



Global Vision Perspective

57 Tufton Street, London SW1P 3QL, Tel 020 7233 3121, Fax 020 7222 4388
info@global-vision.net

The EU Single Banking Market Programme: Fit for Purpose?

By Professor Kent Matthews and Dr Simon Norton

Introduction

The EU Single Banking Market Programme represents the vanguard of the Single Market Programme for services. The principle of a single banking market allows for consumers to purchase financial services from any part of the EU and for financial intermediaries to supply financial services to any part of the EU. The aim of the single banking market is to foster competition and greater efficiency in banking.

While it is clear that the Single Banking Market Programme has improved efficiency through greater consolidation and merger within continental Europe, improved competition has proved to be more elusive because of the existence of informal barriers to entry. In the UK, the single banking market is an irrelevance because it already operates in a competitive environment, with a relatively light regulatory touch and in the context of a shareholder value maximisation model of bank management. It would be a hindrance only if the EU attempted to harmonise financial regulation around the continental model of stakeholder value.

The Details

The European Union has been enacting and implementing various banking directives with the aim of creating a single EU banking market. This is part of a wider aim to create a single market in services. What a single banking market (SBM) effectively means is that any banking service provider in the EU can establish or acquire another bank across the EU and any EU customer can bank with any legally established banking institution across the EU. The long-term plan is to remove entry barriers and foster improved competition in the banking market EU-wide. After nearly 20 years of trying to establish a single banking market the EU is still some distance from its goal. In short, the single banking legislation is not fit for purpose.

In principle a single banking market can be created by one of two ways. One way is the removal of barriers to entry and acquisition with a single regulatory framework that is EU-wide. This can generate a level playing field but not necessarily an efficient and competitive banking market. A second way is to remove entry and acquisition barriers and allow banks to be regulated by home country regulations rather than host country regulations. This process allows regulatory competition to determine the optimal level of regulation and create the conditions for an efficient and competitive banking market.

The SBM Programme is based upon several directives that address the key issues of barriers to cross-border activity, capital adequacy, and deposit protection. Crucial in the harmonisation process was the adoption of the

Second Banking Directive in 1989, implemented in 1993. At its core the Directive has two elements: first, the principle of home country control or 'mutual recognition'; and second, the concept of the 'single banking passport'.

Home country control means that banks are regulated in accordance with the legislative frameworks of their home country, the domestic regulator being the 'parent'. If a bank in one EU Member State conducts business in another EU state, then the regulatory authority in the 'host' will recognise the primacy of the home country. The 'single passport' means that if a bank is licensed to do business in one EU state, it is similarly entitled to do business in any other EU state. In this way an EU state-based bank can set up a branch or subsidiary in any other EU state or perhaps, more importantly, take over any bank in another state. This passport provision was intended to open up the EU banking market, exposing domestic banks to the threat of foreign acquisition if uncompetitive. States are not officially allowed to impose barriers to this external threat, for example by imposing an obligation upon non-domestic but nevertheless EU-based banks to establish separate capital bases for entities established within their borders, or by requiring the obtaining of permission from officials prior to the launching of takeover bids.

Other directives such as the Own Funds Directive and the Solvency Ratio Directive were intended to set common capital adequacy standards across the EU market. One of the central objectives was to bring about greater cross-border activity whilst removing the ability of domestic regulators to obstruct ownership of banks passing into foreign control.

So the principles that have guided the SBM legislation have been limited harmonisation, national treatment and mutual recognition. But it is recognised that full harmonisation of the regulatory framework is not feasible because the regulation of financial markets is closely related to local commercial and contract law which will vary from country to country. The principle of national treatment allows for some market access and a degree of free trade, and the mutual recognition principle would in theory open up the possibility of regulatory competition. But in reality harmonisation is hampered by the acceptance of the 'general good' principle that allows for opt-outs from specific directives.

The banking systems in continental Europe are fragmented, with small-scale highly concentrated networks bedevilled by excess capacity and lack of competition. In contrast, the UK banking system is significantly less labour intensive; employment laws are more flexible than those of other EU states, enabling UK banks to adjust relatively quickly to changes in global conditions as well as to respond to external non-EU originating threats.

Other obstacles to the process of harmonisation include:

1. Differences in taxation and fiscal policies; in some countries the deductibility of mortgage interest for income tax purposes is dependent upon the borrower raising finance from a domestic lender;
2. Large public sector involvement in the banking sectors of some states in the form of shared ownership (although this is declining) and/or management provides implicit or explicit guarantees by the state. These give domestic banks a competitive advantage not related to the efficiency or effectiveness of their delivery of financial services. Innovation resulting from economies of scope is less likely given the inclination of domestic banks to 'rest on their laurels' and depend upon the state's involvement in this way;
3. Culturally, some EU governments are not prepared to regard larger domestic banks as simply another form of business which should be allowed to fail (subject to safety nets for stakeholders) if they are inefficient or mismanaged.

