Jürgen Stark: The emerging face of European banking

Speech by Dr Jürgen Stark, Vice-President of the Deutsche Bundesbank, at the European Banking Technology Fair 2000, held in Frankfurt, on 30 October 2000.

I

Ladies and gentlemen,

Given the pace of developments in the financial markets, any attempt to describe the emerging face of European banking can only mean providing an appraisal of major current trends and specifying the driving forces in the foreseeable future. The various determinants in the financial sector operate in concert, as if in an interactive process, and give rise to ever-new responses by the banks and other market players.

What, then, are some of the key factors that shape the image of the European banking sector?

I should like to dwell briefly on

- the integration of the European financial markets,
- aspects of bank profitability, and of the shifting of focal points of business, and
- the impact of technology, and of new forms of organisation in the banking system (catchword: "outsourcing"), and finally
- consolidation in the banking sector, which is gathering pace.

II

Ladies and gentlemen, the launch of the euro has manifestly fostered integration of the financial markets of Europe. However, some distinctions must be drawn here. Owing to the single monetary policy and the interlinking of national markets through the TARGET payment system, the interbank money market is meanwhile highly integrated. On the capital market, by contrast, (notwithstanding some progress towards integration) genuine European segments such as a single equity market and bond market are still lacking. To help the bond market in particular to become more integrated, and to enhance its liquidity, it is sometimes suggested that the national governments in the euro area should pool their dept issuing with the aid of a central agency. But that would also imply a pooling of the risks and liabilities of the public borrowers. That, however, would contravene Article 103 of the EU Treaty (known as the "no-bail-out clause"), which prevents governments from assuming any liability for other governments, and is therefore to be rejected.

Banks' customer business has been affected to different degrees by the launch of the euro. Retail banking in general has so far stayed a largely national domain on account of the prevailing tax, legal and "cultural" differences remaining in the EU countries. In other words, the changes due to the advent of the single market and of the euro are rather making themselves felt gradually in retail banking. In wholesale banking, by contrast, cross-border operations are continuing to accelerate, with a focal point within the Euro area. Altogether, the growth rates of cross-border operations within the euro area are much higher than those of domestic operations in many lines of business.

III

The higher degree of integration of the markets in Europe at the same time ensures stiffer cross-border competition. Credit institutions' interest-based business is more strongly affected by that than their off-balance-sheet operations, which generate commission earnings.

However, the focal point of the business of many banks continues to lie in traditional, interest-based business. On the continent, banks' receivables from domestic lending operations are far higher - both in absolute terms and relative to GDP - than, for instance, in the capital-market-based financial system of the United States. Thus the virtually global decline in margins in banking business is reflected particularly clearly here. Although the share of non-interest-based receipts in the aggregate operational revenue of continental European banks has gone up sharply in recent years, in the dynamic and profitable field of commission-based business (e.g. investment banking or asset management), many credit institutions are still lagging distinctly behind the banks in English-speaking countries. The often-cited "return on equity" (ROE) figure of over 20% reflects magnitudes which have yet to be attained.

Altogether, the pressure on the banks to substitute other receipts for the relatively declining interest income is increasing. A strategy geared merely to greater volume and higher risks in lending business in order to stabilise or increase profitability could not work in the long run, and at all events could be no substitute for the requisite structural change.

Further efforts will also be needed on credit institutions' expenditure sides in order to enhance their profitability.

A number of countries in the euro area, including Germany, are sometimes designated as "overbanked" or "overbranched". As a matter of fact in 1998, according to the latest IMF figures, Germany with about 1,800 inhabitants per bank office was, by international standards, distinctly below the figures of the United States and Japan (about 4,300 and 2,900 inhabitants per bank office respectively), and also below the United Kingdom, where each bank office caters for about 3,700 inhabitants. On the other hand, according to statistics of the OECD and BIS, the number of staff members per bank office in Germany is much lower than, say, in the United States. On balance, the ratio of "number of inhabitants to bank-office staff members" in Germany is below the comparable figure in the United States. Moreover, the presentation of the current situation with the aid of simple statistical indicators remains unsatisfactory. Qualitative factors, such as the duration of opening hours or the range of services provided by bank offices are disregarded.

