European Banking Integration: Don't Put the Cart before the Horse

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This paper reviews the progress in European banking integration over the last twenty years, and evaluates the current system of banking supervision and deposit insurance based on 'home country' control. The public policy implications to draw from the paper are threefold: First, after a relatively slow start, European banking integration is gaining momentum, in terms of cross-border flows, market share of foreign banks in several domestic markets, and cross-border M&As of significant size. If this trend continues, the issue of adequate supervision and safety nets in an integrated European banking market will become even more pressing. Second, although until recently banks have relied mostly on subsidiary structures to go cross-border, this is changing with the recent creation of the European company statute, which facilitates cross-border branch banking. A review of the case of the Scandinavian bank, Nordea Bank AB, helps to understand some remaining barriers to integration, and the supervisory issues raised by branch banking. Third, it is argued that the principle of 'home country' supervision is unlikely to be adequate in the future for large international banks. Because the closure of an international bank would be likely to have cross-border spillovers, and because some small European countries might be unable to finance the bail-out of their very large banks, centralization, or at least Europe-wide coordination, of the decision to close or bail-out international banks is needed. This raises the issue of European funding of bail-out costs, European banking supervision, and European deposit insurance.

I. INTRODUCTION

In 1985, the European Commission published a White Paper on The Completion of the Internal Market, which provided for the free circulation of persons, goods, and capital in the European Union. Following various European councils, the 1986 Single European Act,[1] the 1988 Council directive on the liberation of capital movements,[2] the 1992 Treaty on European Union,[3] the creation of the Euro in 1999, the Financial Services Action Plan 1999–2005, the adoption of the Lamfalussy approach for legislation draft, and the entry of ten new member countries in May 2004, legal barriers to an integrated European

[1] OJL 169, 29.6.1987.

[2] Council directive on the application of Article 67 of the EEC Treaty, June 1988.

[3] Europe document n° 1759/60.

banking market have been progressively dismantled. Twenty years into this transformation period, we review the impact of this legislation on the European banking industry. A review of a twenty-year period of advanced integration will hopefully help to better understand the public policy issues raised in cross-border banking. Specific attention is paid to the allocation of banking supervision and deposit insurance to the various countries involved. Should it be the 'home' country (that of the parent bank), the 'host' country (that of the branch or subsidiary), or a newly created European authority?

In Section II, of this paper we present a brief historical review of the major legislative steps in European banking integration. We provide empirical evidence on the impact of the new legislation in Section III, and, in Section IV, we attempt to better understand the remaining barriers to the creation of a truly single European banking market. In particular, we observe that cross-border consolidation very often appears to take the form of subsidiaries, not branches. Special attention is paid to the case of the Scandinavian bank Nordea, which has announced its plan to adopt the statute of *Societas Europaea*, a single corporate legal entity operating across borders with branches. Careful attention to this case helps to identify the remaining barriers and the regulatory challenges. Finally, in Section V, we evaluate the current system of 'home country' supervision and deposit insurance. The main conclusions of the paper are summarized at the end of the paper.

The public policy implications to draw from the paper are threefold: first, after a relatively slow start, European banking integration is gaining momentum, both in terms of cross-border flows, market share of foreign banks in several domestic markets, and cross-border mergers of significant size. If this trend continues, the issue of adequate safety nets and supervision in European countries will become even more pressing. Second, although, until recently, banks have relied mostly on subsidiary structures to go cross-border, this is changing with the recent creation of the European company statute, which facilitates cross-border branch banking. A review of the case of the Scandinavian bank, Nordea, helps to understand some remaining barriers to integration, and the supervisory issues raised by branch banking. The move to branch banking is a fundamental change as, under current European legislation, it moves banking supervision and deposit insurance from the 'host' country to the 'home' country. Third, it is argued that the principle of 'home country' control, which has guided European banking integration so far, may be inadequate in the future. Because the closure of an international bank would be likely to have cross-border spillovers, and because some small European countries might be unable to finance the bail-out of their very large banks, centralization, or at least Europe-wide coordination, of the decision to close or bail out international banks is needed.This raises the issue of European funding of bail-out costs, European banking supervision, and European deposit insurance.

II. FROM FRAGMENTATION TO INTEGRATION: THE INSTITUTIONS

The effort to integrate European economies date back to the 1957 Treaty of Rome. For the sake of space,[4] we review the last twenty years: the "1992" directives regarding a single banking license, home country control, mutual recognition, and freedom of cross-border services, the creation of the single currency in 1999, the Financial Services Action Plan (1999–2005), and the entry of ten new member countries in May 2004.

The Completion of the Internal Market (1983–1992)

While most international agreements have used the national treatment principle, which ensures the equal treatment of all firms operating in one country, the European Commission used a powerful method of integration: home country control with minimal harmonization of national regulations.

In 1985, the European Commission published a White Paper on *The Completion of the Internal Market*, which provided for the free circulation of persons, goods, and capital in the European Union. In the context of banking, the White Paper called for a single banking license, home country control, and mutual recognition.[5] These principles were incorporated into the Second Banking Directive,[6] under which, all credit institutions authorized in an EU country would be able to establish branches or supply cross-border financial services in the other countries of the EU without further authorization, provided that the bank was authorized to provide such services in the home state.

The banking model adopted by the EU is the universal banking model, which permits banks to undertake investment banking activities, while leaving it to national regulators to control financial conglomerates, the ownership structure of banks, and their relationship with industry.

The Second Banking Directive called for home country control on solvency,[7] which, under this directive, extends to the bank itself, its foreign and national subsidiaries which have to be consolidated for supervisory purposes, and its foreign branches. With regard to the latter, the host state retains the right to regulate a foreign bank's activities in that state only to the extent that such regulation is necessary for the protection of "public interest". Thus, the manner in which a bank markets its services and deals with customers can be regulated by the 'host state'. The 'host state' may also intervene in those matters which

[4] A more complete historical review is available in Dermine (2003_a).

[5] The principles of home country regulation and mutual recognition have been inspired by the famous 1987 case Cassis de Dijon (EC Commission vs. Germany. 205/84, ECR 3755). In this case, the European Court of Justice found that Germany could not prohibit the import of liquor that was lawfully produced and sold in France solely because the alcoholic content was too low for it to be deemed liquor under German law.

[6] Directive 89/646/EEC.

[7] As discussed in Norton (1991), the EC directives have basic ideas in common with the Basle Concordat (June 1993) on guidelines for consolidated supervision, and the division of supervisory responsibilities between the home and host states.

have been expressly reserved to it, notably liquidity, monetary policy and advertising. Moreover, in emergency situations, the host-country supervisor may—subject to *ex-post* Commission control—take any precautionary measures necessary to protect depositors, investors and others to whom services are provided (Walkner and Raes, 2005). A bank constituted in a member state has the right to open a subsidiary in another member state on the same conditions as nationals of the latter state. The establishment of a subsidiary bank is subject to the control of the country in which it is established, since that is the 'home state'.

To address the need for a minimal harmonization of regulations, the Second Banking Directive called for harmonized capital adequacy standards and large exposure rules, and supervisory control of banks' permanent participation in the non-financial sector. A major supportive piece of legislation was the 1988 Directive on Liberalization of Capital Flows. This directive, however, contained a safeguard clause authorizing member states to take necessary measures in the event of balance of payments problems.[8] A degree of uncertainty, therefore, existed, concerning the complete and permanent freedom of capital flows.

A directive on Deposit Guarantee Schemes[9] was accepted by the Council of Ministers in 1994. This directive provides for mandatory insurance for all EU financial institutions. The coverage per depositor is a minimum of € 20,000, with a franchise of a maximum 10%. The directive does not deal with funding, so that the level of insurance premium is be chosen at the national level. Deposits of a branch-multinational are covered by the deposit insurance system of the home country. In this case, if the host country's deposit insurance coverage is higher than that of the home country, the multinational bank can obtain complementary coverage from the host state (deposit insurance *top-up*). In the case of a subsidiary-type multinational, deposits are covered by the deposit guarantee system of the host state.

The 1992 Maastricht Treaty on European Union confirmed the Single Market program. Although the primary objective of the European System of Central Banks (ESCB) is to maintain price stability, there are explicit references to regulation and supervision in the Treaty:

Article 105 (2)

"The basic tasks to be carried out by the ESCB shall be:

- *to define and implement the monetary policy of the Community;*
- *to conduct foreign exchange operations consistent with the provisions of Article 109;*
- *to hold and manage the official foreign reserves of the Member States;*
- *to promote the smooth operations of payment systems.*

[8] Directive 88/361/EEC. The June 1988 capital directive (Article 3) provided for the temporary implementation of capital controls. In the case of large speculative movements, the Commission, after consultation with the Committee of Central Bank Governors, could authorize capital controls. In very urgent cases, a country can implement them, but only after giving prior notification to the Commission.

[9] 94/19/EC.

Article 105 (5)
The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

Article 105 (6)
The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings".

The Treaty is explicit on the principle of decentralization and allocation of regulatory and supervisory powers to national central banks. It is only in very special circumstances, and with unanimity in the European Council, that the ECB will be allowed to regulate or supervise financial institutions.

It should be recognized that the single banking market went beyond the fifteen members of the European Union. On May 13, 1992, the countries of the European Free Trade Association (EFTA),[10] with the exception of Switzerland, joined the European Economic Area (EEA). With regard to banking, this implies that the EEA countries accept the European banking legislation covering a single banking license, home country control, mutual recognition, and acceptance of common regulations.

The Creation of the Single Currency, 1999

In 1989, the Committee for the Study of Economic and Monetary Union recommended, in the *Delors Report*, a three-phase transition spread over ten years. Its conclusions were incorporated in the 1992 Treaty on European Union. This led to European Monetary Unification (EMU)[11] on January 1, 1999. With irrevocably fixed exchange rates, the money and capital markets moved into the Euro, while the retail market continued to operate in legacy national currency. Euro notes and coins were introduced in January 2002. An important feature of the single currency is the payment system and the clearing mechanism. The payment system is organized at the national central bank level, while large Real Time Gross Settlements (RTGS) between financial institutions flow through the ECB Target system.[12]

[10] EFTA comprises Iceland, Liechtenstein, Norway, and Switzerland. In January 1995, three EFTA countries, Austria, Finland and Sweden, became members of the European Union.
[11] The initial members included eleven countries. Greece joined on January 1st 2001. Denmark, Sweden, and the United Kingdom have kept open their option to join at a later date.
[12] As will be discussed later, the organization of the payment system at the national level constitutes a barrier to integration.

The Financial Services Action Plan (1999–2005)

In May 1999, the Council launched the Financial Services Action Plan (FSAP),[13] which consisted of a large series of initiatives taken to ensure the full integration of banking and capital markets by the year 2005. The objective was to develop the legislative and non-legislative framework along four objectives: a single EU wholesale market, open and secure retail banking and insurance markets, the development of state-of-the-art prudential rules and supervision, and optimal wider conditions (essential fiscal rules) for an optimal single financial market. The Tenth Report (European Commission, 2004_a) concludes that the Financial Services Action Plan was delivered on time, with 39 out of 42 measures being adopted. These include among others a directive on the reorganization and winding up of credit institutions,[14] a regulation on the application of international accounting standards,[15] a directive on European Company Statute,[16] and a directive on the taxation of savings income in the form of interest payments.[17]

With regard to the drafting of new regulation and the harmonization of efficient banking supervision, the extension, in 2004, of the *Lamfalussy* approach[18] from the securities markets to the banking and insurance sectors allows a distinction to be drawn between legislative principles and technical rules. A 4-level procedure works as follows. Level-1 deals with European directives and regulations concerned with broad principles. Level-2 covers more detailed, technical legislation. The Commission is assisted by a Level-2 Committee, the *European Banking Committee (EBC)*. This committee of regulators replaces the former *Banking Advisory Committee (BAC)*. Level-3 works on uniform implementation of directives and exchange of information among supervisors. It is assisted by a Level-3 committee, the *Committee of European Banking Supervisors (CEBS)*, based in London. Finally, Level-4 concerns the application and enforcement of EU regulations.[19]

EU Financial Services Policy (2005–2010)

In May 2005, Charlie McCreevy, Internal Market Commissioner, published a Green Paper on financial services policy over the period 2005–2010 (European Commission, 2005_a). It will focus on implementing existing rules and enforcing

[13] COM (1999) 232.
[14] (2001/24/EC of 4 April 2001).
[15] (1606/2002/EC of 19 July 2002, effective from 1 January 2005).
[16] (Directive 2001/86/EC and Regulation 2001/2157/EC of 8 October 2001-entry into force on 8 October 2004).
[17] (2003/48/EC of 3 June 2003).
[18] The *Lamfalussy* approach was set out by the Committee of Wise Men on the Regulation of European Securities Markets (2001). That committee was chaired by Alexandre Lamfalussy, former President of the European Monetary Institute.
[19] 'Comitology' refers to the procedure according to which the European Commission is assisted by a committee comprising member states' representatives.

co-operation rather than propose new laws. Given the slow progress of integration in retail banking markets (as an example, less than 1% of mortgages are sold across borders), it might consider the possibility of a "26^{th} regime", meaning that a few specific products, such as mortgages or life insurance, could receive a special European status, bypassing the fragmented legislation of the 25 member states.

