Lars Heikensten: The integration of European banking - some regulatory challenges

Speech by Mr Lars Heikensten, Governor of Sveriges Riksbank, at the seminar "The Integration of Financial Markets in Europe", at the "Riksdagshuset" (Swedish Parliament), Stockholm, 21 April 2004.

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Thank you for inviting me to share my views on the integration of financial markets in Europe. We have just heard about the positive role capital markets might have in fostering economic growth and stability. We have also heard about how the regulatory process has been changed to promote the growth of an integrated European market for capital and securities. It is my hope that also the area of bank regulation will become part of this simplified process. It is certainly needed. Compared to the European securities market, the banking market is lagging many years behind in terms of integration.

True, large companies may have access to foreign bank funding as well as to international debt and equity markets. When it comes to choosing your bank at the retail level, however, Swedish households and small and medium sized companies are left to a market which is to more than 90 percent dominated by Swedish banks. This situation is shared by most other EU countries. This is not a problem in itself. Swedish (or, in general, domestic) banks might very well be excellent. However, most of us tend to believe that cross-border integration, just as trade, is something good because it increases competition. Higher competition, in its turn, improves the efficiency, which ultimately leads to higher quality and lower prices for consumers. Indeed, this is one of the main ideas underpinning the European single market. This idea is undoubtedly true also for the banking industry. There is increasing evidence of the positive link between the efficiency of the financial system, of which banking is the most important part, and the wealth and growth of the real economy. Thus the potential benefits of a more efficient financial system are substantial.

Considering that most financial services bought by consumers (private individuals and SMEs) are bought from their bank, the low integration (and in many cases low efficiency) of European banking is a significant hindrance to creating an overall efficient market in financial services.

Barriers to integration

Why then is integration of European retail banking not happening or only happening very slowly? The first and second bank harmonisation directives and more recently the many initiatives within the Financial Services Sector Plan, FSAP, have set the legal framework for cross-border expansion. In principle, any European bank can easily set up or acquire a subsidiary in another member state. More importantly, a bank only needs one single banking licence in one member state to be able to offer banking services in all EU member states.

So why are we not seeing serious integration of European banking? A number of possible reasons have been cited. These could roughly be divided into three kinds: economic, regulatory, and political. Starting with the economic reasons, academics have been arguing that scale and scope economies are limited in banking and perhaps even negative once a certain size has been reached. The standard argument goes like this: banking is a "relationship business", where a large part of a bank's value lies in its customer-relationships. It is from these relationships the bank's value-added comes in the form of its expert knowledge about the financial needs and risks of its customers and its understanding of the local economy. So a bigger bank cannot create more value, because it's all about being close to and knowing your customer. Size just increases bureaucracy. And, if the bank would expand abroad, the sources of value are less obvious, since it would lose its natural expert knowledge, and be disadvantaged compared with the incumbents. Hence, the economic case for integration would not be as strong in banking as in other sectors.

I question this view. On the academic side, more recent banking research actually finds evidence of scale economies. After all, to a large extent, modern banking is about efficiency in running huge operations consisting of vast branch networks, IT-systems and thousands of employees. That scale economies exist is also supported by the domestic consolidation taking place in the US as well as in individual EU countries. The banks that are best at running their operations should have plenty of good reasons for expansion. Why would the most efficient retail bankers not be able to export their concept, just as IKEA, McDonald's, or American Express, to name a few other retail service companies, have done in their industries?

However, there are economic obstacles related to the cost of entry into new markets. Major cross-border expansion must, with few exceptions, be made through mergers or acquisitions. The success of a cross-border deal depends on the ability to realise synergies. This takes a number of tough decisions regarding reductions in staff numbers and overlapping or inefficient systems and operations. If then to this entry cost are added extra hurdles in the form of regulations and politics it is easy to see that the difficulties related to cross-border expansion might seem insurmountable to a bank manager. On the margin, I think these extra hurdles or barriers might be more important than the inherent economics of banking.

Generally, in countries where the costs of entering the national banking market are relatively low, the market share held by foreign banks tends to be higher. In the last decade, countries with less developed banking systems and few or no powerful incumbents have seen extensive entry by foreign banks. Witness the expansion by European and American banks into emerging markets, e.g. in Central and Eastern Europe and Latin America. In the EU, in contrast, national banking markets are generally well developed and incumbents are strong, making entry costs much higher. Hence, the insignificant degree of EU cross-border banking integration is probably partly explained by economic factors.

However, the existence of large differences in profitability and efficiency between individual EU countries' banking systems indicates potential for cross-border expansion also within the EU. In competitive industries, such differences do not exist for a longer period, as less efficient firms would be pushed out of business or acquired by more efficient competitors. These wide profitability gaps should attract more efficient entrants.

Against this background, it is interesting to note that many European banks seem more attracted to the US banking market. The US banking system is by many considered as the most developed and competitive in the world. You would indeed expect EU-based banks to find it easier to expand within the EU than into the US. Still, several major European banks have much larger retail operations in the US than they have in neighbouring European countries, e.g. HSBC, ABN Amro, and BNP Paribas. One cannot avoid the question of whether larger obstacles to cross border banking exist in Europe than in the US.