Despite these warranted qualifications of statements about "overbanking", cost-intensive and not always very profitable branch-office operations are sometimes regarded as a reason why German banks, on an international comparison of profitability figures, tend to lie in mid-table.

IV

Ladies and gentlemen, the deployment of new technologies will no doubt also prompt the banks to reconsider the dimensions of their branch networks. But the significance of technology extends well beyond that: it is a main driving force behind change in the banking sector, and in financial markets worldwide.

At the moment, we are witnessing the advent of completely new forms

- of communication between bank and customer,
- of the marketing of financial services, and
- of the organisation of banking operations.

A very important platform of communication between banks and their customers in the future will unquestionably be the Internet. According to recent data, at the end of 1999 - in Germany alone - no fewer than over 10 million online accounts were being operated. That represents a growth of as much as 50% on the previous year. Current expansion is so dynamic that the forecasts of future growth, both in Germany and in Europe, lie far apart, albeit at a high level. The wide range of the forecasts demonstrates, incidentally, that the banking sector in its projects and development has to plan and invest under conditions of great uncertainty, i.e. has to run significant strategic and other risks. That applies to an even greater extent to "mobile banking", e.g. via WAP (Wireless Application Protocol) mobile phones, which is expected to expand sharply following the introduction of the UMTS standard.

What might the banking business of the future look like under these conditions? Many observers assume that in future at least retail banking will constitute a combination of “click and mortar”, i.e. will be offered and implemented in the context of multi-channel banking strategies in several different forms, that is to say both through the physical branch network (“bricks and mortar banks”) and through virtual PC banking windows, via WAP mobile phones and television sets. In this context, the presumably shrinking branch network will concentrate increasingly on those services which require counselling, whereas the sale of products and settlement of banking transactions will be effected in large part online.

The new information and communication technologies may have significant indirect effects in business with corporate customers, too. Thus the new technologies may reinforce tendencies towards disintermediation, since corporate customers are increasingly in a position to take personal charge of, say, cash management and capital procurement as part of in-house banking operations.

Quite generally, the emergence of financial service providers on the Internet not only ensures enhanced transparency of the service range but also blurs the geographical boundaries of business operations. This increases the competitive pressure on every institution on account of foreign competitors, as well as domestic ones. At the same time, the degree of customer attachment decreases. Especially at the international level, banks compete not only with other banks, but also with other enterprises, such as insurance companies, investment and pension funds or online brokers.

So-called “aggregators”, i.e. Internet platforms which juxtapose offers by different financial service providers at the touch of a button, increase price pressure still more, above all that for standard services.

V

Closely associated with the enhanced deployment of technologies such as the Internet, but also parallel to that, are the efforts of many banks to realise cost savings by optimising their own organisation. The outsourcing of certain banking operations is high on the agenda here, and is regarded by many institutions as a potential means of streamlining their operations. It is particularly the new technologies that are making the outsourcing of functions appear attractive, and are encouraging it.

In this connection, the banking supervisors must define the possibilities and limitations of outsourcing very carefully. In my view, a prudential bias is appropriate here. In the final analysis, a purely virtual bank, which has outsourced almost all its functions to other enterprises, would be incompatible with our supervisory legislation. Moreover, in the sphere of the outsourcing accepted by the supervisors, the monitoring and control options of the bank’s management must be retained without reservation. The auditing rights and control options of the banking supervisors must likewise be safeguarded.

VI

Ladies and gentlemen, irrespective of any new marketing channels for financial services, and of innovative forms of the division of labour by means of outsourcing, in future credit institutions will mould the structure of the banking sector in different ways from in the past. What I am thinking of is one of the most conspicuous developments in the field of banking, namely the consolidation process. A topical example of that is the recently announced merger of Banca Intesa and Banca Commerciale Italiana (BCI). That merger is intended to create the largest credit institution in Italy, which wishes to establish itself among the Big Banks of Europe.