Finally, the European Central Bank would like to achieve a single Euro payment area (SEPA) by 2010 (European Central Bank, 2004_a). The vision for the SEPA is that all Euro area payments should become domestic and reach a level of safety and efficiency at least on a par with the best performing national payment system.

From 15 to 25 Member States

Ten new member states joined the EU on May 1, 2004. They include the Baltic States (Estonia, Latvia, and Lithuania), five countries from Central and Eastern Europe (Poland, Hungary, the Czech Republic, Slovenia, and Slovakia), and Cyprus and Malta. In preparation for the accession, these countries undertook major reform (privatization and deregulation) of their banking systems (Roland, 2005).

III. FROM FRAGMENTATION TO INTEGRATION: EMPIRICAL EVIDENCE

Empirical evidence is provided on three effects of the single market program: indirect effects stemming from deregulation, the impact on bank mergers and consolidation, and, finally, evidence on the degree of integration of European banking markets.

Deregulation

The conjecture of analysts (e.g., Neven, 1993), according to whom the main benefit of the single market was to launch a process of competitive deregulation among national regulatory agencies using their power to help their banking industry, was fully supported by facts. Over the years, a series of regulations had been progressively lifted. These included control of interest rates, capital controls, stock exchange membership, branch restrictions, foreign bank entry, credit ceilings, mandatory investment requirements, and restriction on insurance activities (Dermine, 2003_a). Twenty years later, a level playing field was created, with a regulatory convergence toward a minimum set of regulations on banking license, capital, and large exposure limits. The ending of 'repressed' banking systems is, most likely, one of the major contributors of the single market program. Anecdotal, but quite to the point, was the change in German law in 1990 to allow the creation of financial futures markets in Germany to compete with the successful *bund* futures contract traded on the London International Financial Futures Exchange (LIFFE). This period of massive deregulation led to an exceptional expansion of the banking systems. In Table 1, we report the

Table 1: GNP, Population, Bank Asset, Employment in Banking Sector

Country	GNP 2003 €bn	Population (millions)	Assets 2003 €bn	Assets/GDP 2003	Assets/GDP 1981	Number of Employees 2003 (‘000)	Number of Employees 1990 (‘000)
Belgium	267.5	10.4	829.0	309.91%	112%	73.6	79
Denmark	188.2	5.4	568.9	302.28%	56%	46.0	55
Germany	2,128.2	82.5	6,393.5	300.42%	103%	725.6	664
Greece	152.6	11.0	213.2	139.71%		61.1	
Spain	743.0	40.8	1,507.9	202.95%	101%	243.5	251
France	1,557.2	61.5	3,994.2	256.50%	76%	420.3	440
Ireland	131.9	4.0	575.2	436.09%		35.7	
Italy	1,300.9	58.1	2,125.4	163.38%	116%(1985)	337.7	331
Luxembourg	23.5	0.5	656.0	2,791.49%		22.5	
Netherlands	460.0	16.2	1,472.5	320.11%	98%	119.9	123
Austria	224.3	8.1	586.5	261.48%		73.3	
Portugal	130.4	10.4	348.7	267.41%		53.9	
Finland	142.5	5.2	185.8	130.39%	60%	26.7	46
Sweden	267.3	9.0	519.3	194.28%	107%	39.5	
UK	1,589.5	59.4	6,175.3	388.51%	100%	495.2	455 (1997)
EU15	**9,307.1**	**382.6**	**26,151.2**	**280.98**%		**2,774.2**	

Country	GNP 2003 €bn	Population (millions)	Assets 2003 €bn	Assets/GDP 2003	Number of Employees 2003 ('000)
Cyprus	10,09	0.7	27.2	269.6	7.7
Czech Republic	79,38	10.2	77.6	97.8	39.0
Estonia	7,96	1.4	6.3	79.1	4.3
Hungary	73,19	10.1	52.5	71.7	26.5
Latvia	9,73	2.3	6.4	65.8	8.9
Lithuania	16,11	3.5	8.4	52.2	Na
Malta	4,29	0.39	17.4	405.4	3.4
Poland	185,49	38.2	103.6	55.9	151.3
Slovakia	28,76	5.4	21.4	74.4	19.8
Slovenia	24,51	2.0	20.9	85.3	11.4
NMS10	**439,51**	**74.2**	**341.7**	**77.7**%	
EU25	**9746,61**	**456.8**	**26,493.0**		

Source: ECB (2004_b, 2005), Dermine (2003_a).

ratio of banking assets-to-GDP in 1981 and 2003, as well as the number of bank employees for the 15 'old' member states (MS) and for the 10 new member states (NMS). In many of the 15 MS countries, the asset-to-GDP ratio has more than tripled over the past twenty years, with an almost constant workforce.[20] In the Netherlands, for instance, that ratio went from 98% in 1981 to 320.11% in 2003. In the United Kingdom, the ratio went from 100% to 388.51%. This growth was achieved with a quasi-constant workforce, a notable exception being Finland, which faced a severe banking crisis in the early 1990's. The workforce in Finland fell by 42% in the last thirteen years. In the 10 new member states, the ratio of banking assets-to-GDP stood at 77.7% in 2003, compared to the 280.98% average in the 15 'old' MS. This ratio, often used as an indicator of potential development, helps to explain the foreign direct investment in the financial sector in these countries.

M & A in Europe

The level of Mergers & Acquisition in European banking has been high in the last fifteen years. In the EU, with 15MS, the number of credit institutions fell from 12,256 in 1985 to 7,444 in 2003.

Data from Table 2 provides a clear picture of the types of M&As taking place in European banking. Over the period 1997–2004, out of a total of 1,024 transactions involving at least one credit institution, 47% involved within-border transactions, 24% transactions within the European Economic Area, and 29% of deals were with third countries outside the EEA. In value terms (Table 3), out of a total of acquisitions of banks by a bank of €581.4 billion, 76.7% concerned domestic acquisitions. In terms of acquisitions of banks or insurance companies by a bank, the acquisition of banks represents 92% of deal value. Tables $4_{a,\ b,\ c}$ report significant transactions. Domestic mergers have led to a massive consolidation process in many European countries. A series of specific cross-border transactions have involved the acquisition of merchant banks (most registered in the United Kingdom) to access expertise in corporate finance and asset management. Finally, until recently, few cross-border transactions of significant size have been observed. Significant transactions include the Dutch ING Group, with the acquisition of banks in Belgium and Germany, Nordea Bank AB, with the merger of four Scandinavian banks, and the German HypoVereinsbank (HVB), with the acquisition of banks in Austria and Central and Eastern Europe. Recent transactions, involving large banks, include the purchase of the British Abbey National by the Spanish Santander Central Hispano, and the purchase of the second German bank HVB by the Italian UniCredito.

Out of eleven sources of economies of scale and scope discussed in Dermine (2003_a), four appear to be a major strategic drive of acquisition: revenue-based

[20] The banking asset-to-GDP ratio underscores the real growth in banking activities, as it ignores the off-balance sheet activities of European universal banks.

Table 2: Mergers in Europe: Domestic, Intra-EEA, Outside-EEA (number of transactions including at least one credit institution, 1997–2004)

Country	Domestic	Intra-EEA	Outside-EEA
Belgium	10	14	26
Denmark	6	11	3
Germany	91	29	51
Greece	21	9	10
Spain	47	36	42
France	80	31	39
Ireland	1	3	3
Italy	154	27	22
Luxembourg	0	21	3
Netherlands	9	17	17
Austria	18	4	27
Portugal	14	14	6
Finland	2	5	5
Sweden	5	12	13
United Kingdom	22	11	33
Total	480 (47%)	244 (24%)	300 (29%)

Source: ECB 2004_b, own calculations.

scale economies in investment banking, X-efficiency gains, financial diversification, and market power.

With the accession of the 10 NMS and the reported potential for growth, significant transactions have taken place (see Table 5). Surprisingly, the two largest acquirers are banks from small countries (Austria and Belgium), which may well have been perceived as a smaller threat to the acquired domestic banks.

Focarelli and Pozzolo (2001) indicate that the volume of M&A is much smaller in the financial sector than in other sectors. They attribute this to the difficulty of operating in foreign markets due to asymmetric information and to non-regulatory barriers. Despite legislation on freedom of entry, rumours

Table 3: M&A Deals in Value (€bn ; 1990–2003)

	Target							
	Domestic		Intra-EEA		Outside EEA		Total	
Acquirer	Bank	Insurer	Bank	Insurer	Bank	Insurer	Bank	Insurer
Bank	446.3	40.7	75.1	4.3	60.0	5.1	581.4	50.1
Insurer	52.3	115.3	20.2	36.9	3.9	73.3	76.5	225.6

Source: Dierick (2004).

Table 4_a: Domestic Mergers in Europe (Not complete. For illustration only.)

Belgium	1992	CGER-AG (Fortis)
	1995	Fortis-SNCI
	1995	KB-Bank van Roeselaere
	1997	BACOB-Paribas Belgium CERA-Indosuez Belgium
	1998	KBC (KB-CERA-ABB)
	2001	Dexia-BACOB
	2004	KBC-Almanij-KBL
Denmark	1990	Den Danske Bank Unibank (Privatbanken, Sparekassen, Andelsbanken)
	1999	Unibank – TrygBaltica
	2000	Danske Bank-RealDanmark
Finland	1995	Merita Bank (KOP-Union Bank of Finland)
France	1996	Crédit Agricole-Indosuez
	1999	BNP-Paribas
	2004	Crédit Agricole-CL
Germany	1997	Bayerische Vereinsbank-Hypo-Bank (HBV)
	2001	Allianz-Dresdner
Italy	1992	Banca di Roma (Banco di Roma, Cassa di Risparmio di Roma, Banco di Santo Spirito) San Paolo- Crediop
	1995	Credito Romagnolo (Rolo)-Credit Italiano (UniCredito)
	1997	Ambroveneto-Cariplo (Intesa)
	1998	San Paolo-IMI
	1999	Intesa-BCI
	1999	SanPaoloIMI-Banca di Napoli
	2002	Banca di Roma-Bipop SanPaolo IMI-Cardine
Netherlands	1990	ABN – AMRO
	1991	NMB-PostBank-ING
Portugal	1995	BCP-BPA
	2000	BCP-BPSM
Spain	1988	BBV(Banco de Vizcaya-Banco de Bilbao)
	1989	Caja de Barcelona-La Caixa
	1992	Banco Central-Banco Hispano
	1994	Santander-Banesto
	1999	Santander-Banesto-BCH BBV-Argentaria
	2003	Sabadell-Atlantico
Sweden	1993	Nordbanken-Gota Bank
	1997	Sparbanken Sverige-Föreningbanken

Switzerland	1993	CS-Volksbank-Winterthur
	1997	SBC-UBS
United Kingdom	1995	Lloyds-C&G-TSB
	2000	RBS-NatWest
	2000	Barclays-Woolwich
	2000	Abbey Nat.-Scottish Provident
	2001	Halifax-Bank of Scotland

Table 4_b: International Mergers in Europe[1]

Buyer	Target
Deutsche Bank	Morgan Grenfell
ING Bank	Barings
Swiss Bank Corp	Warburg, O'Connor, Brinson, Dillon Read
Dresdner	Kleinwort Benson
ABN-AMRO	Hoare Govett
UNIBANK	ABB Aros
Merrill Lynch	Smith New Court (UK) FG (Spain), MAM
Morgan Stanley Dean Witter	AB Asesores
CSFB	BZW (equity part)
Société Générale	Hambros (UK)
Citigroup	Schroder
Chase	Robert Fleming
ING	Charterhouse Securities

[1] Not complete. For illustration only.

