Implementing the Single Banking Market in Europe

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Financial integration of the European Community requires actions by both the EC and its member states to create a common EC-wide competitive and regulatory environment. This paper focuses on the EC's creation of the single market for retail banking services. It tracks the EC legislative process and the adoption of EC directives designed to create the single market. The study also examines some of the costs and benefits associated with the single banking market. This paper evaluates the EC's success in creating the single market by examining the rate of implementation by the member states of the EC single banking market directives. It concludes with an assessment of the European Community's progress toward its goal of a single banking market.

Following a turbulent year for European unity the European Community (EC) created the framework for a single European market for retail banking services on January 1, 1993. This action is expected to increase competition in the financial services industry in Europe as national markets are integrated into an EC-wide market. This paper attempts to evaluate the progress of the EC member states in implementing the framework for the single banking market based on their actions taken to adopt the key single banking market standards.

After adding three new members on January 1, 1995, the EC now encompasses fifteen European nations that cover most of western Europe.[1] As a single market with nearly 368 million people, the EC is a major economic and financial power that accounts for up to 20 percent of world trade.[2]

Financial integration of the EC requires actions by both the EC and the member states to create a common EC-wide competitive and regulatory environment. Member states must eliminate competitive barriers that may protect their domestic financial service industries. While some national industries and some firms may suffer as a result of the transition to a more competitive environment, the single market is expected to generate significant overall benefits for the EC and the member states.

The EC integration process is complex. The single European market initiatives for banking institutions were only one part of a wide array of "single market" initiatives for financial services. Creation of a single market for insurance services, both life and nonlife, was instituted on December 31, 1993, and on July 1, 1995, a single market for securities investment services was implemented. (See Commission of the European Communities 1994c, pp. 31–53 and pp. 54–66.)

Moreover, the single market for financial services is just a small part of the EC efforts to create a huge integrated

1. On January 1, 1995 the EC added Austria, Finland and Sweden to the dozen member states: Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the United Kingdom. Norway, which also had been accepted for entry, voted in November 1994 not to join the European Community.

2. Harrison (1988) p. 13, reports 40 percent.

single EC market by eliminating impediments, such as tariffs, quotas, nontariff barriers and differing national standards, that can reduce the trade of real goods and services within the EC.

The single banking market is primarily designed to increase competition for retail banking services across the large EC market. Traditionally retail banking services primarily have been provided to customers in the member state where the bank is headquartered. These are primarily offered to businesses and individuals and include payments services, consumer credit, credit cards, mortgage products, foreign exchange and travelers checks, as well as commercial loans and letters of credit.

In addition to offering retail banking services, many banks also are active in providing wholesale banking services. These services are typically designed to provide financial and money market products to large corporations and financial institutions. However, these services often are supplied to large and multinational firms in competitive financial markets that are already integrated on a regional or global scale.

The focus of this article is on the EC's creation of the framework for a single banking market for retail banking services and the adoption and implementation of the EC's single banking-market standards by the twelve nations that were EC members in 1993. The paper is organized as follows: Section I describes both the history and the legislative process for the EC banking reform legislation and reviews the major EC Banking Directives that set the framework for the single market. Section II examines some of the costs and benefits of the EC's move toward a single banking market. Section III evaluates the success of member states in the implementation of the EC directives designed to create a single banking market. Section IV provides an assessment of the progress toward creation of the single market.

I. LEGISLATION AND BANKING DIRECTIVES

The Treaty of Rome (1957) created the basis for establishing an internal "market" for goods and services, including financial services, within the European Community. The Community's goal is the elimination of barriers to the movement of goods, services and capital (Commission of the European Communities (1988c) p. 8).

Slow progress in financial services reform led to the EC's 1985 White Paper that called for renewed efforts to establish a single financial market by 1992. As a result of this action, the EC passed the Single European Act of 1986. The act redefined the EC market as "an area without internal frontiers in which the free movement of goods, services, persons and capital is ensured." It also targeted 1992 for the achievement of a unified European market.

Integration

A key to the success of the EC integration process is that the expected gains from increased efficiency of the single market are expected to benefit all member states. The EC also tries to offset adverse impacts by allowing for transfer payments to help mitigate transitions that hurt certain industries, regions or nations, as they adjust to the imposition of market forces. There are tradeoffs however; not all member states will benefit from all aspects of the single market.

This latter point is worth returning to when we examine the pace of the adoption of the single market for specific goods or services, like the banking industry. Integration may provide some member states with an incentive to allow their adoption of some single market activities to lag behind the EC deadlines, especially if they expect an unusually large negative impact. Still, in the long run, given the wide array of markets involved and the overall expected benefits, it seems likely that member states will accept some hardships in selected industries as the price to pay for the overall benefits of EC membership.

