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European banking after EMU



European Investment Bank

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# The case for a European-wide strategy



**Jean Dermine**

## 1. Introduction

Although a large series of papers have been concerned with macroeconomic issues such as price stability or employment, very few studies have discussed the impact of the euro on the competitive structure of European banking markets. Two questions are being addressed in this paper:

- How does the move from national currencies to the euro alter the sources of competitive advantage of banks?
- What are the main strategic options available to financial firms?

A review of the European banking industry shows the apparent importance of a national currency. For instance, the markets for pension funds and mutual fund management, or the euro-francs and euro-guilder bond markets are quite fragmented with domestic institutions capturing a very large market share. This paper shows how, besides an obvious loss of intra-European currencies trading business, the introduction of a common currency changes fundamentally the sources of competitive advantage of banks. Clearly, this calls for a major review of strategic options.

The paper is structured in two parts. Drawing on research discussed in an earlier *EIB Papers* article, the first section summarises a number of impacts of the euro (1). In the second part, the strategic options are outlined.

## 2. Banking with a single currency

The first two items that have been identified concern capital markets, including the bond market and its fast growing appendix the interest rate derivative market and fund management. The third factor concerns the broader impact of the single currency on foreign exchange markets, credit risk, and on bank profitability in a low inflation environment.

### 2.1 The bond market, underwriting and trading

The government bond market in Europe is a very fragmented market with domestic players capturing a large market share of the underwriting and secondary trading business. Feldman and Stephenson (1988), a Federal Reserve Study (1991), and Fox (1992) show that this dominance of local players is the result of history (with local players having a privileged access to the public debt issuer), domestic currency denomination (which provides access to, and an understanding of a large investor home base), and expertise in the domestic monetary environment (providing essential information to operate on the secondary bond market).

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*1) Jean Dermine's (1997) paper "Eurobanking, a new world" was winner of the 2nd prize in the EIB's biennial essay competition. It is published in Volume 2, Number 2 of the EIB Papers. The same issues are developed further in Dermine (1998) and Dermine and Hillion (1999).*

**Currency denomination has been a critical source of competitive advantage in bond and equity underwriting and secondary trading.**

Will these sources of competitive advantage survive with a single currency? As domestic currency denomination, the main source of competitive advantage identified for local banks in the literature, will disappear, it is quite likely that we shall observe the emergence of a truly integrated European bond market. If access to a Europe-wide investor base does facilitate placement and if access to market information seems essential for secondary trading, then very likely large-scale European-wide operations will become a necessity, and one will observe a consolidation of the government bond underwriting and trading businesses.

Currency denomination has also been a critical source of competitive advantage for local institutions in corporate bond and equity underwriting and secondary trading. The Eurobond market provides an illustration. A study by the Federal Reserve Bank of New York (1991), confirmed in Dermine (1996), McCauley and White (1997) and Harm (1998), reports a strong correlation for non-dollar issue between the currency denomination and the nationality of the lead bank manager. For instance, French banks are the lead managers for more than 80 percent of the time for French franc-denominated eurobonds issued by French companies, and 75 percent of the time for similar bonds issued by non-French borrowers.

Under EMU savers will diversify their portfolio across European markets, since exchange rate risks have been eradicated. The two main sources of comparative advantage that remain for local players will be historical customer relationships and the understanding of credit (business) risk through a better knowledge of the accounting, legal and fiscal (not to mention language) environment. Whenever the business risk embedded in corporate securities can be better assessed by domestic banks, these players will control underwriting and secondary trading. Local expertise would be particularly valuable for smaller companies, venture capital or the real estate market.

However, for larger corporations, worldwide sectoral expertise (in automobiles, telecoms, etc) will most likely dominate any national advantage. Placing power and trading across Europe will lead to consolidation of this major segment of the securities industry. As a tentative base for comparison, the top five American underwriters of investment grade debt control 65 percent of the US market.

## **2.2 Fund management**

An important segment of capital markets business is the fund management industry, and here too we see the dominance of local firms. In this case, the main sources of comparative advantage come from the retail distribution network, a home-currency preference by customers, the possible existence of economies of scale and research expertise (Kay, Laslett and Duffy, 1994).

The first source of competitive advantage in the retail segment is the control of the distribution network. This is in the hands of local banks in several countries. Indeed, domestic control of distribution is even protected under current European legislation which gives national authorities the right to regulate the marketing of funds into their own territory. Domestic banks will keep their competitive advantage as long as the branch network remains a significant channel of distribution.

The customer preference for home-currency assets was also often imposed by regulation. A single currency will, of course, eliminate this factor and reinforce the need for European-wide portfolios.

The possible existence of economies of scale and scope in the fund management industry is still a subject of debate (Bonnani, Dermine and Röller, 1998). However, it is quite likely that we will see very large, low cost, European index-tracking funds (where scale may be more relevant) competing with smaller research-based funds.