Table 4_c: International Mergers in Europe

Buyer	Target
DEXIA (B- F)	Crédit Communal (B), Crédit Local (F), BIL (L), Crediop (I), BACOB (B)
BACOB (B)	Paribas (NL)
ING (NL)	BBL (B), BHF (G)
GENERALE BANK (B)	Crédit Lyonnais (NL), Hambros (UK, corporate)
FORTIS (B- NL)	AMEV + Mees Pierson (NL)/CGER/SNCI/ Generale Bank (B)
NORDBANKEN (S)	Merita (F), Unidanmark (DK), Christiania (N)
SCH (E)	Champalimaud-Totta (P), Abbey National (UK)
HSBC (UK)	CCF (F)
Hypovereinsbank (HBV)	Bank Austria-Creditanstalt (A)
Barclays (UK)	Banco Zaragozano (E)
Danske Bank (DK)	NAB (Irl)
UniCredito (I)	HVB (G)

Table 5: Largest Acquires According to Deal Values in Central and Eastern Europe Countries (1990–June 2004)

Acquirer	Target Nations	Number of Deals	Deal value (€ mn)
Erste Bank (AT)	CZ, SK, HU	8	2,141
KBC (BE)	CZ, PL, HU, SI	16	1,983
Société Générale (FR)	CZ, SI	2	1,329
Citigroup (US)	PL	3	1,038
Bayerische Hypo Vereinsbank (DE)	CZ, PL	7	932
SEB (SE)	LT, EE, LV, PL	14	568
IntesaBCI (IT)	SK	1	440

Source: ECB (2005).

abounded of public intervention to deter the entry of foreign banks in the case of the sale of CIC in France and of Générale de Banque in Belgium, an (unsuccessful) attempt to prevent the sale of the bank Totta of the Champalimaud group to Banco Santander in Portugal, and of a desire expressed by the Central Bank of Italy to keep the large banks independent. Two recent cases in Italy received a great deal of public attention in Europe. ABN-AMRO was competing with Banca Popolare Italiana (formerly Banca Popolare di Lodi) for a takeover bid on Banca Antonveneta, a large regional bank in Northern Italy. ABN-AMRO accused the Bank of Italy of unfair treatment, as its rival was allowed to increase its share of the target, while ABN-AMRO bid was being delayed. A second case involved the attempt by the second Spanish bank, BBVA, to take control of Banca Nazionale del Lavoro (BNL), Italy's sixth largest bank. Unipol, a small Italian insurer (with a market capitalization of a quarter of that of BNL) is bidding, with the help of seven Italian property developers. In this case, an issue was whether BBVA could be allowed to take effective control of BNL with less than 50% of the shares.On July 22, 2005, BBVA abandoned its takeover bid for Banca Nazionale del Lavoro. On July 25th, ABN AMRO acknowledged failure to gain majority control. However, that battle was not yet closed as court actions were still pending on some of the other investors. After requesting information from the Bank of Italy, European commissioners for competition, Neelie Kroes, acknowledged in July 2005 that no rules had been broken by the Bank of Italy.[21] The banks complained that, even if rules were not broken, a delay in their applications favored Italian bidders. Amid continuing criminal probes into insider trading, price manipulation and false statements, the chief executive of BPI resigned, and, on September 19th, ABN AMRO agreed to acquire 39.37% of Ambroveneta shares from BPI

[21] *Financial Times,* 26 July 2005. However, the Commissioner for the internal market, Charlie McCreevy, was still pursuing his investigation.

and its allies, increasing its stake to 70%. Succumbing to mounting pressures, the governor of the Bank of Italy, Antonio Fazio, resigned on December 19^{th} 2005.

As expected the domestic mergers have created significant level of concentration in several countries. The CR5 concentration ratio, reported in Table 6, stands at 67% in Denmark, 84% in the Netherlands, and 81% in Sweden. In most MS countries, it has expanded since 1997. The Herfindhal-Hirschman Index (HHI) coefficient[22] exceeds the "2000 high level concentration" threshold in a number of countries. In the 10 NMS, the CR5 is also quite high, exceeding that of the small MS. Although, to the best of the author's knowledge, no

Table 6: Concentration Ratios (CR5), Herfindahl Index, Number of Credit Institutions, 1997–2003

Country	CR5 2003	CR5 1997	Herfindahl 2003	Number of CI 2003	Number of CI 1997
Belgium	83	54	2,065	108	131
Denmark	67	70	1,114	203	213
Germany	22	17	173	2,225	3,420
Greece	67	56	1,130	59	55
Spain	44	32	521	348	416
France	47	40	597	939	1,258
Ireland	44	41	562	80	71
Italy	27	25	240	801	909
Luxembourg	32	23	315	172	215
Netherlands	84	79	1,744	481	648
Austria	44	44	557	814	928
Portugal	63	46	1,044	200	238
Finland	81	88	2,420	366	348
Sweden	54	58	760	222	237
United Kingdom	33	24	347	426	537
EU15	**46**	**53**	**541**	**7,444**	**8,637**
Cyprus	88.4			14	
Czech Republic	65.8			77	
Estonia	99			7	
Hungary	52.3			218	
Latvia	63.1			23	
Lithuania	81.6			117	
Malta	82			16	
Poland	52.3			660	
Slovakia	67.5			21	
Slovenia	67.4			30	

[22] The Herfindhal-Hirschman Index (HHI) is the sum of the squared market shares of each firm in a market. An index of 10,000 would indicate that there is only one firm.

European-wide data are available on the creation of new banks, it does not appear that there have been many in recent years in Europe. This is in sharp contrast with the United States, where 4,000 *de novo* commercial banks have been created in the past twenty years (DeYoung *et al.*, 2004). Community banks, with assets below US$1 billion, appear to play a major role in lending to SMEs in the United States.

The Degree of European Banking Integration

Several authors have analyzed the degree to which the single market legislative program has led to integrated European banking markets.[23] Due to asymmetric information and switching costs, one needs to draw a distinction between wholesale and retail markets.

Given that asymmetric information is less of an issue with large corporate firms and that the size of transactions will reduce the relevance of switching costs, one would expect, *a priori*, that the banking market for large corporate and financial firms would be much more integrated. The evidence on large integration of money and bond markets is overwhelming. As anticipated (Dermine and Hillion, 1999; Dermine, 2003_b), the impact on the bond underwriting industry has been great, with a much larger size of bond issues and a significant drop in underwriting fees (Santos Tsatsaronis, 2002). The money and government bond markets are fully integrated (Hartmann *et al.*, 2001, and Adam *et al.*, 2002).

With regard to the retail markets, including personal and small and medium size enterprises, the consensus is that they are still fragmented. Three dimensions of international integration have been analyzed: (i) the law of one price, (ii) the amount of cross-border business, and (iii) the amount of foreign direct investment and market share of foreign firms in a market. These three dimensions are analysed successively.

(i) The Law of One Price on the Retail Banking Markets

In the context of the single market program, the European Commission published the Cechini report on the Costs of non-Europe (European Commission, 1988). In an attempt to estimate expected consumer gains from the single market, the authors reported the potential price falls in several banking products by comparing the current price to the average of the lowest four observations. The implicit assumption is that the retail banking product is a homogeneous service traded in a perfect market so that cross-border competition will drive away price differentials. The law of one price is presumed to hold. However, several authors have pointed out that banking services are unlikely to meet the

[23] Hartmann *et al.* (2001), Adam *et al.* (2002), Dermine (2003_a), Hartmann *et al.* (2003), Baele *et al.* (2004), Manna (2004), Gual (2004), European Banking Federation (2004), Barros *et al.* (2005), Walkner and Raes (2005), European Parliament (2005), European Commission (2005_c).

traded 'homogeneous' product definition (e.g., Geroski and Szymanski, 1993). Four reasons justify this:

First, there is the issue of trust and confidence. When you deposit your entire savings of a lifetime, you want to ensure that they are in safe hands. If there is an error or a fraud in a transaction, you want to access an easy mechanism for redress. Knowledge of the bank, proximity, and national legal system will de facto create differentiated banking products.

Second, it has been observed that retail customers buy a package of financial services from the bank providing the payment service (MacKay, 1998, and Competition Commission, 2002). If, for convenience, customers buy a bundle of financial services, the law of one price will hold for the bundle of services, but not necessarily for each component. Moreover as mentioned earlier, since the payment clearing is done at the national level, a domestic bank will have a competitive advantage, particularly in the handling of checks.

Third, asymmetric information in lending is quite important (Diamond, 1984, Rajan, 1998, or Bolton and Freixas, 2000). In many cases, local knowledge can help to reduce this information asymmetry.[24] Fourth, and not specific to banking, the law of one price assumes the absence of transportation costs and regulatory barriers. If these are significant, the services will belong to the non-traded goods category (such as hairdressing and medical services). The law of one price will apply at the domestic level only.

These four arguments help to understand the extent of switching costs and why the law of one price is unlikely to hold in retail banking. Switching costs can explain a relatively low price elasticity, the absence of price competition on some markets, and the persistence of profit. This has been observed by Cruickshank (2000) and the Competition Commission (2002) for the United Kingdom, and the CPB Bureau for Economic Policy Analysis for the Netherlands (Canoy *et al.*, 2001).

Progress in information technology has reduced transportation costs (Vesala, 2000), but the other three factors remain. This explains, why, so far, stand-alone e-banking has had a minimal impact on commercial banking competition in Europe[25] and why the standard seems to be the multi-channel distribution route with a combination of telephone, electronic and branch proximity (Cabral, 2002).[26]

Two sources of evidence document the claim that the law of one price does not hold in the retail market: pricing of cross-border transfers, and interest margins on deposits.

[24] Padilla and Pagano (1997) makes the point that information sharing with credit bureaux partly reduces this asymmetry.

[25] The impact on share brokerage is a notable exception. Another case is the success of ING Direct in collecting savings deposits in several countries (Dermine, 2005).

[26] The Commission has launched a European Union-wide network of financial services complaints bodies (ombudsmen) called FIN-NET (2002) that can provide cheap and effective cross-border redress, thus avoiding the need to seek recourse in court.

The Costs of Cross-Border Transfers. One good example where the law of one price does not hold concerns the charges on cross-country transfers. At the end of 1999, the Commission conducted a study on the charges for standard cross-border transfers of €100. There were wide variations, not only across countries, but also within countries. The cost of a transfer from France to Belgium, for instance, could vary from €5.52 to €28.28, and the cheapest rate was from Luxembourg to France (€1.98), compared to a cost of €46.76 from Italy to Austria. Over the years 1993–2000, one observed a 50% price reduction in some countries but virtually no change in others. Frustrated with the little progress observed in the reduction of price differentials between domestic and international payments, the Commission, in 2001, introduced a regulation on cross-border payments in Euros.[27] This price regulation applies the principle of equal charges for electronic payment transactions of up to € 12,500, regardless of whether they are within-border or cross-border.

