LESSONS FROM EUROPEAN BANKING LIBERALIZATION AND INTEGRATION

by

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I. INTRODUCTION

This paper surveys developments in European banking related to liberalization and financial market integration to find out what it may tell us about regulation and public policy. The analysis rests upon the present state of knowledge of competition and regulation in banking.

Banking has been in a state of change since the start of the process of liberalization and deregulation in the US in the 1970's. The increased reliance on competition, internationalization and financial market integration, have put pressure on restructuring the financial sector. At the same time, liberalization has been linked to episodic crises with costly consequences for the economy and, consequently, has put into question regulatory and supervisory procedures. Europe has embraced the liberalization process and the European Union has fostered market integration (the Single Market Program in 1992) and Monetary Union (EMU in 1999).

What can we learn so far from the European experience of liberalization and market integration?

Section II outlines the general transformation of the banking sector. Section III describes the evolution of banking markets in Europe taking the US as a benchmark. Section IV addresses European financial market integration and the impact of monetary union. Section V considers banking failures, and their links to the liberalization process, supervision, corporate governance and competition policy. Finally, in Section VI we draw some lessons from the European experience. The Appendix provides a conceptual framework for the analysis in which we discuss, from a theoretical perspective, competition, sunk costs and market concentration, and regulation.

II. THE TRANSFORMATION OF BANKING

We can distinguish two broad periods in the recent history of banking: a period of tight regulation and high stability from the 1940's until the 1970's; followed by a period of liberalization and greater instability which continues up to today. The banking industry has gone through a major overhaul in the transition, and its business is being further transformed by technological developments.

The shortest way to characterize the transformation of the banking industry is to say that the emphasis has gone from regulation to competition. Indeed, in the first period, rate regulation, entry restrictions and charter limitations of banks (including the separation of commercial and investment banking) have been used by regulators to limit competition.[1] Other regulatory facilities, like the lender of last resort and deposit insurance, have been widely implemented in order to prevent runs and instability in the banking system.

In general, the regulatory changes have promoted competition by decreasing geographical and activity restrictions and thus reducing entry barriers.[2]

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1 Basic regulation in the US is contained in the Pepper-McFadden Act (1927) and in the (Glass-Steagall) Banking Act (1933). The latter separates commercial from investment banking. In Europe universal banks, with the capacity to hold equity positions in firms, were allowed in different countries following the German model. In some countries savings banks have been traditionally specialized in channeling savings into mortgage loans. Deposit rate regulation was established in the US during the 1930's and in Europe at different times. Rates have remained regulated in most countries until relatively recently. Sometimes governments (chiefly in Europe) encouraged collusive agreements among banks. (See Baltensperger and Dermine (1987) and Vives (1991).)

2 The deregulation wave which followed from mutual fund competition for deposits in the US scrapped restrictions on rate setting (regulation Q). This provided a first important instance in

The following are underlying factors in the liberalization and deregulation process:

(i) The liberalization of international capital movements (with the oil shocks of the 1970's playing an important role);

(ii) Technological advances in information systems, data processing and transactions (affecting retail banking with ATM's, PC banking, and bank by phone, as well as increasing the productivity and creating economies of scale in the back office);

(iii) Advances in the techniques of risk management and hedging, and securitization (affecting asset management, investment banking and corporate lending);

(iv) Globalization understood as a decrease of "transport" costs and reduction in barriers to trade (affecting wholesale banking, investment banking and asset management);

(v) Demographic changes with an aging population and crisis in the financing of the welfare state (affecting asset management and private banking with an enhanced demand for pension systems);

(vi) A move towards shareholder value (affecting the market for corporate control both of banks and firms).

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which regulation is by-passed and made ineffective by financial innovation. By 1983 all depository institutions in the US could freely compete in rates offered to customers. In Europe rate setting is now mostly liberalized. In Spain, for example, there is complete freedom in rate setting since 1987. Some exceptions in the liberalization trend have been demand deposits in France, interbank agreements on interest for checking accounts in Belgium, and some coordination on rates through banking associations (with antitrust exemptions) in Germany. (See Gual and Neven (1993) and Demirgüç-Kunt and Detragiache (1998).)

These underlying factors induce in turn the following outcomes:

*Market integration (in Europe, in the US and internationally). This implies an effective increase in the size of the banking and financial market;

*An increase in competition (both internal, from the banking sector, and external, from new competitors);

*A disintermediation process in which the capital market competes directly with the banking sector;

*Financial innovation with the development of new products and processes both in retail and corporate banking.

The end product is a complete transformation of the banking business. Banking has moved from traditional business, accepting deposits and awarding loans, to the provision of services to investors and firms. In wholesale and investment banking, services like underwriting, trading, brokerage, rating, and Mergers and Acquisitions (M&A's) are provided to large and medium-sized firms. This implies a change away from the financial margin and towards fee income. However, we should expect that banks will maintain a liquidity insurance provision role.[3] This transformation is accompanied by a movement from investment in branches ("bricks") to investment in communication networks and information technology, as well as specialized human capital. Banking is moving towards a knowledge-based activity. This transformation implies that the new sunk costs (investment in information technology, product development, specialized research etc.) become relatively more important than the cost of establishing a new branch. As a consequence, size and

3 See Diamond (1997) and Holmström and Tirole (1998) for a theoretical analysis.

economies of scale grow more important than in traditional business. It is perhaps not surprising then that the industry is subject to a strong restructuring and consolidation process.

III. THE EVOLUTION OF THE BANKING SECTOR IN EUROPE AND IN THE US

The process of transformation of the European banking sector should be compared against the backdrop of the evolution in the US where, in general terms, the process seems more evolved (with the possible exceptions of the UK and Switzerland).