The trend towards consolidation in the European financial system, which has been evident for a number of years, has several dimensions, notably:

- the geographical aspect; and
- the question of which banking categories are affected, and why.

An analysis shows that mergers in the European banking sector have hitherto mainly taken place within national markets. Mergers between smaller banks (especially in the savings bank and cooperative bank sectors) are in the forefront in terms of number. In these areas, the objective of mergers is frequently to reach an optimum size of bank or even to ensure the survival of the institution. The optimum minimum size of a bank (which is difficult to define anyway) has presumably increased in recent years, not least on account of the need to invest in state-of-the-art banking technology, and to ensure more efficient compliance with supervisory requirements.

Mergers and takeovers involving major, mainly private institutions must undoubtedly be seen against the background of the need to secure a better position on national markets. Ultimately, however, all mergers are motivated by the wish to cut costs by exploiting rationalisation potentials, for instance by reducing the branch network, some of which is then redundant.

Altogether, although the number of mergers in Europe declined in the second half of the nineties, the volume of the business operations involved substantially increased. Such mergers resulted in the creation of more than fifteen of the thirty largest banks in the Euro area, and the average size of the five largest banks in Europe has doubled since 1995. As a result, the degree of concentration on the banking markets of many countries has vastly increased. Especially in the smaller countries of Europe, the five largest banks often account for more than 50% of the national market. In some countries, such as Belgium or the Netherlands, the concentration is even more marked; there, in each country the two largest banking corporations account for over 90% of the total volume of business. In the larger countries, the degree of concentration is considerably lower, with Germany having the least concentrated banking market in the Euro area (the market share of the five largest banks, on a single-institution basis, and relative to the domestic volume of business: about 20%).

Cross-border mergers have so far been less numerous, but have been at the centre of public interest on account of the size and eminence of the banks concerned. The primary aim of the banks involved has been to present themselves more effectively in the face of European and global competition, as well as the wish to open up new markets and new lines of business. I may mention, as the most recent example, the announced takeover of the Norwegian *Christiana Bank og Kreditkassen* by the Finnish-Swedish-Danish financial group *Merita Nordbanken*. Beyond the European horizon, I may also mention the merger between *Deutsche Bank* and *Bankers Trust*.

Viewed as a whole, however, the number of cross-border mergers has hitherto been very limited, compared to those within national boundaries. What are the principal reasons for that?

Mergers are considerably easier to implement if they take place in the familiar cultural, linguistic and legal (especially tax) environment.

Particularly in the larger countries, there have so far been enough options for mergers and diversifications on the home market, so that it has not been essential to step over the border.

In part, national mergers, with the establishment of “national champions”, are a preliminary to cross-border expansion.

The differences in corporate cultures, which give rise to frictional losses, are much more obvious in international terms, especially if banks from countries with different banking systems are involved.

Given the problems posed by cross-border mergers, a number of banks are currently fostering the establishment of pan-European strategic alliances. Mutual capital interests are intended to bolster cooperation agreements, and to reduce the risk of hostile takeovers.

Even so, in my opinion, and notwithstanding all the problems, an increase in the number of cross-border mergers in the banking and financial sectors is to be expected in future, as well as more mergers within national markets.

VII

Ladies and gentlemen, a lot is currently in a state of flux in the European banking sector. The markets are undergoing massive changes. The pace of such structural changes actually seems to be

accelerating, with not least the ongoing IT revolution, new types of division of labour and the consolidation of the banking sector exerting a significant impact.

Needless to say, in a more dynamic environment the risks faced by credit institutions will increase. Those risks must remain manageable by the individual enterprise and by the market as a whole. Specific banks will withdraw from the market in future, too; the propensity to withdraw might even increase. It is therefore essential for credit institutions, supervisory authorities and policy makers to safeguard the stability of the European financial system effectively. Only then can the European banking and financial sector discharge its macroeconomic duties, that is to say, bolster economic growth and employment efficiently.

Thank you very much for your attention!