### **2.3 Foreign exchange markets, credit risk and low inflation**

An obvious direct effect of the single currency is that intra-European foreign exchange transactions will disappear, together with the competitive advantage of a particular bank in its home currency. As an example, a Belgian bank operating in New York will not be any more the Belgian franc specialist, but will compete with other European banks for euro/dollar business. Following the same logic as before, one is likely to observe consolidation of the commodity-type low-cost spot foreign exchange business (2).

Are there any implications for banks of having euro as an international currency? Three benefits can be identified. The first one is that an increased volume of euro-denominated assets or liabilities will ease the foreign exchange risk management of bank equity. Indeed, a large part of bank assets will be denominated in the same currency as the equity base, easing the control of currency-driven asset growth and capital management. Secondly, access to a discount window at the European Central Bank will make the liquidity management of euro-based liabilities marginally cheaper. Finally, if third countries issue assets denominated in euro or use the European currency as a vehicle, European banks will be well positioned in secondary trading for the reasons mentioned earlier.

#### **The nature of credit risk could change under a single currency.**

An additional impact of the euro is its potential effect on credit risk. There are reasons to believe that the nature of credit risk could change under a single currency. The argument is based on the theory of Optimum Currency Areas and on the ECB's objective of price stability.

The first issue relates to the impact of an asymmetric economic shock. If a bank concentrates its business in its home country, and if that country were to be subject to asymmetric shocks, it is quite possible that the central monetary policy would not soften the impact of the shock. This means that the greater the risk of such shocks, the more banks have to diversify their loan portfolios.

A related effect of EMU on credit risk is that the statute of the European Central Bank will prevent inflationary policies. *Ceteris paribus*, this could increase the potential for losses resulting from default, as one cannot count anymore on a predictable positive drift for the value of collateral assets (3). This will also change fundamentally the nature of credit risk as firms and individuals cannot rely any more on the nominal growth of their revenue to reduce the real value of their debt.

Low inflation could have other effects. During the last twenty years higher inflation and interest rates have provided substantial interest margins on price-regulated deposits. For instance, in the early 1980s, interest margins on demand deposits were above ten percent in Belgium, France, and Spain, but by the mid-1990s margins had dropped by a factor of about one-half. One can safely conclude that low inflation will reduce the source of profitability on the deposit funding business.

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2) However, some banks may find market niches by developing differentiated products based on service quality or technical innovations.

3) Although non-inflationary policies may also reduce the amplitude of business cycles.

However, if this effect is quite significant in a large number of countries, two additional effects of a low inflation environment might soften the impact of lower margins on deposits. One positive factor is that a low interest rate environment leads usually to a much higher margin on personal loans because of the relative inelasticity of interest rate on personal loans. For instance, in France, loan rate stickiness has raised the margin on hire purchase (consumer) loans from 6.3 percent in 1990 to 10.1 percent in 1996, a period of rapidly declining market rates (Banque de France, 1996). A second positive impact of a low inflation environment is that the 'inflation-tax' will be much smaller. The overall impact of a low inflation environment on the profitability of banks will thus depend on the relative importance of reduced margins on deposits, higher profit on personal loans, and on the significance of the 'inflation-tax'.

### 3. Some strategic issues

A considerable amount of domestic restructuring has already taken place in Europe, driven by the creation of the Single Market in 1992. In most cases, domestic mergers were based on cost-cutting reasons. For instance, White (1998) reports that the restructuring of the Finnish banking system, undertaken after a severe financial crisis, has reduced employment by 32 percent (4). These domestic mergers have increased concentration and produced firms of bigger size, albeit at national level. A first series of cross-border deals took place in the merchant banking area, where independent merchant banks (many of them British) were purchased by continental banks (5). These acquisitions were no doubt motivated by the wish to rapidly acquire a necessary expertise in securities-based corporate finance and asset management. Until quite recently, cross-border mergers of commercial banks of significant size have been rare. The difficulty in merging two national cultures was often put forward as a barrier to cross-border mergers. But two noticeable deals have taken place recently: the purchase of the Belgian Banque Bruxelles Lambert (BBL) by the Dutch Internationale Nederland Groep (ING), and the merger of the Swedish Nordbanken with the Finnish Meritabank. These cross-border deals are noteworthy because they involve very large domestic players. It is also worth observing that these deals involve small countries with banks attempting to create a larger customer base.

As discussed above, the arrival of the euro will rapidly change the sources of competitive advantage in various segments of the capital markets. If one accepts the argument that size will matter on some of these markets, a question is raised of either exiting (outsourcing) part of these activities, or of reaching the appropriate size. Moreover, one should of course bear in mind that an additional, potentially much more significant change concerns information technology. IT should allow, in principle, the distribution of financial services to retail clients across borders and without a physical presence. As concerns this threat (or opportunity), the key issue is the speed of acceptance of this new delivery channel by customers and their willingness to entrust a significant part of their financial affairs to a foreign supplier.

