policy brief

European retail banking: Will there ever be a single market?

By David Shirreff

★ Over the past 25 years, smaller European countries have gradually opened up their retail banking sectors by allowing in foreign competitors and harmonising rules with their neighbours. But in some of the bigger member-states, there has been resistance to change. As a result, Europe's retail banking sector is still highly inefficient.

★ The European Commission should keep using its competition powers to take on vested interests and national prejudices as it has done in the past. But, whenever possible, is should adopt a light-touch approach to new legislation.

★ European regulators should create a framework in which each business within a bank has its own profit-and-loss account and its own dedicated capital. This would increase the scope for cross-border acquisitions and alliances below the level of mega-mergers.

A well-functioning financial services industry is vital for the competitiveness of the European economy. Easy access to capital is a pre-condition for the growth of new and innovative businesses, which the EU needs if it is to keep pace with the economies of America, China and India. The integration of European financial markets would also make the EU's creaking pension systems more sustainable by encouraging people to invest in equity-based private pension funds. Crucially, the integration of Europe's banking sectors would do much to deepen European economic integration. Only once it is possible to run a business across Europe as easily as in a single country, or for consumers to purchase goods and services from suppliers in another member-state through a single bank account, will the full potential of the single market and the euro be realised.

At the Lisbon summit in March 2000, EU heads of government signed up to an ambitious programme designed to achieve a single market in financial services by 2005. The financial services action plan (FSAP) was an attempt to reduce the legal obstacles which prevent businesses – whether retail banks, insurance companies or stock exchanges – from selling their products and services across the EU. The EU has made relatively good progress towards creating a viable single market in wholesale financial services, such as securities trading.[1] However, it has secured only limited integration within the retail financial services sector.

[1] *Alasdair Murray and Aurore Wanlin, 'The EU's new financial services agenda', CER working paper, February 2006.*

In fact, today's banking landscape in the EU is still enormously inefficient. Each country is dogged by its own banking sector's characteristics. Few countries' national banking systems offer their customers a full range of banking products and where they do the prices are often excessive.

As for finding a bank that truly serves a customer with pan-European needs: forget it. The closest to it may be Citibank, which has retail operations in a number of European countries. Unfortunately, holding an account at Citibank UK, for example, does not mean automatic access to the services of Citibank in Germany. Credit clearance in one country does not mean credit clearance in another, and so on. The subsidiaries of the bank operate as islands, which are consolidated only on the balance sheet. Although there is firm-wide risk management, the benefits do not trickle down to individual customers.

Centre for European Reform
14 Great College Street
London SW1P 3RX UK

T: 00 44 20 7233 1199
F: 00 44 20 7233 1117
info@cer.org.uk / www.cer.org.uk

Similarly, consumer credit companies that have major operations in several European countries, still treat each country as a separate entity. In fact, financial supervision requires this for subsidiaries, though not branches. Under existing EU rules, the home country's supervisor is responsible for the activities of a branch, and consolidated supervision of the entire banking group, while the host country's supervisor oversees the activities of a subsidiary. Automatic 'passports' are thus granted for branches and the quality of home supervision has to be taken on trust. The problem is that retail banks often prefer to use subsidiaries in the countries where they operate: branches of foreign banks only pick up marginal business in other EU countries. This is mainly because it is hard to shift customers from their traditional bank – thus, the most effective way to acquire such customers is to buy the bank.

As a result, retail financial services in Europe are not leading but rather following the spread of other consumer services – for example entertainment, communications, the sale of merchandise such as computers, cars and food. One can buy almost any of these at comparable prices from the Arctic Circle to Cyprus, and beyond. But financial services are a different kettle of fish for three main reasons:

★ First, financial services require a watertight legal framework, since they involve not tangible goods, such as a car or washing machine, but an abstract equivalent. The purchaser has to be sure that the abstract equivalent has value that will survive the small print and stand up in court.

