selection problem by enabling lower quality borrowers to obtain financing, resulting in moral hazard and credit rationing (Petersen and Rajan (1995)) or a higher interest rate (Broecker (1990)). In Dell’Ariccia (2001), adverse selection generates an endogenous fixed cost, constituting a barrier to entry in the industry limiting the number of competing banks even when markets become very large.

Similarly, a decrease in the fixed-cost component of the relationship-building technology in Hauswald and Marquez (2003a) not only leads to an increase in the number of banks and more competition, but also results in a retrenchment towards relationship lending. The lower entry barrier then leads to sharper adverse selection problems and higher loan rates for the borrowers closest to the relationship lender, but lower loan rates for customers farther away. In effect, loan rates will decrease (increase) more per unit of distance between the borrower and the relationship (transactional) bank.

Distance, Borrower Information, and Experience

Casual observation suggests that borrowers do not always frequent the closest bank, as most spatial models dictate they should. Incomplete borrower information and other bank product characteristics cause borrowers to visit more distant banks.

First, borrowers may not be fully informed about the precise location of all competing banks and the availability and conditions of the loans offered there. Grossman and Shapiro (1984) and Bester and Petrakis (1995) model such location *cum* informational differentiation. In Grossman and Shapiro (1984), consumers buy a product from a particular seller upon becoming informed of its location through advertising. The advertising itself is not localized. The sales price in their model exceeds the full information price, by the magnitude of the transportation cost, as informational differentiation lowers the elasticity of demand. In addition, consumers in their model, as they are unaware of all sellers, do not necessarily patronize the closest one. Bester and Petrakis (1995) model the advertising of lower price offers. In the absence of advertising, customers are only informed about “local” prices. Producers will advertise lower prices to attract customers from more distant locations. Hence, more distant informed customers will be observed to receive lower prices.

Second, while borrowers often mention bank branch proximity as a major concern (Elliehausen and Wolken (1990), Binks and Ennew (1997)), location is obviously just one characteristic of a bank’s product that is important for its customers. Hence, borrowers may not patronize the closest bank branch when another bank’s loan product exhibits other, more preferred, characteristics (Pinkse, Slade and Brett (2002)). And, once borrowers have experienced a good match and have observed the high-quality services provided by their current bank, they will switch to another bank only when offered a considerably lower price (Tirole (1988), p. 294).

To conclude, most theoretical models imply a negative (positive) correspondence between the borrower-lender (competing bank) distance and the loan rate, caused by either transportation costs (for either the borrower or the lender) or asymmetric information. Information availability, experience, and other product characteristics may abate the

strength of the distance – loan rate relationship.

Empirical Evidence on Spatial Pricing

Petersen and Rajan (2002) are among the first to provide concrete evidence on the possible presence of spatial pricing in bank lending. They find for example that a small business located one mile from the lending bank *ceteris paribus* pays around 38 basis points less than a borrower located around the corner from the lending bank. In Degryse and Ongena (2004) we also include the distance to the closest competitors in the specifications. Please notice that both papers include a variety of controls (and exercises to control) for firm risk to avoid picking up the spurious effects of spatial rationing on pricing.

In Degryse and Ongena (2004) we find a somewhat smaller impact of physical distance on the loan rates than Petersen and Rajan (2002), but the impact we measure is still highly statistically significant and economically relevant. The impact on the loan rate of both distance to the lender and distance to the closest competitor is actually similar in absolute magnitude, but of an appropriate opposite sign, which in itself is also evidence suggestive of spatial price discrimination. For example, for small loans loan rates decrease 7 basis points per mile to the lender and similarly increase 7 basis points per mile to the closest (quartile) competitor. We further deduce that, given current transportation costs and opportunity costs of travel, the average first-time borrower in our sample needs to visit the lender between two and three times to obtain a bank loan.

Most studies find no impact of the number of competitors on the loan rate, while the magnitude of the impact of the concentration index varies widely (see the Appendix in Degryse and Ongena (2003a) for details). However, it remains difficult to compare results across specifications, banking markets, periods, and HHI measures. Concentration measures are alternatively based on loans, deposits, or branches, and vary widely (across studies) in geographical span (Morgan (2002)).

Location Rents for Banks

To conclude, spatial price discrimination caused by either (borrower) transportation costs, (lender) monitoring costs, or asymmetric information may explain the results in both Petersen and Rajan (2002) and Degryse and Ongena (2004). Transportation cost provides the most consistent and comprehensive interpretation of all the results documented in Degryse and Ongena (2004). Inferred changes in lending technology may make an interpretation of the results in Petersen and Rajan (2002) more difficult. In Degryse and Ongena (2004) we run through a number of straightforward exercises but cannot find any trace of adverse selection increasing in the (admittedly short) distances to the uninformed lenders. In either case, our results suggest that the distance to the closest competitors is important for competitive conditions and that the actual location of the bank branches may be relevant when assessing the intensity of competition.