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4) This has to be compared with a drop in bank employment of 5 percent in France and 0.3 percent in Germany (White, 1998).

5) Examples include the purchase of Morgan Grenfell by Deutsche Bank, Barings by ING Bank, Warburg, O'Connor, Brinson, Dillon Read by Swiss Bank Corp, Kleinwort Benson by Dresdner, Hoare Govett by ABN-AMRO, Smith New Court (UK) and MAM (Spain) by Merrill Lynch, BZW by CSFB and Hambros by Société Générale.

In view of this new Eurobanking world, banks face three major strategic options:

- **National (regional) champion.** A firm acquires a significant market share on its domestic market through M&A activity. It outsources part of its capital market activities to larger international firms. Domestic size will provide the ability to achieve cost efficiency and to offer high quality services. This strategy can survive until new technology allows large foreign firms to target local clients directly, disintermediating the local financial "supermarket". Under such a scenario, the domestic champion will be absorbed sooner or later by a large international player who would benefit from a large, low cost, operating platform. Given the loyalty of retail clients and the particular nature of financial services for which trust (which cannot be acquired so rapidly) is an essential element, one could take the view that significant competition from foreign competitors on the retail market will not take place for several years. This domestic strategy could be adopted by national banks or even by some regional banks, such as the Cajas in Spain, which have a very strong local retail franchise.
- **Cross-border merger or acquisition.** This allows the institution to reach size and international coverage rapidly. Corporate control can be efficient as the process is managed with authority from a centre, but the allocation of responsibilities in the newly created entity appears to have been a very difficult process for many financial firms (6). This is the top-down approach.
- **The co-operative strategy (bottom/up approach).** Local co-operatives created national centres several decades ago to serve their treasury or international needs (the case of the Rabobank in the Netherlands, or of the Crédit Agricole in France). In a similar way, groups of national institutions could create European centres taking care of asset management and, potentially, large international corporates. This approach has the merit of being decentralised at the national retail level, with an efficient management of capital market activities at the international centre. As history has shown (such as that of European American Bank or European Asian Bank), the danger is a lack of control or speed of decision by the various members.

**Size will be important to operate on some segments of the market and a European coverage will be necessary.**

A premise of the above analysis has been that size will be important to operate on some segments of the market and that a European coverage will be necessary. This premise demands identification of the major competitive difference between large domestic size versus large size at the European level. Indeed, one could argue that two large banks of an equal size (one domestic and the other one European) could have the same market power on the bond or currency markets. This question is relevant since it will be much more difficult to create an international institution than a domestic one.

It is the author's belief that European coverage will dominate a domestic one for two major reasons. The first is that some corporate clients have become increasingly international, giving preference to banks with an international coverage. The second, more significant, argument in favour of a European coverage is that it provides a most welcome source of diversification. This is, of course, necessary to reduce overall credit risk, but is also relevant to stabilise the demand for services in capital markets. Indeed, because of a recession or a major change in the legal-fiscal environment, a large domestic bank would rapidly lose what was deemed necessary to compete: Local market knowledge plus placing power. A European coverage would be a way to stabilise business flows, allowing an adequate size to be retained permanently.

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6) An interesting case in 1998 is that of the highly praised Wells Fargo failing to integrate FirstInterstate successfully, and recently being forced into a merger by Northwest.

#### 4. Conclusions

*Consolidation of the European banking industry will take place in the capital market business, and further domestic rationalization of commercial banking will be needed.*

The objective of this paper has been to identify the various ways through which the euro would alter the sources of competitive advantage of European banks and to analyse the various strategic options available. Besides the obvious fall in revenue from intra-European currencies trading, the analysis has identified significant and permanent effects on several segments of the industry. One can forecast a rapid consolidation of the commodity-type business, such as government bonds, interest rate derivatives and spot currency trading. This is motivated by the loss of a main domestic source of competitive advantage, namely the national currency. If domestic expertise in the accounting, legal and fiscal environment gives a competitive advantage to domestic players in some segments of the corporate bond and equity markets, other factors such as placing power across Europe, trading capacity and global industry expertise will lead to consolidation of that industry. On the fund management side, very large European-wide index-tracking funds will compete with specialised funds. On the commercial banking side, the nature of credit risk is likely to change as one of the instruments of monetary policy, devaluation, will not be available. Finally, the impact of a low inflation environment on bank profitability will work through reduced margins on deposits, higher profits on personal loans and a lower 'inflation-tax'.

Furthermore, one should highlight the obvious but important fact that the single currency will make irreversible the creation of a single European banking market. A more predictable environment will facilitate the exploitation of economies of scale and the optimal location of processing units.

If the premises underlying the above analysis are verified in the future, one can anticipate the creation of a new Eurobanking world. A major international consolidation of the European banking industry will take place in the capital market business, and further domestic rationalisation of commercial banking will be needed.



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