1. Is banking in decline ?

A first interesting fact is that, despite the disintermediation process, the US banking sector did not decline in the period 1979-1994. In the US the banking industry grows as fast, or faster, than the (real) GDP when accounting for off-balance sheet activities and loans by foreign banks to US firms. However, the reduction of traditional business is taking place. In the same period, the percentage of total credit market debt held by US commercial banks (i.e. loans) decreased by one third as does the percentage of total non-credit market debt of financial intermediaries held by US commercial banks (i.e. deposits).[4]

Banks have an even stronger position in Europe (see White (1998)):

*Banks' assets in Europe account for a much larger percentage of total assets of financial institutions (50 to 80%) than in the US (about 22%);

*European firms rely much more on bank loans than on the capital market. The share

[4] It must be pointed out though that the increase in loans by foreign banks to US firms more than offsets decline of loans by US banks. See Berger, Kashyap and Scalise (1995).

of bank loans on total liabilities, which is about one third in the US, is about 80-90% in continental Europe;

*The markets for corporate securities are underdeveloped (with the relative exceptions of France and Spain);

*European banking is already universal (in Germany in particular) and EU institutions can engage in a wider range of activities than their US counterparts (for example, moving into insurance with "bancassurance");

*European banks have a stronger foothold on the asset management business (the market share of independent funds is much smaller than in the US).

Furthermore:

*Fee income is still a small fraction of total bank revenues (with the exceptions of the UK and Switzerland);

*The balance sheet of European banks still relies a lot on loans to firms with relatively less weight in trading and consumer loans;

*The development of ATM and the use of credit cards is widespread in several European countries.

An analysis of the evolution of the banking systems of France, Germany and the UK in the period 1982-1995 (Schmidt et al (1999)) finds that only in France is there an appreciable trend towards disintermediation and a decline in the role of banks, while the tendency towards securitization is general. The data shows a general tendency for banks to specialize in lending operations rather than a general move from intermediation to markets. This is because the role of non-bank intermediaries in mobilizing deposits is growing.

2. The consolidation process: economies of scale and diversification[5]

A second fact is the important consolidation process underway in US commercial banking with a massive reduction in the number of banks (from 12.463 in 1979 to 7.926 in 1994). From 1980 to 1994 there was an average of 423 mergers per year. The total number of mergers represents about 43% of the total number of banks in 1980. There were 142 mergers involving large banks and about 56% of those were inter-state (Rhoades (1996)). The market assessment of mergers is either inconclusive or it is found that the acquirer suffers a loss of market value. Although large horizontal mergers in the US are found to cut total costs - basically staff costs and data processing systems and operations - this does not mean that cost efficiency is improved. Indeed, most academic econometric studies in banking find that economies of scale are exhausted at relatively low asset levels, and that the supposed cost efficiencies of mergers are hard to find or inconclusive (see Rhoades (1998), Calomiris and Karceski (1998) and Piloff and Santomero (1996) for overviews).

Furthermore, the evidence on the effectiveness of the market for corporate control in eliminating or reducing bad management is ambiguous.[6] Concern has also been raised about the effects of consolidation on lending to small firms.[7]

The evidence from the megamergers of the 1980's suggests that there are no indications of increases in cost efficiency, but that the mergers may have improved profits through diversification. The evidence of megamergers of the 1990's is scarce.

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5 See the Appendix for an analysis of sunk costs, entry and concentration.

6 See Hawamini and Swary (1990) on the positive side and Hannan and Rhoades (1987) on the skeptic side.

7 See European Commission (1997) and Vander Vennet (1996).

However, work by Hughes et al (1996, 1998) points to strong benefits of consolidation (improving market value efficiency, production efficiency and reducing insolvency risk) when the degree of macroeconomic (geographic) diversification increases. More precisely, those authors find that geographic diversification offsets the tendency of larger banks to take more insolvency risk (controlling for diversification). An expansion in asset size is associated with a less than proportionate increase in expected profit, and a more than proportionate increase in risk. However, an expansion in asset size, and the number of branches within the same state, is associated with a more than proportionate increase in expected profit, and a less than proportionate increase in risk. An expansion in asset size, branches and diversification across states is associated with an improvement in value efficiency and reduction of insolvency risk. Consolidation within the state reduces insolvency risk but does not improve market value.

These results may represent the start of the resolution of a puzzle linked to empirical banking studies of economies of scale: while academics are skeptical, banks continue to merge! According to Hughes and Mester (1998) the problem is that empirical studies of scale economies do not account for risk. The studies measure the effect on cost of the joint increase in scale and risk (noting that the lower cost of risk management of a larger better diversified bank may induce the bank to take on more risk). Cost savings may not be detected if no account is made of asset quality. Indeed, if bankers are risk-averse, lower asset quality may require spending more on screening and monitoring loans in order to keep risk under check. Controlling for risk taking, large economies of scale that increase with asset size are found in US banks.

In Europe the consolidation process is less advanced although it has recently accelerated, M&A deals in Europe start at low intensity and only catch up with the US later on, averaging about 15 a year before 1985 and increasing to between 50 and 90 deals per year up to 1994. In the period May 1997-May 1998, M&A deals in the US amounted to $392 billion while, in Europe, it was $127 billion. M&A's in Europe tend to be smaller in size than in the US and are paid in cash instead of equity. Furthermore, there are many more domestic M&A's than cross-border in Europe. For example, recent large mergers are domestic: Hypobank-Vereinsbank in Germany, UBS-SBC in Switzerland, BNP-Paribas (and, at the time of this writing, perhaps SG) in France, IMI-San Paolo and Crédito Italiano-Unicrédito in Italy, Santander-BCH in Spain.[8] At the same time in Europe the market share of mutuals and publicly owned banks is still quite important (despite privatizations of public banks like in Spain).[9]

Some studies have found economies of scale in European banking institutions but they appear to be exhausted soon after, following cyclical changes. (See Altunbas et al (1996) and European Commission (1997)). Other studies do find benefits of mergers in Europe. For example, Vander Vennet (1996, 1997), studying a sample of 492 takeovers between EU credit institutions in the period 1988-1993, finds that domestic mergers among equally sized partners improve performance (in terms of profitability and operational efficiency), and that cross-border acquisitions improve cost efficiency. Mergers among small institutions may be profiting from economies of scale, while in large mergers probably cost rationalization is responsible for the improved performance.

