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CAHIER COMTE BOËL
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Pan-EU Retail Banking
- What Industry Wants and Consumers Need -

FOREWORD

ELEC has a long standing record of monitoring and encouraging progress in the various dimensions of European integration. The publication of a "Cahier Comte Boël" [1] signals that ELEC has a keen interest in the issue under consideration, that it has devoted resources, time and energy to its discussion and that it wishes to add its contribution, in a forward-looking manner, to the expected policy action in the field.

This new "Cahier" is intended to serve that purpose in connection with the hotly discussed subject of the future of retail banking in Europe. The idea and the substance of this "Cahier" arose from a meeting of the ELEC Monetary Panel, held in Rome in March 2007, followed by sessions in Vienna in May, Brussels in July and Amsterdam in November. It was felt that the debate was adding value to the current wave of "brain storming" on the issue and therefore deserved publication in this form.

This publication is arranged in two parts and some appendices. **Part I** consists of the view points of several ELEC members that were stimulated by the papers in **Part II** – Contributions to the debate. In the Executive Summary, we draw out our responses to the identified problems and make some recommendations for action.

We wish to thank all members of the ELEC Monetary Panel who took part in the discussions leading to this "Cahier", and in particular Graham Bishop, Bouke de Vries, Marianne Kager, Gianluca Salsecci, and Stefan Schaeffer.
Neither ELEC nor its members are committed to endorse the views expressed in the "Cahier", which remain the responsibility of the authors. Moreover, the authors write in their personal capacity and do not necessarily represent the views of their employers.

Anton van Rossum — *Jean-Claude Koeune*
International President — *Secretary General*

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[1] This series is named after Comte René BOËL (third President of ELEC, 1951-1981) who generously bequeathed a sum of money to ELEC. The Central Council decided to use this to publish occasional papers.

Table of contents

What is ELEC?

The European League for Economic Co-operation is a non-governmental and non-party organisation that aims to promote the economic integration and socio-cultural identity of Europe, and to enhance Europe's role in the world. ELEC was created in 1946-47 by a group of influential policy-makers who, even then, were involved in a process of reflection aimed at paving the way for a Europe that would be federated politically, economically and culturally. The majority of ELEC members come from banking, business, scientific circles or high-level administration. So they are ideal observers of the full spectrum of events unfolding in Europe and some participate in the European decision-making process.
Background on ELEC: http://www.elec-lece.eu/A1desc_E.htm

EXECUTIVE SUMMARY and ELEC RECOMMENDATIONS

ELEC fully supports the creation of a single market in European retail banking. All consumers, enterprises and financial institutions must be able to reap the benefits of European integration. Despite the important progress with the Financial Services Action Plan and the Internal Market strategy there is much scope for improvement. Retail banking markets are still fragmented. Current efforts of policy makers and the industry are aimed at reducing differences in national legislation, improve the opening of markets, e.g. the access to credit registers, and amongst others to build a competitive and open payment area in Europe (SEPA). ELEC welcomes these efforts and supports the creation of a level playing field in Europe.

ELEC also underlines the importance to empower consumers and to enable them to make the best financial choices. In doing so, a balance has to be found between own initiative and responsibility of customers, and a duty for financial institutions to give high quality information in an understandable and concise way. It sounds easy enough but as will be illustrated in this cahier, practice proves it is not.

Meanwhile, the unfolding international credit crisis demands much attention of financial institutions and policy makers. Eyes are now on the likes of the Fed, ECB, the Financial Stability Forum and the Basel Committee to restore the confidence in the stability of the financial system and to prevent future problems from arising. Europe should in our opinion not hastily seek refuge in more regulation. All parties, i.e. financial institutions, hedge funds, private equity funds, rating agencies etc should learn from the credit crisis and make the necessary improvements in their risk assessments and disclosure. This cahier however does not focus on the credit crisis. The main subjects of the cahier are harmonisation of legislation in Europe, empowerment of consumers, and the creation a healthy financial services sector with attractive opportunities to do business.

In the opinion of ELEC, the future efforts to improve the internal market for financial services should focus on:

1. Targeted full harmonisation of other relevant laws and regulations.
2. Harmonisation of deposit guarantee schemes *in order to create equal conditions for all providers of financial services.*
3. Increasing the transparency of markets and improving the availability of prices and quality of financial products - partly by increasing the financial literacy of consumers. But there should also be encouragement of internet information "aggregators" – subject to ensuring that they do in fact make proper comparisons, especially cross-border.
4. Elimination of barriers for foreign internet suppliers of financial products to offer simple products that can be easily compared (the classic example may be ING Direct).
5. Monitoring of the SEPA process to encourage market forces as these are the best method of ensuring that it really leads to lower prices for cross-border payment services, without raising prices for domestic payments. Citizens will not expect a market-opening measure to have perverse effects.
6. Close scrutiny of competition practices within countries.

In **monitoring** competition and market practices, the focus should not be on concentration issues alone, says Wim Boonstra, chairman of the Monetary Panel of ELEC, in the first chapter of this Cahier. Traditional concentration ratios on the national level are poor proxies for the intensity of competition. It is better to watch concentration on the level of relevant submarkets and/or regional level. There, concentration levels can differ strongly from concentration on the macro-level on national scale. Moreover, measuring the availability of branches of several suppliers of financial services might be a useful addition as a measure of potential market power, as a high concentration ratio in a densely populated area has a totally different impact than the same degree of concentration in a rural area. Furthermore, more research is needed on the **behaviour** of consumers. Where the Commission strongly focuses on the costs of switching banks, it pays so far no attention to the fact that in some countries more and more consumers hold accounts with several banks at the same time. Competition between suppliers tempts clients to go for the best offer in the market, increasing their number of banking relations in the process.

ELEC holds the opinion that government **intervention** in the operation of banks should be kept to a minimum and, even in this case, aimed at ensuring the healthy working of competitive market forces.

One of the latest developments is that the Consumer Credit Directive has been adopted by the European Parliament (January 2008). The working party of ELEC that has prepared this ELEC cahier concludes that the final version of the CCD is as a whole a more acceptable outcome for the banking industry than the first proposals. These were in our opinion not going to be effective and also very costly. The CCD will now hopefully contribute to the further development of the internal market for retail banking services. Specifically, we consider it positive that full targeted harmonization has been respected on some key points. It is crucial that national implementation is as consistent as possible.

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Part I: The Debate amongst ELEC Members

Introduction of the Chairman of the Monetary Panel Wim Boonstra [2]

The European unification process, and in particular the introduction of the euro, were major integrating forces for financial services in Europe. They have contributed fully integrated money, capital and wholesale banking markets within the eurozone. However, retail banking in the EU remains fragmented so far, and is still almost completely organised on a national level.

Retail banking is extremely important. It is over 50% of total banking activities and it generates 2% of EU GDP annually in gross income. Even more important: it touches the daily lives of all citizens of the European Union and it is exactly the field where consumers should experience the benefits of European monetary integration. A successful creation of a single European market for retail banking, with visible benefits for consumers, will have a strong positive effect on the overall political support for the process of European integration.

Today, there still is ample room for progress in this field. Differences in quality and prices for retail financial services between countries within the EU are large and cross-border retail banking is largely underdeveloped. Prices for similar products differ strongly between countries. Such differences are unacceptably high. But obstacles are deeply embedded e.g. the local character of retail banking, the relevance of relationship bank in Europe, the "proximity bias" etc. - but also the presence, still, of regulatory and behavioural barriers which should be usefully removed). Although matters are improving slowly, it remains important that the integration process in retail banking is accelerated.

While wholesale financial markets in the EU have largely been integrated over the last ten years, financial services providers are still confronted with the obstacles that continue to weigh on Europe’s retail banking markets. The Commission’s inquiry has identified a number of deficiencies in the way these markets work that cause higher cost for consumers and small businesses and deter entry by new players. These deficiencies concern the markets for payment cards, (non-card) payment systems and certain core retail banking products. Particular indicators are large variations in merchant and interchange fees for payment cards, barriers to entry in the markets for payment systems and credit registers as well as obstacles to customer mobility and product tying. All these need to be tackled in the same way that the Giovannini Group proposed tackling apparently insuperable barriers to cross-border securities settlement. Identify the precise barriers and then allocate the lead task to a body that is already empowered to resolve it.

Currently, the European Union is, for historic reasons, characterised by a variety of legal systems and differing attitudes towards socio-economic issues, including consumer policy. While this is understandable as a result of historic developments and may, to some extent, reflect differences in national preferences, the differences in consumer policy regimes are, under the present

[2] Wim Boonstra is Chief Economist of Rabobank

regulatory arrangements, an impediment to market integration and have severe welfare implications: They make it costly, if not impossible, for suppliers to establish pan-European business models and hinder consumers from taking advantage of products offered by suppliers domiciled outside their home-country. Thus, consumers are prevented from getting access to a wider range of products and suppliers, while financial institutions cannot fully exploit market opportunities and economies of scale.

I have no illusions that full harmonisation is a realistic (or even desirable) goal as many additional policy instruments are available: Targeted full harmonisation [3]; mutual recognition or industry standards. So there is a clear need to identify key sectors for harmonizing and our policy recommendations clearly distinguish between what the Commission could propose to the co-legislators, what regulators could do and what bankers' associations could do by way of industry standards.
The simple fact remains that financial institutions encounter various barriers if they wish to offer services in other EU member states. The key legal differences lie primarily in the field of contract law, consumer protection law, insolvency law, procedural law and foreclosure law. But there are also other obstacles such as language, cultural differences, lack of consumer confidence and prevailing customs.

I would like to turn now to the set up of the report. In the next section the main considerations of the working group and the starting point of our discussions about the retail banking legislations are described, e.g. the corner stones of the green paper on financial services and the sector inquiry. Then the conclusions of the ELEC working group are presented. The first chapter ends with two case examples that illustrate the speed of current market developments on the one hand and the complexities market participants face on the other hand. Then we move on with individual contributions of Ms Schwimann (European Commission, DG Competition), Mr Gobbi (Bank of Italy, Economic Research Department) and Ms Kager (Chief Economist of the Bank Austria Creditanstalt). Some statistical data can be found in the Annex.

To conclude my introduction, we have selected Marianne Kager's title "**what industry wants and consumers need**" as motto for this work. I can say on behalf of the working group that we now look forward to receiving responses from consumer organisations and other parties to determine whether we have been on the right track with our observations. [4]

Wim Boonstra
Chief Economist of the Rabobank Group
Chairman of ELEC Monetary Panel

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[3] Michel Pebereau (Chairman of the European Banking Federation) defined the concept thus in a Financial Times article of January 18, 2006: "The European Banking Federation, which supports a high level of consumer protection, has proposed an original concept called "targeted full harmonisation". We believe certain elements in consumer credit contracts are essential and need to be harmonized so that Member States should not be allowed to introduce more stringent rules. These are:
- pre-contractual and contractual information;
- definition of the Annual Percentage Rate of Charge (APRC);
- right to withdraw and withdrawal period;
- right for consumers to repay early and identical calculation methods for compensating the provider.