Regulatory schemes and practices still a major problem for integration

Given the gradual increase in harmonisation of EU banking and financial sector legislation, it is perhaps surprising to find regulation to be one of the most important barriers to further integration. In my view, there are two issues here. First, although the general legal framework has been converging, the practical implementation of rules and regulations still differs widely between member states. EU level harmonisation often applies to high level principles and minimum requirements, while implementation, additional requirements and enforcement is left to the member states. In practice, this becomes a barrier to integration. An EU bank will be subject to as many different reporting requirements and regulatory relationships as it has countries of operation. For a banking group involved in life insurance and securities trading this number should be multiplied by three. For instance, ABN Amro is rumoured to be dealing with 47 different regulators only in the EU. Second, today's banking regulation was originally designed to protect the soundness and stability of the national banking system and sometimes even to politically control it. Thus, supervisors as well as central banks have national mandates and responsibilities vis-à-vis their politicians and citizens. This was all fine in the so called good old days of closed national markets. Now, however, it may sometimes be in conflict with the ultimate goal of a single market in financial services.

Some of the work needed in these areas has already been started. The Brouwer reports to the Ecofin well describe some of the difficulties. The BSC Task Force on Crisis Management has taken the first steps towards a more structured approach to crisis management of cross-border banking groups, through the signing of a Memorandum of Understanding. CEBS (Committee of European Bank Supervisors) is also trying to take on some of these issues, in particular regarding the convergence of supervisory practices. And very recently the Financial Services Committee decided to further investigate (1) how to manage supervision of cross-border banking groups, whether subsidiary or branch structure, and (2) arrangements for cross-border crisis management.

So, which are the developments in cross-border banking that have necessitated further consideration of the existing rules, policies and structures? Which are the regulatory challenges indicated in the title of this speech? I think the convergence of regulations is a process that, although being long and slow, is already going in the right direction. Even though, as mentioned earlier, there are still way too many differences in implementation and actual practices. But when it comes to the genuine conflicts of interest between nationally motivated regulators and an integrated European financial market, we are just in the beginning of a major rethinking.

The challenges regulators have to face

At the heart of the matter lies the emergence of large foreign subsidiaries and branches. The presence of foreign subsidiaries and branches is not new. What is new is that they might make up a substantial part of your domestic financial system. Whereas the typical bank group might be described as “Big mama, small daughter”, the opposite may now be increasingly true in many cases, and in particular if seen in relation to the size of the home and host countries. This is already true in most of the acceding countries. To give an example, more than 90 percent of Czech banking assets are held by foreign owned banks. What might this development then imply? Consider the following three areas: supervision, deposit guarantee systems and crisis management.

Supervision. There are good reasons for banks to expand through branches and so be able to slim down their own internal bureaucracy, and have a single point of contact with supervisors and a substantially reduced reporting burden. But would this be accepted by national authorities? Home supervisors would become responsible for banks with in some cases a systemic presence in foreign markets. Host supervisors would find themselves legally limited in supervising even systemically important institutions in their own domestic market. The traditional home-host principle simply does not work for systemically important branches. The fact that we have not yet seen much of cross-border branching indicates there are some “invisible” barriers. One of these barriers probably is scepticism from national supervisors. With a few exceptions banks still expand through subsidiaries, which is costly and makes synergies hard to realise, and thus hampers integration. Can we find a way to secure financial stability without limiting the positive drive for further integration?

Deposit Insurance Guarantees. Minimum standards are set by the EU, but in practice the national guarantee systems differ widely. Notwithstanding the existence of limited deposit guarantee systems, for larger banks the government will probably have to pay up the main part in the case of problems, due to lack of funds. This might be politically acceptable as long as depositors are domestic residents. However, cross-border branching extends the government guarantee to deposits of foreign residents. Would it be acceptable to use tax-payers money to refund foreign depositors at a larger scale? This might pose problems both for the home and host country. The wide divergence of national systems clearly needs attention. Potential solutions might include increased co-operation and harmonisation regarding fees and entry and exit rules.

Crisis management. National central banks have national mandates in extending emergency liquidity assistance. In a future integrated European financial market, the mandate of the lender of last resort will not be as clear-cut. How should this function be organised when the largest banks might be systemically important in several EU member countries? There will also be banks that are very important in one country while being completely insignificant in a European context. Another issue is whose interest a national supervisor will protect in a crisis involving a cross-border banking group - strictly its own national interest (the case now) or the interest of all member countries where the group might have operations?

Conclusions

These issues, or challenges, are essentially political. They are about how to share the risks and costs of financial integration. And as long as these challenges are left unaddressed they constitute political barriers to integration. We all say we want financial integration but as usual, nothing comes for free. Financial integration brings some difficult issues for authorities and politicians. Public authorities will have to rethink their roles and priorities. Politicians cannot make beautiful declarations about providing their citizens with the best possible financial services at the lowest possible prices without facing the consequences of that. In practice, this might mean stopping the nurturing of national champions. At the moment it is quite obvious that in banking no significant cross-border deals can be made without the silent approval from concerned governments. No wonder, banking integration is slow.

To conclude: in order to gain the full benefits of financial integration, we must build a regulatory framework which minimizes the costs and barriers of cross-border expansion. This does not have to mean less regulation, but certainly more efficient and harmonized regulation. Again, there must be an efficient process to continuously update banking regulation to take account of developments in banking activities, instruments and structures. At the same time, we must adjust our supervisory and crisis management arrangements so that we can deal with this new banking landscape in an adequate way. We have had enough of declarations. Let us now move to attack the real political problems.