However, domestic bank acquisitions (absorptions) do not improve cost efficiency and the evidence is consistent with market power and growth (size) motives. Cybo-Ottone and Murgia (1998) perform an event study analysis of 54

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8 An exception is Deutsche Bank acquisition of Bankers Trust.

M&A deals in the EU and Switzerland. The authors restrict attention to deals in which control changes and both the target and the bidder are listed. This implies that they are large deals. They find that the combined stock market performance of target and bidder improve at the time the deal is announced. They trace the improvement to domestic combinations and diversification of banks into insurance. Again, the first is not inconsistent with a market power motive for the combination. It is also worth pointing out that the benefits of international diversification within Europe are somewhat limited because of the increased correlation of the cycles of European regions from different countries due to market integration, coupled with a decreased correlation for the cycles of regions within the same country (see Fatás (1997)).

3. Market concentration

National concentration levels are much higher in Europe than in the US and have tended to increase in the last ten years, in particular in smaller countries.[10] For example, the concentration ratio C_5 for deposits ranges from 30 to 80% in EU countries, with the exception of Germany which is less concentrated. Gual (1999) tests the character of competition in retail banking in eleven EU countries during the period 1981-1995 and finds that it can not be rejected that the classical model (of investment in branches rather than on information technology)[11] is behind the observed concentration pattern.

The C_5 deposit ratio had a value similar in the EU and in the US (around 12%) in 1997. However, in 1998 in the US the ratio jumps to 22% due to the merger wave. It is worth remarking that - despite an increase in concentration at the US level in the

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9 See White (1998).

10 See ECB (1999).

11 See “Sunk costs, entry and concentration” in the Appendix.

last ten years (for example, the percentage of assets in the hands of the top height in the US goes from 22.3% in 1988 to 35.5% in 1997) - local concentration (measured in MSA and non-MSA counties) does not show a definite tendency (Berger et al (1999)). This is because of the weight of interstate mergers in the US. In Europe the predominance of domestic mergers tends to increase local concentration. This is worrisome because what does matter, for the exercise of market power in retail, is precisely local concentration.[12]

IV. FINANCIAL MARKET INTEGRATION AND EMU

1. Market Integration

The liberalization program in Europe has been based on deregulation measures taken at the national level, coupled with European directives abolishing capital controls and establishing the freedom of cross-border financial services.

The European Directives provide the foundation for the Single Market Program in banking and financial services (with focal date 1992). The centerpiece is the Second Banking Directive (dated 1989, revised in 1992 and 1995 and in effect from 1993) which established the principles of the *single banking license* and the *control of the home country* under the regime of common rules on admission and supervision. Authorization for a financial institution to operate in one country of the European Union is enough for the institution to open branches, or supply financial services (from the list established in the Directive), elsewhere. The Second Directive calls for home country control on prudential supervision, and the mutual recognition by the national regulatory authorities in the EU of the rules in the countries of origin of the banks operating in their territory. The Directives provide for essential

12 See Neven and von Ungern-Sternberg (1998) for an analysis of the competitive impact of the UBS-SBC merger.

harmonization of access to the banking activity, capital required to cover credit and market risk, solvency ratios, putting limitations on risk concentration in lending, standardization of accounting procedures, including consolidated accounts.[13] In the Directive on deposit insurance (in effect since July 1995) a minimum EU-wide coverage is called for, normally up to 20.000 ECU per depositor (reflecting more an interest in protecting small investors than in preserving the stability of the financial system), and the home-country principle is applied; while banks licensed in an EC country are covered by the home country deposit insurance scheme when operating in another EU country.

The principles of home country control and mutual recognition lay out a regulatory competition frame which may be beneficial in avoiding regulatory burdens over and above the minimum European harmonization. At the same time, it may spur information production and limit the potential opportunism of the national regulators.[14]

The combination of deregulation at the national level, abolition of capital controls and the Single Market Program initiatives have substantially increased competitive pressures in European banking. Banks have tried to compensate apparent reductions in net interest margins with an increase in fee income, and there are indications of effective cost reductions (and decreases in X-inefficiency). For example, bank staff costs per unit of output have tended to decline.[15] Still, European

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13 Main directives are Investment Services (dated 1993, implemented in 1995), and Solvency Ratio and Capital Adequacy (of 1989 and 1993, amended in 1992, 1995, 1996 and 1998).

14 See Kane (1989) for the account of the benefits of regulatory competition.

15 However, there seems to be a strong cyclical component in reductions in X-inefficiencies. There is also mixed evidence on variations in productivity in the banking sector in the 1990's. (See

banks seem to be less cost efficient than their US counterparts using as criteria income generated per employee, staff costs as percentage of gross income, or the decrease in employment from (historical) peak levels. There are also several indicators pointing to overbranching in several European countries although the average size of branching networks tends to diminish.[16]

It is hard to identify EU Directives as the origin of changes like the tendency towards tougher competition or cost cutting measures.[17] The role of the EU Directives and, in general, the Single Market Program (as conjectured in Vives (1991)) has been rather to provide the focal point on which the expectations of change towards a more competitive system have converged. The SMP made a difference by constituting a credible commitment to the liberalization of the different national banking sectors, and focusing the expectations of banks on the change from a game in which regulation and collusion were at the center-stage of competition.