Our estimates in Degryse and Ongena (2004) also indicate that spatial price discrimination targeting borrowers located near the lending bank branch yields average bank rents of around 4% (with a maximum of 9%) of the bank's marginal cost of funding. Taken at face value, our findings substantiate an important source of rents accruing to financial intermediaries, based on location. "Location rents" are distinct from rents derived from

customer switching costs (Klemperer (1995)), which are in credit markets often attributed to pervasive informational asymmetries or the endogenous economic borders discussed earlier (Sharpe (1990), Rajan (1992), von Thadden (2004)). Kim, Kliger and Vale (2003), for example, provide the first estimates of switching costs faced by bank borrowers. Their findings imply average annualized bank rents of roughly 4% of the banks' marginal cost of funding. In Degryse and Ongena (2004), the increase of the loan rate during the average bank-firm relationship points to annual "information rents" of less than 2% of the bank's marginal cost of funding.

(iii) Distance and Lending Conditions: Spatial Rationing

Distance also affects the availability of credit. Stein (2002), for example, models the organizational impact of the ease and speed at which different types of information can "travel" within an organization. "Hard" information (for example, accounting numbers, financial ratios, etc.) can be passed on easily within the organization while "soft" information (for example, a character assessment or the degree of trust) is much harder to relay. Hence, if the organization employs mostly soft information, a simple and flat hierarchical structure and local decision-making may be optimal.

The type of information, hard or soft, that is needed and available to arrive at optimal lending decisions also translates into a correspondence between distance and credit rationing. For example lines embedded in credit cards are extended solely on the basis of a quantitative analysis of hard and easily verifiable information (for example, age, profession, address, etc. of the applicant). As a result credit cards are offered by mail and across large distances in the US (Ausubel (1991)).

A lot of small business lending on the other hand is still "character" lending. To screen successfully, loan officers need to interact with the borrower, establish trust, and be present in the local community. The "soft" information collected in this way is much harder to frame and to convey to others within the organization. As a result small (opaque) firms borrow from close, small banks (Petersen and Rajan (2002)), while large banks mainly lend to distant, large firms employing predominantly hard information in the loan decision (Berger, Miller, Petersen, Rajan and Stein (2004)). Small firms then may be subject to credit rationing when seeking financing across larger distances.

However, from an empirical point of view, the severity of the rationing of credit affecting small firms is not entirely clear. For example, the results in Petersen and Rajan (2002) indicate that the effect is economically rather small in the US, while preliminary findings by Carling and Lundberg (2002) seemingly indicate the absence of distance related credit rationing in the Swedish banking sector. Alternatively, results in Degryse and Ongena (2004) suggest that transportation costs that are fixed per loan (i.e., do not vary by loan size) may explain why larger loans are obtained across larger distances (mainly by larger firms).

(iv) Distance and Market Presence: Branching and Servicing

Only very few papers study the importance of distance in determining market presence, i.e., the branching and servicing within certain areas (the Northeast cell "Distance / Market Presence" in Figure 2). A recent paper by De Juan (2003) is an exception. She studies how

distance between own branches influence bank branching decisions in Spain. She finds that the number of own branches in a particular (sub) market has a positive (but small) effect on the further entry decision of the bank in that market. Hence, her results suggest that branch expansion is partly affected by the proximity of other branches of the same bank.

Results by Berger and DeYoung (2001) provide a partial explanation for these findings. Berger and DeYoung (2001) document how efficiency of bank branches slips somewhat as the distance between branch and headquarters of the bank increases. Hence in order to guarantee consistency in servicing across bank branches, banks decide to branch out methodically across certain areas rather than to build isolated outposts.

(v) Borders and Lending Conditions: Segmentation

Next we turn to the impact of borders on lending conditions and market presence. A recent literature has started to investigate how different types of borders shape lending conditions and result in segmentation of credit markets (the Southwest cell “Borders / Lending Conditions” in Figure 2).

National borders that often coincide with many of the exogenous economic borders discussed earlier continue to play an important role across the world. Recent work by Buch, Driscoll and Ostergaard (2003) for example suggests that national borders in Europe still hold back bank investments. As a result, European banks “over”-invest domestically and it is in particular country-specific credit risk that does not seem fully reflected in the interbank rates (see also Baele, et al. (2004)).

But other type of borders may also result in segmented credit markets. Empirical evidence suggests that “outside” lenders often face difficulties (or hesitate) in extending credit to mainly small local firms (Shaffer (1998), Guiso, Sapienza and Zingales (2004)). This happens in particular when for example existing relationships between incumbent banks and borrowers are strong (Bergström, Engwall and Wallerstedt (1994)) or when the local judicial enforcement of creditor rights is poor (Bianco, Jappelli and Pagano (2003)). In all these cases borders will lead to market segmentation and difficulties for cross-border outside banks to engage any local borrowers. In effect this market segmentation highlights the importance for the outside banks to strive to build an actual physical presence in the targeted market.

(vi) Borders and Market Presence

Indeed, academics and bankers alike have long recognized borders as important factors in impelling bank entry and cross-border bank mergers and acquisitions (the Southeast cell “Borders / Market Presence” in Figure 2).

Bank Entry

An older literature going back to Goldberg and Saunders (1981) and Kindleberger (1983) assert that banks often pursue a “follow-the-customer” strategy when deciding upon cross-border market entry. However recent evidence casts some doubt on this “follow-the-customer” strategy as the only game in town. In particular banks entering the US market have not primarily a follow-the-home-country-customer motive or at least not persevere in servicing only the home country customers. Indeed, foreign banks in the US also

apparently engage many local borrowers (Seth, Nolle and Mohanty (1998), Stanley, Roger and McManis (1993), Buch and Golder (2001)).