★ Second, most national banking systems are a kind of oligopoly. This has partly to do with history – a history of government interventions after crises. But it also reflects the reluctance of customers to switch their main bank account from one provider to another even when they are unhappy with the service.

★ Third, governments have been jealously protective of their national banking systems, supporting them in times of crisis, and relying on them at times when the government itself is short of cash – an uneasy mutual dependence.

The characteristics of retail banking markets vary widely across Europe. In the Netherlands and the UK, for example, a small number of large national banks dominate, whereas Germans tend to do their retail banking with small, regionally-focused savings banks. In light of this heterogeneity, what would an integrated European retail banking market look like? Do certain member-states provide more suitable models than others? And which EU countries stand to profit from a more integrated retail banking sector?

EU action to create an integrated retail financial services sector

The European Commission is well aware of the substantial benefits that a common market in retail financial services would bring to EU consumers – providing them with a greater choice of products and making it easier for them to move across Europe.

In theory, existing EU legislation, such as the second Banking Directive which came into force in 1993, should permit financial retail companies to compete across borders. In practice, however, substantial obstacles remain. Firms find it difficult to offer similar products, such as bank accounts or mortgages, in different countries because of incompatible national laws or consumer protection rules. The tax treatment of financial products also varies widely. In addition, banks have little incentive to encourage cross-border competition.

The EU has been particularly keen on acting in the following three areas: mortgages, consumer credit and cross-border retail payments – with little success so far.

Banks have objected that harmonising mortgage practices across Europe may be counterproductive. National housing markets have different characteristics, including financing and taxation. So it would be difficult to offer a standardised 'pan-European' mortgage, as some have demanded. Sensibly, the European Commission, in its latest 2005 proposal on harmonising consumer finance, expressly excluded mortgages from the package.

Consumer credit is a different matter, however. Personal loans, for example, are simple instruments with easy-to-understand repayment terms and (at least potentially) transparent costs. Some countries have more developed consumer credit cultures than others: most notably Britain and Germany. But even simple instruments are difficult to harmonise when subjected to the consumer protection laws of each member-state. Consumer protection must be a priority in the sale of any financial instrument across borders. However, in practice, this means that the seller must be prepared to safeguard a product against legal claims in all 27 EU member-states. Until the EU finds a way to resolve such a dilemma, pan-European consumer credit will remain a dream.

Creating a single euro payments area (SEPA) has been on the EU's agenda since the introduction of the euro in January 1999. Nothing would contribute more to pan-European business and consumer activity than the ability to make payments, collect on invoices, or run a business in euros across Europe as easily as in a single country. SEPA has the potential to give huge impetus to the economic integration of the eurozone. Once all euro payments in the single currency area are treated as domestic payments, the current differentiation between national and cross-border payments will disappear.

This highlights a little discussed issue, namely that a single euro payments area will increase the costs of staying out of the eurozone. So far, the EU countries that opted against adopting the euro have experienced

few economic disadvantages. Trade between members of the eurozone has grown slightly more rapidly than trade among the EU-15 as a whole. But opponents of participation, especially those in the UK, have been able to argue that the economic costs of staying out have not been significant enough to offset the advantages of greater monetary policy and exchange rate flexibility. A fully functioning SEPA would increase the costs of staying out of Economic and Monetary Union (EMU) if it acts as a catalyst for accelerated economic integration.

The European Commission has already forced a certain level of harmonisation by requiring banks, from January 2002, to charge no more for fund transfers of up to €12,500 across the eurozone than they do for domestic transfers. Since January 1st 2006, the rule has been applied for payments of up to €50,000. The regulation had a dramatic effect on cross-border charges, bringing down the average cost for transferring €100 from €17.37 in 2001 to €2.46 in 2003. But it failed to create a true SEPA. In fact it is simply costing the banks money to comply, because they have hardly altered the way they make payments, which is through correspondent banks.[2]

[2] *A correspondent bank is one that regularly performs services for another financial institution usually located in another country.*

In March 2007, the Council of Ministers also approved the draft of a European Payments Directive which would allow non-banks to compete for payments business, while subjecting them to supervision and a level of prudential capital.[3] It is difficult to see, however, how non-banks can replace banks at the beginning or end of a payment transaction, which traditionally moves money from one bank account to another. It is easier to see such non-banks entering the market as intermediaries, reducing the cost of the electronic transfer of funds and perhaps bearing some of the operational risk.