Despite the SMP, the degree of cross border penetration is very small (for example, in terms of the percentage of deposits captured or loans granted by foreign subsidiaries and by foreign banks, see White (1998)). This points to the importance of barriers to entry in retail (like the established branch networks and relationships with clients) and the presence of significant switching costs for customers.[18] Furthermore,

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European Commission (1997).) All in all hard complete evidence on the effect of liberalization is still lacking.

16 See Gual and Neven (1993), Cerasi, Chizzolini and Ivaldi (1997) and European Commission (1997), McCauley and White (1997).

17 See Cerasi, Chizzolini, Ivaldi(1997) and European Commission (1997).

18 Dell'Aricia (1998) builds a model where asymmetric information constitutes a barrier to entry in banking.

the differences among countries in the degree of competition, amount of cost reduction and stage in the transformation process are important. There are indications that countries which have introduced more competition experience larger reduction in margins, profitability and cost reduction (like, arguably, Spain). Some countries lag behind in the move towards services like France, Italy and Spain as compared with Germany or the UK. There are also differences in the financial strength (health) of banks (with Moody´s ratings above the US for banks in several European countries).

In summary, European banking is still quite segmented across national boundaries (particularly in retail).

2. The impact of EMU

EMU eliminates two sources of segmentation, or competitive advantage, of local banks: currency risk; and expertise on national monetary policy (and in general any home currency advantage). EMU will also make market practices more uniform and pricing more transparent, increasing competitive pressures.

The first order effect of EMU will be to deepen financial markets, working as a catalyst in the development and integration of security markets and making them more attractive relative to intermediate solutions (for example, favoring securitization, expanding the institutional investor base with mutual and pension funds of European dimension, inducing medium sized firms to raise money in the corporate European bond market etc.).

EMU will reduce, but not eliminate, market segmentation. Segmentation can be resilient due to differences in preferences and barriers to entry in the retail market, for example. Furthermore, some regulatory restrictions which induce segmentation may remain in place. An instance may be restrictions on the portfolio composition of institutional investors.

EMU will accelerate the transformation of the sector, although the transformed banking sector need not be smaller. The acceleration of the transformation of the sector, coupled with an increase in market integration leads to restructuring. In the US the merger wave is explained in part by the lifting of restrictions to interstate banking (coupled with a more lenient antitrust climate). In Europe, exchange rate risk was a brake to cross border mergers. EMU could be a pivotal factor in changing the structure of the European banking sector. However, we have seen the predominance of domestic mergers so far in Europe. The explanation is that there are obstacles to cross-border mergers in Europe which are not present in the US. Namely, problems of labor mobility, even at the managerial level, differences in corporate culture and political interference (i.e. the fostering of national champions). At the same time, domestic institutions may consolidate to cut costs (reducing branching overlap, for example) and increase market power.[19] However, cross border mergers may develop in a second phase to acquire local expertise, to access high margin deposits or to diversify while, at the same time, size is gained to compete in the global market segments.

V. LIBERALIZATION, BANKING FAILURES AND RESTRUCTURING

1. Liberalization and crisis

The stability of the banking system was guaranteed over the long period from the 1940's to the 1970's, when the system was tightly regulated. The problem of excessive risk assumption, owing to the implicit guarantee of the lender of last resort and/or deposit insurance, did not arise. Essentially, competition was eliminated by means of the regulation of interest rates, activities and entry into the sector. In addition a profitable

19 See Giavazzi et al (1999).

sector was maintained - with collusion even being encouraged - and this, in view of the fear of losing the bank charter, lowered the incentive to take risks (Keeley (1990)).

The introduction of competition has not been without problems. International evidence (Demirgüç-Kunt and Detragiache (1998)) indicates that banking crises are more likely to occur in liberalized financial systems (other independent effects are bad macro policies, adverse macro shocks and vulnerability of the foreign sector). However, the effect of liberalization is weaker in a "strong" institutional environment (in terms of the rule of law and contract enforcement restraining corruption).[20] There is also evidence in favor of the theory that bank franchise values are eroded due to liberalization, providing a potential explanation of the increased risk of taking incentives and associated fragility.

International evidence of successful bank restructuring emphasizes: the importance of prompt corrective action; a reparation of the institutional shortcomings in the legal, accounting and regulatory systems; and improved supervision. Problems in the banks' management tend to be always present in a crisis.[21]

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20 Liberalization is also associated to lower concentration ratios, an increased presence of foreign banks and with higher capitalization. Financial liberalization helps financial development, and therefore output growth (consistently with King and Levine (1993)), in the absence of banking crises or even with banking crises if the economy was financially repressed (defined as having negative real interest rates) to start with.

21 Resolution methods of distress include: a rescue package, a forced merger or takeover with healthy banks (for example, Baring's was taken over in the end by ING), liquidation (like BCCI) or, with a systemic problem, a special regime managed by the deposit insurance fund (or the government directly). Liquidation is not a favored method of resolution. It is important also that the central bank provides emergency liquidity support when necessary. The separation of

Europe is no exception to the international experience. Banking crises have occurred, and the causes are also in line with crises outside Europe, despite the fact that liberalization linked to market integration has not been accompanied by systemic problems in continental Europe. Indeed, after 1985 we can identify only four major banking failures: BCCI in 1991, Banesto in 1994, Barings in 1995 and the enduring problems in Crédit Lyonnais. This is not to say that systemic problems have not developed in Europe. Spain suffered a severe banking crisis at the beginning of the 1980's, and Scandinavia another at the beginning of the 1990's.[22]

In this sense, Europe is not different. For example, in Scandinavia the roots of the beginning of the 1990's crisis lay in a conjunction of factors preceded by the financial liberalization of the 1980's: lax enforcement of capital requirements; poor supervision; and lack of internal risk control methods; augmented by mistakes in fiscal and monetary policy in the context of an asset price bubble. Amongst the factors behind the Spanish banking crisis in the first half of the 1980's, with financial liberalization started in the 1970's, were: the strong impact of the economic crisis from the oil shocks; the close links of banks with industrial firms; lack of diversification of banks' industrial portfolios; bad management; and inadequate supervision.[23] It must be pointed out also that, when put in an international

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authority between the central bank and the supervisory agency makes less likely the involvement of tax payers or other commercial banks in the rescue effort (Goodhart and Shoenmaker (1992)).