However banks encounter many difficulties (in other countries than the US) in successfully pursuing a strategy of engaging local firms by cross-border entry through local branches. DeYoung and Nolle (1996) and Berger, DeYoung, Genay and Udell (2000) for example document how most foreign bank affiliates are less efficient than domestic banks, the exceptions being the foreign affiliates of US banks in other countries and most foreign bank affiliates in for example Eastern Europe and South-America. The latter affiliates are often financially sounder than the domestic banks (Crystal, Dages and Goldberg (2002)). Why are most foreign bank affiliates less efficient than the local crowd? A paper by Buch (2004b) documents the inefficiencies by foreign bank affiliates are mostly due to the presence of economic borders (language, culture, etc.) and do not seem driven by physical distance.

But there is a second reason why banks shy away from following-the-customer, apart from the fear of getting stuck with inefficient branch outposts. Findings by Berger, et al. (2003) suggest customers are not that interested in being followed! Indeed, they find that foreign affiliates of multinational companies choose host nation banks for cash management services more often than home nation or third nation banks. This result is consistent with so-called “conciierge” benefits dominating “home cookin’” benefits. This is a surprising finding given that these large multinationals might be expected to be prime targets for preferential treatment by their home nation banks. On the other hand, the opening of a foreign affiliate is a good occasion for a firm to escape a hold-up problem at “home”. In this way, the establishment of new plants or subsidiaries in foreign countries is an opportunity to add a new (foreign) bank relationship.

Berger, et al. (2003) also find that bank reach (global versus local) is strongly associated with bank nationality. For example, if a host nation bank is the choice of nationality, then the firm is much less likely to choose a global bank. Finally, they also find that bank nationality and bank reach both vary significantly with the legal and financial development of the host nation. For example, firms appear to be much less likely to choose a host nation bank and more likely to choose a global bank when operating in the former socialist nations of Eastern Europe.

Berger, et al. (2003) conclude on the basis of this evidence that the extent of future bank globalization may be significantly limited as many corporations continue to prefer local or regional banks for at least some of their services. Though, as pointed out by Dermine (2003), this conclusion is partly predicated on the continuing (and endogenous) absence of foreign direct investment and possibly more importantly cross-border mergers taking place.

Frequency and Value of Cross-Border Bank Mergers and Acquisitions

However, cross-border bank mergers and acquisitions (M&As) are still a relatively rare species in many parts of the world, though the number in the euro-area has steadily increased. Hartmann, Maddaloni and Manganelli (2003), for example, document that in 1995 61% of all mergers involved institutions in the same country and only 11% involved banks situated in two different countries of the euro area. By 2002 the percentage domestic deals dropped to 47%, while the euro-area deals remained stuck at 11%. Focarelli and

Pozzolo (2001) also demonstrate that cross-border bank M&As occur relative to within-border M&As less frequently than cross-border M&As in other industries, *ceteris paribus*, while Berger, Demsetz and Strahan (1999) show that cross-border bank M&As occur less frequently than domestic bank M&As. And it is again economic borders,⁴ not distance, that make cross-border bank M&As less likely (Buch and DeLong (2001)).

Hence taken together these studies suggest that not only exogenous economic borders (that also affect other industries) but also endogenous economic borders specific to the banking industry (information asymmetries in assessing target bank portfolios) may make it hard to pull off a successful cross-border bank M&A.

Bank managers are apparently aware of the difficulties awaiting them when engaging in a cross-border M&A and seem to refrain from undertaking many. But also investors recognize the dangers. A nice recent study by Beitel, Schiereck and Wahrenburg (2004) for example documents that the combined cumulative abnormal returns for stocks of bidder and target bank in cross-border bank M&As in Europe over the last few decades is actually zero or negative! This finding stands in stark contrast with other industries where the combined CARs of cross-border M&As are typically found to be positive. Hence investors seemingly evaluate cross-border bank M&As as destroying value. Beitel, Schiereck and Wahrenburg (2004) results are quite similar to findings in DeLong (2001). She reports that in the US only the combined CARs of geographically focused bank M&As are positive, although it is not entirely clear what factors are driving this empirical finding.

Borders and Cross-Border Bank Mergers and Acquisitions?

The evidence presented so far is not clear whether it is exogenous or endogenous (informational) economic borders that create most problems in making a cross-border bank M&A possible and successful. A recent paper by Campa and Hernando (2004) suggests exogenous borders play a role. Their study shows that the combined CARs of M&As are typically lower in industries, such as banking, that until recently were under government control or are still or were most heavily regulated. CARs of cross-border M&As in these industries are actually negative, evidence in line with Beitel, Schiereck and Wahrenburg (2004). One possible interpretation is that the (lingering) effects of regulation make for harder economic borders.

However while such residual regulatory and “institutional reasons are undoubtedly important, strong economic forces may impede the unification of banking markets” (Rosengren (2003)). Economic forces may explain why there has also been so little interstate merger activity in the US, despite very homogeneous banking markets. Cost savings are often impossible in cross-border mergers. In-market mergers however allow for a reduction in redundant branch networks, underwriting activities, and/or local monitoring of credits. Anticipating such savings may allow an in-market (domestic) acquirer “to bid more” than any other out-of-market (foreign) acquirer “in the auction of the target assets”. More in general the promise of cost cutting and indirect labour shedding may allow domestic banks to gain an upper hand in any complex and politicised merger dance involving also foreign suitors. In addition, acquiring an in-market competitor limits the number of entry points for any out-of-market competitors and may increase the in-market acquirer’s market power and monopoly profits.