[3] *Regulators impose requirements on banks regarding the amount of capital they should hold in relation to the riskiness of its assets.*

Credit card companies are already doing this across borders virtually worldwide. But the fees charged for such card-based transactions have historically been enormous. Various anti-trust actions and class actions by merchants have forced down these so-called interchange fees in several countries. But Visa and MasterCard, the two biggest providers of these services, have enjoyed a duopoly for decades which other competitors are only starting to undermine slowly. Other payment intermediaries like PayPal, which offer web-based solutions, do not ultimately usurp the role of banks, so they put little downward pressure on prices.

Creating a true SEPA will require national payment networks to be interoperable, or the creation of a pan-European clearing house – which would run against considerable national interests and be costly. The banks, through the European Payments Council (a bank-sponsored lobby group), agreed to provide seamless cross-border credit transfers and card payments by January 1st 2008, with the embryonic SEPA scheme co-existing with the various domestic schemes. By the end of 2010, the European Commission wants the domestic schemes to be phased out, leaving just the fully harmonised European system. The reason for this compromise is a mismatch between the target date set by the European Commission and the differing investment cycles of each of the national payment systems – some have already paid for themselves, others have only just come on stream. So for the next few years, rather than needlessly scrapping expensive investments, they will be made increasingly interoperable.

The infrastructure for a single European payments area could, therefore, be in place by 2012. But the European Commission must establish the legal framework for the provision of direct debit services across borders before the SEPA is fully operational. Direct debits would allow a company or utility in one country to draw funds directly from the bank account of a customer in another. It is possible that a single euro payments area will be in place by around 2012, roughly a decade after the introduction of euro notes and coins.

The landscape will change: but how?

The impact of borderless payments could be huge, paving the way for truly pan-European sales, marketing and invoicing of goods and services. It would also, in theory, make redundant the need for companies or individuals operating in several countries to have a banking relationship in each: all business could be done from one bank account.

In theory, national banking systems would then be open to competition from outside. The more cashless the society becomes, the greater the scope for banks from other countries to compete for customers on price and user-friendliness. The effect on the banking sector however, is difficult to predict: will it lead to more cross-border deals, or will it make such consolidation unnecessary? Banks will still compete to acquire customers and to keep them loyal, but competition will come not just from domestic rivals. That is likely to lead banks to form cross-border alliances rather than consolidate at home, which, in some countries, could lead to anti-trust cases.

During the past few decades there has been a drive to consolidate banks into bigger economic units, first within national borders and then internationally. The rationale is better diversification of risk and economies of scale in information technology, risk management systems, marketing and branding. Domestic mergers also lead to cost savings by cutting staff and branches. The greater the domestic consolidation – some banks, for example in Britain, the Netherlands and Spain, would have anti-trust problems buying more market share at home – the stronger the drive to play the same game across borders.

In the past few years, the most significant cross-border deals have been Banco Santander of Spain buying Abbey National of Britain in 2004, and Unicredit of Italy buying HVB of Germany in 2005. In October 2007, a consortium of Royal Bank of Scotland (RBS), Banco Santander and Fortis of the Netherlands successfully took over ABN AMRO of the Netherlands, and began to share out the pieces. The new concept introduced by this episode was that a bank, even one the size of ABN AMRO with branches in 53 countries, could be broken up and shared between members of a consortium. This is a significant step, not only for the European banking landscape but also for its regulators. It suggests that there may be a new way of regarding banks: as a collection of discrete businesses, each with its own economic capital and risk profile, rather than as a monolithic brand.