22 The cost of the crisis are estimated, in percentage of GDP, to be about 8-10% in Finland, 4-6% in Sweden, 4% in Norway and 15% in Spain, see Caprio and Klingebiel (1996) and Dziobek and Pazarbasioglu (1997).

23 Caminal, Gual and Vives (1990) describe in the following way the banking crisis in Spain: "From 1978 till 1983-5 the banking system suffered a severe crisis in Spain. Between 1978 and 1983, 51

perspective, Europe has fared better than the average in terms of recovery from banking crisis (Caprio and Klingebiel (1996) and Dziobek and Pazarbasioglu (1997)).

Spain is an example of the successful turnaround of a troubled banking system precisely because of improvements in the institutional setting (for example, a deposit insurance fund was instituted in response to the crisis), tightened supervision by the Bank of Spain, coupled with a slow-down, but not a stop, of the liberalization process against the background of a reasonable, although far from perfect, contractual and rule-of-law framework. This recovery explains the present health of the Spanish banking system (in terms of capitalization, profitability, quality of service, stability and competitiveness) and its international projection in Latin America. Without the deepening of the liberalization process maintaining a healthy (although perhaps still insufficient in some market segments) level of internal competition which has

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banks (representing 46% of the existing banks in 1977) involving 20% of total 1983 non-equity liabilities were affected. The peak of the crisis was in 1982 (12 banks failed) and 1983 (21 banks, basically the Rumasa group-20 banks). Five more banks were affected till 1985. The causes of the crisis are diverse but coincide in general with the experience of other countries. First of all the industrial crisis derived from the raise in the prices of oil in 1973 and 1979. Spain suffered the impact of the crisis more severely than other industrialized countries. The consequences for the banking system were more profound also due to the close links between banks and industrial firms. The industrial portfolio of banks was substantial and it was not well diversified. Secondly, bad management and fraud. The third cause was the lack of monitoring from the central bank of banks in trouble. In fact, in Spain a Deposit Guarantee Fund ("Fondo de Garantía de Depósitos", FGD) is instituted only in response to the crisis. The crisis had its effect on the structure of the market leading to a noticeable increase in concentration over the period 1980-1984 and slowing down the liberalization process since authorities were worried about the solvency and stability of the system."

ameliorated efficiency, the international expansion of Spanish banks would probably not have happened.

The experience of liberalization and market integration in Europe is consistent with the idea that to introduce competition in banking is good, provided that appropriate regulation and supervision is in place. (See the Appendix.)

2. Corporate governance, national champions and supervision

It is important to distinguish between systemic failure and individual bank failure. Indeed, it may be efficient to let a bad bank fail, provided it does not cause a systemic problem. The noted individual banking failures in Europe illustrate different aspects of problems in financial regulation.

The cases of Banesto and Crédit Lyonnais were examples of excessive credit expansion coupled with bad management and fraud. Both banks provide a tale of aggressive expansion, supervisory forbearance and a failure of corporate governance. They exemplify the tendency of banks to "gamble for resurrection" once they have got into trouble.

In the case of the public Crédit Lyonnais, there was the idea of creating a national champion in the European arena which would help French industry. Surely Crédit Lyonnais was “too big to fail” (TBTF). It ended up amassing about $17 billion in bad loans. A chain of supervisory mistakes compounded the problems of the bank at the beginning of the 1990's. For example, bad debts were assumed by the Consortium de Réalisation which, until the European Commission complained, was under the control of Crédit Lyonnais. The Competition Policy Commissioner ended up imposing the privatization of the bank together with temporary constraints on its activities and dividend policy (selling subsidiaries, limiting the growth of the bank's assets, and requiring paying a minimum substantial percentage of income as dividends). The intention of the French government is to keep the bank in French hands.[24]

Political interference and lack of transparency characterized successive attempts to rescue the bank. The problem was the closeness of supervisors and managers (because of the French system of elite education based on Grandes Écoles, and the revolving door between regulators and management of large firms). In this corporate governance system, a group of high civil servants took turns running the government, including its regulatory agencies, and major national corporations. The system of checks and balances was replaced by collusion and the exchange of favors. The role of the competition authority in the European Commission has been crucial in the restructuring process, limiting public aid to the ailing national champion.

Banesto was private (and still is, although under the control of Banco de Santander) but corporate governance failed here as well. The board was probably captured by management and did not play an independent supervisory role. At the same time, most likely, regulatory authorities were slow to react to indications of problems because of the "too big to fail" (TBTF) syndrome which induced forbearance; and the intrinsic difficulty of collecting necessary verifiable evidence in the face of a fraudulent strategy by management. The Bank of Spain intervened in December 1993, though an investigation into the bank, because of insufficient capitalization, had already started in March 1992. The Spanish deposit insurance fund (FGD) came to the rescue of Banesto and shareholders kept part of their investment.

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24 See The Economist, May 23, 1998.

We have, therefore, an example of TBTF policy which partially rescues shareholders (though not management).[25]

The increase in the loan portfolio of Banesto in the period 1988-1991 was close to 110%, whereas in Spanish banking generally it was 60%. Moreover, the average cost of borrowing rose above the average at other banks. Banesto concealed its bad balance sheet by means of creative accounting, and by operations between firms in the group.

