Christian Noyer: The euro and the banking sector

Speech by Mr Christian Noyer, Vice-President of the European Central Bank, at the Duisburger Banking Symposium, organised by the European Center for Financial Services, on 27 September 2000.

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Ladies and gentlemen,

It is a pleasure for me to speak here at the Duisburger Banking Symposium. The famous American comedian, Bob Hope, once typified a bank as "a place that will lend you money if you can prove that you don't need it". As we all know, this description does not give credit to the extremely important role that banks play in a modern economy. Nowadays, economic life simply would not be possible without the wide range of services and products that banks offer to various groups of society.

The issue that I shall address today - the euro and the banking sector - cannot be fully comprehended without considering the particular, and to a large extent unprecedented, nature of the introduction of the euro. The single currency does away once and for all with internal exchange rate fluctuations, completes the structure of the Single Market and, by virtue of its availability to almost 300 million people, increases the efficiency of currency use in an unprecedented manner. The introduction of the euro was a regime shift that will undoubtedly have a major impact on the euro area economy and its financial structure in the years to come. We have already seen some evidence of more diversification in the sources of finance of private firms in the euro area, in particular the increasing use of securities financing.[1] The euro will continue to act as a catalyst in further integration of national financial structures of the euro area into a truly euro area-wide financial structure. The euro's function as catalyst is particularly important for the banking sector. It will reinforce already prevailing trends in the EU banking systems, such as pressure for the reduction of excess capacity, increased internationalisation and conglomeration, and further mergers and acquisitions.[2]

I intend to approach the relationship between the euro and the banking sector from two different angles. First, I shall discuss the factors underlying the changing structure of the financial system, in general, and the banking sector, in particular. Second, I shall touch upon the impact of the euro on the euro area banking sector in the field of both wholesale and retail business.

Factors underlying the changing structure of the financial system and the banking sector

Widespread deregulation and liberalisation, accompanied by technological development, have changed the environment in which banks are operating. In addition, globalisation and the increased and transformed wealth of individuals have affected the operations of financial institutions, in general, and of banks, in particular. In the euro area, the impact of these developments has been amplified further by Stage Three of Economic and Monetary Union, in particular as a result of the introduction of the euro, the single monetary policy and the integration of the euro area financial markets. I shall now briefly discuss how these underlying factors are expected to affect the banking sector.

First of all, technology has already been shaping the structure of the financial system. It has reshaped the relative costs of different banking and financial services and facilitated the provision of new types

[1] ECB Monthly Bulletin, "The euro area one year after the introduction of the euro: key characteristics and changes in the financial structure", January 2000; ECB Occasional Paper Series No 1, "The impact of the euro on money and bond markets, July 2000".

[2] European Central Bank, "Possible effects of EMU on the EU banking systems in the medium to long term", February 1999; ECB Monthly Bulletin, "Banking in the euro area: structural features and trends", April 1999.

of services. The costs of collecting, processing and using information have decreased dramatically. This has, for example, led to greater efficiency in the provision of financial information and better techniques for assessing and pricing risks, in turn reducing the cost of external finance. On balance, it has tended to favour markets more than banks as it has allowed the former to rely more heavily on public rather than private information.

It has also affected banks' income and cost structures, as they have been able to make profits as a result of advances in technology. That is, banks have been able to specialise in the provision of information and the monitoring of credit exposures, for example in the context of loan securitisation, thus raising the share of non-interest income. On the other hand, banks' profits have come under pressure in some areas, such as lending to large firms. This resulted from the fact that technological progress has opened these areas to competition from inside the domestic banking sector, from international banks and also from other financial intermediaries such as institutional investors. In point of fact, the development of institutional investors has been facilitated by technological changes reducing the costs of collecting savings, gathering and disseminating public information, and assessing risks.

Technological development has also facilitated the rapid development of new financial products. While a large proportion of innovations would not have been possible without the breakthroughs achieved in financial theory, it has been predominantly technological progress that has made the widespread use of these innovations possible.