Bank industry observers sometimes also note that for example bank organization and corporate governance may be an area shaped in ways that hinders merger activity. The mutual structure of dominant banks in France and Germany in particular (for example, Credit Agricole, Landesbanken) is often passed of as a major hurdle for these banks to initiate and pursue a successful M&A (Wrighton (2003)). But exogenous economic borders may also make cross-border bank M&As result in complex holding structures (Dermine (2003)), i.e., cross-border consolidation in Europe functions through subsidiaries and not branches as is common in US cross-state banking. Hence, it appears as if the so-called “single passport” of the European Second Banking Directive is not very much used. Subsidiary configurations possibly further complicate future M&A activity.

Finally, the impact of endogenous (informational) economic borders on cross-border bank M&A activity is less researched. It is possible that the domestic merger activity, we have observed until now in Europe, creating so-called “National Champions” is partly made possible by the existence of informational borders. Outside banks seeking to acquire a local bank find it more difficult than incumbent banks to assess the value of the loan portfolio of the possible target banks. As a result of the winner’s curse problem, outside banks refrain from stepping in and most M&A activity, driven by for example (revenue and cost) scale and scope considerations, occurs between domestic banks.

However as the domestic banks increase in size, diversify,⁵ and possibly partly refocus their lending towards larger firms they become easier-to-value targets. If this is indeed the case we contend that the informational asymmetries facing the outside acquiring banks may actually endogenously decrease over time as possible target banks that are shielded within the bordered area prosper, grow and merge among themselves resulting in a further diversification of their loan portfolios. National competition policy concerns may ultimately hinder further domestic consolidation. As further local mergers may be under scrutiny of competition policy authorities, winner’s curse problems may further decrease, facilitating cross-border M&As. Hence one could argue that informational borders and the accompanying winner’s curse problem have a tendency to partly and endogenously self-destruct, that M&As may become the optimal route of entering a market long before cross-border servicing or direct entry are economically feasible, and that “National Champions” will almost inevitably metamorphose into “European Champions”.

A natural question is then how borrowers will be affected by cross-border bank M&As. It is possible that “in the first round” small local firms serviced by domestic target banks suffer somewhat as with domestic mergers (Sapienza (2002), Bonaccorsi di Patti and Gobbi (2002)). Eventually niche banks may arise taking over part of the foreclosed lending activities (Berger, Saunders, Scalise and Udell (1998)). But technological developments and regulation undoubtedly will also play a role. That is the topic of the next section.

III. THE IMPACT OF TECHNOLOGY AND REGULATION ON THE GEOGRAPHICAL SCOPE OF BANKING

We argued so far (in section II) that the impact of distance on loan rates seems considerable, that the impact on credit rationing is currently unclear, and that the impact on bank branching and servicing is seemingly minor. We have also discussed how the impact of borders on both lending conditions and market presence seems substantial. We now turn

to the second question broached in this paper, which is how technology and regulations may shape the correspondence between distance and borders on the one hand and lending and market presence on the other.

(i) Technology and Distance

Berger (2003) investigates how advances in technology, in particular in communication and information processing, substantially alter current practices in the banking sector. He argues that recent technological developments reduce “distance-related diseconomies”, in particular in four areas: (1) the monitoring and risk management of loans, (2) the offering of traditional banking services, through for example improvements in credit scoring, (3) the management of staff, and (4) the provision of new services over the internet. Hence Berger in effect argues that technological developments will change the impact of distance on both lending conditions and bank market presence.

However advances in communication technology and increased capacity for information need not imply more exchange of information at different levels. First, take information exchange *inside the banks*. Wilhelm (2001) for example argues that loan officers have limited incentives to transfer information, as they are the content originators but also the monopolists in the human capital needed to create proper credit assessments. Hence loan officers may try to tie the now commodity-like distribution (sending reports by email) to its origination. They can do so by arguing some information cannot be hardened or is too sensitive to move through the bank (or branch) organization.

In addition, loan officers may initially be uncertain about the value added by the new technologies and may therefore be unaware of its desirability. Recent work in game theory shows that both adoption and non-adoption of new technology are potential equilibria, leaving an important role for coordination in equilibrium selection. Pre-play communication or cheap talk may help to choose the Pareto-dominant equilibrium and solve the coordination problem. Myatt, Shin and Wallace (2002) show that adoption not only hinges on the expected value added by the new technology, but also on both the “fundamental uncertainty” – uncertainty concerning the value added – and the “strategic uncertainty” – uncertainty concerning the actions of others. The interaction of these two types of uncertainty determines the strategy selected by the individual players and hence the actual adoption of the new technology.

The advances in communication technology and increased capacity for information need also not imply more exchange of information *between firms and banks*. For example, Yosha (1995) and Bhattacharya and Chiesa (1995) have argued that firms choose the type and the number of financiers on the basis of concerns for confidentiality vis-à-vis product market competitors regarding proprietary information (R&D results, etc.). Similar concerns refrain firms from giving the chosen financier(s) more specific information or limit the format in which the information is transferred (for example firms prefer to provide oral presentations rather than supply full-fledged project manuals; improved communication technology has not altered this desire).