The Banesto and Crédit Lyonnais cases provide an example of the need to intervene early in intermediaries that develop problems and are not adequately capitalized. Those institutions misuse the competitive tools and need to be constrained in order to avoid excessive risk taking. Crédit Lyonnais also exemplifies the danger of worsening the TBTF problem when promoting national champions, and the need for independent supervision.

The crisis of the Bank of Credit and Commerce International (BCCI) presents a case of externalities among countries, created in this case by the failure of a bank authorized in Luxembourg. Many of the bank customers were residents of other European countries, and therefore a substantial share of the costs of BCCI's failure were borne by investors outside Luxembourg. Furthermore, the failure of BCCI triggered concern about contagion in other institutions in the UK. Indeed, local authorities in the UK reexamined their relations with small banks because of their exposure to BCCI.

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25 The new president of Banesto, Alfredo Sáenz, stated at the shareholders meeting that approved the restructuring of the bank, that the interest of the shareholder had been preserved because shares were valued at 400 pesetas when "technically their worth was zero" (El País, March 27, 1994).

The case of Baring's points to insufficient internal control of an institution – in this case related to its risk exposure on operations in derivatives. Baring's collapsed because of losses in derivative instruments traded in Singapore by an employee.

Individual banking crises underline the need for an effective corporate governance system which controls managers and facilitates the exit of inefficient or badly managed institutions. Obstacles to corporate control, in the form of political interference or charters protected from market discipline, should be removed. In particular, the privatization of remaining public institutions and a rethinking of the governance structure of mutuals and savings banks is in order. Indeed, such corporate control does not exist for public banks, and savings banks under the diffuse control of public institutions. Neither can be taken over (but they can take over other banks).

European countries have enjoyed a better-than-average recovery from their banking problems, which do not differ substantially from the international norm, probably because of a strong institutional structure and strengthened supervision. The shortcomings of national regulators, when facing restructuring problems, have sometimes been overcome with the help of the European competition authority. However, there are still barriers to restructuring in place in the form of: public ownership; lack of a market for corporate control; and concerns about the national interest (and national champions). These barriers may prove to be important in the context of monetary union.

3. Competition policy

In Europe, cartels were seen as necessary to safeguard the stability of the system. Cartelization was supposed to be unambiguously good and authorities tended to promote it. Essentially, this meant that competition policy was not applied to banking.

The present view is that competition has to be promoted, although the application of competition policy to the banking sector has to take into account the notion that some degree of market power may be efficient in banking (see the Appendix). However, domestic consolidations, predominant in Europe, with their potential to substantially raise local market power in the retail market, have to be carefully examined by antitrust authorities. Across-country consolidations might be regarded in a more positive light due to the possibility of increased diversification and lessened concern about market power. It is possible, though, that the protection of national champions might interfere with such across border-mergers. The recent case of the Spanish BSCH trying for an alliance with the Portuguese group Champalimaud which was vetoed by the Portuguese government; and the insistence of the French regulator on a "French" solution to the BNP battle with SG over the merger with Paribas, make clear such chauvinist tendencies in Europe. The role of the European competition policy authority in such cases may prove crucial in keeping such tendencies in check. At the same time, such an authority may represent a commitment to screen state aids, according to market failure principles, away from local lobbying pressures and help to national champions.[26] This intervention may be optimal then, even in the case where no negative cross-border externalities are involved because of the state aid.

The European experience underlines the need for explicit consideration of competition policy in banking at both national and European levels. The concern for stability can be strengthened by allowing bank regulators to also have a say in bank mergers. The competition authority will tend to emphasize the benefits of

26 See the analysis of Besley and Seabright (1999) for related points.

competition, while the regulator considers its potential costs in terms of stability.[27] From this conjuncture, more information should be generated about the costs and benefits of a merger, or even about the use of public money to help ailing institutions, for example.

4. EMU and new challenges for supervision

Increased financial market integration, with markets playing a bigger role, increases the external effects among countries and the risk of contagion (as the BCCI crisis shows). The prospect of a liquidity crisis, or a domino effect because of a failure of interbank commitments, is not remote, as the international financial crisis of 1998 makes clear.

This means that Europe needs a lender of last resort (LOLR) and coordinated supervision of financial institutions.[28] The latter will be particularly true if pan-European institutions emerge. The present arrangements in the Maastricht Treaty do not entrust the European Central Bank with responsibility for the stability of the financial system, or give it supervisory capacity. All this, in principle, rests in the hands of national authorities (national central banks or national regulatory agencies).

The problem with this approach is twofold: potential excessive intervention; and potential lack of decisiveness in crucial crisis moments. National regulators will not have the appropriate incentives to intervene in a crisis when external effects are important. A national central bank may have (or may be pressured into having) an excessive incentive to intervene to save a national champion. Furthermore,

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27 For example, in Italy the decisions of the Central Bank over banking mergers often run contrary to the (nonbinding) opinion of the competition policy authority (Cafagna and Sciolli (1996)).

28 The analysis of this topic is developed in Vives (1999) (see also See Chiappori et al (1991) and Giavazi et al (1999)).

coordination of national central banks may not be enough to respond to a potential liquidity crisis, such as the one caused by the failure of LTCM, if the European Central Bank does not have the necessary information.

The 1998 financial crisis originating in East Asia uncovered large exposures to the area of some European banks (German particularly). Meanwhile, Spanish banks are investing heavily in Latin America. Both cases probably reflect the quest for fatter margins in less competitive, but more risky, markets. International expansion can be a sign of strength, but it will also provide new challenges for supervisors. Indeed, short-term lending to emerging markets has proved risky.

VI. CONCLUDING REMARKS

The European experience with liberalization is consistent with the view that the opening of the banking sector to competition is good, but that supervision has to be strengthened. This is particularly true for institutions that develop problems (as signaled, for example, by low capitalization). Those institutions tend to misuse the competitive tools and take too much risk. Restrictions should be imposed on their activities.

