

# Perspectives of the European Banking Sector

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## 1. THE FUTURE OF EUROPEAN BANKING IN THE LIGHT OF EUROPEAN INTEGRATION - STRUCTURAL DIFFICULTIES AND PROBLEMS.

European economic planning is in many respects the child of the financial markets and their laws. The freedom of financial markets and free movement of capital was one of the prerogatives of European integration and an important forerunner of the political endeavours that strived for more cohesion in economy.

On the other hand it cannot be overseen that the European banking scene is presently in turmoil. The pace of mergers and acquisitions has accelerated and banks that have long been in trouble are disappearing more rapidly. All this has happened in a certain suspicious coincidence with the preparations for a European Monetary Union. Is the EMU really behind this acceleration? Where is the industry heading? What risks lie ahead in the transition? period ?

EU financial markets are very segmented. On the supply side - the savings habits - are the home bias of European households. On the demand side - the behaviour of companies - one needs to understand why European corporations stay away of the bond market and borrow from banks. The past US experience of the last fifteen years, in particular the transformation of US banks illuminates these phenomena. The US financial industry for example has had a massive consolidation and a lesser concentration on the level of the local banking markets, whereas the European scene saw mergers among commercial banks mostly within national markets and to a lesser degree at a European level. The understanding of this background is essential in understanding the forthcoming changes the EMU will bring about. In other words - traditional bank borrowing through companies will most likely decrease and as the US example shows, firms will more and more try to find access to the bond and stock markets for their financial needs.

## 2. RESHAPING THE FINANCIAL MARKETS AND THE BANKING SCENE

Recent developments however show that European financial markets are increasingly welded together. The European Monetary Union has helped eliminate remaining barriers between capital markets and investors can consequently choose from a growing range of different cross-border products whilst issuers can borrow from the most competitive sources. This trend continues as the cross-border investments within the EURO zone are rising. Progressive deregulations of capital markets and the resulting increase in competition levels have driven institutional investors to diversify their EU portfolios. For instance, Dutch pension funds and French insurance funds especially have been investing for some time now in European assets, particularly corporate bonds, reducing the relative share of domestic bonds in their portfolios.

It is still too early and too insecure to have precise details about the size and the characteristics of these trends, but some quantitative information is already available. By the end of 1998 net inflows of European equity funds totalled about €87 bn, nine times more than in 1996. To a large extent this is due to the fact that investors are moving away from national funds and into pan-European equity funds.

At the same time European portfolios are shifting towards riskier corporate liabilities. The end of multiple currencies and currency risk in the euro-zone allows European investors to avoid mismatches between the currency denomination of their assets and their liabilities.

These improvements in European capital market's liquidity is supporting cross-border integration, the launching of several stock exchanges (Frankfurt, Paris, Amsterdam, Milan and Brussels) for high-growth company stocks which have been integrated under the EURO.NM initiative.

Banking in Europe is likely to remain quite different from banking in the US and this is not good news. While the European banking industry will certainly undergo major changes it is likely to be made on a national level, where mergers are easier in terms of culture and regulation and will bring local market power with them. But there will be losers from such increases in market power, notably small businesses that will not be big enough to access the new Euro financial markets directly. Besides that, market structures and lending practices differ across Europe and the same change of interest rates that will be fixed through the ECB will affect many economies. This could constitute a major obstacle in creating a single monetary policy. One of the reasons why transmission mechanism differs across EMU states is the heterogeneous structure of the European financial industry.

## 3. EUROPEAN BANKING SYSTEMS AND THEIR FUTURE

However, the major policy implications will be related to regulation and bank supervision. Risk in the industry is likely to increase in the transition and the steady state as well. European countries will approach the EMU from very different initial positions as far as banks are concerned. In the steady state a more competitive industry will squeeze margins and raise risk. EMU will confront these changes without a clear strategy in the areas of regulation and prudential supervision. The European Central Bank claims that it will not be involved in these activities, which should remain the responsibility of national governments and national central banks. The coordination problem that will arise will make dealing with crises more difficult and will involve higher risks. Will the EMU be the last straw that will break the back of traditional European banking?

No doubt the coordination necessities will involve parallel rules for the monitoring of risks and procedures in case of a crisis. But at what speed will this happen - slower than the economic development, above all the accession of the CEE countries?

#### 4. EUROPEAN BANKING: EFFICIENCY, TECHNOLOGY AND GROWTH

The retail-banking sector has undergone immense changes over the last decade, such that the industry is barely recognizable. The creation of the European Single Market has of necessity initiated deregulation, whilst the increase in telephone and Internet banking has impacted on economies of scale. Financial services are now operating in uncharted territory and with considerable effect.

European banking systems products in view of the problems of integration will have to be constantly improved and adapted to the needs of the markets. For instance the Internet banking which still has a huge potential on the Old Continent. Whilst it has about 20 % market share in the US in, in Europe it is used to a much lesser degree, although recent polls have shown that Europe Internet users are warming to the idea of internet banking. In the UK 31 % of surfers seek financial advice, trade shares, buy insurance and bank using the internet. Denmark leads the group with 41 %; Germany follows with 34 and France with 33.8 %. However the services offered on the screen should be improved and security questions remain a priority for those banking online.

The changeover to the EURO will mean another large step towards integration. While large corporations have already been for a long time forerunners in establishing pan-European networks, small and medium-sized industries will profit from the €zone.

The new currency has led to significant opportunities as it eliminated foreign exchange risks, reduced administrative expenses related with foreign currency dealings and made imports cheaper. It will bring a greater price transparency in the Euro zone, leading to increased competition among suppliers and will lead to less fluctuation in procurement costs. Many industries operate in a single reference currency. The US \$ for instance is the standard used in the oil and chemical industries. The use of the Euro as an international reference currency would remove various long-term risks associated with the use of multiple currencies and would allow European companies to concentrate on structural competitiveness and productivity. The use of the euro as a trading currency will be facilitated due to the fact that the EU countries' world wide exports are greater than those of the United States. The euro will stabilize trade patterns and thus reduce marketing costs. Neighbouring countries such as Norway, Switzerland and Central European countries will be under pressure to link the value of their currency to that of the euro, thereby enlarging the zone of monetary stability.

The very ardent question whether European financial market integration will be helping to increase or decrease the probability and impact of financial crises requires a look at the causes, which are generally triggered by a sudden and sharp loss in the value of financial assets. This can concern either currency, equity or in case of a banking crises the assets and liabilities of financial institutions. The vulnerability of financial assets stems from the uncertainty attached to the underlying investment projects in combination with an asymmetric distribution of information between those who invested and those who provide the financing. In addition to that, the possibility to exchange financial assets on liquid markets exposes them to potentially large changes in valuation. Therefore financial crises may occur as some kind of market failure, where rather trivial price changes may trigger massive and fundamentally unjustified changes in asset valuations and make financial crises difficult to predict or to prevent. We all know that the past year was not the year of the analysts!