[4] Please note we will publish responses on the website unless requested otherwise.

Considerations of the working group

Our debate took place in the context of the following events:

- May 2006 - Communication "A Citizens' Agenda: Delivering a Europe of Results"
- January 2007 - Final Report of sector inquiry into European retail banking
- May 2007 - Commission's Green Paper on retail financial services / *see extracts below*
- November 2007 - Commission package of initiatives to turn its Citizens' Agenda into a consistent set of actions / *see extracts below*
- December 2007 - Payment Services Directive (PSD) published in Official Journal (after April agreement by Parliament) with transposition into national law by 1 November 2009, at the latest
- January 2008 - European Parliament Plenary vote on Consumer Credit Directive / *see the box text*
- March 2008 - New single market priorities.

Our considerations and the main points we have taken on board of these reports are the following:

The Green Paper sets out the Commission's overarching objectives in the field of retail financial services. The Commission seeks to develop integration in EU retail financial services markets by ensuring that properly regulated open markets and strong competition deliver products that meet consumers' needs, offering choice, value and quality; enhancing consumer confidence by ensuring that consumers are properly protected where appropriate, and that providers are financially sound and trustworthy; empowering consumers to make the right decisions for their financial circumstances through improved financial literacy; clear, appropriate and timely information; high-quality advice; and a level playing field between products perceived as having similar characteristics.

On bank accounts, the EU banking industry will be invited to develop, before mid-2008, via self-regulation, a set of common rules to the benefit of all customers (individuals and corporates alike). These rules will be designed on the basis of benchmarks determined by the Commission in the light of best existing practices. Banks will also be invited to abolish existing discriminations, either based on nationality or residence, which abusively prevent individuals from opening accounts on a cross-border basis. Should the banking industry fail to set up adequate arrangements, initiating legislation would need to be considered.

In the field of payments, efforts will continue towards the development of the Single Euro Payments Area (SEPA). An efficient payments market, where payments can be made quickly, cheaply, easily and reliably, is a key component of a competitive economy. Currently, national payment markets are fragmented with widely differing prices and performance levels. Each Member State has its own rules on payments and the annual cost of making payments between these fragmented systems is high. Efforts will in particular focus on ensuring a smooth and timely migration to SEPA products, on enhancing competition in the cards market and on developing high-value services such as e-invoicing.

The access to and availability of credit data is an important factor in promoting competitive retail financial services markets. Customers seeking to take out a loan with another institution (be it in the domestic market or cross-border) may face higher prices or be denied access to credit because of the lender's inability to access complete information on the consumer. This reduces customer mobility and choice. Inability to access complete credit data may also impede the ability of new credit providers – be they domestic or foreign – to compete for customers. The ultimate objective is to allow for a smooth lender access to loan applicants' credit histories, and to ensure that the data available is accurate.

The potential benefits of a single market in retail banking are huge, being estimated at 0.5 to 1% of GDP, underlining why policy makers want to strengthen integration in retail financial services. The problem with these benefits is that they are not tangible yet and based on research studies. The public and national politicians want to be convinced by concrete examples that are recognizable in their own daily experience. But this cannot be delivered by the banking industry as long as the legal preconditions for a single retail market are not in place: A classic chicken-and-egg problem. We will therefore cite two specific examples at the end of this section that are very concrete: (i) the mortgage market in the Netherlands. Foreign banks entered the market – using all the new technologies for distribution as well as achieving economies of scale in production. Result: clear benefits to those consumers who choose to take advantage of the new products. (ii) pooling mortgages from more than one jurisdiction so that they can be securitised. The example of Deutsche Bank's securitisation of German and Italian mortgages show the legal difficulties that need to be overcome – in sharp contrast to the economic simplicity of the underlying transactions and the benefits that can flow to consumers from cheaper mortgage loans.

In its Sector Inquiry on Retail Banking, the Commission identified several obstacles to cross-border integration, including entry barriers and limited competition. Some of these obstacles involve fundamental features of domestic financial systems. Therefore, it will take time to connect, for example, all domestic payment systems into one E(M)U-wide single payments area but SEPA is now moving forward quickly. Even after the removal of barriers to access to common infrastructures, enhancing customer mobility and a higher degree of price transparency and product competition may be needed. Enlarging the size of the market with a single set of rules is a way to increase competition but may not necessarily prevent the formation of oligopolies.

It is accepted that consumers probably trust national systems of protection more than European ones, even though standards of consumer protection vary widely across countries. If consumer financial products are to be engineered and offered cross-border, that would imply a requirement for harmonisation of some key elements, but combined with mutual recognition for less important, non-core issues. This seems the best way to guarantee that regulation on the key issues does not impede cross-border business. It creates a level playing field and ensures consumer confidence within the EU Single Market.

The Consumer Credit Directive has recently been adopted by the European parliament. In the following text box we discuss the implications (see next page).

Consumer Credit Directive

After six years of negotiation, EU lawmakers enacted the heavily-disputed Consumer Credit Directive, on 16 January 2008. After a final round of negotiations between the EP and Council failed on 10 January, the outlook for the directive seemed uncertain. In a last-minute attempt, the Liberals and Socialists tabled a package of amendments, which found support among EU Member States in the Council. The package was also backed by the left GUE/NGL group and a majority in the centre-right EPP-ED. The Directive adopted by the European Parliament must now be formally agreed upon by the Council. It will enter into force on the twentieth day following that of its publication in the Official Journal of the European Union. Member States have two years from the date of the entry into force to implement the CCD.

The working party of ELEC that has prepared this ELEC Cahier about retail banking, concludes that the final version of the consumer credit directive is as a whole a more acceptable outcome for the banking industry compared to the first proposals that were not going to be effective and also very costly. The CCD will now hopefully contribute to the further development of the internal market for retail banking services. We consider it positive that full targeted harmonization has been respected on some key points. It is crucial that national implementation is as consistent as possible. If we are not able to accomplish this, the industry will be faced with the costs of new regulation without getting any benefit. Also the consumer will be disappointed: if comparing offers from several providers in Europe is going to be burdensome, no one is going to bother. The result will be that competition is not going to be enhanced and the consumer does not get extra choices. The directive as such is thus important. However, we are not satisfied with the scope of application and the requirements for pre-contractual information. In our opinion, the final version of the directive takes a few steps backward in comparison with MEP Lechner's report on both issues.

The new legislation will cover consumer loans between €200 and €75 000, which have to be repaid within more than one month. The directive will apply to loan contracts on which interest is paid, and not to products such as deferred payment cards (charge cards). It will not cover mortgage credits either. The lower limit of €200 is very low – at least it is for the old member states - and thus extends the scope of the directive to a very wide category of consumer loans. The banking industry has favoured a higher limit, because of the high relative high costs for small credits of fulfilling all requirements of the directive.

The directive lays down the standard information that must be given to the consumer. It concerns information mentioned in advertising when containing financial information on a loan, pre-contractual and contractual information. Lenders will be expected to provide information on the borrowing rate and on any charges included in the total cost of the credit to the consumer. As far as the harmonization level is concerned, it will go further for pre-contractual information, which must be provided to the consumer using the standard European Consumer Credit Information form - SECCI. We consider it to be a weaker point that the effectiveness of SECCI, i.e. the influence of SECCI on the decisions of consumers, has - to our knowledge - not been tested with consumer groups.

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Conclusions of the working group about retail banking legislation

We believe that all regulatory steps should be exclusively geared towards correcting market imperfections and consumer policy should not aim at stipulating market results, but at putting into place a well-functioning framework for a competition-driven approach towards more integrated EU retail banking markets.

In line with the Commission's commitment to better regulation principles, we would like to stress that any regulatory measure which the Commission may propose, must be subject to a thorough cost-benefit-analysis. Regulatory and legislative action may only be taken if this analysis shows that the measure envisaged would yield a net positive welfare effect.

As is welcome practice today, the desirability, effectiveness and consequences of new EU regulations should be studied before their actual implementation and a systematic consultation process should form part of any policy initiatives by the Commission.

Greater harmonisation of consumer protection rules must in our opinion not come at the price of state-imposed product standardisation, as this would reduce choice for consumers and limit business options for suppliers. The whole process should neither lead to a profusion of required consumer information as consumers are most unlikely to feel genuinely empowered if they are flooded with an excess of information.

ELEC welcomes targeted full harmonisation of the key consumer protection regulations, as it creates an appropriate environment for banking across Europe. However, we accept it is an illusion to think that a high level of harmonisation will be achieved within the foreseeable future so attention should be focussed on "full harmonisation" proposals that are feasible in the reasonably near future. Full harmonisation would seem beneficial for definitions (such as "consumer", "entrepreneur", "collateral", "advice"), requirements pertaining to information Reflection period and right of withdrawal, costs related to a product (effective interest rate and other product-related costs), advertising rules, rights and obligations of consumers.

Furthermore it may be worthwhile to study the possibility to make more extensive use of Regulations rather than Directives. Examples of effective Regulations (although some involved considerable costs) include the Regulation on cross-border payments and the Regulation on compensation and support for air travellers in the case of cancellations and long delays. These objectives would not have been achieved at the same pace if they had been established via a Directive – experience suggests that it would most likely have caused again national differences.

Another suggestion is to promote simple, inexpensive and cross-border dispute handling for consumers. FINNET was developed on the initiative of the European Commission in 2001. FINNET aims to promote cross-border extrajudicial settlement of disputes involving financial services. This initiative could receive more attention from both consumer organisations and financial institutions that provide or wish to provide cross-border financial services.

Access to national credit registers should be improved. One of the main obstacles to cross-border lending comes from the fact that credit institutions are unable to assess credit worthiness as efficiently at the European level as at the national one because each country has different systems that work well domestically, some private, some public (central banks), some managed by professional associations, some positive, some only negative, etc.. The Commission has identified this as a key problem but which bodies are collectively empowered to resolve the difficulty? Trying to impose the same system on all countries would be disruptive, impossible to reach and unnecessary. The important requirement is that data can circulate following the principle of reciprocity. Even today, the main obstacle is not to assess creditworthiness but to recover the credits cross-border.

Advantages of the Internal Market can be realised by shortening the procedure of mortgage creation and the foreclosure period. The mortgage creation process is completed relatively quickly in a number of EU countries, including the Netherlands. But in other countries it can take months. Foreclosing on a mortgage costs considerable time and hence money in primarily southern EU countries.

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Case examples

Example I: Foreign banks gain ground in the Dutch mortgage market

Foreign banks are enjoying increasingly greater success in the Netherlands by offering a limited range of attractively priced (standard) mortgages. According to the number of new entries in the land registry, the market share of foreign banks has risen from 4% in 2002 to 9% in 2007. These mortgages are sold via internet, telephone and intermediaries. Argenta is currently the largest foreign provider with a market share of approximately 4.5%, followed by the Royal Bank of Scotland with a market share of approximately 3%. Bank BNP Paribas and a financing company of General Motors (Altas Funding) are also active in the Netherlands, although GMAC had to withdraw after facing funding problems in the aftermath op the subprime crisis. Heightened competition has caused the margin on new mortgages to be halved in recent years.