Finally, technological developments not necessarily enhance sharing of information *between banks*. While technological progress shapes the structure of the information sharing industry itself (as it allows for example exploiting economies of scale), the degree

of information sharing or incentives to share information may remain unaffected. Concerns about free-riding between banks and adverse selection and moral hazard at the firm level have long been recognized as a driver of the determination of the optimal degree of information sharing. Even dramatically lower costs of information sharing may not alter such fundamental strategic calculations (Padilla and Pagano (1997), Bouckaert and Degryse (2004)). Similarly, Vercammen (1995) for example argues that it is optimal for information sharing bureaus to limit the number of years of credit history that is maintained in the database. Not for technological reasons (for example the cost of data storage) but because the incentive of the borrowers for compliance is reduced as credit histories lengthen and the value of a negative piece of information is reduced. And indeed in all European countries surveyed by Jappelli and Pagano (2003) the public credit register eventually “forgets” though the precise memory system varies from country to country. Again, it seems unlikely that technological developments will alter these specific trade-offs.

(ii) The Impact of Technology on Spatial Pricing

Nevertheless technology may have an impact on spatial pricing of deposits and loans. For example, on-line banking spurs competition and alters the impact of distance on deposit rates (Bouckaert and Degryse (1995)). Vesala (2000) for example shows that loan mark-ups were decreasing substantially in recent years in Finland, in lock step with the rapid development of internet and mobile banking in that country. On the other hand, Corvoisier and Gropp (2001) find only a small increase in contestability in European loan markets in recent years despite technological advances in many countries and despite an increase in contestability in deposit markets.

A paper by Hauswald and Marquez (2003b) offers an explanation for these differential findings, providing yet another take on how technology need not lead to more exchange of information and competition. In their model better access to information by banks leads to more competition and lower loan rates, but the improved ability by banks to process information actually leads to higher loan rates and higher bank profits as banks are better able to “carve out a niche” and generate informational rents.

(iii) The Impact of Technology on Spatial Rationing

The impact of technology on spatial rationing is equally unclear. First, note that technological developments may increase competition from capital markets as individual investors can more cheaply obtain and process information. Increased capital market competition pushes the natural habitat of bank financing towards more opaque firms, as depicted in Figure 3 (Berger and Udell (1993), Greenbaum and Emmons (1998), Mannonen (2001)). However increased capital market competition also leads for example to changes in bank orientation away from relationship banking towards more transactional banking and more bank industry specialization (Boot and Thakor (2000)). In contrast, they argue that more interbank competition leads to more relationship lending.⁶ Hence, Boot and Thakor distinguish between two sources of competition, i.e., capital market competition and interbank competition, and they allow banks to choose between relationship lending and transactional lending. In their model stiffer capital market competition reduces relationship lending, while interbank competition actually increases the relative amount of relationship lending. A bank offering a relationship loan augments a borrower’s success probability.

Relationship lending then allows extracting higher rents from the borrower. Fiercer interbank competition pushes banks into offering more relationship lending, as this activity permits banks to shield their rents better. Any reorientation in Boot and Thakor (2000) alters both financing habitats and informational needs of the banks and possibly affects the impact of technology on the availability of credit.

Controlling for firm and lender characteristics, Petersen and Rajan (2002) estimate a rather substantial increase in the (predicted) distance between lender and borrowing firms in the US over the last decades, from around 11 miles in 1973 to around 18 miles in 1991 (their Figure 3).⁷ Petersen and Rajan (2002) also find that the modes of communication between lender and borrowers have become more impersonal over time. In contrast, firms in Belgium “moved away” from their bank by only 0.02 miles per year in the period 1973 to 1997 (Degryse and Ongena (2004)). Differences in technological development seem unlikely to be the only explanation for this divergent growth rate in lender – borrower distance in the US and Europe, as the divergence started early in the 70s and seem to have continued to this day.

(iv) The Impact of Technology on Branching and Servicing

The impact of technology on bank branching and servicing may be equally muted. Berger and DeYoung (2001) for example assert that technological developments only partially mitigate the negative effects of distance on efficiency. But then remember that the effects were relatively mild to start with. In addition, Cabral (2002) points out that the so-called “multi-channel” route in banking has now established itself as the standard in many countries. Bank customers access bank services through ATMs, telephone, internet, and through personal contact in the bank branch itself!

Hence branch proximity continues to play a non-negligible role in determining bank choice, muting the impact technological developments may have. There is even reason to believe bankers and industry watchers for a while have underestimated the importance for customers of bank branch proximity.

“The hot news in banking: bricks and mortar. Customers prefer branches so banks are opening ’em like crazy”,

headlined an article on April 21st, 2003 in *Business Week* (Gogoi (2003)) suggesting that de-branching may have gone too far and that incumbent or *de novo* banks are correcting these recent mistakes. In addition, banks have incentives not to cut back on branches too much in order to keep potential entrants out of their incumbent markets.

To conclude, the impact of technological advances may be limited to abating somewhat the impact of distance on the pricing and availability of loans and market presence. There is still only limited evidence that advances in technology completely removed “the tyranny of distance”; in particular in Europe “distance still rules” as before.