More specifically, the lessons that can be drawn from the European liberalization experience are the following:

First, the importance of the Single Market Program (SMP) as an external commitment to liberalization must be highlighted. The SMP induced national authorities to liberalize in anticipation of the opening of the market, and focused the strategies of financial institutions on competition, as opposed to trying to influence regulation, and to establish and maintain implicit and explicit agreements that constrained rivalry. The indirect effect of the SMP seems to have been much more important than the direct effect on the competitive environment. Furthermore, the

SMP has also provided a minimum degree of regulatory harmonization consistent with fostering competition and market integration.

Second, Europe is not different from other areas in terms of banking crises. There are instances of both systemic problems; and problems with (large) individual institutions related to the TBTF syndrome. However, Europe's relatively strong institutional structure (in terms of the rule-of-law, for example) has helped in the better-than-average recovery of financial institutions and systems from distress. Successful examples of recovery are Spain and the Scandinavian countries. In particular, the Spanish banking sector made an impressive turnaround from the large-scale crisis of the early 1980’s to become competitive, well-capitalized and with international projection (mostly in Latin America). The key was the strengthening of supervision coupled with the introduction of competition. On the other hand, international investment in emerging markets may pose new challenges to regulators.

Third, Europe is also an example of political interference with banking regulation and supervision, with the promotion of national champions in the cause of industrial policy. France is the most conspicuous case. The predominance of domestic consolidation in Europe is related to this issue, among other underlying factors. One consequence is that the TBTF problem may become worse because national champions will tend to be protected. At the same time, the European competition authority has played a positive role in checking state aids to ailing national champions and ensuring efficient restructuring, as well as removing obstacles to cross-border operations. This highlights the importance of the role of external supranational regulatory institutions which can represent a commitment to efficiency.

Finally, in order to reap the full benefits of opening the banking market to competition, Europe needs to put in place some further structural reforms which would allow an efficient restructuring of the sector while, at the same time, providing a check on excessive risk taking. This is particularly important in the frame of monetary union, which will accelerate the transformation of the banking sector.

Such reforms would include the removal of obstacles to the market for corporate control, in the form of political interference and charters protected from market discipline. This applies in particular to the remaining public institutions and mutuals and savings banks.

Competition policy needs to play a more active role in the European banking sector, mostly in regard to the control of domestic mergers where the main motive may be market power in the retail segment. Some leniency is probably necessary, particularly when diversification economies are important, but the divestiture of branches should take place when a merger substantially increases local market power. In any case, both the competition authority and the bank regulator should have a role to play in bank mergers.

Monetary union makes apparent the need to put in place a LOLR facility and a much stronger coordination of supervision at the European level, both because of the increased external effects among countries, and the risk of contagion. In this case supervision can not be left completely in the hands of national authorities who may not have the appropriate incentives. This applies equally to regions in the world in which financial integration is at an advanced stage.

In summary, Europe may prove to be a very valuable laboratory to explore the consequences and problems of financial market integration and their potential solutions.

APPENDIX:

THE CONCEPTUAL FRAMEWORK: COMPETITION, LIBERALIZATION AND REGULATION[29]

1. Competition and market power

Competition has always been a contentious issue in banking. The benefits of competition for allocative and productive efficiency have been well established since Adam Smith. But competition is in general imperfect, and banking is no exception. Sources of friction in retail banking are entry barriers and switching costs, and in corporate banking established relationships and asymmetric information. The result is that there is room to exercise market power (Vives (1991)). All in all, however, competition is perceived to be good for efficiency.[30] Furthermore, a healthy degree of rivalry is perceived to be necessary to keep a vigorous pace of innovation in an industry, that is, for dynamic efficiency.

This view is probably at the basis of the trend towards introducing more competition in the banking sector all over the world. However, banking has some specificities. Crucial features are the important weight of debt in banks' capital structure, and the wide dispersion among small investors of this debt (deposits). The large amount of debt increases the risk of failure (or insolvency) while the dispersion on small investors limits their ability to monitor the activities of the bank. Further, the social cost of failure of a bank is perceived to be large. This social cost includes

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29 For an extension of the arguments presented here see Vives (1991), Matutes and Vives (1996, 1998).

30 The importance of X-inefficiency in explaining deadweight losses in banking does not seem to be less than in other industries, and may dominate scale and product mix efficiency (Berger and Humphrey (1992)).

both financial distress and economic distress. In summary, in banking the probability of failure is important, with a potentially severe moral hazard problem, and failure has associated with it a large social cost, typically of a systemic nature.

How does the specificity of the banking business affect the desirability of competition in the sector?

Perhaps the most salient aspect is that market power, at least up to some level, has added benefits. This is easily seen considering both models of competition in deposits and credits (Matutes and Vives (1996 and 1998), Caminal and Matutes (1997a,b)). The reason is that a bank which enjoys market power (and a high charter value) turns more conservative because its opportunity cost of going bankrupt is high. Indeed, the decline of charter values due to deregulation and liberalization has been blamed for the increase in failures in the banking sector from the 1980's on (Keeley (1990), Hellmann et al (1997)).

2. Sunk costs, entry and concentration

In an industry characterized by the presence of a sunk cost of entry, it is easy to see that concentration decreases as the ratio of the market size to the sunk cost of entry increases.[31] The prediction from the standard entry model, therefore, is that an increase in the size of the market (induced by market integration and liberalization) will decrease the number of banks, but concentration in the enlarged market (say at the European level) will be lower than originally in the individual countries.