The Dutch mortgages market is appealing for foreign providers primarily due to the considerable size of the market and the high average mortgage amounts. The total mortgage debt of Dutch households amounted to EUR 540 billion at the end of 2006. The average outstanding mortgage amount per household totalled approximately 165 thousand euros, which is nearly twice as much as the amount in 1999 according to figures of Statistics Netherlands (Centraal Bureau voor de Statistiek). This relatively high loan amount is connected with the tax treatment of mortgages in the Netherlands. The Dutch tax system encourages a high interest-only loan amount/payment on the maturity date using accumulated savings or an investment trust. This is because Dutch homeowners are able to deduct mortgage interest from their income for a period of thirty years and thus gain a maximum tax advantage by borrowing the entire mortgage amount until the maturity date.

Foreign providers can immediately gain access to a large group of customers via intermediaries without being required to first develop a network. Intermediaries sell approximately 65% of all new mortgages in the Netherlands. But the foreign organisation’s offering must be distinctive in order to be successful in view of the increasingly fierce battle to gain the top-shelf position among intermediaries. The commission/bonus scheme for the intermediaries, mortgage processing performance and the quality of the product (product and price/interest rate) are vitally important for whether intermediaries are willing to offer mortgages from specific organisations. Distinctiveness can also be achieved by offering combinations of products. Some organisations, for example, combine their mortgage offering with the payment of a high interest rate on an internet savings account. Besides distribution via intermediaries, most foreign providers also distribute their products via a direct formula based on telephone and internet sales. Some providers also sell their products via other banks. For example, Friesland Bank - a small Dutch bank with primarily regional operations - sold a limited range of mortgage products in association with Altas Funding, a division of General Motors Acceptance Corporation. These mortgages are characterised by their long life to maturity of 15, 20, 25 or 30 years and a discount on the average market interest rate.

The barriers for new entrants are limited in the Netherlands in comparison to other EU countries. The Netherlands has an open economy, a history of trade and maintains numerous trade relations with other countries. This has consequently created an open attitude towards foreign financial institutions and capital flows. There are, however, also calls for protectionism in the Netherlands from time to time, for example in connection with the increasingly greater role that hedge funds and (international) private equity play in the business community. Unrest has recently also arisen regarding the strategic stakes that Chinese and Russian state-owned funds have announced to take in European companies. But as an open economy and trading country, the Netherlands has nothing to gain from protectionism. Moreover, Dutch financial institutions are themselves extremely active internationally. Approximately 1,400 foreign financial institutions are currently active in the Netherlands.

New entrants are able to launch operations in the Netherlands on the condition that they have a European passport (recognition of an institution in one of the EU member states) and are registered with the De Nederlandsche Bank. 35 foreign banks are now members of the Netherlands Bankers' Association. This membership provides them with access to the expertise and the lobbying efforts of the Netherlands Bankers' Association and a platform for exchanging knowledge. The fact that the majority of customers (particularly retail customers and SME companies) still opt for national providers is owing to factors such as confidence, greater awareness of national names, habit and the value that is nonetheless attached to the possibility to visit an office for personal advice. However, foreign providers are already increasingly a logical partner for larger business customers, and the bank's international network is an important factor.

To conclude, foreign providers operate at low costs thanks to limited overhead, a limited product range of straightforward products and by outsourcing the administrative processes. This advantage can be passed on in the form of low prices. It is conceivable that foreign organisations will be able to achieve further growth in the Dutch market on the basis of this proposition. There is, however, fierce competition in the Dutch mortgages market. The marketing costs are also high and the funding of new mortgage loans must be well-organised. Foreign players furthermore do not offer tailor-made products. Customers that value advice and tailor-made solutions are, for example, better off with domestic all finance banks.

Bouke de Vries
Rabo Bank Economic Research

Example II: Bi-national mortgage securities

By securitising a portfolio of Italian and German mortgages in the spring of 2007, Deutsche Bank has carried out a landmark transaction, because for the first time ever a RMBS deal bundled collateral from two different jurisdictions: The underlying portfolio consists of 666 German (average balance €132,772) and 1278 Italian (average balance €138,592) loans, which amounts to a total portfolio volume of €265.5million. The loans were originated by DB Mutui, a wholly owned subsidiary of Deutsche Bank SpA (which itself is Deutsche's Italian subsidiary), and by DB topimmo, a specialised mortgage platform within the retail banking unit of Deutsche Bank, respectively. The former is dedicated to acquiring near prime and non-standard mortgages in Italy, while the latter carries out the same task in Germany. Both units employ a network of intermediaries to originate the loans. The term "non-standard" mainly refers to the LTV ratios of the loans securitised, which are, on average, higher than usual, but other product features (e.g. purpose of taking out the mortgage, repayment structure) might also be "non-standard".

When pooling the mortgages, Deutsche Bank had to overcome some obstacles due to the binational character of the securitisation. Legal and regulatory idiosyncrasies regarding the underwriting standards, the assignment of the loans, the repayment type, the valuation of the properties and so on resulted in a split structure: The German and the Italian assets were separately sold and transferred to the "Eurohome Mortgage 2007-1 plc", the special purpose vehicle, and separate servicing agreements had to be concluded between the SPV and the German and the Italian originator, respectively. Accordingly, rating agencies had to conduct the asset analysis for both pools separately. Thus, while it proved possible to perform a binational RMBS transaction, realising significant economies of scale seems to be much more complicated.

These problems notwithstanding, the deal exemplifies the change European markets for residential mortgages are undergoing: (1) The rising importance of intermediaries shows that the break-up of the value chain gathers momentum. (2) The product range widens all across Europe, non-standard mortgage are becoming more and more common. (3) Last but not least, of course the first binational RMBS transaction means a big step forward towards the Europeanisation of mortgage funding.

Stefan Schaefer
Deutsche Bank Research

Example III: Equens and the Single Euro Payments Area (SEPA)

There are political arguments behind this as well as practical economics. Without its advent, citizens might gradually lose faith in the euro but the current reality is that cross-border payments only represented at most 5% of total payments in the euro area (and for example less than 2% of total payments made by French public authorities). Arguably only a few citizens currently feel in need of SEPA. They might well view it with suspicion out of a concern that banks might take advantage of it to raise fees. Indeed there is a risk that SEPA might be misused to raise fees because of the cost of SEPA-compliance.

However, this should be a commercial decision on the part of banks which accepted the system and were willing to bear its cost. In the background, there is the growing importance of non-bank payment mechanisms, such as telephone banking, General Electric money and prepaid cards. Such innovations should be welcome as they brought more competition into the market. Why does one need a bank to make a payment? The current arguments about interchange fees for credit cards may turn out to have a critical influence on the pricing of non-bank alternatives. The cost of entry may be high for relationship banking, but it is low for payment banking - thus allowing for possible greater competition.

The Panel was enlightened by a presentation from Dr. Salmony of Equens, a European payment services company whose total yearly volume of transactions processed currently equalled 1.5 times the European GDP. His analysis covered the European payments market: its size, main characteristics, variety of systems, growth rates of different payment instruments, and evolution of non-cash transactions in member countries. He highlighted the likely impacts of SEPA: the radical changes it would bring about, their consequences for banks, companies, and consumers, and the strategic choices this implied for banks. Having described the evolution of e-invoicing, e-payments and m-payments, he argued they were increasingly driving the dynamics of the market for payments. As non-bank service providers were more and more active, this would give rise to new challenges for banks and regulators.

Though the motives behind SEPA was originally to obtain greater equality in the pricing of transactions across Europe, its real advantages now lay in its forcing a reform of national payment systems according to European standards. Though politically inspired at the beginning, the subject had become highly technical but the effort now to involve 7000 banks behind SEPA necessarily gave it a political dimension.
It seems there are extra benefits provided by SEPA relative to what for instance VISA already offered. As an example, it would greatly facilitate the paying of salaries by European corporations. Moreover, competition in a European market for payments would lead to downward price alignments and provide a payment infrastructure that could be useful for the development of new services at the European level. Indeed final goal is real-time payments but no pan-European real-time payment system existed yet.

Interestingly, no new security issues arise beyond those that already existed in national payment systems. Under SEPA, anti money-laundering and anti-terrorism measures would continue to be handled by individual banks. Target II mostly existed for transferring funds between large banks, whereas the range of services offered by Equens was much broader. That raised the issue of discouraging cash versus non-cash transactions but this depended on local legislation. However, the cost of cash transactions had already been reduced by ATM equipment and cash use would only be reduced further by the provision of alternatives such as payment with mobile phones.

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Part II: Contributions to the Debate (*)

A Voice from the European Institutions "Sector inquiry identifies widespread competition barriers in retail banking"

European Commission - Retail Banking Inquiry
Irmfried Schwimann [5]

On 31 January 2007 the European Commission published the Final Report of its sector inquiry into European retail banking markets [6]. The inquiry has identified a number of deficiencies in the way these markets work that cause higher cost for consumers and small businesses and deter entry by new players. These deficiencies concern the markets for payment cards, (non-card) payment systems and certain core retail banking products. Particular indicators are large variations in merchant and interchange fees for payment cards, barriers to entry in the markets for payment systems and credit registers as well as obstacles to customer mobility and product tying.
On 31 January 2007 the Commission also adopted a Communication summarising the results of the inquiry and describing areas for further investigation and antitrust enforcement to open markets and stimulate competition. [7]
The decision to open inquiries into certain financial services sectors – namely retail banking on the one hand and business insurance [8] on the other - was taken in June 2005 [9]. Retail banking covers a wide range of activities and markets. Some of these markets and players have been repeatedly under antitrust scrutiny, for instance, payment cards and payment card networks. Others, such as the wide variety of the markets for core retail banking products seemed to be relatively untouched by competition investigations. Against this background, the retail banking inquiry was split into two main parts: first, the markets for payment cards, on which an Interim Report was already published on 12 April 2006 [10] and, secondly, the markets for current accounts and related services. Preliminary results of the latter part of the inquiry were published on 17 July 2006 in a separate Interim Report. [11]

With the publications of the preliminary findings of the sector inquiry the Commission invited market participants to submit comments. This wide and open consultation as well as the public hearing that took place on 17 July 2006 has

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(*) *These contributions were drafted in the Spring of 2007 to be presented at the Rome meeting of ELEC Monetary Panel (30 March 07) and, except for minor editing, are printed here as they were.*

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6 http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/sec_2007_106.pdf

7 http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/com_2007_033_en.pdf

8 Preliminary findings regarding the sector of business insurances were published on 24 January 2007 (http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_24012007.pdf)

9 Alongside the decision to open the energy sector inquiry where the final report was published on 10 January 2007 (http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/energy)

10 http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_1.pdf

11 http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_1.pdf

resulted in extensive and valuable feedback [12]. All received comments contributed to the elaboration of the final report that covers both parts of the retail banking inquiry.