Interest Margin on Deposits. In Table 7, we report the interest margin on savings deposits for six MS observed in 2005. Calculated on the basis of a common Euro money market rate of 2.15%, the margin ranged from a low of −0.53% in the Netherlands to a high of 1.07% in Spain. If the range is clearly not indicative of the law of one price, one observes a convergence of margins on savings deposits over the period 1980–2005. However, this is mostly driven by the convergence of money market rates in the Euro zone to a low interest rate level, rather than to the result of international competition and the law of one price.

(ii) Cross-Border Banking Business

In addition to the law of one price, a second indicator of market integration, the flows of cross-border banking business, can be looked at. Data reported in Table 8 concern the cross-border deposits or lending to non-financial institutions. Unfortunately, these data do not discriminate between the retail and corporate segments. In the 13-year period 1990–2003, one observes a significant (often threefold) increase in Belgium, Denmark, Finland, Italy, Germany, and Spain. In Belgium, for instance, claims on the non-resident non-banking sector increased from 10% in 1990 to 28.2% in 2003. In Spain, it increased from 2% to 6.37%. It is fair to assume that this trend is driven mostly by the large corporate or public sector. Indeed, a Green Paper by the European Commission (2005_b) reports that less than 1% of retail mortgages are sold cross-border. Although cross-border banking still represents a small percentage of total assets in large countries (often less than 10%), the trend is however encouraging. This is confirmed by Perez *et al.* (2004) and Papaioannu (2005). A third dimension of an integrated market is the cross-border investment and the market share of foreign banks in a particular country.

[27] Regulation EC 2560/2001.

Table 7: Intermediation Margin[1] (%) 1980–2005

	1980	1985	1990	1995	2000	2005
Belgium						
Treasury-Bill	14.4	10.7	10.4	5.36	3.34	2.15
Margin on Savings Deposits	9.4	5.7	4.9	0.72	0.75	0.57%
Margin on Consumer Loans				6.92	3.63	5.59%
Retail Intermediation Margin				7.64	4.38	6.16%
Margin on Corporate Loan	0.8	1.04	1.05	1.15	1.14	1.55
Netherlands						
Treasury-Bill	9.2	6.85	8.13	5.18	3.34	2.15%
Margin on Savings Deposits	4.2	3.5	5.63	3.13	1.84	−0.53
Margin on Consumer Loans	5.3	1.65	3.62	2.32	2.91	5.55
Retail Intermediation Margin	9.5	5.15	9.25	5.45	4.75	5.02
Margin on Corporate Loan	3.05	−0.6	1.12	−0.18	0.41	2.31
Finland						
Treasury-Bill	13.8	12.8	16.05	5.85	3.34	2.15
Margin on Savings Deposits	9.55	7.55	11.55	3.85	1.84	1.07
Margin on Consumer Loans	−3.64	−1.1	−0.45	4.09	2.75	2.36
Retail Intermediation Margin	5.91	6.45	11.1	7.94	4.59	3.43
Margin on Corporate Loan	−3.64	−1.1	−1.29	1.58	0.89	na
France						
Treasury-Bill	12.2	9.5	10	5	3.34	2.15
Margin on Savings Deposits	5.3	3	5.6	0.66	0.92	0.1
Margin on Consumer Loans			5.4	3.03	4.85	4.54
Retail Intermediation Margin			11	3.69	5.77	4.64
Margin on Corporate Loan		3.83	1.19	2.28	1.75	0.55
Germany						
Treasury-Bill	8.86	5.87	8.3	5.16	3.34	2.15
Margin on Savings Deposits			2.08	1.37	1.31	0.13
Margin on Consumer Loans			4.32	8.18	6.84	6.59
Retail Intermediation Margin			6.4	9.55	8.15	6.72
Margin on Corporate Loan	0.8	2.39	1.31	4.16	4.34	2.51
Spain						
Treasury-Bill	12.2	12	14	8.33	3.34	2.15
Margin on Savings Deposits	8.45	8.25	11.58	5.58	2.37	−0.09
Margin on Consumer Loans	2.57	5.03	3.18	5.62	4.67	6.15
Retail Intermediation Margin	11.02	13.28	14.76	11.2	7.04	6.06
Margin on Corporate Loan	−3.64	−1.1	−1.29	1.58	0.89	1.1

[1] Methodology:
Margin on savings deposits: treasury bill rate – rate paid on savings deposits
Margin on consumer loans: rate charged on loan – treasury bill rate
Retail intermediation margin: rate charged on consumer loans – rate paid on savings deposits
Margin on corporate loans: rate charged on loans – treasury bill rate
Source: ECB, National Central banks, Dermine (2003).

Table 8: Claims/Deposits on Non-Residents 2003 (1990) (% of total assets)

Country	Claim All	Claim Non-Bank	Liabilities All	Liabilities Non-Bank
Belgium	60.40% (36)	28.24%(10)	50.57% (39)	19.07% (6.6)
Denmark	14.75% (na)	4.88% (2.6)	21.84% (NA)	2.16% (2)
Germany	24.72% (12)	10.10% (3)	19.47% (10)	5.36% (2.3)
Greece	18.84%	6.14%	14.69%	5.06%
Spain	15.02% (5.9)	6.37% (2)	24.43% (9.8)	9.47% (4)
France	22.94% (16)	9.72% (3)	24.42% (18)	1.96% (1.7)
Ireland	56.65%	30.52%	47.79%	9.65%
Italy	12.60% (7.1)	3.60% (0.3)	16.41% (11)	1.16% (0.9)
Luxembourg	92.22%	30.97%	69.00%	25.15%
Netherlands	34.73% (31)	12.33% (8)	33.17% (27)	6.82% (8)
Austria	23.25%	8.86%	18.94%	2.70%
Portugal	22.31%	5.86%	39.46%	5.63%
Finland	25.82% (6)	2.91% (2.2)	22.00% (23)	1.14% (1.4)
Sweden	17.26% (8.5)	4.69% (3.6)	24.47% (15)	2.57% (2.2)
United Kingdom	44.33%	17.35%	48.31% (49)	13.30%

Source: BIS, Dermine (2003).

(iii) Market Share of Foreign Banks

If some financial services are non-tradable for the reasons mentioned earlier, European integration through cross-border investment could bring competition and efficiency. We report in Table 9 the market share achieved by foreign banks in some markets. These vary from high figures in the small countries of Luxembourg and Ireland (respectively, 93.87% and 43.95%) to low figures in France , Italy, and Germany (11.15%, 5.8% and 5.95%, respectively). Over the period 1997–2003, the trend is encouraging in Austria, Sweden and Portugal, but negative or neutral in other countries. So, although a large number of cross-border M&As took place, many of them must have involved small firms, as they do not change the market share of foreign banks in a significant way. In 2004 and 2005, two significant deals indicate a break with the past. The Spanish Santander Central Hispano purchased Abbey National in the United Kingdom, while the Italian UniCredito purchased the German HVB. These are the first mergers involving banks from large countries.[28]

[28] Anecdotal but clear evidence of the progressive elimination of barriers to entry on the retail market was a decision of the European Court of Justice on 5 October 2004. Spanish Caixa Bank wanted to offer, in 2002, interest-paying demand deposits in France. They were prevented from doing so by an old regulation on *zero interest rate* demand deposits accounts in France. The European Court of Justice forced the repeal of this regulation on the grounds that it was creating a barrier to entry and competition.

Table 9: Market Share of Foreign Banks (% of assets). Branches vs. Subsidiaries.

Country	Market Share 2003	Market Share 1997	# Branches 2003 EEA	# Subsidiaries 2003 EEA	# Branches 1997 Non-EEA	# Subsidiaries 1997 Non-EEA
Belgium	22.92%	30.4	38	20	10	6
Denmark	15.96%	4.5	15	7	0	0
Germany	5.95%	4.3	65	20	19	25
Greece	22.00%	15.85	14	3	6	0
Spain	11.04%	12.5	50	44	7	10
France	11.15%	10.4	52	123	28	57
Ireland	43.95%	53.5	31	20	0	10
Italy	5.80%	7	76	7	15	0
Luxembourg	93.87%	92.5	43	83	7	32
Netherlands	11.76%	7.2	20	13	8	16
Austria	19.64%	3.4	18	14	0	10
Portugal	26.50%	14.8	22	11	0	4
Finland	7.37%	8.4	18	3	0	0
Sweden	7.57%	2.5	17	14	0	9
UK	49.84%	44.65	84	15	97	76
EU15	**22.28%**	**27.86**	**563**	**390**	**201**	**258**
Cyprus	12.3%					
Czech Republic	96%					
Estonia	97.5%					

Table 9 (*Continued*)

Country	Market Share 2003	Market Share 1997	# Branches 2003 EEA	# Subsidiaries 2003 EEA	# Branches 1997 Non-EEA	# Subsidiaries 1997 Non-EEA
Hungary	83.3%					
Latvia	46.3%					
Lithuania	95.6%					
Malta	67.6%					
Poland	67.8%					
Slovakia	96.3%					
Slovenia	36%					

Source: ECB (2004_b, 2005), own calculations.

The picture is very different in most of the 10 NMS, in which foreign banks hold a very large market share: For instance, 97.5% in Estonia, 83.3% in Hungary, 96% in the Czech Republic, and 67.8% in Poland. This situation is explained by the privatization programs that took place in those counties (Roland, 2005).

Three additional barriers to an integrated European banking markets have been reported (apart from the obvious barriers of language, culture, and tax differentials): national consumer protection laws, value-added tax (VAT) on services supplied by 'shared services' centers, and costly reporting to host and home country authorities. Consumer protection laws in some countries can severely limit the cross-border transfer of information across subsidiaries. Access to customers can be restricted (by, for example, rules on 'cold calling'). Products cannot be standardized, as they need to meet national consumer protection regulations on information and the possibility to withdraw from a contract. A significant barrier in a subsidiary structure is VAT on services provided by a 'shared services center. Indeed, a major source of economies of scale in cross-border commercial banking lies in the creation of shared-services entities (such as risk control, accounting, IT, and call centers). The services sold across countries would incur VAT charges, but since banks typically receive low VAT revenue, the net VAT charges increase the cost of the service. This reduces significantly the benefits expected from 'shared services' centers.

Twenty years into the creation of a single European banking market, the picture that emerges is one of integrated wholesale markets, and fragmented retail markets in the large countries. This is consistent with a retail market fragmented by the issue of trust, asymmetric information, and/or transportation costs.[29] However, the trend in cross-border activity is positive, and the recent large cross-border mergers from Spain to the United Kingdom and Italy to Germany are clear indicators that the speed of banking integration is gaining momentum. This adds further to the necessity to review the current institutional framework dealing with bank supervision and safety nets.

IV. THE CHOICE OF CORPORATE STRUCTURE: BRANCHES VS. SUBSIDIARIES

As reviewed in Section II, the grand vision of the single European market was to push the boundaries of each country in order to create the equivalent of an enlarged EU-wide national market. One banking license would be needed, one home country regulator would supervise, one home country deposit insurer

[29] At least two authors have analyzed the impact of banking deregulation on the real European economy. Romero de Avila (2003) finds a positive impact of the lifting of capital controls and deregulation of interest rates on real economic growth. Cetorelli (2004) studies the impact of bank concentration on the size of firms in the real economy. It is argued that entry into the EU and deregulation has increased competition, leading to entry and a reduction of firm size.

would insure the deposits raised throughout the European Union, and single bankruptcy proceedings would apply. The intention was to decrease the regulatory costs, to facilitate entry into foreign countries, to increase competition, and to facilitate legal proceedings in the event of a wind-up of an international bank. However, to be allowed to go freely cross-border, a bank would need to operate within one corporate structure and a series of branches. If it were operating with subsidiaries, the European passport would not apply as subsidiaries are considered as local banks in each country. The corporate structure choice by European banks is discussed first. We then review a very recent development, the adoption of a new corporate statute, the *Societas Europaea*, which facilitates branch-banking greatly.