(v) Regulation and Borders

The impact of changes in regulation both in the US and Europe have been substantial and profound. Nevertheless retail loan markets in Europe remain surprisingly segmented, in contrast to wholesale capital markets in both Europe and the US (Danthine, Giavazzi and

von Thadden (2001), Adam, Jappelli, Menichini, Padula and Pagano (2002)). In addition, the distance at which banks lend internationally in Europe, and hence cross border, has not at all increased over time in Europe in contrast to the US where the distance at which banks lend internationally has steadily increased (Buch (2004a)).

IV. STATE OF THE EUROPEAN UNION

(i) Exogenous Economic Borders

What does this all mean for European banking? Most regulatory borders are, as already noted, removed and in principle the European banking market should be open for business for all banks chartered in the European Union and provided with the single passport of the European Second Banking Directive. In practice things are not that simple, as both exogenous and endogenous economic borders remain formidable barriers.

Take differences in legal systems and practices. Europe contains within its national boundaries all the (former) standard bearers from all major legal regimes, creating work for corporate lawyers but headaches and costs for bank management. Another example: the variation in banking supervisory practices within the European Union is as large as the variation in the World (Barth, Caprio and Levine (2001)). Needless to say it is close to zero within the United States. Differences in corporate governance and the mutual structure of a few key banks in Europe create further barriers to integration.

And then we haven't touched yet upon the undeniably profound differences in politics, language, and culture within the European Union. Is there any other common market on earth where people from its various places and corners are for example so specialized in very different sports with assorted Olympic medals and world titles to show for: just think about the Norwegians in cross-country skiing, the Dutch in ice-skating, and the Flemish in cyclo-crossing.⁸

(ii) Endogenous Economic Borders

Endogenous (informational) economic borders also remain quite high in Europe. As pointed out before, the impact of technology on informational borders is unclear *a priori* from a theoretical point of view. But Europe further faces specific problems when it comes to reducing informational asymmetries. Hardening of information for example could in principle alleviate some of the informational asymmetries. But hardening of information may also be more problematic in Europe than in the US as it is not clear that all information that is already hardened is equally reliable across Europe. For example, La Porta, Lopez-Silanes, Shleifer and Vishny (1998) report a *Rating on Accounting Standards* that ranges between 36 and 83 for countries in Europe and between 24 and 76 for the rest of the world (the US score equals 71 while the average for all countries is 61). In addition a lot of local knowledge is often still needed to correctly interpret the "hard facts" often involving translating "hard information" into "soft information".

Technological developments may bring an outcome. But the introduction of new lending technology seems rather slow in most parts of Europe. Various factors such as the small distances, a lower GDP/capita, centralized decision-making, a wait-and-see attitude, and lack of financing for innovation could reasonably be listed as suspects, but more research

seems needed to identify the true culprits.

(iii) Distance Dies Another Day

To conclude, borders (and as a result also distance) “may die another day” in Europe. We would argue that as most lending occurs over shorter physical distances in Europe, informational asymmetries increasing in distance might not be an important issue. Hence lending practices on the ground may be driven more by transportation technology than by changes in communication and information processing technology.

However information asymmetries increase dramatically when crossing a border. In this regard one could argue that the various exogenous and endogenous economic borders are mutually reinforcing and also that current technological and regulatory developments remain to large extent impotent in dismantling these formidable barriers.

V. POLICY RECOMMENDATIONS AND CONCLUSIONS

Our review of the academic banking literature highlights that retail banking markets remain to a large extent local: pricing and availability of credit hinges on local market conditions. We pointed at a number of exogenous and endogenous market imperfections that persistently make retail-banking markets “less competitive” than in the absence of these imperfections. The most recent deregulatory steps and the recent technological developments will most likely not remove the remaining exogenous and endogenous economic borders. Our policy recommendations are straightforward and withstood the test of time in terms having been recommended frequently. That doesn’t make them any less relevant.

To the extent that the rush towards building “National Champions” was the result of a winner’s curse problem, the trend may have run its course (Danthine, Giavazzi and von Thadden (2001)). It is therefore time that the National Champions start naturally spilling across borders as well. We should note however that (1) cost savings are often impossible in cross-border mergers and (2) current cross-border mergers have produced negative combined cumulative abnormal returns. To facilitate cross-border M&As further national supervisors need to treat domestic and cross-border merger candidacies more equally.

Indeed, in a few high profile cross-border M&A attempts that took place in Europe, national supervisors wielded their informal and/or formal mandate in the bank merger review process to derail or maim the planned cross-border bank merger. The role of banking supervisors in the merger review process is a natural and undisputable proper corollary to (1) its licensing mandate (capital requirements, “fit and proper management”, etc.), (2) its role in the bank default or restructuring process, and (3) its general engagement and responsibility for the maintenance of banking sector stability (Carletti and Hartmann (2003)). However, it appears as if in a number of these recent instances national banking supervisors were mobilized or swayed by domestic political interests to block European cross-border bank mergers, fielding arguments of improper management or financial instability as only the flimsiest of excuses. Further pressure from the European executive branch and judicial system, and enhanced national supervisory independence should put a stop to such rather dubious practises.