Taking stock of where the SBM is today, it is clear that the existing SBM legislation has resulted in an outcome that is neither a level playing field or a desirable competitive outcome. By allowing individual countries to derogate from the full harmonisation of regulation on the basis of the 'general good' opt-out, an uneven playing field is created. While the national treatment principle enables banks from one EU country to set up branches or subsidiaries in any other Member State and be treated equally as domestic banks, they still face economic barriers to entry into the lucrative retail market due to language, culture, brand name identification and the lack of a branch network. This barrier can be potentially overcome if there are no barriers to acquisition of a host country bank with a branch network.

In reality, the contestability of the banking market in the EU excluding the UK is weakened by the existence of implicit or informal barriers to acquisition. This sort of barrier is hard to measure but would include government officials trying to prevent foreign entry and expansion in favour of domestic institutions, or encouraging domestic defensive mergers to prevent foreign entry. One instance of this is the attempt by the Antonio Fazio, the former Governor of the Bank of Italy, to rig the takeover of Banca Antonveneta by another Italian bank, Banca Popolare Italiana, rather than ABN Amro. Because in this case the implicit barrier was revealed, ABN Amro was able to secure 39.4% stake in Antonveneta. Contrast this with the relative ease by which Bank Santander took over Abbey National.

The paradox is that whilst EU states are prepared to accept and encourage competition and consolidation (subject to relatively inflexible labour laws) within their domestic financial services markets as explicitly required by the EU

legislative framework, they are not prepared to harmonise where to do so would risk foreign acquisitions of domestic banks and inevitable post-takeover rationalisation (or loss of jobs). In contrast to the Continental protectionist tendencies, the UK banking sector facilitates and encourages internal consolidation as well as welcomes the competitive pressure presented by external non-domestic threats.

So the key question is how much competition has been generated by the SBM programme and how has it improved the efficiency of banks and the welfare of consumers? While it is justifiably argued that market penetration is not necessary to create competitive conditions if there exists credible threat of entry, Berger (2007) has argued that implicit government barriers to foreign bank competition separates 'Old Europe' from 'New Europe'. Old Europe being the EU15 (excluding the UK) and New Europe being the accession countries. Chart 1 shows the share of assets in the banking markets of other EU country banks in the UK Germany (GE), France (FR), Italy (IT) and Spain (SP). Chart 2 shows the market penetration of non-EU banks and Chart 3 shows the market penetration of all foreign banks.

Clearly the UK being a centre for international banking will have a much stronger foreign banking participation than any of its EU counterparts but it is surprising how little foreign bank (including inter-EU) participation actually exists in the other large economies of the EU. If the threat of entry is non-credible, the Single Banking Market Programme may not have improved competition in the banking markets of 'Old Europe'.