Legislative Process

The integration of the EC has taken place using a legislative process that starts with the European Commission, which acts as the executive and administrative body of the EC. The Commission proposes EC legislation, which is then reviewed and potentially modified by the European Parliament, before going on to the European Council for adoption. The Commission also is responsible for negotiating trade agreements for the EC and for ensuring that EC rules and regulations are enforced.

The EC legislative processes include the use of both regulations and directives. *Regulations* are binding laws that take precedence over national laws. *Regulations* may take effect as soon as 20 days after they have been published and they become effective throughout the entire EC. Member states need not pass implementing legislation (see Price Waterhouse (1994) pp. 1–7 and Commission of the European Communities (1994a) pp. 1–11).

Directives are legislation that also are legally binding. However, directives generally require action on the part of the member states to be implemented. EC directives set a result or objective that must be achieved by each member state while leaving the means of compliance to the member states. Typically the member states pass legislation that conforms their national laws and regulations with EC standards. This process creates similar statutes across member states while still allowing for some variation between member states.

Once legislation is adopted, the member states "notify" the EC of their actions and then the European Commission reviews them to determine whether the national legislation meets the EC requirements. Member states commonly have about two years from the date of publication of the directive to take action to revise their laws and regulations to conform with the EC directive, although in some cases they have had four years or more.

The Infringement Process

In cases where the European Commission is not satisfied that a member state has implemented the required directive, or has not done so in a timely manner, the EC automatically begins infringement proceedings against the member state. These legal actions are designed to force the member state to take action on implementation before infringements are referred to the Court of Justice. However, the EC also allows member states to miss implementation deadlines.[3]

Banking Directives

From this multi-step legislative process two key banking directives have emerged. The First Banking Directive (1977) and the Second Banking Directive (1988) set the framework for the integration of the EC banking market in 1993. Through 1993 these two directives were followed by eight additional banking directives. The First Directive was designed to "...establish the rules for banks to establish branches in other Member States." Essentially, this directive set the rules for expansion across national boundaries within the EC by adopting the concept of "host country rule." Under host country rule, expansion is possible. However, a foreign bank or branch is required to gain permission from the supervisory authorities in the *host* country before they are allowed to operate in the host nation. Thus before 1993, banks and branches were typically regulated by each host country's regulatory agency. Under this regulatory regime, banks involved in cross-border expansions were required to operate under multiple regulatory and capital standards, i.e., one for their home country and another for each host country where they operated.

While host country rule opened the way for cross-border expansion of retail banking services in the EC, it did little to eliminate the differences in banking powers and regulatory regimes that existed across member states. Furthermore, as long as those differences continued to exist, they were likely to act as barriers to cross-border competition in retail banking services. As a result, there was relatively little movement by banks in cross-border mergers, acquisitions or alliances in the retail banking area until after passage of the Second Banking Directive.

The Second Banking Directive (1988), adopted in 1989 for implementation on January 1, 1993, went well beyond the reforms of the First Banking Directive. It included several major changes that are expected to lead to a more efficient financial sector, and one that is more competitive in the global financial markets. Among the key changes leading to the creation of a single market or "single passport" for banking services are: (1) The "harmonization" across EC nations of essential standards for prudential supervision of financial institutions; (2) "Mutual recognition" by the supervisory authorities of financial institutions in each member state of the way in which they apply those standards; and (3) "Home country control and supervision" by the member state in which the financial institution is based.[4]

These changes have brought about major alterations in the framework for banking in the EC. The first principle, harmonization, lead to the creation of directives designed to create uniform safety and soundness standards and a comparable competitive environment across the EC member states. Under this principle, banks operating in more than one EC member state face only a set of uniform EC standards and capital requirements, not a dozen different regulatory systems and capital standards.

The mutual recognition of a single banking "license" or "passport" eliminates the need for EC banks to get a local banking charter from the host country for branches and/or bank products that are permitted by their home country

3. Commission of the European Communities (March 29, 1994) p. 5. Infringement proceedings are the first step if a member state fails to comply. More serious failures may be referred to the Court of Justice for a decision, although this is not very common. Both infringement proceedings and referrals to the Court of Justice typically are resolved in a settlement between the EC and the member state. Failure to implement EC directives into national law, even after a Court of Justice judgement against a member state, would lead the Commission to start a new infringement action against the member state. This process allows a member state to lag in the adoption of a directive that it finds particularly onerous.

4. Commission of the European Communities (February 1988) and American Bankers Association (1990) p. 18 or Fitchew (1990) p. 9.

bank regulations.[5] Moreover, the directive defined a list of banking services that may be provided throughout the EC, provided that they also are authorized by a bank's home country. This list thus sets the standard for banking services across the EC.

