Executive Summary

Banking is in turmoil. The bank as an institution is changing; the industry is changing. Advances in information and financial technologies are transforming banking practices at the same time as regulatory changes have transformed banking markets. This is true in the United States, with the Riegle-Neal Act of 1994 and the gradual repeal of the 1933 Glass-Steagall Act. It is even more so in Europe, where the ultimate regulatory change has been EMU - the adoption of a single currency.

These changes have been accompanied by an unprecedented wave of mergers and acquisitions. A handful of huge global institutions seem prepared to dominate the scene. At the same time, the Asian crisis and its aftermath have left deep wounds. Banks, European banks in particular, appear to be vulnerable to economic accidents like Asia and Russia, and in some respects, banks are more fragile than ever before as the consequences of the near-collapse of Long Term Capital Management illustrate.

Will EMU be the 'last straw' that breaks the back of the traditional European banking industry? There seems little doubt that inside EMU, the practice of banking and the process of financial intermediation will become more uniform, but at what speed and on which model will they converge? What are the implications for competition within the European market and for the competitiveness of European banks? And how should governments manage regulation and bank supervision? These are some of the key questions addressed in this Report.

Will the European banking industry end up just like its US counterpart?

On purely objective grounds, the post Riegle-Neal Act United States and post-EMU Europe will be very similar, suggesting that the two industries may converge on a single model. But the transformation of the US and European banking industries are different in two important respects:

- First, the United States is more advanced in the deregulation process - not only because the currency segmentation of European markets has only now been removed (and only among 11 countries), but also because the EU's Single Market Directives, while substantial on paper, have not to date been as effective in practice.

- Second, despite the massive consolidation of the financial industry, in the United States, concentration at the level of local banking markets has, if anything, decreased. In Europe, on the contrary, mergers among commercial banks have so far been mostly within national markets.

While the European banking industry will certainly undergo major changes, it is likely to remain quite different from its US counterpart because of three fundamental factors:

- First, EMU countries are not US states: the diversification of macroeconomic risk requires less cross-border consolidation.

- Second, the weight of different European cultures and languages will not disappear, at least at the retail, consumer market level.

- Third, the European financial framework is far from harmonized, including law, taxation and, more importantly, regulatory and supervisory institutions.

- Finally, history matters: in the restructuring process, European banks will benefit from the advantage of incumbency in European markets. Conversely, in the United States, the incumbency advantage of US investment banks and asset managers is likely to compensate more than enough for their inability to exploit existing economies of scope with commercial banking activities. The convergence of banking models in Europe and the United States will thus be conditioned by their history of universal and specialized banking respectively.

What prospects for competition and consolidation among European banks?

The limited evidence available suggests that although the European banking industry appears to have gone through a significant increase in competition, there is certainly room for a further intensification of competitive pressures. In part because of the current lack of regulatory harmonization, but also due to past heritage, competitive conditions have not yet provided a powerful impetus for change. Non-regulatory barriers, taxation and corporate law in particular, are also likely to remain important for the foreseeable future as a source of continuing market segmentation.

The existence of different currencies has been an important factor in European segmentation, playing in some sense the role of interstate banking restrictions in the United States. Alone, however, the euro will not be enough to create a true single European financial market.

One key observation for understanding this is that, maybe counter-intuitively, diversification possibilities in Europe are almost as good within countries as they are across countries. This is in contrast with the United States where states are more homogeneous, and diversification benefits must be sought across state borders. In Europe, the benefits from consolidation that have driven the US merger wave can be obtained by merging within a country.

It is clear why a European bank’s first bids for growth by acquisitions would naturally be made nationally, where mergers are easier in terms of culture and regulation, and where they may also bring local market power - a welcome relief from increasing competitive pressures. But there will be losers from such increases in market power, notably small businesses, which will not be big enough to access the new euro financial markets directly, and consumers, at least until direct banking becomes more widespread.

Competition is not the only argument why this tendency for national consolidation is unhealthy. Because national banking market structures and lending practices differ across Europe, the same change in ECB-set interest rates will affect EU economies differently. This could be a serious hindrance to the operation of a single monetary policy. One reason why transmission mechanisms differ across EMU states is the

heterogeneous structure of the European financial industry. The creation of new cross-border suppliers of financial services, at a time when Europeans consumers and firms are likely to become more similar, would plausibly result in a homogenization of financial practices across EMU.

Asset management and investment banking: whose turf?

Asset management and investment banking are the areas of European banking most affected by the euro. Both activities involve economies of scale that are likely to become more important with the introduction of the single currency. These scale economies will induce two types of mergers:

- First, acquisitions with the simple purpose of enlarging the stock of assets under management.
- Second, acquisitions with the purpose of buying human capital (teams) and technology.

The first kind of merger need not be cross-border: domestic acquisitions are good enough to build up volume. But acquisitions designed to build expertise in the technology and process of asset management will be cross-border, though mostly directed towards US and UK-based investment banks.

Economies of scope between investment and commercial banking provide an organizational advantage to universal banks. So despite the fact that early attempts at integrating commercial and investment banking cultures have not been successful, the incentives of commercial banks will change. Relying on the experience of past failures at building universal banks may not be a good way to think about future developments.

Few European banks will make it to the status of universal banks. But those that make it will try to exploit the economies of scale across EMU fighting the battle with US universal banks and specialized investment banks. The outcome is uncertain. European universal banks will be boosted by the advantage of incumbency in most of the areas in which they are active. The difficulty of integrating investment and commercial banking cultures is the strongest point in favour of US specialized institutions - and the biggest challenge for the new European universal banks. But regulation provoked by the desire to stop commercial banks taking on too much off-balance sheet risks could slow down the emergence of European universal banks.

No more national champions?