A striking feature of the process of cross-border European banking is that it often took place via subsidiaries, not branches. In Table 9, we report the number of branches and subsidiaries established in each of the 15 MS. In 2003, there were, in total, 563 branches and 390 subsidiaries for banks from EEA countries, while the order was reversed for banks from non-EEA countries, i.e., 201 branches and 258 subsidiaries. More significant for the purpose of this study, is the fact that cross-border mergers involving banks of significant size have all resulted in holding company structures with subsidiaries. This is, at first glance, a very surprising outcome of the single banking market, as it would seem that a single corporate bank structure would have reduced the regulatory costs significantly.

To gain insights into the corporate structure issue, we first present three major cases of cross-border banking in the European Union: Nordea, ING Group, and Cetelem, the large consumer credit subsidiary of BNP-Paribas.[30] We then seek to explain the choice of a corporate subsidiary structure. Insights are gleaned from the corporate finance literature, the international business literature, and interviews conducted in two of these banks. Not only do these cases help to understand the effective barriers to a truly single European banking market, but they also raise significant public policy issues as to why and how the choice of corporate structures matter.[31]

Nordea is the result of the merger of four leading banks in Finland (Merita), Sweden (Nordbanken), Denmark (Unidanmark) and Norway (Christiania Bank). The group holds significant bank market shares in Nordic countries: 40% of banking assets in Finland, 25% in Denmark, 20% in Sweden, and 15% in Norway. The group structure, that prevailed from 2001 to 2004, is described in Figure 1. A listed holding company, Nordea AB, based in Stockholm, was the owner of banking subsidiaries operating in Scandinavia.

The ING Group originated in 1990 from the merger between the Dutch insurer Nationale Nederlanden and the bank NMB Postbank Groep. Since the merger,

[30] An additional case is HypoVereinsbank (HVB). The 'Bank of the Regions in Europe', it has major activities in Austria through its subsidiaries, Bank of Austria and Creditanstalt and several subsidiaries in Central and Eastern Europe. HVB merged with the Italian bank, UniCredito, in 2005.

[31] A complete analysis is in Dermine (2003_a).

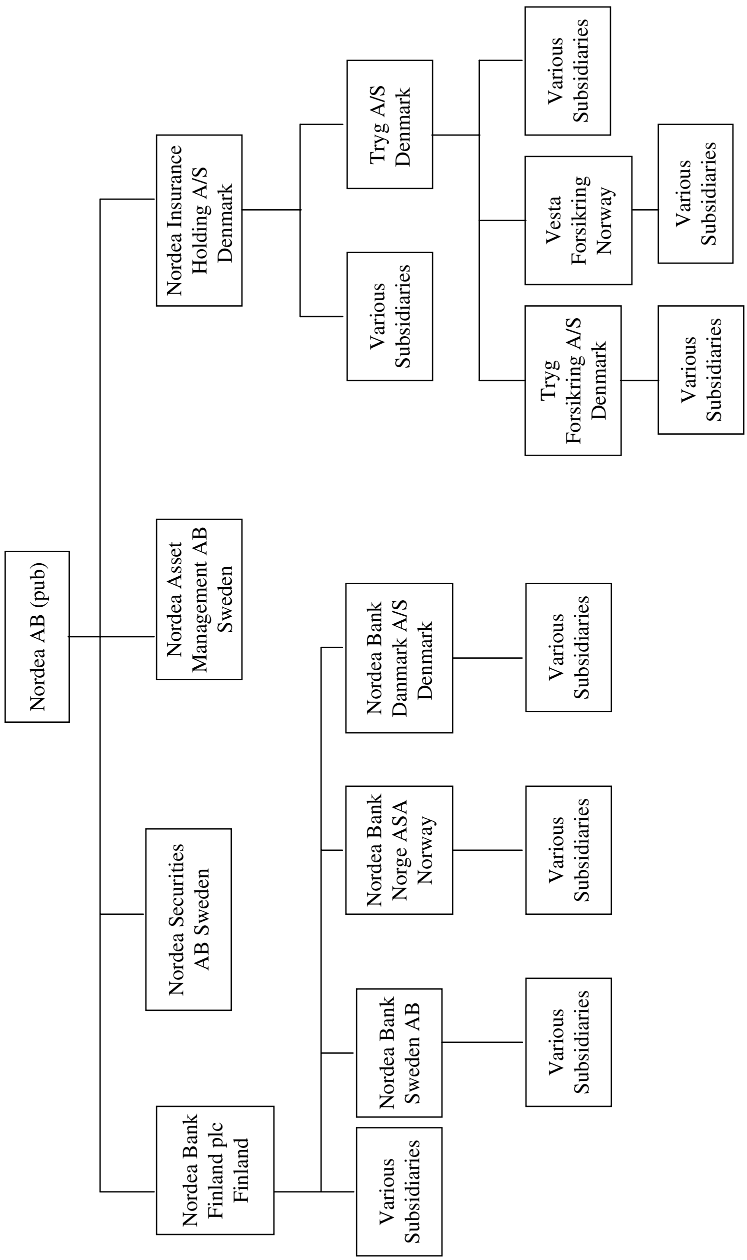


Figure 1: Nordea AB, Group Structure (up to March 2004).

ING has experienced a decade of rapid expansion. Notable acquisitions on the banking side include the British merchant bank Barings in 1995, the Belgian Bank Brussels Lambert in 1998, the German BHF-Bank[32] in 1999, and the Polish bank Slaski in 2001. Cross-border acquisitions have also been made on the insurance side.

Cetelem is the consumer credit subsidiary of the French bank BNP-Paribas. Created in 1953, it operates in 20 countries on four continents. In the European Union, it operates in eleven countries.[33] In each one of them, a subsidiary structure has been chosen.

The corporate finance literature helps to understand the nature of imperfections, which can lead to the creation of subsidiary structures. In a world with no transaction costs, corporate structures would not matter. However, conflicts of interest (agency problems) can arise between several parties: bank shareholders, depositors, deposit insurers, borrowers, and bank managers. Imperfect asymmetric information between parties, the monitoring costs, and complexity make it impossible to draw up complete contracts for each state of the world. This has raised interest in financial contracting. Although very much applied to the debt vs equity financial structure issue, it has also been applied to the choice of corporate structure. Applications include, for instance, the use of project finance (Brealey and Habib, 1996; Esty, 1999), loan securitization (James, 1988), the use of bank subsidiary structure with bad loans housed in a 'bad bank' (Kahn and Winton, 2004), the public listing of subsidiaries (Habib *et al.*, 1997), and corporate spin-offs (Chemanur and Yan, 2004).

Developing on Esty (1999), it appears that incentive distortions can fall into one of the following four categories: overinvestment in negative NPV project (known as free cash flows, or cross-subsidization), investment in a high-risk NPV project (risk shifting), underinvestment in a positive (even riskless) NPV project (the debt overhang[34]), and underinvestment in a risky positive NPV project due to managerial risk aversions. Leaving aside the debt overhang (an issue for distress companies and/or countries), the general corporate issue of overinvestment (free cash flows, cross-subsidy, or low managerial effort), and managerial risk aversion, it appears that the issue of risk shifting is an important one in banking. The well-known moral hazard argument states that due to limited liability of shareholders and asymmetric information between insiders and outsiders (opacity), shareholders can expropriate debt holders or deposit insurers by increasing the riskiness of assets (risk shifting).

A subsidiary structure for a bank could make sense for three reasons. First, it would reduce the dilution cost of outside finance if the financiers did not have to worry about risk shifting in a far away and 'opaque' subsidiary. Kahn and

[32] Parts of BHF were sold in 2004 to the German private bank Sal. Oppenheim.

[33] Countries where Cetelem is present with dates of opening: France (1953), Spain (1988), Belgium (1991), Portugal (1993), Czech Republic (1996), Hungary (1996), Italy (1996), Poland (1998), Slovakia (2000), Germany (2001), and Greece (2001).

[34] There can be underinvestment when the net present value benefit of a project cannot accrue fully to shareholders, being shared with the existing debtholders.

Winton (2004) argue that the problem of risk shifting is particularly acute when two entities have very different degrees of risk. The creation of a corporate subsidiary helps to insulate a business from other sources of risk.[35] Second, a subsidiary structure could help to exploit the put option created by deposit insurance. In a single corporate entity, there would be some form of co-insurance between the results of the four national entities such that the probability of default states would be low (with a lower expected payout by the deposit insurer). With separate corporate subsidiaries, the probability of states in which one of the subsidiaries might default would be higher.[36] Of course, one could argue that, in order to protect its reputation, the holding company would not let its subsidiaries default. The argument is certainly a valid one, but one cannot rule out cases in which the cost of bailing out a subsidiary would be greater than the loss of reputation.[37] A third reason for a subsidiary structure is that it allows a separate public listing which can solve asymmetric information problems between uninformed investors, informed investors, and managers of the firm. The increase in the number of traded securities make the price system more informative (Habib *et al.*, 1997). To summarize, the corporate finance literature shows that corporate structure, branches versus subsidiaries, matters when the problem of risk-shifting can harm debt-holders or deposit insurers in cases of non-sensitive insurance premia. The public policy issues raised by the existence of subsidiary structures are discussed in Section V.

The international management literature (e.g. Rangan, 2000) gives additional reasons why cross-border mergers of equals can lead to a subsidiary structure, at least in the early years of the joint entity. The first argument is that a subsidiary structure can help to break managerial resistence to a merger. By committing to keeping in place a local structure, the staff of both entities are reassured. This argument is of a short-term nature and should disappear after a few years. The second argument is that international firms must balance the benefits of economies of scale with proximity. Proximity is facilitated by subsidiaries. As a local corporate firm and as a member of the local bankers' association, a company can influence its environment better. A second benefit of proximity is that clients and suppliers can sue the distressed firm under local laws. A third benefit is

[35] Risk insulation is sometimes referred to as 'ring fencing'. This explains why Spanish banks operate with subsidiaries in Latin America. This protects the debt-holders and the deposit insurer of the home Spanish bank. Other cases of 'ring fencing' include the separation of banks and insurance companies with subsidiaries.

[36] In the option pricing literature, in which deposit insurance is viewed as a put option (Merton, 1977), a portfolio of put options on a series of assets is worth more that one put on the sum of the assets.

[37] Two banks decided in 2002 not to bail out their distressed subsidiaries in Argentina: the Canadian Bank of Nova Scotia with its subsidiary Quilmes, and the French Credit Agricole with its three banks, Banco Bisel, Banco Sugia, and Banco de Entre Rios (FT May 21 2002). Former depositors of Banco Bisel lost a lawsuit against Crédit Agricole in January 2005 (Les Echos, 13/01/2005).

decentralization and assessment of the local corporate subsidiary on its own merit.[38] So, irrespective of the existence of a single market, the international management literature predicts that international firms will operate with a mix of branches and subsidiaries to optimize the proximity/scale trade off.

The third source of insights were interviews conducted at ING Group and Nordea[39]. Both banks explain that, in principle, a single corporate entity will facilitate the exploitation of economies of scale. This is why, in the structure of Nordea AB, for instance, the asset management and securities business are put into cross-border structures with branches. The motivation to keep a subsidiary structure for banks is driven by eight arguments. The first four are of a temporary nature, likely to disappear overtime. The others are more permanent.

A first argument in favor of the subsidiary structure at the time of the merger is to keep 'business as usual' and not to change the brand. This has a short-term timespan as both banking groups, Nordea and ING, are busy building their own brands. A second argument is one of reassurance of the local management that key-functions will not be transferred. The reassurance of shareholders so as to get their approval is the third argument. MeritaNordbanken started with a dual listing in Stockholm and Helsinki. A dual structure reassures shareholders, as it gives both flexibility and continuity. The fourth argument is that of the need to reassure nations that they will keep their bank. When acquiring the Norwegian Christiania Bank, Nordea stated that it would continue to operate as a legal entity. A fifth, and major, reason concerns corporate tax. A subsidiary structure is often more flexible from an international corporate tax point of view than a branch structure. In other words, in case of future group restructurings, start-up losses are more easily preserved and taxable capital gains are more easily avoided in a subsidiary structure. Moreover, the conversion of a subsidiary into a branch could create a corporate tax liability. A sixth (surprising) argument, to be developed further below, is deposit insurance. If Nordea, based in Sweden, transformed its Norwegian subsidiary into a branch of its Swedish bank, it would have to contribute extra deposit insurance premia to the home country Swedish guarantee fund, while losing all contributions made to the Norwegian insurance fund. The seventh argument for a subsidiary structure is ring-fencing (protection form risk-shifting) and the ability to do a separate listing. Finally, the eighth argument put forward in favor of a subsidiary structure is the ease with which a business unit can be sold.