The Retail Banking Sector Inquiry complements the Commission's strategy on financial services. It also contains important lessons for the development of the Single Euro Payments Area – a project of major economic importance.

Main conclusions

The findings clearly confirm that markets remain fragmented along national lines. Fragmentation means that the potential of a 450 million citizen market is not fully exploited, that consumers have limited choices and often pay more than they should for current accounts, loans or payments. Despite all efforts at European level to further integrate the EU financial services markets, access to several product and geographic markets still appears to be difficult. The inquiry has found a great variation of prices, profit margins and selling patterns between countries and, at the same time, a contrasting homogeneity within the individual Member States. This suggests the existence of regulatory or behavioural barriers. Indeed the inquiry has identified a variety of such barriers, be it of the one or the other kind or, most often, a combination of the two. It also indicates that widespread co-operation within markets or networks may lead to the alignment of prices and other parameters.

1. Findings on retail banking market structure and performance

The inquiry has identified important characteristics in the operation of the supply side in retail banking markets. Firstly, market infrastructures such as payment systems and credit registers are generally fragmented along national lines. Secondly, retail banking typically displays high levels of cooperation among industry players, who encounter each other in several product markets. Thirdly, barriers to entry remain in retail banking, arising from several sources. Such barriers may be natural barriers as well as those arising from regulation or anticompetitive behaviour.

On the demand side of retail banking, two factors may weaken the operation of a competitive market. Firstly, information asymmetry - where banking consumers lack or are unable to act on full information - reduces the intensity of price competition. Secondly, switching costs - notably the informational and transactional costs of changing some banking products - discourage consumers from leaving their current provider.

The inquiry’s analysis of market concentration suggests that European retail banking markets in general are 'mildly' concentrated, at least at national level. They also confirm the perception that Belgium and the Netherlands on the one hand and the Nordic countries on the other, have more concentrated retail markets than the European average. Some other Member States, most notably

[12] http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/retail.html

Germany, but also others such as Spain and Italy, show comparatively low concentration ratios.

Integration of European retail banking markets remains low. With the exception of the Benelux and Nordic countries, few players are among the leading five banks (measured by market share) in two or more countries. In general, very few foreign banks are among the top five in each Member State, though foreign banks hold strong positions in several New Member States.

Financial performance in retail banking varies considerably across the Member States. During the period 2002-2004 most Member States show average profitability ratios close to the EU average of 20 to 30%. Ireland, Spain and the Nordic countries reported sustained pre-tax profitability ratios of about 40%; well above the EU average. Several other Member States, including Germany, Austria, and Belgium reported low profitability throughout. The distribution of cost-income ratios naturally followed a similar pattern, with banks reporting lower cost-income ratios in Member States where profitability was higher.

The inquiry found wide national variations in banks' income for specific product lines. Comparisons across a range of retail products show that banks' income per customer is typically twice as high in the EU15 as in the new Member States. Overall, mortgages generate the highest share of banks' gross income and high degrees of cross-selling.

Based on comparative OECD data the Commission services conclude that the long-term trend of profitability is upwards in the EU banking sector as a whole. Moreover, from the clear overall trend of rising pre-tax profitability, it can also be inferred that retail banking profitability has risen over the long-term.

2. Findings and recommendations on current accounts and related services

Despite significant growth and diversification that has taken place in the banking industry over the last two decades, traditional retail banking has remained the industry's most important sub-sector, representing over 50% of total EU activity in terms of gross income. Structures of the markets for current accounts and related services are, however, still fragmented; suppliers rarely offer their services on a cross-border basis. They all remain divided along national lines. This is due to factors such as cultural differences and historically grown industry structures. However, the report has also identified regulatory and behavioural barriers that are of particular concern from the viewpoint of competition policy.

The inquiry found, for example, access barriers in key infrastructures, particularly in (non-card) payment systems and credit registers. These schemes and platforms are often run by the incumbent banks that have a very limited interest in facilitating third parties' market access. For newcomers, however, non-discriminatory access to these facilities is indispensable to compete.

In particular, banks and credit providers require access to good quality credit data in order to overcome information asymmetry when they set prices for new or potential borrowers. Thus credit registers are an important element of retail banking market infrastructure. To ensure strong competition among credit providers in retail banking markets it is vital that credit registers enable open and non-discriminatory access to credit data.

The inquiry has found that in several Member States, coverage of credit information markets is limited. Credit information markets remain also fragmented along national lines. Only a few credit bureaus conduct cross-border reporting, albeit for low volumes of data. While this may be largely explained by low demand for cross-border credit, regulatory barriers in some Member States further limit the development of cross-border data sharing.

Indeed, the survey evidenced a very low rate of customer mobility in Europe. While it is likely that a large proportion of banking customers do not switch because they are satisfied with their current bank, there are others who are not fully satisfied with their current provider or are seeking to change bank for other reasons. The inquiry's analysis suggests that between 5.4% and 6.6% of current account customers in the EU will change provider per year. However, industry surveys suggest that the proportion of unsatisfied customers is typically much higher. For this group, the level of switching costs will be an important consideration. The evidence gathered by the sector inquiry suggests that high levels of switching costs in the retail banking industry may weaken competition in two ways. Firstly, switching costs may increase banks' market power, enabling them to set higher prices for established customers who appear locked in to a banking relationship. Secondly, high switching costs and low customer mobility may limit prospects for market entry in full service retail banking, notably through greenfield operations.

The sector inquiry has identified four sources of switching costs that are likely to reduce the ability of consumers to switch bank: administrative burden; information asymmetry and low price transparency; closing charges; and bundling and tying.
The practice of product tying, for instance, ties the opening of a current account to a mortgage or a SME loan, and is widespread in the EU. Indeed, the survey suggests that in most Member States the majority of banks tie a current account to mortgages, personal loans and SME loans. Moreover, where the largest bank in a Member State ties its products, the inquiry's data suggests that the majority of its competitors, including foreign entrants, choose to follow suit. From a competition view point, product tying in retail banking may weaken competition in three ways. Firstly, tying raises switching costs and therefore is likely to reduce customer mobility. Secondly, by binding customers into buying several products from the same bank, tying is likely to discourage the entry of new players and growth of smaller players. Thirdly, by introducing additional – perhaps unnecessary – products into the transaction, tying reduces price transparency and comparability among providers.

The Commission is concerned that possible anticompetitive effects will be strongest in markets where one or more large banks tie products. Product tying by one or more undertakings in a particular Member State may constitute an exclusionary abuse of dominance under Article 82 EC, where such undertakings have a dominant position. Clearly the assessment of a particular tying practice would depend on the specifics of the case. Depending on the circumstances of the case, tying may thus reduce customer choice, render price competition intransparent or create obstacles to customer mobility.

Finally, the inquiry also analysed the area of co-operation between banks. Retail banks co-operate in a variety of areas such as the setting of standards and the operation of infrastructures, such as the above mentioned payment systems and credit registers or the operation of payment systems. Certain types of banks, namely savings and cooperative banks, traditionally have even closer co-operative ties. These specific types of banks cover a significant proportion of the retail banking activities in Europe and play an important role in several Member States such as Germany, France, Austria, Italy or and Spain. Insofar as savings and co-operative banks remain legally independent, they tend to co-operate in a variety of fields. They often run their own payment infrastructures, have a joint risk management and protection scheme for deposits or may even have a common business and marketing strategy including a common brand. Some savings banks and/or co-operative banks apply territorial restrictions – the 'regional principle – reserving a defined geographic area for the activities of an individual retail bank.
Certain forms and areas of cooperation are indispensable for bringing about efficiencies and consumer benefits. It usually does so where the banks involved are SMEs and/or jointly do not possess a significant market share. Cooperation is also necessary to agree on common standards and infrastructures for the operation of networks such as payment systems. On the other hand, benefits resulting from certain areas and forms of cooperation cannot justify all potential competition restrictions. In particular, severe competition restrictions such as market sharing or price fixing are unlikely to be outweighed by economic benefits. Even if individual cooperation agreements bring about economic benefits, the effects on market competition have to be thoroughly analysed on a case-by-case basis.

Thus, co-operation can result in economic and consumer benefits. There are, however, also competition risks. The variety of ownership and company structures, the difference of the scope and scale of the co-operation as well as certain national regulatory provisions render a uniform assessment impossible. The Commission is planning to gather further information to assess whether cooperation between banks that have significant market positions appreciably restrict competition either between themselves or in relation to other actual or potential competitors.

3. Findings and recommendations on payment cards and payment systems

The European payment card industry provides payment means with an overall value of €1 350 billion per year. These payments annually generate an estimated €25 billion in fees for banks. The inquiry has identified several competition concerns in this important sub-sector.
The business of acquiring credit cards and debit cards in the international networks appears highly concentrated. Issuing, on the other hand, is much less concentrated. Indeed, joint ventures in acquiring may be a structural issue leading to various entry problems for foreign acquirers. For example, local issuing banks may agree on preferential ('on us') interchange fees with the

incumbent acquirer (an inter-bank association in which they have financial interests) but charge higher, multilaterally agreed interchange fees to any foreign acquirers attempting to compete with the incumbent.

Credit cards issuing is highly profitable. Interchange fees appear to magnify the profits of card issuers. It appears that 62% of all banks surveyed would still make profits with credit card issuing even if they did not receive any interchange fee revenues at all. In 23 EU Member States, at least one bank participating in the survey was able to make a profit from issuing credit cards without interchange fees.

The Inquiry has detected widespread access barriers in payment card markets. Access to clearing facilities, as a pre-condition for banks to enter new markets, may be an obstacle where local banks have no commercial interest in sponsoring a potential competitor. In order to promote cross-border competition, card payment systems should be invited to set objective and verifiable rules to grant new entrants a right of access to sponsorship by one of the incumbent banks or – if technically feasible – set up a multilateral clearing platform. Furthermore, in several Member States, payment cards networks set a range of discriminatory rules: they may demand very high joining fees for new entrants, set unfair membership conditions or restrict the geographic reach of their members' cards.
The prohibition on cooperative agreements with competing networks or non-banks, i.e. co-branding, may hinder national debit card payment systems from entering into competition with MasterCard and Visa or impede retailers or other operators from entering into competition with the incumbent card issuer.

Furthermore, there are large variations in payment card fees across the EU. There are substantial discrepancies in merchant, cardholder and inter-bank fees across the Member States. The results of the inquiry suggest that retailers in some countries pay fees that are up to four times higher than in other countries for accepting the same major credit card. Ultimately, these fees are passed on to consumers in higher retail prices. These findings challenge the hypothesis advanced by some industry participants and some of the economic literature that an increase in interchange fees is fully offset by reductions in cardholder fees. These results are consistent with the findings of the inquiry's analysis on profitability and may cast doubt on the relevance of the arguments put forward by industry participants and the economic literature concerning the role played by the interchange fee in the payment cards industry. Indeed, if issuers do not pass or return the additional interchange fee revenues back to cardholders this implies that interchange fees are a way to transfer profits to the side of the scheme where they are least likely to be competed away.