The readiness of the Dutch authorities to see a major national firm dismembered and shared among largely foreign competitors demonstrates a commendable lack of economic nationalism. The European Commission suspects other member-states remain less open to foreign capital and ready to use prudential banking rules to obstruct foreign takeovers or competition. Such rules are supposed to allow regulators to stop financially risky firms from undermining the health of a country's banking system, not halt unwanted mergers and acquisitions. To prevent abuse of prudential rules, the European Commission is preparing a directive which will strictly limit the scope of national bank supervisors to employ prudential rules to thwart cross-border mergers or takeovers.

The wave of cross-border consolidation also results from the introduction in January 2007 of the EU's Capital Requirements Directive (CRD), commonly known as Basel II. The CRD requires banks to hold levels of capital that more closely reflect the actual risks they bear in terms of the credit ratings of the borrowers, the exposure to derivatives and the volatility of securities. This sophisticated approach should in theory give a more accurate picture of a bank's performance and its ability to withstand market shocks. It should also give a more accurate market price for the bank or any of its divisions. In the long term, being able to value a bank in this way should make it easier for supervisors and central banks to reduce their responsibility to intervene or act as lenders of last resort.

Since Americans have decided to apply Basel II later and more gradually, Europe may have a head start as a market in which banks can be sold, wound up, or allowed to fail, rather than being treated as a hallowed part of the infrastructure. But it is hard to know whether this was the intention of Charlie McCreevy and Neelie Kroes, the EU's single market and competition commissioners.

However, although it is becoming easier to buy banks in some EU countries, it is still very difficult in others. In France, the chauvinist view that its major banks should stay French-owned lives on. Apart from HSBC buying Credit Commercial de France, a medium-sized bank, in 2000, there has been no significant foreign takeover of a French bank. Foreign bankers have said they have not tried, simply because they know that closed French ranks would not allow them to succeed. In Italy, a similar view has only begun to erode in the past two years. A showdown in 2005, in which the Italian central bank governor, Antonio Fazio, lost his job because of over zealous defence of national champions, eventually allowed ABN AMRO to buy Antonveneta, a medium-size Italian bank, and BNP Paribas to buy Banca Nazionale del Lavoro. In theory, that has opened up the Italian banking sector to the winds of competition. But bank charges on Italian current accounts are still among the most expensive in Europe. Even the foreigners, it seems, are taking advantage of customer inertia.

In Britain, the big four incumbent banks still control around two-thirds of the retail market, partly because of customer inertia but also because the government has made little attempt to encourage greater competition. In Germany, there is almost the opposite problem: regional laws and restrictive practices have prevented consolidation and open competition in the banking sector. The result has been the worst of both worlds: a fragmented market with poor customer service and poor economies of scale among the providers.

Looking for a model

Part of the problem in predicting how the European banking landscape will look, and trying to influence the outcome, is that there is no particular 'best' model. Each country's retail financial sector has developed according to its own ground rules.

Benelux and Nordic role models

The Benelux and Nordic countries are the most open markets, but they have few first-tier banks. Nordea could be a model for a truly pan-European bank, since it has operations of comparable size in all four Nordic economies. But the very close links between the Nordic countries mean they are probably a special case: the average Swede has fewer reservations about banking with an institution based in Denmark than the average German does about banking with an institution based in Spain.

British profitability

Britain has the most successful banks in the EU, but their growth and profits are partly the result of insufficient competition: for years British banks were able to keep prices high and see off competition. That is changing, but only slowly. According to the European Commission, in 2004, "excess borrowing fees" represented about one quarter of the income of British, Cypriot, French and Spanish retail banks – the European average was 10 per cent. British banks

have long relied on such penalty charges. That is partly because, while the Financial Services Authority oversees the risks they run, it explicitly does not address competition issues. A voluntary banking code has not fully addressed the problem. Change might be under way, however. In March 2007, in response to many complaints, the UK's competition authority finally announced it would look into hidden charges on current accounts, including overdraft fees.