Of the eight arguments advanced to explain the choice of a subsidiary structure, four appear temporary (protection of the original brand, management trust, nationalistic feelings, and shareholder approval), two stem from the incomplete process of European integration (corporate tax and deposit insurance), but the last arguments are permanent features of business (asymmetric information and risk shifting, listing, and flexibility).

[38] In principle profit center-based accounting could lead to a similar outcome.

[39] In both cases, we were able to meet the general counsel, the tax and compliance directors, and executive directors in charge of the corporate structure.

To conclude this section, it appears that the European bank operating abroad, exclusively with branches, is currently a myth. As a corporate structure has major financial stability implications, more work was needed to eliminate the barriers to an efficient corporate structure. This will be one of the achievements of the *Societas Europaea*. But, one cannot ignore that, even if these barriers are eliminated, there are several economic reasons as to why a corporate group will continue operating with a mix of branches and subsidiaries.[40]

Societas Europaea

In 2003, Nordea AB announced its plan to move to a single corporate structure with the use a European Company (formally, the *Societas Europaea* or SE). The corporate structure adopted by Nordea Bank AB in March 2004 is described in Figure 2. The holding company in Sweden has received a banking licence. Progressively, the banking entities of the various countries will be housed into one single corporate banking entity, incorporated in Sweden. Officially coming into effect on 8 October 2004, the SE is a limited liability corporation. Its formation and corporate structure are partly governed by EU Law (Regulation on the Statute of a European Company[41] and the Directive Supplementing the Statute for a European Company with Regard to the Involvement of the Employees[42]), partially by the law of the EU member State in which it is incorporated, and partly by its articles and bylaws (IBFA, 2003; Friedfrank, 2004). The importance of the SE statute, the expected economic benefits , and the remaining obstacles to the transformation into an SE are discussed successively.

Before October 2004, there were legal obstacles to the transformation of subsidiaries into branches. Previously, legal mergers between corporations incorporated in different Member states posed numerous legal and practical issues. Because of the lack of EU legislation that would determine which country's laws prevailed in the event of a cross-border merger, such combinations have been rare and costly (Friedfrank, 2004). For instance, the transfer of rights of clients or bond holders from the subsidiary to a new legal entity presented a complex legal challenge. The SE presents a much simpler vehicle to transform subsidiaries into branches.

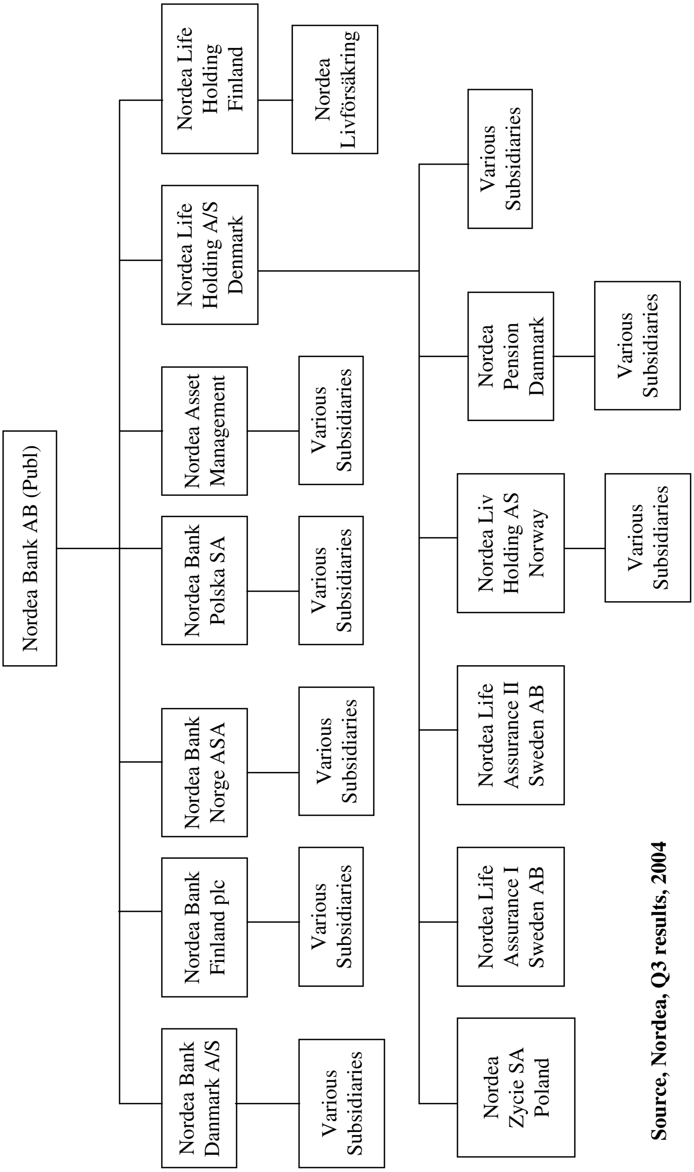
The stated economic advantages of a single company structure are stated as follows[43]: corporate efficiency, reduction in operational risk, transparency, reduction of VAT, and efficient use of capital. Corporate efficiency allows the firm to run a business line across countries, for instance retail banking or asset management, without a burdensome double-reporting at country and business line level. More technical, but relevant for corporate clients, a single bank

[40] A similar observation is made by Herring and Santomero (1990) in the context of the corporate structure of financial conglomerates. Rosengren (2003) observes that, in the United States, different activities (such as leasing) are housed in separate subsidiaries, but that banking assets are usually booked in one corporate structure.

[41] Council regulation 2157/2001.

[42] Council directive 2001/86/EC.

[43] The author is grateful to Nordea for sharing this information.



Source, Nordea, Q3 results, 2004

Figure 2: Nordea AB, Group Structure (as of March 2004).

deposit account, instead of the need to have one in different countries, eases cash management. Reduction in operating legal risk comes from the fact that one does not need to worry in which country and by which persons a contract has to be approved, as it can be drawn up by the single SE. Transparency is relevant for the rating agencies and counterparties who will evaluate more easily the counterparty risk on a single entity as opposed to a web of subsidiaries. Reduction in VAT, as explained above, is due to the fact that shared-services center can be established in a branch, not anymore in a subsidiary. This means not only the avoidance of VAT, but also the absence of costly tax reporting. Note that, as the SE directive is not dealing with taxation, there is still some uncertainty on the treatment of VAT, which, at the time of writing, was in the process of clarification. Finally, in the context of the Basel II capital regulation which apply the regulatory capital ratio to the group and each subsidiary, a single corporate structure with branches will avoid the problem of costly transfer of capital across subsidiaries.

However, the transformation of a bank *cum* subsidiaries into an SE has come up against several obstacles, some of which have not been resolved. For instance, Finland had to change its law, as the financial contributions of branches are not the same as those of subsidiaries for the financing of bank supervision. Morever, deposit insurance appears to be the most important obstacle on the way. It raises both a financial and a commercial issue.

The current rule is that the deposit insurance system of the home country of incorporation of the SE, Sweden in the case of Nordea, would be in charge of insurance deposits raised across the four Nordic countries. If a host country offers a better coverage, the bank can opt for a *top up*, meaning that a complementary deposit insurance coverage is offered by the host country against payment of an additional premium. As shown in Table 11, Denmark offers a deposit insurance coverage of Dkr 300,000 (*circa* € 40,000), while Sweden has a coverage of SEK 250,000 (*circa* € 27,000). If Nordea adopts the SE structure, it implies that the host insurer in charge of subsidiaries would be replaced by a common insurer, i.e., that of the Swedish deposit insurer system. A financial implication is that Nordea would lose the money it has already contributed to the Norwegian and Finish insurance funds. The reason is as follows. As explained in Table 12, deposit insurance premia are collected in the four Scandinavian countries until the guarantee fund reaches a certain percentage of insured deposits, for instance 2% of insured deposits in Finland. When this amount is reached, the annual deposit premium is either reduced or returned.[44] As the 1994 Deposit Guarantee directive did not provide for exit rule, Nordea would not be able to claim back the money invested in the Norwegian or Finish

[44] An economic interpretation of this guarantee system is that the member banks are the holders of the equity of the guarantee fund. The equity is in place to cover unexpected loss in the banking system. When no annual loss occurs, the banks, owners of the equity, receive the profit (the unused premium).

guarantee funds.[45] A second issue is fair competition in the deposit market. Since the funding of deposit insurance was not covered by the 1994 EU directive, the insurance premium charged on foreign branches of banks licensed in different countries, but operating in the same host country, can differ. Moreover, the deposit insurance coverage of foreign branches could exceed that offered to local banks. As an example, the coverage of branches of Danish banks operating in Sweden exceeds that of Swedish banks. The third issue is that depositors in one country might be doubtful about the coverage and the speed of payments by the deposit insurer of an other country. Although , one could wonder whether European depositors are concerned with deposit insurance,[46] this particular issue is quite a sensitive one in the Scandinavian countries, which experienced a banking crisis in the early 1990s. To resolve this issue, Mr Schütze, member of Nordea Group executive Management, announced in June 2004: "Nordea will apply to Internal Market Commissioner Frits Bolkenstein for a "grandfather clause" for the 1994 Directive to exempt *SE* formed by the merger of existing banks in different countries from the home country requirement for deposit guarantees and thereby simply continue in local schemes" (Nordea, 2004). With the objective to dismantle the remaining barriers to European banking integration, the Commission launched a review of the Deposit Guarantee Schemes directive in August 2005 (European Commission, 2005_{d}). If accepted, grandfathering rules would take us back to the situation before the 1994 *Deposit Guarantee Directive*, time when all deposits were insured at the host country domestic level. Its '*home country*' format was adopted to ensure a matching of responsibility and accountability between deposit insurance and bank supervision (Baltensperger and Dermine, 1987). If the Swedish supervisors have the home country control task of supervising the whole Scandinavian group Nordea, they should be in charge of providing the deposit insurance scheme. Two different logics are at stake. A business logic that favors a single corporate entity to minimize the regulatory/supervisory costs and risks, as well as proximity to the clients with deposit insurance provided by the local host country, and an accountability logic that recommends allocating supervisory power to the deposit insurer.

Although the commercial logic is understandable, we favor the accountability logic. As the quality of banking supervision is fundamental to the stability of banking systems, the country in charge of supervision should bear the cost (deposit insurance or bailing-out) resulting from poor supervision. In reverse, as in the case of the insurance industry, any insurer would want to control the risk being taken. These arguments lead to accountability and the matching of

[45] A tricky competition issue is raised on the deposit market. Nordea would have to pay an insurance premium to the Swedish guarantee fund on deposits collected abroad, while foreign competitors would not need to pay a premium, their own guarantee funds having reached the proper size.

[46] Unlike the case of the United States, European banks do not advertise the existence of deposit guarantee schemes.

supervision and deposit insurance. Supervision and deposit insurance could take place at the home country level (the current system under the 1994 directive),[47] at the host country level, or at the European Union level. This core policy issue raised by cross-border European banking is discussed next.