However, we have argued that banking is being transformed towards a service industry in which the sunk cost is controlled by the bank by investing (for example, in

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31 For example, when markets A and B are put together the equilibrium number of firms falls from n_A+n_B to n_{A+B}, which is larger than $n_A= n_B$. That is, the concentration in the integrated market is lower than in any of the individual markets but there is a reduction in the number of banks.

communication networks/information technology or specialized human capital) in order to reduce costs, or to improve the quality of the services offered. Then, if the sunk cost of entry is not like the fixed cost of opening a branch, but is controlled by the banks via investment, and influences the cost of production and delivering services and/or the quality of the services (that is, there is vertical differentiation) then an increase in market need not lower concentration (Sutton (1991)).

The situation can be modelled as a three stage game: first, entry decisions (paying a fixed cost); second, investment decisions (like expenditure in cost reducing information technology and/or fixed investment in information acquisition, and; finally competition in the marketplace. Then there are circumstances where increasing the size of the market does not generate more entry in equilibrium, in fact it may generate exit, because competition at the investment stage is very fierce. The required circumstances are that the fixed expenditure must loom large in relation to the variable one at the production and market stage, and that market share must be sufficiently sensitive to the investment effort. Increasing the size of the market just generates increased expenditures by a few firms at the investment stage. Under those circumstances there is typically an upper bound to the number of active firms in the market (no matter how large). (See Schmalensee (1992).)

It is an empirical question to what degree in banking sunk costs are "endogenous" in the sense described above. It is likely, however, that the increased importance of investment in information technology, and in information acquisition, has increased the degree of endogenous sunk costs in banking, that the fixed expenditures loom large, and that market share has increased its sensitivity to the investment effort. If this is so then it may be true that in the new global market place there is only room for a few global players, even in an expanded market. This applies particularly to wholesale and investment banking (providing services - underwriting, trading, brokerage, rating, M&A - to the top tier of multinational corporations and medium-sized firms with international operations).

3. Regulation and supervision

The general trend is to introduce competition into banking, and to check risk taking with capital requirements and appropriate supervision.[32]

Theoretical work points to the fact that the main tool to control risk, namely, capital requirements, may not be sufficient. Capital requirements are potentially useful to control risk because, when the bank has its own capital at stake, it will bear some of the downside of a risky investment. The problem is that when competition is intense and the social cost of failure of a bank large (and this characterizes present conditions), in the presence of insured deposits with flat premiums, the incentive to take excessive risk is also large (Matutes and Vives (1998)). This is particularly true of institutions that have run into trouble – where their margins are eroded and they

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32 Capital requirements have been harmonized by the Basle Committee and the guidelines have been adopted also by the directives of the European Union. It is required that bank capital be at least 8% of a weighted sum of risky assets and off-balance sheet activities. This is a rigid view of the capital ratio which has given way to a more flexible approach when evaluating the market risk. Both the Basle Committee and the EU accept now the internal risk control models of banks (of the VAR type). The capital requirement is then set (arbitrarily) equal to three times the maximum possible loss in the portfolio position of the bank during a certain time period and with a certain statistical degree of confidence. (See Rochet (1998) for an analysis of this regulation from the point of view of incentive theory.)

have an incentive to use a "go-for-broke" strategy. This is what happened with a segment of the US S&L industry.[33]

However, it does not seem reasonable to impose limits on competition under normal circumstances. First of all, the informational requirements to implement rate regulation, or direct asset restrictions, may be very high. Furthermore, as is well known, rate regulation has other costs, among them, the induced tendency to over invest in services, excess entry and the possibility of regulatory capture (see, for example, Vives (1991)). Second, even if it were desirable, given the present pace of innovation in information technology, marketing channels, and financial engineering, it may not be possible to limit competition. Indeed, new competitors would spring to replace the forbidden activities of banks, or new products would be invented to circumvent the regulations. The cost that would be incurred by limiting competition would be too large.

Both risk-based deposit insurance and improvements in the disclosure of the risk position of a bank, discipline risk-taking behavior (the first by imposing risk sensitive premia and the second by the discipline introduced by well-informed depositors). However, while it is feasible to introduce disclosure requirements of the market positions of banks, increasing transparency, it is more difficult to assess the

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[33] The US 1991 regulatory reform implicitly recognizes the limitations of capital requirements, particularly for weak institutions. Indeed, the US 1991 FDICIA allows risky activities only to well-capitalized banks. When a bank solvency level is below a certain limit it can not expand its assets. Larger decreases in solvency may trigger the need to recapitalize or even rates ceilings may be imposed.

riskness of the illiquid loan portfolio of a bank.[34] Furthermore, more disclosure may, in fact, induce information-based runs of depositors (Postlewaite and Vives (1987) and Jacklin and Battacharya (1988)) generating instability. Some runs however, can be optimal to punish imprudent behavior by banks.

The possibility of runs leads us to the contagion issue and systemic problems, which are at the basis of the provision of Lender of Last Resort (LOLR) facilities and too big to fail (TBTF) policies. A basic problem is that a blanket guarantee to help institutions in trouble induces moral hazard on the part of banks (indeed, the candidates to be helped will tend to take too much risk).

In summary, some market power seems to be optimal in banking and, therefore, in the trade-off between competition and stability it is worth allowing a certain degree of market power. However, it is probably not feasible, and even unwise, to try to limit competition directly. Instead one can rely on a more lenient policy towards mergers, particularly those that substantially improve diversification. In this sense the status quo before the liberalization process, essentially with no competition and tight regulation, was far away from the optimal balance of the trade-off between enjoying the benefits of competition at the cost of increased instability. Indeed, central banks were too complacent with collusion agreements among banks. A case in which restraints on competitive activities should be enforced is when a financial institution is in trouble and has a low capital base, in order to avoid "gambling for resurrection" strategies. On the other hand too big to fail policies turn out to be difficult to justify and are subject to political interference.

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34 See Cordella and Yeyati (1998a, b) for an analysis of the effects of disclosure and risk-based insurance.

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