The inquiry gathered significant evidence on multilateral interchange fees ("MIFs"), i.e. the fees that are paid by the acquiring bank to the issuing bank for each payment card transaction at the point of sale of a merchant. The Commission’s sector inquiry provides indications that interchange fees are not intrinsic to the operation of card payment systems. Several national systems operate without an interchange fee mechanism, resulting in generally lower merchant fees. This evidence therefore rebuts to a large extent the industry's arguments for the economic benefits of high interchange fees. It shows that several card networks can and do operate efficiently with low or even no interchange fees. The report does not condemn the existence of MIFs as such:

any concrete decision concerning interchange fees will have to be taken on a case-by-case basis. The sector inquiry has, however, highlighted the necessity to critically review academic justifications for this pricing mechanism. The present MIF in many of the schemes examined indeed seems problematic.

Some rules and practices harm competition at retailer level. Small merchants on average pay 70% more for payment card acceptance than large merchants. In theory, this could be explained by the lower average costs of acquiring merchants with higher transaction volumes. However, a comparison of price differentials between large and small merchants in the international schemes (MC/Visa: 70%, Amex 50%, JCB 40%, Diners 35%) with those in domestic systems (7% on average) suggests that scale may not be the decisive factor. It could be that smaller merchants pay a premium for accepting MasterCard and Visa cards. If that were true, the differentiation of prices according to the size of the merchant could be a measure for the exercise of market power by banks within a given system.

Blending of merchant fees by acquirers can have direct implications for inter-network competition, as it removes an important parameter of price competition; differential MSC levels. The potential outcome of blending may be higher rates than the merchant needs to pay for acquiring services, since there is no pressure to drive down these charges through inter-network competition.

The ban on surcharging appears to restrict inter-network competition, notably by concealing the true cost of payment cards for consumers via cross-subsidisation, and may result in the use of non-optimal payment instruments. It has been suggested that the surcharging prohibition may constitute a barrier to entry for alternative non-cash payment instruments, such as mobile phones or e-money. Retailers surveyed in the inquiry were strongly in favour of the possibility to surcharge, since it would strengthen the incentive for consumers to use cheaper payment instruments.

Finally, the existence of joint ventures of acquirers in several Member States as described above has the potential to foreclose the market; it also means that retailers cannot benefit from competition as they have only one 'offer' on the market.

The publication of the interim report as well as the subsequent consultation with industry and other stakeholders has already yielded positive results in a number of Member States where market players have taken initial steps to address the Commission's concerns. [13]

Finally, the sector inquiry has highlighted several market barriers that need to be addressed by all involved in the Single Euro Payments Area (SEPA), a project driven by the European banking industry and strongly supported by the European Commission and the ECB. In view of the inquiry's results regarding current network structures competition authorities have already engaged to closely monitor the process.

[13] Report on the retail banking sector inquiry, point B 2.2., page 93 (electronic version): http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/sec_2007_106.pdf.

4. Conclusions

The final report of the Retail Banking Sector Inquiry is not the end of the story but the start. The Commission services have already begun the follow-up work to the inquiry and will press ahead to tackle the most serious barriers to competition.

More concretely, the Commission is examining the scope for possible antitrust proceedings, in discussion with national competition authorities. The area of payment cards is one of the priorities for follow up. Amongst others, the Commission intends to facilitate the access to some payment card networks and payment systems in question and tackle high interchange fees and merchant fees in line with our ongoing case work (e.g. MasterCard). The Commission will also address the concerns regarding product tying practices and credit registers. Further fact finding and analysis is also under way regarding co-operation between independent savings and between co-operative banks that have a strong – combined - market position.

The Retail Banking Sector Inquiry's findings also underline the importance of strong competition in SEPA. The Commission will examine the industry's plans carefully to make sure they will increase competition and benefit consumers. The Commission will consider the appropriate policy lessons for the future development of the Single Euro Payments Area (SEPA) – for both payment cards and wholesale payment systems.

Finally, the Commission will consider the implications of the findings for the ongoing work on retail financial services integration in Europe. The Commission's Green-Paper on Retail Financial Services in the Single Market, as well as other Commission initiatives in the area of mortgages, bank accounts and customer mobility are building on the findings of the Sector Inquiry.

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A Voice from the Economic Literature
"Towards a single market in retail banking"

Giorgio Gobbi[14]

Introduction

Over the past two decades the financial industry has experienced dramatic changes overall the world. Under the pressure of technical change and regulatory reforms the traditional borders within the national financial sectors have lost most of their relevance. At one time, commercial banking, investment banking, insurance, and asset management were non-overlapping activities run by distinct classes of financial firms regulated by specific provisions and regulators. In contrast, it is now quite common that all of these activities, and many others, are managed within the same financial firms, usually a universal bank holding company, directly or through specialised subsidiaries.

Even more striking is the process of geographic expansion, both within nations and across national borders which have enormously extended the average distance between the headquarters of a financial organisation and its branch or local firm that deals with costumers.

In the U.S., a series of deregulations in the 1980s and early 1990s removed restrictions on intrastate and interstate banking. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 allows interstate branching in almost all states as of June 1997. In emerging market economies (essentially countries in Latina America, Central and Eastern Europe, and East Asia) financial liberalisation and market-based reforms, such as the liberalisation of the capital account and financial deregulation, paved the way for foreign acquisitions and the integration of these countries' financial firms into an expanding global market for corporate control.

In the European Union, with the notable exception of the new member states, cross-borders consolidation has taken up spottily and with difficulty, notwithstanding the single license provision that permits banking organizations to expand continent-wide dates back to the Second Banking Co-ordination Directive of 1989. A more rapid pace of consolidation at the continental level is often advocated by the European Commission as a mean to foster the integration of financial markets, the current assessment being that in some areas the degree of financial integration in Europe is moving fast, particularly in wholesale markets, but lagging behind in retail markets.

The introduction of the single currency, the euro, has been a land marking event for the integration of several financial markets. If we take as a crude measure of financial integration national differences in prices, all the available indicators point to a high degree of integration in the euro area money market. Cross-country standard deviation for interest rates like EONIA, EURIBOR and EUREPO

[14] Bank of Italy, Economic Research Department. The views expressed in this paper do not necessarily represent those of the Bank of Italy or of its staff.

are negligible. The empirical evidence also shows that after the removal of exchange rate risk government bond yields have fallen in line in all euro area countries and their movements are increasingly driven by common factors, once risk and liquidity premia are discounted for. Also the euro area corporate bond market, which in recent years has grown at a steady pace, appears well integrated. Finally, recent research documents that, after 1999, the relative importance of industry factors exhibited a clear upward trend in explaining cross-sectional volatility and correlation of stock returns in the euro area stock markets. These results support the view of an enhanced integration of equity markets among euro area countries.

The outstanding advancements in these markets on the route of a European single market for financial services compares with the enduring national fragmentation of retail markets. Even within the euro area retail bank lending and deposit interest rates are characterized by a high cross sectional dispersion across countries. National differences in the costs of a wide array of payment, insurance and personal finance services appear to be large and persistent over time. This state of affairs represents an ongoing concern for the European Commission which deems the fragmentation of retail financial markets along national borders a source of inefficiency and of unnecessary costs for millions of consumers [15].

The issue of market integration touches several chords, some of them having a distinct political sound. To approach it from a neutral perspective, three questions need to be addressed. The first one is to investigate whether there are economic reasons that might explain why the process of financial integration is so slow in the retail businesses. The second question concerns what forces are more likely to lead to a deeper integration. Finally the channels that deliver to the European consumers the benefits from market integration need to be carefully investigated.

A plausible answer to the first question is that the supply of retail financial services is still largely a "local business". Notwithstanding the enormous advances in information and communication technologies, the vast majority of transactions require some sort of "face to face" interaction. Internet and phone banking complement but do not replace the traditional distribution channels of financial services to the households. Also, the vast majority of the 20 million European businesses are "small businesses", which means that they rely on relationship lending rather than on transaction lending. Relationship lending implies the exchange of a substantial amount of soft information, which in turn requires some physical proximity. To the opposite of what happens in wholesale markets, the mobility of the demand in retail markets is at best limited and this shifts the burden of integration onto the supply side.

One possible answer to the second question is that retail market integration is bounded to occur through the cross-border activities of large international financial firms. It is not surprising, therefore, that the advocates of European

[15] "The sector inquiry has identified a number of symptoms suggesting that competition may not function properly in certain areas of retail banking. The inquiry has confirmed that markets remain fragmented along national lines, including in retail banking infrastructures such as payment systems and credit registers" Commission of the European Communities, Report on retail banking, 31 January 2007.

integration of retail financial markets also strongly support the dismantling of restrictions to cross-border mergers and acquisitions [16].

The circumstance that the creation of a genuine integration of these markets in Europe is likely to be a supply driven story has several implications. In a demand driven integration process, consumers can choose the suppliers which offer the more convenient products across countries. On the contrary, when integration is supply driven, suppliers choose in which countries to extend their activities and it is not obvious that their choice is the one that maximizes consumers' welfare.

In the extant part of this paper I explore some of the issues for retail banking entailed by the expansion across national borders of large financial institutions in Europe. For the sake of brevity I abstain from discussing the forces behind this process, but I take it for granted. I firstly identify a set of conditions which ensure that consumers benefit from supply driven financial integration. Subsequently, I check these conditions with the results of a large body of empirical academic research. Finally, I draw some very preliminary policy implications from this simple exercise.

1. The virtuous path of supply driven financial integration

One time-honoured view in economics maintains that the number of firms that can effectively compete in any given industry is determined by the size of the market. If there fixed set-up costs and the market is small, the number of suppliers that can profitable operate is also small, entry of new firms is not feasible and incumbents earn monopolistic or oligopolistic rents. Integrating several distinct markets is therefore a route to achieve higher competition and to enhance consumers' welfare. A related albeit distinct argument is that even if market power is checked by antitrust regulation, fragmented local markets may prevent the full exploitation of scale and scope economies. The industry is populated by too many small-sized and inefficient firms.

These ideas are drawn from the basic economics that underlies most of the arguments advocating a faster pace of integration of European retail banking markets. The widely-shared diagnosis is that the current state of competition and efficiency of these markets is wanting and that there are substantial efficiency gains that can be achieved by removing many of the barriers than run along national borders.

The issue is then whether financial integration driven by supply side forces leads unmistakably to higher competition, higher efficiency and more financial innovation, and a widespread improvement in consumers' welfare. To make this proposition empirically tractable it is necessary to break it into its elementary casual links, which are the followings: 1) there are significant scale and scope economies in the production and distribution of financial services; 2) efficiency gains enable large financial institutions to undercut prices or to improve service

[16] "Consolidation in European financial markets is picking-up but is still lagging behind other sectors. This is unfortunate because, whilst consolidation is not an end in itself, it remains a means to achieving greater efficiency. Consolidation allows institutions to reach their full potential and to compete internationally". Statement issued by Charlie McCreevy, European Commissioner for Internal Market and Services on 12 September 2006.

quality and small and inefficient banks are gradually driven off the market; 3) financial innovation and free entry into local markets prevent the persistence of the rents originated by the more efficient production plans made available by the increased bank size and the efficiency surplus is transferred to consumers.