V. EUROPEAN BANKING INTEGRATION: PUBLIC POLICY ISSUES

Two public policy issues, raised by European banking integration, will be analyzed. These include protection of investors, and the design of banking supervision and deposit insurance in an integrated European banking market. A third important public policy issue not directly related to cross-border banking—the impact of M&As and domestic concentration on market power and bank stability—is discussed in Dermine (2003_a).[48]

Investor Protection

A first potential source of market failure is imperfect (asymmetric) information, which can prevent the proper functioning of unregulated private markets. For instance, because of opacity, depositors find it costly to evaluate the solvency of their bank. The economic literature (e.g., Kay and Vickers, 1988) recognizes that the inability of consumers to evaluate properly the quality of a product can create a market failure. Inefficiency may arise because the quality of a service is not valued properly by the market and reflected into higher prices so there is insufficient incentives for firms to produce quality. Regulation (e.g., minimal qualifications in the legal or medical profession) is a way of ensuring a minimum level of quality. In banking, imperfect asymmetric information can create the well-known moral hazard. Finance theory (Merton, 1977) has shown that bank shareholders benefit from an increase in risk, such as higher leverage or riskiness of assets. This provides a rationale to provide protection for the 'uninformed' depositors.[49] In international banking and cross-selling of services, an additional issue is raised. The possibility of competitive deregulation raises the question of the need to harmonize international regulations or to create a single regulator (Dermine, 1996_a; Dell'Ariccia and Marquez, 2001). The answer is again related to imperfect information. Competition among national regulators is desirable whenever the parties can evaluate the quality of regulatory systems. Harmonization of rules to ensure minimal quality would be necessary only if the market could not discriminate. An alternative to the harmonization of prudential regulation is to grant some supervisory powers to the host state,

[47] Note that under the current EU deposit insurance directive, the accountability is not perfect. In case of deposit insurance *top up*, the additional insurance coverage is offered by the host country, which does not have supervisory responsibility.

[48] On the ongoing debate on the impact of competition on bank stability, see Carletti and Hartmann (2003) and Boyd and De Nicolo (2005).

[49] Other privately based mechanisms include disclosure of information, creation of risk-free banks, self-regulatory organizations, and reputation of banks.

whenever it is felt that domestic investors are not adequately protected by foreign regulations or supervision. This is precisely the approach adopted by the European Union, for reasons of public interest, which leaves the right to control foreign branches to each host country (Norton, 1991).[50] The market for mortgage credit in the EU provides an illustration of the issue. As mentioned above, the current level of cross-border sales of mortgages is low, less than 1% of overall residential mortgage credit activity. One line of argument states that this is due to a lack of cross-border supply of mortgages caused by a lack of harmonization. Differences of prudential regulations (such as usury rules, repayment regimes, ceilings on loan-to-value ratios) and credit risk appraisal (ease to realize a collateral in case of default, data protection on credit-worthiness databases) could have an impact on securitization and hamper the supply of cross-border credit supply (London Economics, 2005). This line of arguments calls for harmonization of regulations, or a "26th-regime", which would allow the sale of a few specific products, such as mortgages, across Europe. An alternative view is that these regulatory differences reflect attitude to regulation, economic history and cultural factors, and that its negative impact on supply of cross-border mortgages is very limited. The European Commission (2005) is currently conducting a consultation process to review the need to intervene or not on the retail mortgage market.

Systemic Risk and 'Home Country' Control, an Appraisal

The second market failure is the potential for bank runs and systemic crisis. Banks are special because the financial contract that emerges—illiquid loans funded by short-term deposits—creates a potential market failure and a need for public intervention (Rajan, 1998; Diamond and Rajan, 2005). The liquidity mismatch between assets and deposits and the failure of depositors to coordinate (Diamond and Dybvig, 1983; Postlewaite and Vives, 1987; Allen and Gale, 1998) create the risk that depositors run to withdraw their funds. A run can be triggered by bad news about the value of bank assets or by any unexplained fear. In either cases, there may be a loss, since illiquid assets will be sold at a discount. Moreover, a bank failure could eventually trigger a signal on the solvency of other banks, leading to a systemic crisis.

This market failure explains the introduction of banking regulations and the creation of safety nets to guarantee the stability of banking markets. These have taken the form of deposit insurance, lender-of-last-resort interventions, and public (treasury-led) bail-outs. Deposit insurance funds are unlikely to

[50] The European Commission has clarified the concept of 'general good' to ensure that it is not used as an excuse to protect local firms from foreign competition (Communication, 26 June 1997).

contribute much to reducing systemic risk because they cover small deposits only.[51] Runs are likely to be initiated by large firms or financial institutions. Therefore, lender-of-last-resort interventions by central banks or public bail out remain the most likely tools in order to avoid bank runs and systemic crises. European banking history shows that public bail out is most often the case, given the need to call on tax-payers to finance credit losses (Goodhart and Schoenmaker, 1993; Goodhart, $2003_{a,b}$).

In the context of cross-border European banking, three specific issues are identified: These issues concern, successively (1) the presence of cross-border spillover effects, (2) The financial ability of some countries to deal with bailout costs and large and complex financial institutions, and (3) of a more technical nature, the ability to reimburse depositors rapidly in case of bank closure. A discussion of the adequacy of current EU institutional structure follows.

Cross-Border Spillovers

The first and main issue concern cross-border spillovers and the fear that the provision of financial stability (a public good) by national authorities might not be optimal. Four types of potential cross-border spillovers can be identified: (i) cross-border cost of closure, (ii) cross-border effects of shocks to banks' equity, (iii) cross-border transfer of assets, and (iv) cross-border effects on the value of the deposit insurance liability.

(i) **Cross-Border cost of closure.** Imagine that a foreign bank buys a Dutch bank, and convert it into a branch. According to EU rule on home country control, the Dutch branch would be supervised by the authority of the foreign parent. However, Dutch authorities remain in charge of financial stability in the Netherlands. The Dutch treasury could be forced to bail it out for reasons of internal stability, but would not have the right to supervise the branch of a foreign bank because of home country control. Since the lender-of-last-resort and the treasury will be concerned primarily with their domestic markets and banks operating domestically,[52] and since they will bear the costs of a bail-out, it is legitimate for the insurers to keep some supervisory power on all institutions (branches and subsidiaries) operating domestically. That is, host country regulations could apply to limit the risks taken by financial institutions and the exposure of the domestic central bank or treasury in cases of

[51] As documented in Table 11, the coverage is limited to €20,000 in most European countries. Gropp and Vesala (2004) argue that the creation of a formal deposit insurance system in Europe has increased the degree of bank monitoring by non-insured depositors who, in the past, could count on a full bail out.

[52] It is well known that the Bank of Italy did not intervene to prevent the collapse of the Luxembourg-based Banco Ambrosiano Holding, because it created little disruption on the Italian financial markets.

bailing out.[53] In other words, home country control has to be complemented by some form of host control as long as the cost of bailing out remains domestic. This position appears to have been partly recognized by the European Commission which states that "in emergency situations the host-country supervisor may—subject to ex-post Commission control—take any precautionary measures " (Walkner and Raes, 2005, p. 37). In this case, since the default of a large international bank could affect several countries, the decision to bail out could be transferred to the European level, or should at least require coordination among these countries.

(ii) Cross-border effects of shocks to banks' equity. Peek and Rosengren (2000) demonstrated the impact on the real U.S. economy of a drop in the equity of Japanese banks, resulting from the Japanese stock market collapse in the 1990s. The transmission channel runs through a reduction in the supply of bank credit. Since in a branch-multinational bank, the home country will control solvency (through policy on loan-loss provisioning and validation of probability of default in the Basel II framework), it could have an impact on the real economy of the foreign country.[54]

(iii) Cross-border effects of transfer of assets. In a subsidiary-type multinational, in which the host country retains supervision of the subsidiary, there could be a risk that the home country colludes with the parent bank to transfer assets to the parent bank This risk has been discussed in the countries of Central and Eastern Europe (Goldberg *et al.*, 2004).

(iv) Cross-border effects on deposit insurance. The general argument is related to diversification of risks in a branch-based multinational, which, because of co-insurance, reduces the value of the put option granted by deposit insurance (Repullo 2001, Dermine 2003_a, Harr and Ronde 2003, Loranth and Morrison 2003, and Calzolari and Loranth, 2005). There is an additional dynamic consideration to take into account. A multinational bank could be pleased with its overall degree of diversification, while each subsidiary could become very specialized in local credit risk. This implies that banks in a given country could find themselves increasingly vulnerable to idiosyncratic shock. One could argue that, for reasons of reputation, the parent company will systematically bailout the subsidiaries as if they were branches. This could be true in many cases, but there will be cases where the balance of financial costs versus reputation costs may not be so favorable. Harr and Ronde (2003) make the point that capital adequacy rules should be less stringent on branch-based structure. The more general point is that diversification should be

[53] Bailing out would occur if the failure of a branch of a foreign bank led to a run on domestic banks.

[54] The Basel Committee on Banking Supervision (2003) discusses the respective role of host and home country in validation of probability of default (PD). It calls for adequate cooperation between host and home authorities, and a lead role for the home country authority. In the case of Nordea, the Swedish supervisory authority will have the final control of PDs across the group.

> rewarded with less stringent capital adequacy ratio. They also call to attention that, in a branch-based structure, the parent is not ring-fenced from big losses, so that if a large shock occurs, the equity of the group could decrease, leading to an incentive to gamble for resurrection.

Cross-border spillovers raise the question of whether coordination of national intervention will be optimal (Freixas, 2003). This will be discussed in our assessment of the European institutional framework.

Bailing Out Costs: Too Big? Too Complex?

A second issue is that the bail-out of a large bank could create a very large burden for the treasury or deposit insurance system of a single country (Kaufman, 2003; Jones and Nguyen, 2005). To assess the potential cost of a bail-out, we report in Table 10 the level of equity (book value) of seventeen European banks as a percentage of the GDP of the home country. Not surprisingly, the highest figures are found mostly in small countries: Belgium, the Netherlands, Sweden, and Switzerland. The 2004 equity-to-GDP ratio is

Table 10: Bank Size

Country	Bank	Equity (book value) (€bn, 2004)	Equity/GDP (2004)	Equity/GDP (2000)	Equity/GDP (1997)
UK	HSBC	75.6	4.8%	2.26%	2.00%
UK	RBS	52.3	3.3%	2.43%	0.51%
Spain	SCH	41	5.5%	4.3%	1.75%
F	BNP-Paribas	35	2.2	1.69%	0.8%
NL	ING Groep	30	6.5%	6.65%	5.94%
F	Crédit Agricole	29	1.86%	1.86%	1.55%
CH	Crédit Suisse	27	13.1%	10.55%	5.63%
DE	Deutsche Bank	26	1.2%	1.34%	0.9%
CH	UBS	25.8	12.5%	12.37%	8.65%
UK	Barclays	24	1.5	1.52%	1.28%
NL	Rabobank	22	4.8	3.73%	2.84%
F	SocGen	22	1.4	1.16%	0.89%
NL	ABN AMRO	19	4.1	4.09%	3.88%
B	Fortis[1]	14	1.9	2.27%	1.33%
S	Nordea	12.4	4.5%	na	na
B	KBC	12	4.48	2.85%	1.28%
USA	Bank of America	88.5	0.91%	0.59%	0.24%
USA	Citigroup	97.3	1.0%	0.75%	0.5%

[1] In the case of the Belgian-Dutch Fortis, the ratio is Equity to the sum of GDPs from Belgium and the Netherlands.

Source: Thomson Analytics, author's calculations.

12.5% for the United Bank of Switzerland and 4.5% for Nordea, as compared to 1.2% for Deutsche Bank. For the sake of comparison, the equity of Bank of America and Citigroup represent, respectively, 0.91% and 1% of U.S. GDP. Over the years 1997 to 2004, one observes a marked increase in that ratio, highlighting the impact of consolidation. If one takes as a reference point the fact that the bail out of Crédit Lyonnais has costed the French tax payers twice the book value of its 1991 equity (admittedly, an arbitrary case), the cost of bailing out the largest Swiss bank could amount to 24% of Swiss GDP, as compared to 2.7% of German GDP in the case of a Deutsche Bank scenario.

A related issue that has received much interest is that some banks have become too complex to fail. Imagine the case of a large European bank with significant cross-border activities and non-bank activities (such as insurance or asset management), which runs into financial distress. It would be very difficult to put this bank into receivership. Given the complex web of corporate subsidiaries and the various legal complexities, the uncertainty concerning the costs of a default is likely to be high, and this complexity might create a temptation for a bail out ('too big and too complex to fail'). This point has been emphasized by Herring (2003).