In tandem with national bank supervisors, national and European competition authorities should pursue a pro-active competition policy and cut large financial institutions seeking yet another domestic partner no slack. In addition, there may be a need for the foreseeable future for flexibility in allowing various organizational and corporate governance structures to co-exist. The recently implemented European Company Statute should improve the situation on the ground in this regard. On the other hand, and admittedly somewhat contradictory, questions may have to be raised about the further fostering (allowing) of mutual structures in banks. Finally, possibilities for active pan-European take-overs need ultimately to be created (not only in banking obviously), such that the best combinations of banks can be determined by market participants and not by politicians.

It is not clear the current supervisory framework is ready to handle National Champions growing into pan-European banking behemoths. It may be fruitful to consider to rapidly reinforcing the existing web of bilateral Memoranda of Understanding with multilateral Memoranda agreed upon in one or more rounds of negotiation between national supervisors. Multilateral work if successful may ultimately be more efficient in achieving the supervisory objectives. In addition, serious consideration may have to be given to the creation of a European Bank Supervisor to which supervision and authority pan-European banks can choose to subject themselves to. The newly established Lamfalussy Committees in Banking constitute major steps forward on all of these accounts. In any case, more research on these vital issues seems also warranted.

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Figure 1

The Importance of Distance and Borders in European Financial Markets

		Borders	
		Important	Not Important
Distance	Important	Loans to Small Firms	
	Not Important	Consumer Credit Cards	Corporate Bonds