Home country rule requires the regulators to give up the primary regulatory responsibility for foreign-owned banking institutions operating within their borders and turn it over to the institution's *home* country regulators. Thus, since January 1, 1993, the primary regulatory responsibilities for the entire banking firm have been shifted to its *home* country regulators, even when a bank operates or enters the retail banking business in another member state.

As an example, these reforms mean that a Dutch-owned bank or banking subsidiary operating in Belgium would be regulated by its "home" or Dutch regulatory authorities, rather than by the "host" or Belgium regulators. Its list of authorized EC banking activities would be determined by its Dutch or "home" country powers, not by the list of banking activities for "host" Belgium.

Between 1986 and 1992 eight additional banking directives were passed by the EC. They are described in Box 1. They deal with an array of safety and soundness issues, accounting standards, solvency and exposure issues, and have the net effect of increasing the EC's regulation of banks in those areas. The directives require that banks be examined annually for risk management and risk exposure and that the review take place at the fully consolidated banking institution level. Other directives set minimum capital and solvency standards, both for on- and off-balance sheet assets. Others limit an institution's exposure to borrowers and set standards for reporting financial and accounting data. It is critical for the successful integration of the single banking market that these directives, along with the key First and Second Banking Directives, be adopted by the member states.

Defining Banking Services

As noted earlier, the Second Banking Directive also sets forth a broadly defined list of appropriate banking activities or powers for EC banks. Individual member states may have their own definitions of banking activity that may be more or less restrictive than the EC. Individual EC member states typically have permitted banks to offer a much wider array of financial products than are permitted for U.S. banks, especially in the securities and insurance powers.

The EC list of appropriate services includes both traditional banking activities as well as some new ones (e.g., trading in securities). The list of permitted "banking activities" within the EC was included in the Annex to the Second Directive and is presented in Box 2 below. Most of these activities may be conducted within the bank, or through bank subsidiaries, rather than through a bank holding company as is typical in the U.S. banking industry (Table A1). Finally, the EC also allows banks to hold partial ownership interests in industrial firms and for industrial firms to own banks, as is shown in Table A2.

Integration Incentive

Because the Second Banking Directive embraced the principle of home country regulation for member states that already allowed universal banking, it effectively created an incentive to open up the regulatory process in member states with restrictive banking legislation. The liberal EC standards—compared to the U.S.—combined with the single banking license and home country regulation, give member states with more restrictive banking laws an incentive to loosen those restrictions. Otherwise their domestic banks would face a more restricted set of activities, even in their home country, than would a foreign bank operating there (*Financial Times,* 1991). This incentive also appears to be compatible with the deregulatory forces created by technology and innovation in the financial system.

Banking integration also is made more complicated because the EC banking industry varies widely across member states and within member states as well. As is shown in Table 1, the industry varies widely in terms of the number of banks, branches and the relative size of the industry across countries. When the single market was created at the beginning of 1993, the EC had far fewer banks than the U.S., under 2,500 compared to over 11,700. The United Kingdom, with 511 banks had the largest banking industry as measured by assets, while Greece with only 40 banks, had the smallest volume of assets. Average bank size ranged from a high of \$3.4 billion in the Netherlands to a low of \$863 million in Denmark, which is still well above the \$300 million average for U.S. banks.

Bank structure also varies considerably across member states, although two to five key banks tend to dominate the industry in most countries (*Financial Times,* 1991). The mix of industry orientation between retail and wholesale also varies, complicating cross-border comparisons of size, productivity and profitability (Hawawini and Rajendra (1989) pp. 10–28).

5. Although it has since been superceded by the Uruguay Round Agreement on Financial Services, the EC had adopted a "national reciprocal treatment" standard that allowed non-EC banks to operate throughout the EC as long as the EC banks in the foreign market were treated the same as domestic banks. This was less stringent than "mirror treatment," that would have required EC banks to have had the same powers in a foreign market that a foreign bank would have had in the EC.

BOX 1

ADDITIONAL BANKING DIRECTIVES

- **Directive on Supervision of Credit Institutions on a Consolidated Basis** (1992)
  Requires that supervision of a credit institution, including the review of financial statements, risk exposure and management, take place annually on a consolidated basis.

- **Own Funds of Credit Institutions Directives** (1989 and 1991)
  Define common rules on core capital and supplementary capital for all credit institutions in the EC. Require those rules to be compatible with capital standards set by the Basle Committee and the Group of Ten.

- **Solvency Ratio Directive** (1989)
  Designed to harmonize prudential supervision and to strengthen solvency standards among Community credit institutions. It sets risk weights on various types of on- and off-balance sheet assets that are used in estimating solvency ratios.

- **Directive on Money Laundering** (1991)
  Designed to safeguard the EC financial markets by eliminating activities associated with illegal money laundering.