Chart 1

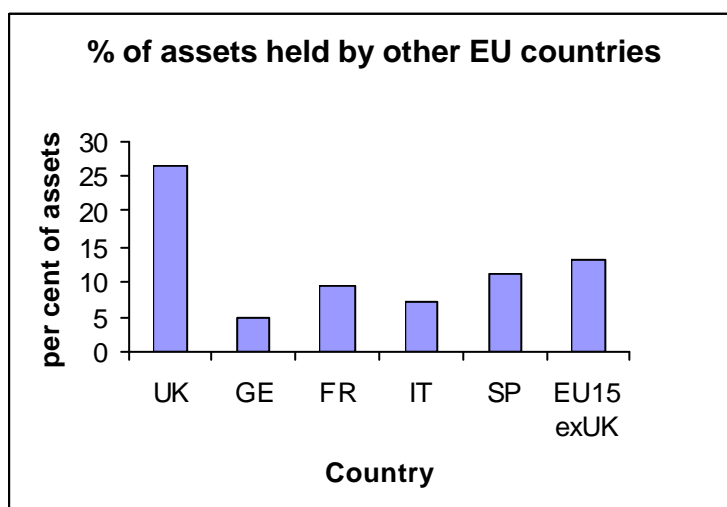


Chart 2

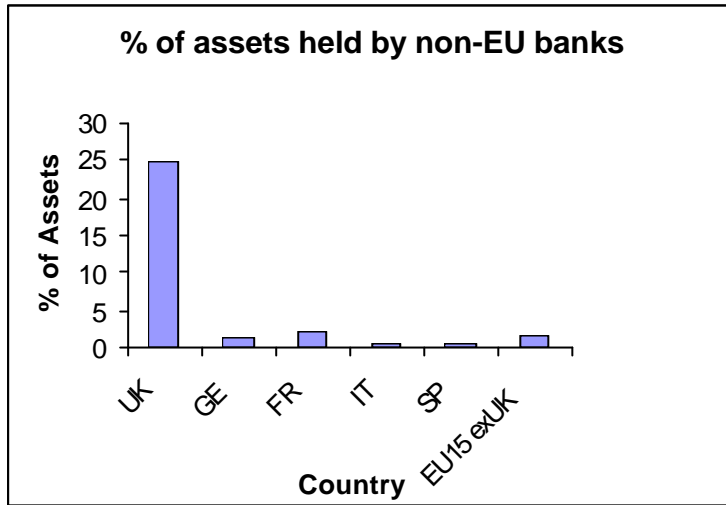
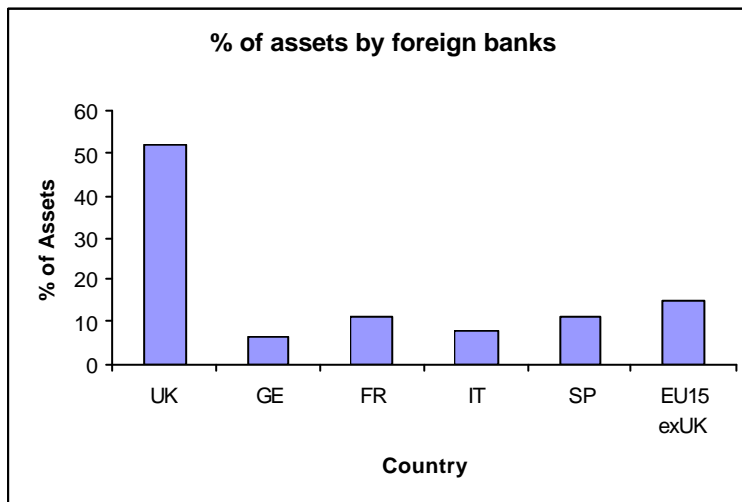


Chart 3



Source: Berger (2007)

The result of the SBM has been to deregulate individual country banking markets, which can only be positive for bank efficiency. However deregulation is a global trend that would have occurred independently of the SBM

programme. The effect of the SBM programme has been to accelerate the process of restructuring and concentration in individual EU economies rather than expand abroad (see Gual, 2004, who also finds that the SBM programme has not resulted in an improvement in price competition through a faster reduction in interest rate margins). Empirical studies by Casu and Girardone (2006) show that the SBM programme has improved efficiency through consolidation and merger but this improved efficiency has not had any impact on the competitiveness of the banking markets.

Worth it for the UK?

So what advantage does the SBM provide for the UK banking sector? The UK is a relatively open banking market. It faces competitive challenges from credible threat of entry not just into the corporate and investment banking market but also in the more profitable retail, consumer credit and mortgage markets. British banks are also more profitable on the basis of conventional measures such as ROE than the banks of 'old Europe'. Llewellyn (2005) explains the profitability advantage of British banks by its adoption of the 'shareholder value maximisation' (SHV) model of bank management whereas the continental European model is predominantly one of 'stakeholder value maximisation' (STV). The STV model involves the shareholders, customers and employees in the management of the bank. Whereas the SHV model recognises that shareholders, customers and employees are all players, it treats their preferences as constraints in the profit maximisation process.

Thus it would appear that there is very little advantage - if any - for the UK from the SBM programme. The UK banking system already works under a competitive environment with a relatively light regulatory touch. The problems for the UK banking sector would surface only if Brussels tried to extend the harmonisation principle from directive to legislation around rules based around the STV model of bank management, which as it stands is an unlikely prospect. Until other EU states accept both the internal and external obligations implicit in the existing EU framework of directives, true harmonisation and a genuinely open single market based on free competitive will remain frustratingly elusive for the rest of Europe.

References:

Berger A N (2007), 'Obstacles to a Global Banking System: Old Europe versus New Europe', *Journal of Banking and Finance*, 31, 1955-1973.

Casu B and Girardone C (2006), 'Banking Competition, Concentration and Efficiency in the Single European Market', *Manchester School*, Special Issue, 441-468.

Gual Jordi (2004), 'The Integration of EU Banking Markets', in *Building a Dynamic Europe: The Key Policy Debates* (ed. J Gual) Cambridge: Cambridge University Press.

Llewellyn, D T (2005), 'Competition and Profitability in European Banking: Why are British Banks so Profitable?', *Economic Notes*, 34, 3, 279-311.

Notes on the Authors:

Kent Matthews is the Sir Julian Hodge Professor of Banking and Finance at Cardiff Business School. He trained at the London School of Economics, Birkbeck College and Liverpool University. He has held academic positions at Liverpool University and Liverpool John Moores University, visiting appointment at Katholiek Universiteit Leuven, Clemson University, University of Western Ontario and Humbolt University Berlin. He has had professional positions at the Bank of England and Lombard Street Research Ltd.

Simon Norton is a Solicitor and lecturer in International Banking and Capital Markets Law at Cardiff Business School. He trained in Law at Cardiff University.

Global Vision is a new campaign group backed by economists and business leaders that argues for a looser British relationship with the EU, based on free trade and mutually beneficial cooperation, whilst opting out of economic and political union. Global Vision believes that this is the right relationship for Britain in the 21st century's rapidly changing world. For more details on Global Vision please visit our website: www.global-vision.net.