Figure 2
Road Map

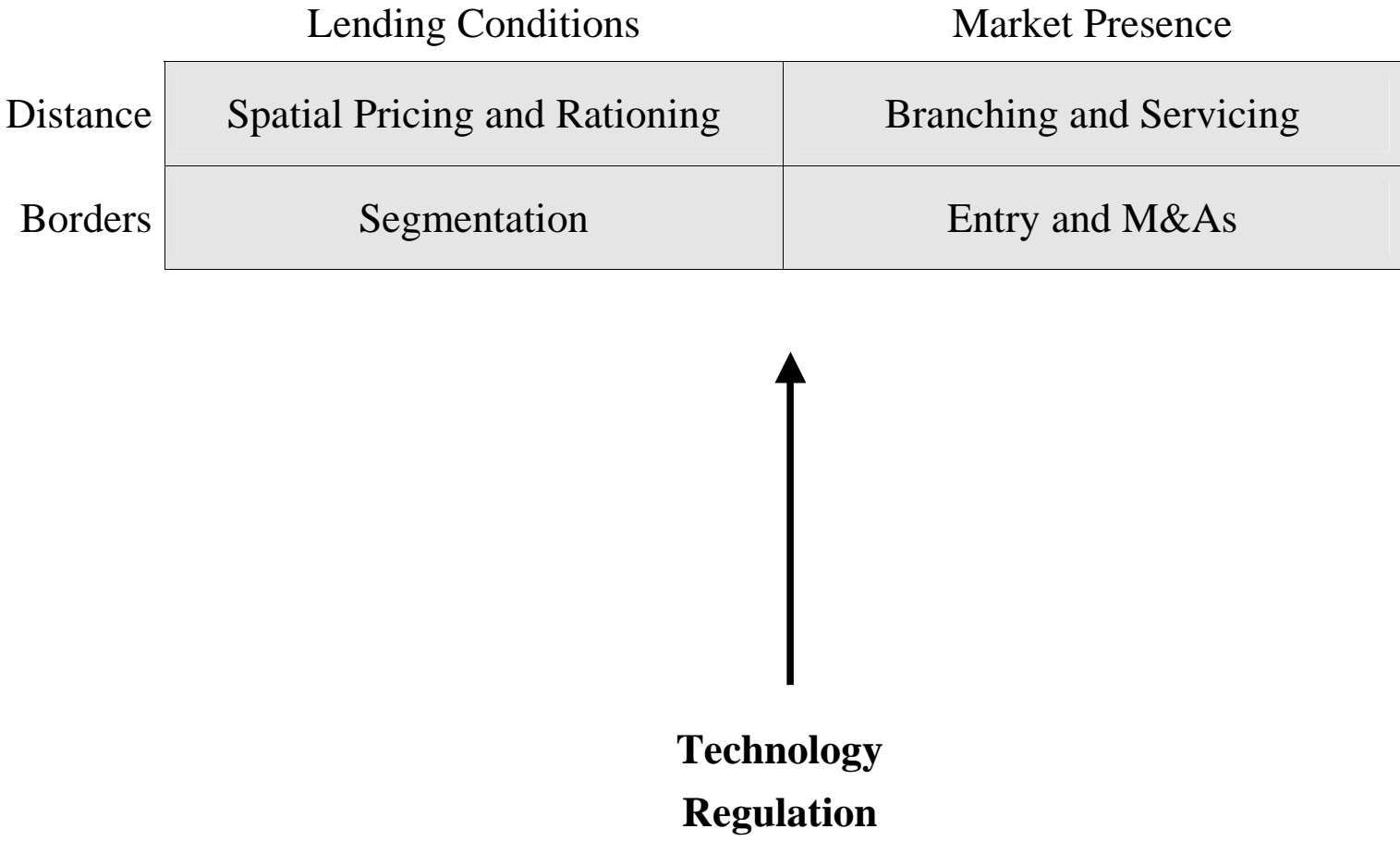


Figure 3
Financing Habitats

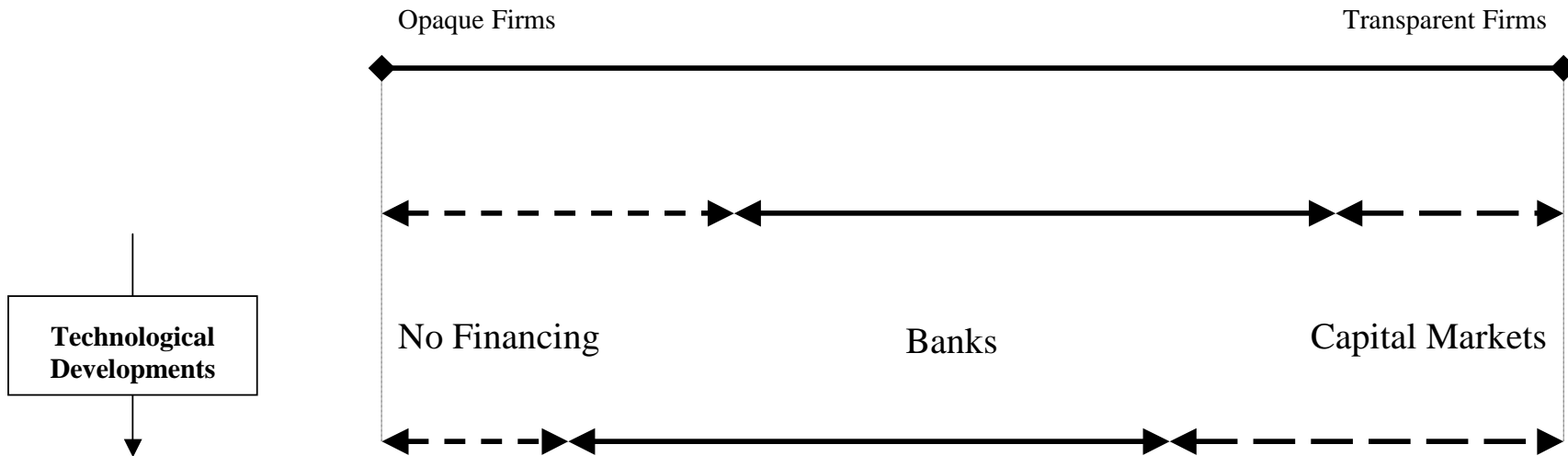


Table 1

Theoretical Models Linking Loan Rates and Distance

<i>Arguments & Discussed Models</i>	Impact on the Loan Rate of the		
	Distance to the Lender*	Distance to the Closest Competitor*	Number of Competitors
<i>Transportation Costs (for Borrower)</i>			
Uniform Pricing	No	no	negative
Discriminatory Pricing	negative	positive	negative
<i>Monitoring Costs (for Lender)</i>			
Marginal Cost Pricing	positive	negative	negative
Discriminatory Pricing	negative	positive	negative
	Distance to the Relationship Bank*	Distance to the Transactional Bank*	Number of Competitors
<i>Asymmetric Information</i>			
Dell'Ariccia (2001)	negative	no	negative
Hauswald and Marquez (2003a)	negative	positive	positive / negative

Source: Degryse and Ongena (2004). Notes. * For a given number of competitors.

NOTES

¹ Recent empirical work on the geographical scope of banking by, for example, Berger and DeYoung (2001), Berger, Dai, Ongena and Smith (2003), and Buch (2004b) include measures for both physical *distance* and cultural, informational, and/or regulatory *borders* in their specifications. Studies by, for example, Grinblatt and Keloharju (2001) on the portfolio choices of Finnish investors and Portes and Rey (2004) on international capital flows also include both distance and border variables.

² Lenders may initially be unsure about the exact location of the borrower. For example, if the borrower is an independent salesman or software consultant and maintains multiple centers of activity, it is not clear at first for the bank where to monitor. In that case, the bank can engage in discriminatory pricing only upon becoming informed about the location and transportation costs faced by their borrowers. In Dell’Ariccia (2001), banks become informed about the location of the borrower through first-period lending. In his model, only "relationship" banks, lending to the same firm for a second time, can engage in spatial price discrimination, while *de novo* "transactional" banks have to resort to “mill pricing”.

³ An increase in the number of banks also decreases the loan rate in more general models of imperfect Cournot competition between a finite number of banks. See, for example, the rendition of the Monti (1972)-Klein (1971) model in Freixas and Rochet (1997) (pp. 57-60).

⁴ Regulatory borders explicitly prohibiting bank M&As have been removed in Europe. However, national and political interests frequently result in the mobilization of the national anti-trust or banking safety apparatus to block cross-border bank M&As. We acknowledge these actions resort somewhere in the gray area between explicit prohibition of cross-border bank M&As (regulatory borders) and inherent political and cultural differences creating difficulties in making a cross-border bank M&A possible and successful (economic borders).

⁵ We conjecture the winner’s curse in von Thadden (2004) for example would decrease in case success across multiple projects undertaken by many borrowers would be uncorrelated.

⁶ Degryse and Ongena (2003b) and Elsas and Krahenen (1998) provide empirical evidence broadly supporting both hypotheses.

⁷ The evidence for deposit markets seems to run in the same direction. Heitfield and Prager (2004) for example document that the geographical scope of competition in US bank deposit markets is still smaller than statewide though not necessarily local any longer.

⁸ Riding (or running with) a road bike on a mountain bike track full of mud and puddles is called cyclo-crossing.