Does it work like that? A huge bulk of academic research shows that all of these three links should not be taken for granted. Given the impossibility to provide an accurate review of this vast literature in a short space, I just mention a few of its main findings.

2. Scale and scope economies

The existence and the economic relevance of scale and scope economies in banking and other financial activities is a long standing unresolved dispute. On the one hand market participants have always emphasized the magnitude of the efficiency gains associated with large size and horizontal business diversification. Ex-ante business plans supporting merging proposals in the financial industry usually quantify large cost savings owing to scale and scope economies, although ex-post assessments are usually more modest. Academic research suggests that only small banks could benefit from scale economies from an increase in size.

The extensive review of evidence included in the G10 report on financial industry consolidation highlights that in the 1990s mergers and acquisitions actually brought some efficiency improvement, although limited to the revenue side. This seems to be case when the financial firms acquiring control in the post deal entity is the ex-ante more efficient one. A class of deals that potentially falls in this category is the wave of foreign direct investment in the banking sectors of emerging market economies. Some studies find these developments have led to a general increase in the overall efficiency of the host countries' financial systems.

Finally, efficiency gains related to size increase are likely to depend on the state of technology. The view expressed by a leading consultant firms in the industry is that "the primary rationale behind the wave of merger in the 1990 - to achieve substantial economies of scale by exploiting technology and deregulation - is naturally weakening. For most large banks, further expansion won't necessarily yield dramatic scale-based savings in systems and product-development costs" [17]. Summing up, changes in technology and market structure might affect scale and scope economies in the future, but at present the relationship between efficiency and firm size in the financial industry is far from robust and should be evaluated on a case by case basis.

3. Large versus small banks' behaviour

Several studies show that large financial institutions have a different business focus than the smaller ones. If this is the case, the increase in size due to industry consolidation is likely to produce both winners and losers among the consumers. I illustrate this with two examples drawn from the experience of two

[17] The McKinsey Quarterly, 2004, n. 1

countries, Italy and U.S., in which regional fragmented banking retail markets were integrated into a national market by a merger wave during the 1990s.
In Italy, at the beginning of the decade banking markets were extremely fragmented owing to geographic segmentation induced by regulation. The creation of new banks and the opening of new branches by existing banks was severely restricted. Restrictions on the line of business were also in place. In 1992 and 1993, the regulatory framework was radically changed: the Second Banking Coordination Directive was implemented and a new Banking Law set new regulatory standards abandoning "structural controls". In the subsequent years, most public banks were privatized and a wave of M&As swept the industry. A large number of small banks disappeared and relatively large banking groups emerged. National integration of local banking markets emerged naturally as a supply driven process.

Owing to branch deregulation the number of different banks operating in each local market (province) increased notwithstanding the sharp reduction in the number of total banks. Large banks shifted their business focus from lending to other services (e.g. asset management services) and from relationship lending to transaction lending. The number of small banks operating in local markets declined by one fourth, but their overall market share in business lending increased by one tenth. Changes in business focus by large banks induced business firms, mainly the small-sized ones, to close their existing relations and to switch to local banks. Relationship lending proved highly resilient to market integration. The benefits of mergers and acquisitions have been shared only by the consumers of some financial services. Others had to bear the switching cost of establishing new relations.

In the U.S., increasingly, large banking organizations have extended their activities over a larger number of the areas typically defined as local banking markets. Some studies have found that large banks, or banks that are part of large banking organizations, set lower deposit interest rates than the small local bank which compete in the same local markets. On the contrary other studies find that small business loan rates tend to be lower in local markets where there is a greater presence of large multi-market banking organizations. A larger role of large banks seems to promote competition in retail loan markets but harm competition in retail deposit markets. Also in this case banking consolidation seems to produce both winners and losers among consumers.

The lesson that can be drawn from both these examples is that the interaction between large and small banks is usually rather complex. Although they offer apparently very similar services, for certain classes of consumers the degree of substitution among different suppliers may be very limited. In many circumstances difference in size is not just difference in efficiency.

4. Competition and consumers' welfare

In the last decade, the consolidation within the banking industry, domestic and cross-borders, has been associated to an unprecedented surge in bank profitability. Several factors have been at work and, given our present knowledge, it is unwarranted to establish a direct link between these two facts, although, both academic research and insights from within the industry suggest that size is positively correlated with earning capacity, which is rather close to market power.

Conclusions

The virtuous surplus transfer chain is per se rather weak to provide convincing arguments for advocating the integration of retail banking markets. Supply driven integration does not automatically increase consumer welfare: efficiency gains are elusive and the risk of reinforcing the market power of large institutions is not negligible. Past experiences of market integration of regional markets show that most likely among the consumers there are both winners and losers. From a policy making perspective it is important to figure out the several trade-offs between industry consolidation (domestic as well cross-border) and competition.

Standard arguments in favour of speeding integration in the retail financial markets through supply side consolidation should be investigated in depth. Competition in the market for corporate control in the financial world is a powerful instrument to enhance efficiency in the way the job of allocating resources and providing financial services is done. However, albeit the abatement of the national barriers that prevent this market from working properly is a necessary condition for increasing consumer welfare, it is far from being a sufficient one. Competition and the abatement of barriers to entry need to be enforced - especially downstream in the product markets, which for most of retail financial services still have a very limited geographic reach. Attention should be paid to the actual extension of relevant markets for retail banking. In academic studies one finds that local market concentration indexes have a high explanatory power of bank profit margins' dispersion.

If consumers do not perceive the benefits of the single market they may start to have doubts over the overall integration process. Policy makers may then be tempted by "wrong" policies, such as administrative interventions on price mechanisms or sponsoring of national champions.

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A Voice from the Industry
"Cross-border retail business: specific problems"

What the industry needs and consumers want
Marianne Kager [18]

Cross-border retail business

With the Financial Services Action Plan the EU has taken a big step forward toward the creation of a single market for the financial services sector. We must nevertheless not overlook the fact that there are still significant gaps in the integration process in precisely the area where citizens can feel the benefits of a single market, i.e. in the retail market.

Retail market segment

The retail market is one of the central, if not the central segment of financial market services. This can be illustrated by some figures:
Retail customer business accounts for 50 % of all financings (loans, leasing) and represents a significant volume of EUR 4,200 bn within the eurozone.
74 % of all deposits, 76 % of retail investment funds (UCITS) and 91 % of life insurance business are generated by business with retail customers.
According to the EU Commission's June 2006 Interim Report, the number of cashless retail payments settled in the EU each year totals EUR 65 bn. As much as about 30 % of the gross income of EU banks is generated by retail banking - about EUR 250-275 bn.

Driving forces of integration

From an economic perspective, there are a number of factors which drive the integration of retail markets. These can be broken down into external and sector-specific factors.

The external integration factors of the last decade include the global liberalisation of financial markets and EMU which embraced 12, and now 15 member states, as well as regulatory initiatives and harmonisation efforts such as the Financial Services Action Plan. These external factors have made a substantial contribution to the phase of consolidation in the financial services sector. As many as about 150 cross-border mergers took place in the EU in the period 2001-2005. The liberalisation and harmonisation process has enabled companies to achieve economies of scale and scope.

In addition, there are also sector-specific integration forces:

- New distribution channels for retail products - in the Scandinavian countries, internet banking as a distribution channel already claims a share of 40 – 50 %.

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- Changes in the production chain - retail products have become much more complex in recent years, so that they are increasingly conceived and produced at group headquarters.
- New products, especially capital market products for retail customers, are based on a global refinancing strategy.
- Last but not least, the enforcement of regulatory provisions is resulting in greater concentration in the areas of risk processing and decision making.

According to the most recent World Retail Report [19], 60 % of international banks are operating their IT systems on a cross-border basis, 41 % have taken steps towards cross-country back-office consolidation (of which 88 % in payment systems, 63 % for consumer credits and 44 % for mortgages).

It is expected that retail banks will increasingly globalise their operating model in the next 5 years. IT will undoubtedly remain the priority in this respect, and within the next five years 90% of internationally active banks will have a common cross-border IT structure with modular application. Furthermore, it is expected that 50 % of these banks will practise global marketing strategies.

Under these circumstances, it is understandable that banks need an integrated retail market which allows them to realise potential economies of scale and scope. In a competitive environment, this will create price effects that should benefit the consumer.

Another example demonstrates that a more integrated retail market is not only in the interest of banks but also of the clients/consumers. The average annual price which a local user pays for day-to-day banking needs is €72 in the eurozone and €84 in non-eurozone countries. Further, the price discrepancies in day-to-day banking services between the countries of a region are significantly less in the eurozone (36.8 %) compared with the non-EMU European countries (48.8 %) and prices converged more rapidly in the Eurozone than in other regions. In the EU, we are nonetheless in a situation where although we have harmonised wholesale markets, the retail market remains highly fragmented.

Obstacles facing integration and harmonisation in the retail market

Why does it seem that a single market for retail products is so hard to achieve? What is it that makes the harmonisation of b-to-c financial services so complicated? One explanation is that in the retail sector we are faced with product specifications, which are related to consumer protection provisions and other provisions of national civil law.

These consumer protection rules have developed over many years in the individual member states, and they are not only based on special consumer protection laws but also on numerous provisions in the Civil Code, the law of obligations, procedural law, etc. of the individual member state. In addition, they also limit the freedom of contract in that "non-disposable provisions" for contracts with consumers need to be applied, i.e. for these contracts there are

[19] 2007 World Retail Report, EFMA (European Financial Management and Marketing Association).

mandatory, specific formal requirements or certain other requirements which cannot be changed by the contracting parties.
Further, we have to consider that any changes to the consumer protection provisions, which have an impact on the daily lives of citizens, are a politically sensitive matter. Changes in this "area" are not only offensive to national feelings but also create uncertainty among consumers. The consequences of such changes are unsettling and in many cases provide an easy pretext for the political propaganda of "control by Brussels".

Even if we all know that, from an economic viewpoint, the single market can supply better, efficient financial services and that EU-wide competition will have positive effects for consumers on pricing and also the variety of products, we have to respect the sensitiveness of consumers and politicians in this field.

The problem is that one can hardly convince consumers (and politicians) of the benefits of an integrated European financial services retail market only with research studies; they want to be convinced by their own daily experience. But this cannot be delivered by the banking industry as long as the legal preconditions for a single retail market are not in place. A classic chicken-and-egg problem!

How can the problem be solved?

Let’s start by asking what it is the industry wants or needs, and what are the interests of the consumers in respect to a cross-border retail market?

What does the industry need / want?

- Easy and efficient access to markets
- Ability to create synergies and economies of scale
- An even, level playing field
- Reasonable standards for consumer protection

What are /could be the interests of the consumer?