However, when it comes to sources of income, the EU sectoral inquiry into retail banking shows that British banks are the most balanced in Europe. They rely more or less equally on current accounts, mortgages, savings accounts, and credit cards, although slightly less on consumer loans. By contrast, Spanish banks make a big chunk of their income from mortgages, and Italian banks from current account charges. Meanwhile, French banks rely heavily on both current accounts and mortgages. With the exception of Britain, the credit card culture has not really caught on in Europe.[4]

[4] *European Commission, 'Interim report II, current accounts and related services, sector inquiry under Article 17 Regulation 1/2003 on retail banking', July 17th 2006.*

Spanish pioneers

The development of the Spanish banking sector is perhaps the most exemplary in Europe. Spanish banks have been particularly good at keeping costs low and expanding across borders. Banco Santander completed a significant European cross-border merger when it bought Abbey in 2004. It has aggressively expanded its consumer lending business into France and Germany. BBVA has been successful in Mexico and recently added Compass, a Texas retail bank. Spanish banks have the best control of costs in Europe, with an average cost-income ratio of 50 per cent and a low level of non-performing loans. In comparison, the Austrian, Dutch and German banks perform poorly, with an average cost-income ratio of over 70 per cent. Of course Spain's booming economy and housing market have contributed significantly to this success. A sharp economic downturn in Spain could leave the business models of Spanish banks looking much less robust.

Italian converts

Italy could develop a more balanced banking sector, now that its resistance to foreign takeovers is waning. The country successfully privatised its sizable but inefficient savings banks. UniCredit, arguably the most successful Italian bank, is the result of a merger of seven Italian banks, and has now expanded into Austria, Germany, and Central Europe. The six biggest banks in Italy now have a 62 per cent market share, and further consolidation of the smaller banks is expected. The big driver is the CRD, which has forced investments in risk management and credit rating systems that reward economies of scale.

French economic patriotism

France has some excellent universal banks: Société Générale is the most profitable perhaps because it has not been as adventurous abroad as BNP Paribas (BNPP) and Crédit Agricole (CA). BNPP's acquisition of BNL in Italy was a significant expansion of the group's retail base. CA recently agreed to take over 654 bank branches in Italy from Intesa SanPaolo and two of its subsidiaries. CA also owns a majority of Emporiki Bank in Greece.

French banks are aggressively expanding their consumer lending subsidiaries abroad. For instance, Cetelem (BNPP) is present in 27 countries, with a commanding position in Spain and the Netherlands, while Sofinco (CA) has a wide European presence reinforced by its 50 per cent stake in Fiat Auto Financial Services. But France needs to overcome its hostility to foreign investment in its retail banking sector. French retail customers would certainly benefit from some outside competition; French bank charges are among the highest in the EU. In 2007 Citibank closed its consumer finance operations in France, after it failed to crack the stranglehold of BNPP, CA and Société Générale. France was also a graveyard for the British Prudential insurance group's online bank, Egg.

German fragments

The biggest headache for European regulators, however, is Germany, where legal barriers prevent the free development of the banking sector. Over 40 per cent of retail assets are held by banks that are publicly owned and it will stay that way unless individual German states and communes change their laws. Another 28 per cent of assets are in the hands of co-operative banks which show little sign of consolidating. That means the country's four biggest private banks have little chance of gaining market share at home by acquisition. Their market capitalisation has also been too small to allow them to participate in the few cross-border mergers in Europe – except as a target, as in the case of HVB.

For the biggest economy in Europe, this is bad news. There is little room for outside competitors or the German private banks themselves to build or buy market share. There have been a few attempts by private banks to buy savings banks, but they have ended in failure. The European Commission seems powerless to break up the sanctity of the German savings bank sector: each savings bank is protected by its own regional savings bank law. A ray of hope was offered by the compulsory sale of Landesbank Berlin, which had to be completed by the end of 2007. That was agreed between the German government and the European Commission after a costly state-funded bail-out of Bankgesellschaft Berlin, Landesbank Berlin's predecessor. But in a determined effort to see off all competition the German savings banks association bought Landesbank Berlin in June 2007.