The second factor underlying the structural changes in the financial system and banking sector is the process of financial liberalisation which has been ongoing for some time already. It has allowed an increase in the overall level of competition in financial systems. In the EU, financial liberalisation gained momentum with the Single Market programme. The single most influential act for banks was the introduction of the Second Banking Coordination Directive, which provided a passport for banks to offer services across the European Union.

Liberalisation in the EU financial services sector is already very extensive. What we see now is an ongoing adjustment of the regulatory environment implemented in the 1980s and early 1990s. In effect, it allows other driving forces to have a more profound effect on the financial system. One of these factors, which has been facilitated by liberalisation, is the trend towards globalisation. This trend is occurring in most private sectors of the economy. As companies and individuals requiring financial services are becoming more globally oriented, they demand appropriate financial services. Globalisation is expected to increase competition in most areas of financial services, and it may also be able to realise economies of scale and scope. At the same time, globalisation has opened up new markets for banks, particularly in trading, asset management and investment banking activities.

Finally, the wealth of individuals has increased, and a larger proportion of the population is making portfolio investments. This is partly a result of the ageing of the population, which has, in itself, increased the average wealth of people. At the same time, it is also due to changes in pension systems in a number of countries from a "pay-as-you-go" to a funded basis. The prospects for the future are for more of such change, as reflected by the recent proposals for pension reforms in Germany and France.

The increased number of wealthy individuals has changed the demand for financial services. Traditional banking services or products, while maintaining a strong position in liquidity provision, are not adequate for people interested in diversification and maximisation of returns subject to risks in the context of long-term investments. The associated rise in demand for securities has led to an increasing need for brokerage, fund management and consultancy services. While there are new providers for these services, banks could remain at the centre stage, albeit with their services oriented more towards asset management.

In addition to the overall increase in the wealth of individuals, the composition of wealth has shifted towards a greater emphasis on wealth in the form of financial assets. This is manifest in the increase in the relative market value of stock exchanges, which is clearly visible in most euro area countries. The increase in financial wealth relates closely to the shift towards a market-oriented financial system and also to the increased importance of institutional investors.

All the developments I have discussed so far underlie recent changes in the structure of the financial system. Financial systems in the euro area could be departing from a bank-dominated structure, becoming more market-oriented or even securitised. An indicator for this development is the declining share of deposits in households' portfolios. Meanwhile, aided by technology, the disintermediation process on the assets side is under way in a number of countries, even though the process has been quite slow.

However, the actual effect of the structural change towards more market-based financial transactions could be larger than the share of external financing from the market would suggest. The existence of market-based financing through increasing competition within the banking sector may have affected the terms and conditions of bank lending in the sense that banks are now more clearly no longer the only potential supplier of external funding for all but the smallest firms. In other words, the contestability of external financing may have increased, with potential competition from market-based financing limiting the scope for banks to profit from lending relationships. It could be added that banks have been encouraged to take part in the process of securitisation by undertaking investment banking activities such as underwriting, which uses their capacities for collecting information as well as private information based on existing credit relations. This also tends to boost the share of non-interest income in the total revenues of banks.

The changes in the structure of the financial system and the role of banks are also illustrated by the emergence of new types of players in the financial system. Most apparent is the rise of institutional investors who are gaining a more important role in allocating savings from the household sector to the corporate sector, both domestically and across borders. On the one hand, they have provided new types of savings products, often supported by tax concessions on pension or life insurance savings, as well as by technological changes which reduce the costs of collecting savings, gathering information and assessing risk. On the other hand, they have created more demand for different types of securities. While they have enhanced structural changes in the financial system, they have also started to compete with traditional banking services in respect of both assets and liabilities.

However, in the euro area these institutional investors often form part of the banking groups. Banks in the euro area still have the most extensive distribution network of all types of financial institutions, even if the importance of this is declining. Their existing customer relations give them a competitive edge in the provision of many new financial services. Therefore, while interest income is being reduced by the process of disintermediation, the growth of new products may increase non-interest income in the same banking groups.

The euro and the banking sector

Despite these fundamental factors which are changing the nature of the financial services business, it is important to note that the financial systems, in general, and the banking sectors, in particular, in the euro area countries have, in the past, been relatively nationally based and fragmented with little cross-border retail activity. However, the euro should function as a catalyst with regard to the effects of the fundamental factors I have mentioned earlier, and thus increase the pressure for structural change. By structural change, I mean not only domestic consolidation, but also increased cross-border cooperation and mergers. In short, the euro area banking sector is expected to look and behave more like the banking sector of a single economy in the future.