Consolidation of the banking industries within individual European countries is undesirable for reasons of competition. But it may prove popular: chauvinistic support for 'national champions' often hides behind the fear that local consumers and firms may be neglected by large institutions with headquarters located far away. Only domestic banks, it is argued, preferably small and with a strong local presence, can understand and service local clients appropriately.

But analysis of the effects of consolidation in the United States - where local competitive conditions have been preserved by authorities - on the availability of bank credit to small American firms, reveals no evidence that local consumers and firms are neglected.

The bottom line is that cross-border consolidation should be encouraged by removing the barriers (legal, fiscal, regulatory and political) to cross-border mergers. Cross-border mergers permit the emergence of efficient producers without prejudice for competitive conditions. They also help homogenize banking practices, promoting the desirable convergence of the mechanisms by which a single monetary policy will be transmitted to the real side of European economies. It is time to favour the emergence of European competitors rather than national champions.

In this endeavour, the main players will be the national competition authorities. If domestic consolidation of the banking industry beyond a certain degree of concentration is made impossible by local competition authorities or by the European Commission, national banks will learn to go against their natural tendencies and start consolidating internationally. At the same time, the role of European competition policy will remain important, particularly in checking that state aids do not derail the necessary restructuring of inefficient banks that are regarded as national champions.

What impact on European citizens?

The transformation of the European banking industry is of no trivial consequences for the welfare of European citizens. An efficient system of intermediation should encourage savings by offering consumers a large choice of high performance savings instruments, and promote investment by providing adequate and low-cost financing to all projects likely to feed economic growth.

The fulfilment of this objective is predicated on the increased efficiency of the European banking industry and on the success of euro-wide securities markets - including markets for closed-end funds, venture capital and lower-grade commercial paper - where firms will be able to satisfy their capital and borrowing needs at low intermediation costs. Two factors could prevent this from happening:

- First, attempts by the banks to defend their turf by obstructing the rapid growth of such a market.

- Second, actions by governments, inspired by national chauvinism, to foster and protect ‘national champions’.

In either case, the cost for Europeans would be high.

What agenda for policy?

With the recent financial crises in Asia and Latin America, the popularity of restrictions on the activity of financial intermediaries is growing. At a time of uncertainty and turbulence, the word ‘control’ is used increasingly. But a better approach would

minimize interference with the market and use market mechanisms to improve regulation. The right word is 'regulation', not 'control'. But it is vital to get regulation right.

Banking should be subject to two types of constraints only:

- First, those derived from a concern for the stability of the financial system.

- Second, those derived from the need to check market power.

On competition, the days in which banking was off-limits for competition policy are gone and should not return. The tendency towards national consolidation is a challenge for European competition authorities since it is likely to reinforce local monopoly power. This is particularly important for small firm lending, as large firms will access the euro capital markets directly, while consumers will have the option of turning to specialized asset managers and direct banking.

On supervision, this traditionally focused on the assessment of the quality of a bank's balance sheet at a specific point in time, and on whether it complies with capital requirements and restrictions on portfolio composition. This approach is no longer adequate in a world in which banks are active players in the capital market and can, because of trading losses, be driven into insolvency extremely rapidly.

Banking supervision is a particularly delicate and urgent issue in EMU. As banks take on more market risk, their ability to withstand sudden fluctuations in market prices also depends on the readiness of the central bank to provide liquidity to the financial system and to banks in particular. In this respect, the ECB is a very different institution from the Fed -- more concerned with and more constrained by the risks it may take onto its own books, and thus likely to be less ready to provide liquidity to banks. The implication is that *ex ante* regulation and supervision are correspondingly more important in EMU than they are in the United States.

It should also be recognized that important as it may be for the growth of European firms, an efficient euro corporate bond market will not spring up in a vacuum. Banks could see in such a market a strong competitor, and use their incumbency advantage to hamper its development. Authorities cannot guarantee that Europe-wide securities markets thrive but, as in the case of cross-border consolidation, they can certainly ensure, through inappropriate regulation and taxation, that efforts to build them fail.

As importantly, a liquid corporate bond market will only blossom if the central bank is prepared to provide liquidity to the system whenever necessary. Although there is no direct mention of this task in the statutes of the ECB, the Board of the Bank should carefully consider the role that the Fed has played in fostering liquid markets in the United States.

Should bank supervision be centralized?

There are a number of risks associated with the current decentralized supervisory system for European banking. The advent of cross-border banking, the likely

emergence of pan-European universal banks, and, more generally, the new competitive climate of European banking, confront national supervisors with delicate coordination issues. In the face of these challenges, it is unlikely that the simple coordination among independent national authorities - as provided for by the Second Banking Directive - will be a safe arrangement.

Past European experience with national supervision has not always been satisfactory, with domestic supervisors sometimes being too close to the institutions they regulate, thus risking being captured. The natural distance that a supra-national regulator keeps would thus appear to be particularly healthy. But it is ironic that while the international financial community is studying the possibility of setting up a ‘world financial regulator’, petty national jealousies appear to be preventing this from happening at the European level, putting the stability of European financial markets at risk.

Building a centralized supervisory body is a possibility already foreseen in the Maastricht Treaty, but it appears only to allow centralization of supervisory responsibilities inside the ECB. While a clear improvement on decentralized supervision, this may not be the optimal arrangement as the ECB is already being perceived as accumulating too much power, and issues of accountability have been raised. An independent European-wide regulatory agency, distinct from the ECB, may generate less concerns in this respect while at the same time facilitating accountability.

Thinking about a new European agency would also allow a fresh consideration of the desirability of combining the supervision of banks and markets. As universal banking makes it increasingly difficult to distinguish between market risk and the risk of individual banks, the argument for combining the two functions of bank and market supervision in a supra-national EU independent agency seems overwhelming.