The fragmentation has meant that only Deutsche Bank (DB) has had much success at expanding abroad. However, it has concentrated mostly on investment-banking, not retail operations. Until recently, it seemed little interested in developing its German retail base. But in 2006 DB bought Norisbank, a consumer bank, and Berliner Bank, an up-market retail bank. Neither is very big, but they allow DB to pursue a multi-brand strategy in Germany, targeted at different types of consumer. It has also started to expand consumer finance in Poland.

Allianz, an insurance group, bought Dresdner Bank in 2000, and has tried to cross-sell retail banking and insurance products, with only marginal success. Now, looking at the longer term, it is beginning to establish Allianz as a banking brand too, launching an online bank in Austria. UniCredit, which owns HVB, has also decided to bring its own online banking brand from Italy to Germany. ING DiBa, an online subsidiary of ING Bank of the Netherlands, is also the market leader in Germany in terms of growth. Since ING took full control of DiBa in 2002, its customer count in Germany has risen from 1 million to over 5 million. Deutsche Bank's push into retail is partly a response to the threat from ING DiBa.

These may be early signs of cross-border marketing of retail brands in Europe. But the savings and co-operative banks are the natural incumbents in the German retail banking sector. Both banking species have formed themselves into so-called Verbünde, or associations with common risk management and, to some extent, pooled capital. Under the new CRD, regulators have recognised one or two of the more closely-knit savings banks groups, which have common risk management, as a single concern, making their intra-group lending zero risk-weighted. Private banks argue that this has tilted the playing field in favour of the savings banks.

The way forward

There is little the European Commission can do to encourage banks to engage in cross-border mergers if the banks themselves are sceptical of the business case for such mergers. The Commission has shown that it can achieve change occasionally by bullying and cajoling banks, as in the case of small-value cross-border payments, but it is more important that European lawmakers set a framework in which such cross-border deals make commercial sense.

The current legal framework has not prevented the survival of certain complex oligopolies in which some banks have a dominant market share and unchallenged pricing power within their national banking systems. With more integrated European markets, some of that dominance will gradually erode. But where national authorities are failing to address competition issues, there is clearly room for intervention from the Commission. It has demonstrated in the past that it was not scared of using its competition powers to take on vested interests or national prejudices and it should continue to do so.

More fundamentally, however, European lawmakers need to decide what types of business they want to be done by banks, and what types by non-bank competitors. Given the high costs caused by banking crises, European regulators and central banks obviously do not want to be faced with a full-blown banking crash. But neither do they want the cost of running a system which is so strongly built and supervised that an individual bank cannot fail.

The more monolithic banking institutions become, the more potential danger the collapse of one poses to the system. For this reason, regulators should be creating a framework for banks in which each business within a bank has its own profit-and-loss account and its own dedicated capital. This would also be the logical outcome of the Basel II framework. An umbrella brand for such a collection of businesses is necessary for marketing purposes, but the brand would be exposed only to reputation risk, not financial risk. Under such a regime, banks would be more like Lego models than monoliths. There would be scope for cross-border acquisitions and alliances below the level of mega-mergers and big egos.

The purchase and break-up of ABN AMRO by a consortium shows that Lego-land has come a little nearer. Regulators and banks with different interests are hoping to manage the process of separating many integrated businesses into a different set of components. Perhaps the exercise will create a new model for the modular running of banks. But that is a long way from where we are today. UniCredit or BBVA are probably the best models we have of what is possible in retail banking: flexible management, multi-branding and a gradual move towards a common European culture. More of the same is probably the best we can hope for.

David Shirreff is the Frankfurt business and finance correspondent of The Economist.

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