Economies of scale and scope may have been changing in different areas of banking and may even have taken different directions. However, the general picture is that the banking industry needs to be in a position to adjust to a new reality. Indeed, since the introduction of the euro, a number of bank mergers in the euro area, including mergers between relatively large institutions, have been announced. Such "high-profile" mergers are likely to contribute towards an acceleration of the pace of both the consolidation and integration process of the banking systems in the euro area.

The recent pattern of consolidation constitutes a continuation of a longer-term trend in the European banking industry, as is highlighted by the large decline in the number of credit institutions in the euro area countries over the past decade or so. In the mid-1980s, there were more than 11,000 credit institutions in the euro area countries, compared with around 7,500 now. This reflects a decrease of 3,500 credit institutions over 15 years, or an average annual decrease of around 230 institutions. The changeover to the single currency seems to have intensified the consolidation trend in the euro area banking sector. The decline in the number of credit institutions is mainly the result of mergers among savings and cooperative banks, which epitomise what are known as “consolidating” or “defensive” mergers, aimed at cutting costs and possibly also at diversifying risks.

So far, this consolidation process has taken place mainly within national boundaries, with the possible exception of some mergers in the Benelux and Nordic countries. The preference for domestic mergers, as opposed to cross-border mergers, may be explained by the fact that the relevant market for retail services is still national rather than pan-European in character. Furthermore, the scope for cost cutting appears to be larger if the activities of the institutions merging overlap, although there is no particularly strong empirical evidence of this as yet. The fact that cultural “proximity”, notably in the corporate style of governance and management, is traditionally seen as a key factor in the success of mergers may also help to explain the limited cross-border merger activity. It has to be said that although most mergers have been domestic, they have often been instigated and influenced by area-wide market developments and the integration of financial markets following the introduction of the euro.

As of today, there is no doubt that the introduction of the euro has fostered the internationalisation of banking activities. In particular, the rapid integration of the wholesale banking and capital markets, as well as large-value payment systems, has already produced more and new kinds of links among banks. As a result, banks are increasingly exposed to risks from abroad, and risks to financial stability are far less frequently confined to national borders.

The most substantial increase in cross-border activity and market integration has taken place in wholesale activities. For example, the currency-based segmentation of the markets for unsecured interbank deposits disappeared very quickly after the euro was introduced. This could be seen from the rapid convergence of national spreads. Furthermore, market integration has not only been reflected in price quotations, but also in trading volumes. The share of cross-border transactions currently accounts for more than 50% of overall activity in both the unsecured and the repo markets. Some large institutions are starting to act as “money centre” banks with an area-wide scope of activity. The smaller institutions still mainly operate with their domestic counterparts. They nonetheless benefit from the more equal market conditions. Accordingly, the share of cross-border transactions in the area of large-value payment transfers through the TARGET system has been increasing steadily.

In addition to the single monetary policy, two main reasons explain the rapid integration of wholesale activities in the euro area, in general, and the market for unsecured interbank deposits, in particular. First, the smooth functioning of the settlement of cross-border payments, mainly performed via the TARGET system, allows banks to trade safely throughout the euro area. Second, the swift acceptance of euro area indices such as EONIA and EURIBOR forms a common basis for pricing. Experience with TARGET demonstrates the importance of the market infrastructure in allowing arbitrage to operate effectively.

Let me now turn from wholesale activities to banks’ customer business. As European banks are typically universal banks, they combine a wide range of products within a single institution. The markets for these products have varying degrees of integration - some are already global or European, while others have remained national or even local in character. At least the major banks already operate in highly internationalised markets for a number of their products and have geographically diversified activities. Even if banks remain nationally based, they are increasingly subject to international market developments. National tendencies are increasingly influenced by international developments. Hence, the usual argument that cross-border mergers and acquisitions are a necessary condition in order to achieve a more integrated and international banking system does not seem very strong.