- Efficient banking services
- Easy access to banking services
- Competitive environment which guarantees a wide choice of products at reasonable prices
- A sufficient level of consumer protection
- Adequate, reliable and comparable (but not excessive, because it is costly and confusing) information: clear, precise, and understandable. It is quality and not quantity that matters
- Transparency of prices, obligations and rights
- Stable financial system

Are these interests really so different that an integrated, harmonised retail market cannot be achieved? Where is the common sense, where are the differences?

Easy and efficient access to markets bolsters competition. With effective competition, higher productivity will have a positive impact on prices and the range of products offered (to the benefit of the consumer); a larger number of bank offices per inhabitant provides easier access to banking services.
As the livelihood of the financial services industry ultimately depends on the confidence of its customers, it must, in its own interest, be interested in sensible consumer protection regulations so as to keep "black sheep" away or separate them from the market. Having said this, the question is how and with which instruments a more integrated cross-border European retail market can be achieved.

Which instrument can provide, on an EU-wide basis, a sufficient level of consumer protection including appropriate information and transparency of prices and obligations on a harmonised basis? But it must also be accepted by the industry as "reasonable standards" and lead to greater integration of the retail market and at the same time improve the efficiency of the financial services industry.
The policy instruments available are mainly:

- Full harmonisation
- Targeted full harmonisation
- Mutual recognition or
- Industry standards.

In a realistic approach, we must assume that a single instrument will not be suitable for all products and processes, but that the appropriateness of an instrument will depend on the respective product or process.

For example, it is understandable that member states' politicians and consumer organisations with a high consumer protection level fear that their national standards of consumer protection are changed by full harmonisation and/or, in the case of mutual recognition, will be undermined by suppliers from abroad.

But the industry also has serious concerns that in the case of mutual recognition and different levels of consumer protection in the member states there will be shortcomings in respect to a level playing field, or in the case of maximum harmonisation the highest level of consumer protection will be introduced.

Whether a reasonable/sufficient level of consumer protection, which is accompanied by adequate and reliable information (as defined above), is negotiable at the EU level, this might first and foremost be a question of political will. Nevertheless, we have to consider that many of the consumer protection rules are directly linked with provisions in the national Civil Code, law of obligations, procedural law, etc.

As a consequence, even harmonised consumer protection rules may in combination with other national provisions have different effects. For example: the transfer of ownership is differently defined in the member states. This transfer of ownership is an important matter, the financing/paying off of real estate transactions and insofar for a harmonised mortgage market. Nevertheless, we have to consider that for a European single market not only non-harmonised consumer protection rules are a serious hurdle, but that these rules are very often linked with (non-harmonised) provisions in the Civil Code, law of obligations, procedural law etc.

In many cases, neither mutual recognition nor maximum harmonisation will contribute to an appropriate solution, due to the fact that no political solution can be agreed or the instrument chosen will not have the intended effect. For example, mutual recognition will not achieve the expected synergies and economies of scale in the production chain of international banks if the chosen distribution channel takes the form of local branches or subsidiaries which are subject to the host country's jurisdiction.

In general, which instrument will be the most effective will depend on the product or process to be harmonised.

What is to be harmonised, and how?

Using a realistic approach, let us therefore ask which variables could be harmonised with which instruments.

1. Full harmonisation

There are nevertheless some requirements which apply to all or most retail products and which could be fully harmonised through regulations which apply to all retail transactions/products. Examples for such horizontal full harmonisation could be:

- Definitions (such as "consumer", "entrepreneur", "collateral", "advice")
- Requirements pertaining to information
- Reflection period and right of withdrawal
- Costs related to a product (effective interest rate and other product-related costs)
- Advertising rules, rights and obligations of consumers.

2. Targeted full harmonisation

Targeted full harmonisation would mean that there is an additional need for the harmonisation of product specific issues which are not captured by the horizontal approach as outlined under point 1 above. All essential elements should be fully harmonized. For those issues which are not essential and which do not put a level playing field into question, mutual recognition should apply.

3. Mutual recognition

In the retail market, mutual recognition might be less an option for product harmonisation than for processes or formal requirements. For example, what are the minimum components which a loan agreement with a consumer must contain for mutual recognition in cross-border business?

4. Industry standards

Industry standards are a flexible and efficient instrument in b-to-b business (see the ISDA Agreement as an example). It is more than doubtful if such industry standards could be an effective instrument to create a single European retail market. Insofar as industry standards cannot rule out national rules, the application of such standards will be limited. Nevertheless, they could facilitate the comparison of products and improve competition.

5. Examples for this step by step approach

Consumer Credit Directive

One of the most prominent examples of the recent past might be the Consumer Credit Directive, even if the proposed directive is not always consistent with the principles described above. In this context the following provisions should be envisaged for targeted full EU harmonisation:

- Access to data
- Information Requirements
- Distinction between information and advice
- Right of withdrawal
- Calculation of the Annual Percentage Rate of Charge (APRC)
- Rules governing long-term loan agreements or loan agreements without a specified term
- Loan agreements with a specified term
- Early repayment

Payment systems

The Payment area is a good example of how targeted full harmonization and industry standards can be combined. There is currently a myriad of different legal provisions for payments transactions, which makes it more difficult to implement SEPA (Single European Payments Area). The PSD (Payments Services Directive) harmonised the legal components which are instrumental for introducing uniform technical standards in European payment transactions. This will make it possible for providers of payment services to take advantage of economies of scale for cross-border payments.

The same problem is also encountered in some other retail banking services. Products which are successful on a national market cannot be sold as easily in other EU markets due to the different national regulations. Through a sensible targeted full harmonisation – which was the case with the PSD - competition could be bolstered, resulting in economies of scale.

Which elements of the PSD are subject to full harmonisation?

- Authorisation requirements
- Authorised activities
- Information requirements
- Rights and obligations of the providers and the users
- Authorisation of procedures

- Execution of payments and execution time
- Liability provisions

In some cases, full harmonisation is disrupted by national options if there is a direct collision with the mandatory sections of national civil law. This would involve an examination of a country's legislation. For example, whether, and to what extent, the user of payment services has acted in a negligent manner as member states can waive the payer's liability in whole or in part, except in cases where it has acted with fraudulent intent. Compensation for payments that have not been authorised is limited to the amount that has not been authorised. Any additional compensation can be granted pursuant to the national law which is applicable to the contract between the customer and the relevant provider of payment services.

Other Examples for further product harmonisation in the retail sector

Current accounts (probably the easiest product to harmonise):

- Harmonisation of
- Account opening procedures
- Information requirements
- Rights and obligations of the account-holder
- Marketing rules
- Ex ante information on closing fees.

UCITS:

- Simplified key information to investors about
  - Objectives of the fund
  - Costs and charges
  - Risk profile
  - Reward profile
- Criteria for the licensing of UCITS – distribution in another member state can be carried out by a simple notification from the home authority to the host authority
- Criteria for the pooling of funds
- Criteria for fund mergers – also on a cross-border basis

Financial intermediaries:

These are becoming an increasingly important distribution channel, especially in the new member states (up to 20% of retail business is acquired via this distribution channel). So far, there is no harmonisation for credit intermediaries, or a harmonised regime that would grant a European passport to financial intermediaries based on:

- Capital requirements / supervision
- Liabilities of financial intermediaries
- Rights and obligations
- Qualification requirements.

Mortgage Credit:

The targeted full harmonisation of the mortgage credit is is a delicate question, and there is no uniform industry standpoint if and to what extent the mortgage credit as a product should be harmonised at a European level. But nevertheless, some subjects could be targeted for full harmonisation, including:

- The Annual Percentage Rate of Charge (APRC)
- Information Requirements (which needs to be separated from advice)
- Right of withdrawal
- Assessment of the clients credit worthiness according to supervisory law
- Euro-hypothek (euro mortgage) standardisation of securitisation rules to promote cross-border sales and the principles concerning every repayment of mortgage loans.

Conclusion

The industry wants a better integrated market for retail financial services. It will benefit not only the financial services industry, but also consumers. It is in the interest of the industry as well as of the consumer to have realistic, uniform standards for consumer protection. But what counts is the quality and reliability of information, and not the quantity. Furthermore, in a contractual relationship, it is not possible for one partner to have only obligations and the other only benefits. A fair distribution of benefits/protection and obligations should be a common principle in business.

There are essential elements that all retail products have in common and those should be harmonised on the basis of targeted full harmonisation. This does not mean that each product has to be (fully) harmonised (for example, the mortgage credit). A combination of industry codes (to facilitate the comparison of a product) and harmonisation by law can also deliver appropriate results.

Using the concept of targeted full harmonisation we have to find out what level of protection a European consumer needs. An accumulation of 27 different national protection regimes will not make the EU more competitive.

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Appendix I: Deposit Guarantee Schemes

By Graham Bishop

The Northern Rock crisis has stimulated EU policymakers to grasp – finally – the thorny problem of burden-sharing. Quaintly described as "inconveniences", deposit guarantee schemes (DGS) will now be reviewed in the context of accepting the need for sharing the cost – which could easily run to percentage points of GDP for a large bank. The Commission's February paper analyses the variation and there are major commercial implications for banks which might have to switch from an *ex-post* to *ex-ante* scheme as they will have to contribute actual cash to a fund. German banks might be particularly affected as the formal *ex-ante* state scheme is not generous but the *ex-post* co-operative sharing scheme covers a "very high" high level of deposits. Switching that to *ex-ante* could be expensive and clients are unlikely to be willing to accept a major reduction in security.

The spill-over of the Northern Rock crisis has already forced the UK to discuss publicly the need for a substantial increase in the limits on guaranteed deposits. Matching that might require a tripling in guarantee levels for many Member States.

- **October 9, 2007: Excerpt from Conclusions of ECOFIN meeting**

  EU arrangements for Financial Stability - The Council adopted the following conclusions:
  The Commission is INVITED to examine possible enhancements, and where necessary propose regulatory changes as follows to:
  - improve interoperability of Deposit Guarantee Schemes (DGS), by removing the inconveniences in the current arrangements, and clarify the practical implications of DGS to absorb and share any financial burdens.
  - Annex II: 2. Review the tools for crisis prevention, management and resolution
  2007-2009: work started in spring 2007 to be continued by the Commission with the objective to clarify EU Deposit Guarantee Schemes Directive, especially: practical agreement and clarification of the scope of the Directive and tasks of DGS, 'topping-up', information exchange between schemes, reducing pay-out delays and improving depositor information. Deposit Guarantee Schemes and relevant authorities in Member States will be involved. Final results are expected by March 2009.

- **February 20, 2007: The Commission released a report estimating the effects of changing the funding mechanisms of EU Deposit Guarantee Schemes.** The cost implications of harmonising the EU DGS financing system are investigated by building four scenarios and analyzing changes in the contributions of each DGS. The scenarios were defined by Commission Services after considering the information collected by means of a survey distributed across EU DGS. According to data collected, member states have been grouped into categories reflecting their fund adequacy, measured in terms of the ratio between the size of their fund and the total amount of their eligible deposits.