Freeze of Deposits

A third issue relates to the real costs incurred through bank failures. As the financial distress cases of the major Swedish banks showed in the early 1990s, it appears very difficult to put a large bank into liquidation. The issue is not so much the fear of a domino effect, whereby the failure of a large bank would create the failure of many smaller ones—strict analysis of counterparty exposures has reduced substantially the risk of a domino effect. The fear is, rather, that the need to close a bank for several months to value its illiquid assets would freeze a large part of its deposits and savings, causing a significant negative effect on national consumption (Dermine, 1996_b). Kaufmann and Seelig (2002) and Demirgüc-Kunt *et al.* (2005) document the timing of the availability of deposits in the case of a winding up. This is reported in Table 11. In most European countries, insured deposits could be frozen for up to three months.[55] The need to scrutinize more carefully the bankruptcy process for large financial institutions (Granlund, 2002) appears timely as a major restructuring trend has reduced the number of banks in a number of European countries to a very few large ones.

Three cross-border banking issues related to financial stability have been analyzed: cross-border spillover effects, size and complexity of bail-out, and freeze of deposits. Let us now review the adequacy of the current EU institutional structure.

[55] With the time needed to resolve the uncertainty about the true value of assets, deposits could be converted into traded securities to resume liquidity (Dermine, 2000).

Table 11: Deposit Insurance Systems in EU (2005)

Country	Coverage (euro, 2005)	Funds Availability (average time)
Austria	20,000	3 Mo
Belgium	20,000	12 Mo
Denmark	Dkr 300,000 (ca 40,000)	3 Mo
Finland	25,000	
France	70,000	na
Germany	Official: 90% of deposits up to maximum euro 20,000) Private: 30% of bank's equity	
Greece	20,000	3 Mo
Ireland	(20,000 ; 90%)	
Italy	103,000	
Luxembourg	20,000	3 Mo
Netherlands	20,000	3 Mo
Norway	NOK 2,000,000 (ca euro 238,000)	1 Mo
Portugal	25,000	
Spain	20,000	3 Mo
Sweden	SEK 250,000 (ca euro 27,000)	
United Kingdom	100% of £ 2000 +90% of next£ 33,000	6 Mo
Cyprus	€20,000	na
Czech Republic	€25,000 (90%)	3 Mo
Estonia	€12,782 (2007: €20,000)	9 Mo
Hungary	€24,300 (90%)	3 Mo
Latvia	€9,000 (2008: 20,000)	na
Lithuania	€14,481 (2008: 20,000)	3 Mo
Malta	€20,000 (90%)	na
Poland	€22,500	4 Mo
Slovakia	€20,000 (90%)	3 Mo
Slovenia	€21,267	na

Source: Granlund (2002), Kaufman and Seelig (2002), ECB (2004), Demirgüc-Kunt *et al.* (2005).

Adequacy of EU Institutions

The EU institutional structure currently in place to deal with financial crises has received a great deal of attention in the last five years. A series of committees have been created to facilitate cooperation and exchange of information, and a directive on winding up financial institution has been adopted.

There are currently four potential forums for coordination. The first two arise from the *Lamfalussy* approach discussed above. The *European Banking Committee* assists the European Commission in preparing new banking community legislation. The *Committee of European Banking Supervisors (CEBS)* is concerned with the application of EU regulations. At the *EU Groupe de Contact*

Table 12: Deposit Insurance in Scandinavia

	Denmark	Finland	Norway	Sweden
Fund target	Dkr 3.2 (ca euro 430 M) Covered	2% of insured deposits	1.5% of insured deposits + 0.5% of capital Covered	2.5% of insured deposits Covered
Premium	0.2% maximum (refund when target is reached)	0.05%–0.3% (1/3 of fee paid, when target is reached)	0.1% of deposits +0.05% of capital (nothing if target is reached)	0.1–0.3% of insured deposits (0.1% when target is reached)

Source: Nordiska Insättningsgarantisystemen.

(GdC), national supervisors of banks meet regularly to exchange information. At the European Central Bank, the *Banking Supervisory Committee* (*BSC*) works in the context of the Eurosystem's task of contributing to the smooth conduct of polices pursued by the competent national authorities relating to the supervision of credit institutions and the stability of the financial system (Article 105 (5) of the Treaty on European Union). The Brouwer reports (Economic and Financial Committee, 2000 and 2001) have very much validated the current EU institutional structure to deal with a financial crisis. They essentially argue that there would be no legal impediment to the transfer of information across borders, and recommend an additional effort to strengthen cooperation through Memorandum of Understanding (MOU) dealing with crisis situations.

In the context of the Financial Services Action Plan, the directive on *Winding up of Credit Institutions*[56] was finally adopted, sixteen years after it was first proposed. This is consistent with the home regulator principle. When a credit institution with branches in other member states fails, the winding up process will be subject to the single bankruptcy proceedings of the home country. Note that, although recognized as a significant piece of legislation to avoid the complexity issue, it falls short of solving the subsidiaries issue.

Accepting the accountability principle, according to which banking supervision, deposit insurance, and bailing-out should be allocated to the same country, it appears that, in European banking, there are three ways to allocate banking supervision: to the 'host' state, to the 'home country', or to a European entity. The pros and cons or the three approaches are reviewed.

In the 'host' state approach, adopted in New Zealand,[57] multinational banks operate with a subsidiary structure. The national central bank retain control on

[56] Official Journal 125, 05.05.2001.

[57] According to Schoenmaker and Oosterloo (2004), to allow them to exercise control, authorities in New Zealand require some overseas banks to establish locally incorporated subsidiaries, instead of operating as branches.

banking supervision, deposit insurance, and bail-out.[58] As discussed above in the European banking context, this system suffers from four drawbacks. First, it does not allow banks to realize fully the operating benefits expected from branch-banking. These benefits were defined in the case of Nordea. Second, a subsidiary structure contributes to the creation of large and complex financial institution (LCFI). Subject to different bankruptcy proceedings, the closure of a large international bank would become very complex (Brockmeier Committee, 2001). In a branch structure, the European directive on Winding Up would be applicable, subjecting the bankruptcy proceedings of one country. Third, the resolution of a crisis could be hampered, as discussed above, by problems linked to transfer of assets from subsidiaries to the parent, or to problem of sharing of information. It appears that a 'host country'-based system would not allow to realize fully the expected benefits of European integration.

The second system, the 'home country' approach, currently applicable to cross-border branches in the European Union, suffers from two drawbacks. The first is that small European countries, such as Sweden, Belgium, Switzerland, or the Netherlands, may find it difficult to bear the cost of the bail-out of a large international bank.[59] European funding might be needed. The second is related to the cross-border spillover effects. The decision to close a bank could affect other countries. In principle, cooperation among countries could take place in such a situation , but one can easily imagine that conflicts of interest between countries on the decision to close a bank will arise, and that the sharing of the bailing out costs among countries will not be simple (Schoenmaker and Oosterloo, 2004). Theses conflicts of interest could, at times, even limit the cross-border exchange of information among regulators. Rosengren (2003) has expressed some concern about the proper exchange of information at the time of a crisis. Enria and Vesala (2003) and Freixas (2003) have called for *ex ante* rules to force this transfer of information. In May 2005, it was announced that an emergency plan for dealing with a financial crisis had been agreed by the European Union finance ministers, central bankers and financial regulators. A Memorandum of Understanding among the 25 EU members which should facilitate the exchange of information will be tested next year with a full scale simulation of a financial crisis (FT, 16 May 2005).

The 'home country' approach has served well European banking until now. But, the recent acceleration of European banking integration and the move to branch-banking questions its adequacy in the future.[60] The two drawbacks of the 'home country' approach, discussed above, lead us to call

[58] It must be observed that the 'host country' approach is applied as well in Europe when banks operate abroad with subsidiaries.

[59] Note that large European countries might prefer the *status quo* to make the expansion of banks from smaller countries more difficult.

[60] In August 2005, the European Commission has launched a consultation on the adequacy of deposit insurance in the EU, with appropriate policy recommendations announced for the Spring 2006.

for a European-based system of banking supervision and deposit insurance for large international banks. A tale of how European supervisory coordination and centralization is likely to develop is as follows. During a weekend, the BSC met in Frankfurt to consider the need to launch the bail out of a large international bank. As it was becoming rapidly clear that the ECB should not increase the money supply to restore the solvency of that bank, and that tax payers' money would be needed to finance the bad debts, ECOFIN, the European Council of Finance Ministers, was invited to take the decision to bail it out. On the following Monday, due to a public outcry, that supervision of the problem bank had not been handled properly by the national supervisor, a decision was taken to transfer supervision to a European agency. An alternative development, which we favor, would be to take anticipatory action, that is, to transfer the supervision of international banks to a European regulatory agency.[61] An international bank would be defined either by its size, equity relative to the GDP of one country (say, 3%), or by its market share in a foreign country (say 10%). Goodhart (2003_b) argued that a European supervisory agency cannot exist as long as the cost of the bailing-out is borne by domestic authorities, with reference to a British saying "*He who pays the piper calls the tune*". There is no disagreement with this accountability principle, but the recommendation to move banking supervision, deposit insurance, and bailing-out to the EU is motivated first by the fact that, de facto, the bail-out of large banks from small countries will be borne by European tax payers, and, second, that spillover effects demand a coordinated resolution. A discussion of cross-border bail-out will turn rapidly into an issue of tax payers' money and into a constitutional debate. "A nation is a community of man living in one territory and willing to organize together a social life, conform to their ideal" (Wigny, 1973). A discussion on the preference of citizens to define the border of the nation at the country or European level cannot and should not be avoided. It will guide the choice among 'host country' or EU-wide control of international banks.

VI. CONCLUSION

A twenty-year review of development in the European banking sector has, hopefully, helped to better understand the dynamics of European banking integration, and the public policy issues it raises. Three of the main conclusions are as follows:

First, after a relatively slow start, European banking integration is gaining momentum, both in terms of cross-border flows, market share of foreign banks in several domestic markets, and cross-border M&As of significant size.

[61] We do not discuss whether supervision should be done by a central bank or by a separate institution, or whether a single or multiple institution should supervise the financial sector. See Vives (2001), European Central Bank (2001), Kahn and Santos (2002), Walter (2003) or Dierick (2004) for a review of arguments.

Second, although until recently banks have relied mostly on subsidiary structures to go cross-border, this is changing with the recent creation of the European company statute, the *Societas Europaea*, which facilitates cross-border branch banking. A review of the case of the Scandinavian bank Nordea helps to understand some remaining barriers to integration, and the supervisory issues raised by branch banking. The move to branch banking is a fundamental change as, under current European legislation, it moves banking supervision and deposit insurance from the 'host' country to the 'home' country. As this trend continues, a review of the institutional framework dealing with safety nets and supervision in European banking markets is much needed.

Third, it is argued that although the 'home country' principle has served well European banking integration until now, it may not be adequate in the future. Cross-border spillover effects caused by bank failure will demand European cooperation. And, de facto, small European countries may not be able to bail-out their large international banks. This raises the issue of transferring the cost of bailing out, deposit insurance, and banking supervision to a European entity.

In 1983, John Kareken wrote an article "Deposit Insurance Reform or Deregulation is the Cart, not the Horse". He was expressing a (prescient) concern that deregulation and expansion of bank powers had taken place in the United States before a proper deposit insurance reform had been introduced. His concern was moral hazard and excessive risk-taking. In Europe, deregulation and opening of frontiers have taken place to create competition and allow firms to reap economies of scale and scope, leading to better terms for consumers. This has taken place over the last twenty years, without any fundamental reform to cross-border banking supervision, deposit insurance and bailing-out procedures. With the speed of European banking integration accelerating, it might be time to put the Horse in front of the Cart, that is, transferring bailing-out and supervisory powers to a European authority before the process of banking integration is fully completed.

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