In particular, many of the asset management and investment banking services are already quite internationalised as the capital markets have taken significant steps towards integration and growth following the introduction of the euro. Banks’ own holdings of securities have also become increasingly diversified across borders. The trend has been quite strong for government securities, as well as for corporate bonds.

To take an example of the financial services provided by banks in the capital market area, the leading underwriters of bonds issued by European firms are the major European banks, alongside the largest US investment banks. The "league" in which these players compete is clearly not a domestic one. Another example, which is particularly telling of integration, can be drawn from the rapidly expanding new European equity markets for technology and growth companies. Underwriting the initial public offerings or IPOs of this type of firm is the kind of service where we should expect the greatest degree of national segmentation, since the companies are usually accessing the capital market for the first time, possibly as captive customers of local banks. However, experience so far shows that, in most cases, a foreign institution was present alongside a domestic one.

By contrast with the services provided to other financial institutions and large corporations, retail activities for personal customers and small and medium-sized firms are still confined quite noticeably to national territories. Within the euro area, both lending and deposit-taking by banks are largely conducted with domestic residents. Nevertheless, internationalisation is also making progress in this area. Business with customers located in other euro area countries is growing faster than domestic business in terms of all major balance sheet items of banks. It should also be noted that retail banking services still tend to be localised, even in individual countries such as the United States. Thus, segmentation of retail services should not necessarily be seen as the failure of integration.

As regards the costs of payment services which banks offer, in particular for cross-border payments, I believe that these costs are still too high. Since the introduction of the euro, private customer prices of cross-border payment services have not decreased and in too many cases, the payee has been charged with some costs even though the payer has been requested to bear all costs. Furthermore, as the service provided in the case of cross-border payments is still poorer than that for domestic transfers in terms of the speed of the transaction, the higher price is not justified by better quality.

In a report published by the Eurosystem in September 1999, it was emphasised that consumers should be able to transfer money as rapidly, reliably and cheaply from one part of the euro area to another as is now the case within each Member State. However, it was also acknowledged that this objective was far from being reached. Since the publication of this report, substantial progress has been made in preparing the ground for a more efficient handling of cross-border retail payments. The banking sector has agreed on so-called straight-through processing standards, which will allow the automated execution of cross-border payments. Furthermore, the Euro Banking Association has announced the development of a payment system specifically designed for low-value cross-border payments.

In addition, the European Credit Sector Associations have taken two initiatives to further improve the prices and quality of cross-border customer payment services. First, a multilateral interbank exchange fee is being developed, which should solve the problem of "double charging" and, second, a "basic" service will be defined which should provide a level of guaranteed service and ensure transparent and attractive price conditions.

In a progress report published this month, the Eurosystem has made several recommendations to achieve further improvements in the price level and quality of the cross-border payment services for both corporate and private customers. Without a doubt, we shall continue to monitor this process very closely in order to ensure further cost and efficiency benefits for euro area corporations and citizens.

Conclusions

I have outlined the factors that are the main determinants underlying the changing structure of the financial system in general and the banking sector in particular. Overall, the various elements of the banking sector show that it is likely that a number of banking activities will be affected by this change.

The foreseen structural changes require the need for adjustment to be taken seriously by all participants in the financial system. This adjustment appears to have intensified in recent years, as there has been an increase in merger activity, an establishment of alliances and an introduction of new products and services, often based on modern information technology. The process of structural change embodies an element of risk, but if these risks are identified early and analysed carefully, then they can be duly taken into account.

What the ECB can do to help in this area is, first of all, to maintain stable monetary conditions. By creating an environment of price stability, we allow private sector agents to focus their attention on those questions which are of most relevance to their activities and to take advantage of the benefits of this stable environment, such as the possible extension of their planning time horizons. Secondly, we can, to some extent, increase the awareness of the developments in the euro area's financial structure and banking sector by providing euro area-wide information, and also analyses of these developments. All in all, the introduction of the euro and the single monetary policy has created a fundamentally new environment for banks in the euro area. A new environment that will entail certain risks, but that will also provide many opportunities for growth and enhanced efficiency in the banking industry. I am convinced that the latter will prevail.