The attached annexes include a description of data collected through the survey not directly used in the scenario analysis, and give insight on the functioning of the schemes on a DGS by DGS basis.

The present report is an extension of the Interim Report, in terms both of dimension of the dataset and types of analysis performed.

In support of the review of Directive 94/19/EEC on Deposit Guarantee Schemes, the Commission's Joint Research Centre has been requested to investigate the cost implications associated with the possible harmonization of Deposit Guarantee Schemes' funding mechanisms. At present, the Directive leaves the Member States free to choose the funding mechanism best suited to their own banking environment.

As a result, guarantee schemes' funding systems in the EU are widely heterogeneous. While some Deposit Guarantee Schemes are financed by regular contributions from members (banks) in order to build up or maintain a float ready to be used in the event of a crisis ('ex ante'), others are not pre-financed at all, but require their members to step in only after a bank has failed and to finance payouts to depositors ('ex post'). There are also mixed forms of schemes between ex ante and ex post financing.

Different cost structures in different countries might lead to a distortion of competition among banks, which would not be in line with the single market objective. Thus, the Commission has investigated whether there is a case for harmonizing the way in which schemes are funded. The Commission's Joint Research Centre has been asked to conduct of a quantitative analysis of the costs associated with modifying the existing funding mechanisms of deposit guarantee schemes throughout the EU on the basis of different scenarios.

- **January 4, 2008: Interview with Chancellor of Exchequer Alistair Darling in Financial Times –** "The chancellor will also outline a more generous deposit guarantee scheme - currently £35,000 of deposits are guaranteed by the Treasury - although this would become less important once the new insolvency regime was in place. Mr Darling added he would announce soon his proposed new threshold, with banks - which would fund the scheme - arguing that a figure of £50,000 would safeguard the interests of 98 per cent of savers. Mr Darling acknowledged the guarantee could not be set too high. "If you were going to guarantee 100 per cent of all retail depositors' savings, you would have go to a very high sum indeed." Mr Darling has rejected creating a new body to oversee deposits in failing banks, such as the Federal Deposit Insurance Corporation in the US, but has drawn on ideas from America, Canada and Belgium in developing the scheme."

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Appendix II: Retail banking data

Retail Banking covers a significant share of the overall banking activity in EU countries and represents a primary source of banking profitability. Wide national variations in banks' income exist for specific products and banks' income per customer is reported to be twice as high in the EU15 as it is in the New Member States. Yet most Member States' banks show an average pre-tax profitability close to the weighted EU average (20% to 30%). Beyond factors such as the economic cycle and deposit/credit market local developments, industry specific factors also matter as these point essentially to different distribution models and degrees of competition. Entry barriers and high switching costs weaken competition and help, in some cases, to keep higher retail bank prices and margins (i.e. market power).

The literature suggests several indicators to measure the degree of integration, mainly quantity indicators, like cross-border activity and share of assets owned by foreign banks, and price indicators, typically the degree of price convergence ("the law of one price") and cross border transaction costs. Most of these indicators point to a low degree of integration in retail banking. When looking at account management fees, closing charges, excess borrowing fees, ATM withdrawal fees, or fees for credit transfers among European banks there are significant differences among member states, even if Eurozone banks continue to price in a narrower range than banks in other world regions with a recent trend pattern towards convergence. According to the last World Retail Banking Report by Cap Gemini, ING and EFMA, in 2006 in the Euro Area, however, prices still varied with a ratio up to 1 to 2.3 among very active and less active users.

It is widely recognised that all market players, pursuing best business opportunities in an open and reliable industry environment, are crucial for the integration process. This can be pursued in different ways: through M&A, cross-border selling of products, cooperation and regulation.

Consolidation in European banking through M&A has undergone a recent acceleration, from an average of about 500 deals during the period 1998-2005 to over 700 in 2006, an increase also confirmed in the first months of 2007. M&A in Europe is dominated by domestic M&A, but a growing role has been played in recent years by cross-border M&A, which also has a heavier weight relative to organic growth abroad. In the EU, the biggest 3 or 5 banks now cover half the entire domestic market. Foreign banks tend to have a much stronger market position in the new member states. In the old Europe, with the notable exception of Benelux and Nordic Countries, few players, however, have a leading market share in 2 or more EU member States.

Co-operation among market players is crucial in several areas. In payments systems, for instance, cooperation among the European Commission, the ECB, and the European Payments Council representing the European payments industry, is leading to the construction of SEPA, the Single European Payments Area. It is estimated by the EC that the implementation of SEPA project could save the EU economy between €50 and 100 bn per year.

We set out in more detail below some of the leading statistics on retail banking:

1. Retail banking: Integration forces

1.1. Definition and main products

Definition: from the demand side: business with consumers and SMEs

Main products:
- Current account
- Deposit account
- Consumer term loans
- Mortgage credits
- Cards
- Payment services
- Funds (UCITS)
- Assets under management

1.2. External integration forces

- Liberalisation of the Financial Markets
- EMU: Convergence of interest rates, no foreign exchange risks / single currency
- Regulatory initiatives/harmonisation (Basel II)
- Single market – whole sale market
- Regulatory initiatives – retail market

1.3. Sector specific integration forces

Forces

- Consolidation – economies of scale / scope
- Technical development (information technologies)
- New distribution channels for example: Internet

- Nordic countries	40 – 50 %
- Other member states	20 – 30 %

- Changes in the production chain
- New products (capital market products for retail clients)
- Concentration on decision making; new risk processing and management techniques

Consequences (examples)

- Cross-border ownership - liberalisation, single market and EMU increased cross-border ownership

11 member states: share of foreign banks is more than 50 %
5 member states: share of foreign banks is more than 25 %

Assets of German banks abroad 1975: 12 %
Assets of German banks abroad 2004: 32 %

Source: ECB EU Banking Structure, Oct. 2006

- IT costs in % of retail banking costs - increasing IT costs foster Credit Institutions to economies of scale

Costs	Today	3y
6 – 10 %	28 %	37 %
11 – 15 %	38 %	35 %
> 15 %	13 %	22 %

- Consolidation wave – Mergers & Acquisitions 2001-2005/1st HY, EU25

2001-2005/1st HY	Cross-border	national
No.	149	323

Source: EU, Interim Report II

- Increase of concentration - Herfindahl Index EU12: 544 □ 600

Number of:	Institutions		Branch offices	
	2001	2004	2001	2004
EMU 12	7,213	6,403	175,200	167,846
EU 25	9,363	8,374	206,265	199,606

Source: EU, Interim Report II

2. ***The Retail Market***

2.1. Retail Market Volumes

Volumes Outstanding	EU25 2005	EMU12 2005	EMU 2006	EMU 1st half year 2007
Consumer credit	887 bn	554 bn	586.6 bn	601.8 bn
Other lending	1,000 bn	722 bn	748.4 bn	752.7 bn
	1,887 bn	1,276 bn		
Loans for housing purchases	4,669 bn	2,915 bn	3,212 bn	3,337 bn
Total	6,556 bn	4,191 bn	4,610.6 bn	4,691.5 bn
Deposit households		4,343 bn	4,552.6 bn	4,678.4 bn
UCITS (Publikumsfonds)	5,000 bn	3,659 bn	4,252.1 bn	4,376.0 bn (Q1)
Life insurance		3,900 bn	4,591.4 bn	

Sources: ECB, Monthly Bulletin, Table 2, EU Banking Structures, Oct. 2006

Volumes (Flows)	EMU12 2005	EMU12 2006
Gross savings by households [1])	768.7 bn	775.8 bn
Net acquisition of financial assets by households	677.2 bn	619.6 bn
Retail [2]) payments – Clearing arrangements:	65 bn cashless payments - 20 bn payment cards - 20 bn credit transfers - 18 bn direct debits - 7 bn cheques	

[1]) *Source: ECB, Monthly Bulletin, Tab. 3.3.*
[2]) *Payments not included in large value payment definition (Sector Inquiry Interim Report, June 2006, page 101)*

2.2. Retail Segment – Gross income and Profitability [1)]

29% of EU banks gross income 2004 is generated in the segment retail banking (in Austria 11%, Germany 17%, Ireland, Spain, Finland 40%)

Gross income share by product lines: (average EU25, year 2004) [2)]

- Personal consumers

Product line	Curr.acc.	Deposits	Loans	Mortgages	Credit cards
Share	28 %	17 %	18 %	30 %	7 %
Per customer in €	114	64	367	1,015	65

- SMEs

Product line	Curr.acc.	Term loans	Credits	Leasing
Share	42 %	38 %	16 %	4,2 %
Per customer in €	588	2,219	-	-

1) 2) Source: Interim Report II, p. 64 and 66

Profitability

- High profitability of the retail segment is noticed in Ireland, Spain, Sweden, Finland, Denmark, UK: 40% profit before tax as share of total retail income
- In Germany, Austria and Belgium this figure is very low: 11 - 20 %
- The EU 25 average is 28.8 %
- Cost/Income Ratio Retail

EU 25 average	63 %
EU 15	65.8 %
Spain, Ireland	~ 45 – 50%
Germany, Austria, Netherlands	75 – 80%

- Cross-selling rate (EU 15, year 2005)

Consumer	Current account	2.24
	Deposits	1.86
	Mortgage	3.07
	Average	2.07
SMEs	Average	2.42

Source: EU Interim Report II, p. 106 and 108

2.3. Concentration rate (Retail Business)

	EU average, weighted by population, year 2004	
	CR3 (Top 3)	**CR5 (Top 5 banks)**
Total retail income	49	58
Income from current account	53	55
Banks' numbers of customer account (Broad range from country to country)	39 (90 % - 20 %)	46

Source: EU, Interim Report II, p. 48ff

2.4. Cross-border activities

- 3 main cross-border strategies
- By local ownership
- Through local intermediaries
- Cross-border distribution (distance selling; for example via internet)
- Overview of integration in selected countries

	Is cross-border activity taking place?	Are prices converging	What is the degree of integration?	Which are the main distribution channels?
Savings account	Yes, some	Yes	Some signs of integration	Local establishment/ intermediaries; phone; on-line; ATM
Home loans	No	Yes	Rather fragmented	Local establishment/ intermediaries
Investment in securities (UCITS) **(Continued)**	Yes	No evidence	Increasingly integrated (but scope for progress)	Distribution through local networks; on-line
Consumer credit	No evidence	No	Very fragmented	Local establishment/ intermediaries/ retailers

Source: Financial integration market, 2006, Commission staff working document p.12

- Cross-border intermediation

Cross-border non-bank securities	50 %
Cross-border interbank loans	30 %
Cross-border non-bank loans	5 %
Cross-border funds (UCITS)1)	16 %

- Cross-border demand: EU 15

	Citizens having a cross-border	Citizens planning a cross-border
Current account	4 %	9 %
Credit card	2 %	8 %
Mortgage	1 %	5 %

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For more information about ELEC and this publication we kindly refer to:

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