- **Directive on the Monitoring and Controlling of Large Exposures of Credit Institutions** (1992)
  Sets limitations on credit institution exposure by category of borrowers.

- **Directive on the Publication of Annual Accounting Documents** (1989)
  No longer requires branches to publish separate annual reports as long as the parent organization publishes these annual documents.

- **Directive on the Annual Accounts and Consolidated Accounts of Banks and Other Financial Institutions** (1986)
  Sets the requirements for banks and other financial institutions reporting balance sheet and profit and loss statements, special provisions, and valuation rules. It also sets consolidation and publication requirements.

BOX 2

BANKING ACTIVITIES PERMITTED WITHIN THE EC

- Deposit taking and other forms of borrowing
- Lending (including consumer credit, mortgage lending, factoring, invoice discounting, and trade finance)
- Financial leasing
- Money transmission services
- Payments services (including credit cards, electronic funds transfer, point of sale, travelers checks and bank drafts)
- Providing guarantees and commitments
- Trading on their own account or for customers in money market instruments, foreign exchange, financial futures and options, exchange and interest rate instruments and securities
- Participating in share issues and the provision of services related to such issues (for shares, bonds and other securities) including corporate advice, and arranging mergers and acquisitions
- Money brokering
- Portfolio management and advice
- Safekeeping of securities
- Offering credit reference services
- Safe custody services

FROM: Commission of the European Communities, “Second Council Directive,” Brussels, 16 Feb 1988, see Annex.

TABLE 1

COMPARISON OF EC COMMERCIAL BANKS
(RANKED BY COMMERCIAL BANK ASSETS, DEC. 31, 1992)

EC MEMBER STATES	NUMBER OF BANKS	BRANCH OFFICES	STAFF	ASSETS (US$,BIL)	POPULATION (MIL)
United Kingdom	511	13,100	397,400	1,454	57.8
France	419	10,366	200,400	930	57.4
Italy	319	18,635	327,192	683	56.9
Germany	334	7,542	221,700	632	80.6
Netherlands	109	4,734	115,563	372	15.2
Spain	159	17,288	152,025	317	39.1
Luxembourg	213	310	17,592	297	0.4
Belgium	93	3,515	49,574	270	10.4
Denmark	119	2,467	47,560	103	5.2
Portugal	35	2,852	60,772	80	9.9
Ireland	43	918	20,731	46	3.5
Greece	40	1,233	40,188	40	10.3
Total, EC–12	2,394	82,960	1,650,697	5,224	346.2
Sweden	15	2,564	40,381	141	8.7
Austria	57	723	18,411	84	7.9
Finland	14	902	24,021	68	5.0
Total, EC–15	2,480	87,149	1,733,447	5,516	367.8
U.S. BANKING INDUSTRY COMPARED TO THE EC					
U.S. Banks	11,719	53,858	1,477,619	3,506	255.5
US as % of EC	472.5%	61.8%	85.2%	63.6%	69.5%

SOURCES: Banking Federation of the European Community (1993) pp. 88–89; *OECD* (1994) pp.6–7; .FDIC (1992), p.5; Board of Governors, *Annual Statistical Digest*, (1992), pp.150–151; and Council of Economic Advisors (1995), p. 307.

II. BENEFITS AND COSTS OF A SINGLE MARKET

Proponents of unified EC markets long have maintained that the pre-EC 1992 banking system was less than ideal. In most national markets the industry was highly concentrated and regulated, and in some cases those regulations tended to create barriers that limited competition (Price Waterhouse, 1994). Hence, analysts like Vives (1991) contended that, "the main effect of integration will be to change the focus from collusion and regulatory capture to competition" (p.10). Eliminating regulatory barriers associated with cross-border expansion into retail banking markets was a special concern of single market proponents.

Barriers

Barriers to trade in the financial services area may take many forms. Exchange controls have been a traditional favorite for limiting international capital flows and were still in effect in Greece and Portugal during the 1980s. Spain, Greece, and Portugal have phased out restrictions on foreign direct investment that could prohibit acquisitions of foreign banks. Regulations prohibiting cross-border solicitation of deposits or securities activities also limit cross-border competition and create barriers to entry, as did restrictions on banking powers, deposit and loan interest rate ceilings, restrictive product standards and different tax structures. The EC hoped to remove these types of barriers, along with "red tape" and nation-by-nation capital requirements and regulatory structures.

As the traditional barriers are removed, the EC also has to monitor the use of "technical standards," standards that also may insulate national banking markets from foreign bank competition. These include such areas as consumer protection laws, ATM network standards and access polices, company policies and merger and acquisition policies.

Price Differentials

The existence of barriers is consistent with discrepancies in cross-border banking service prices prior to the single banking market. The EC tried to verify and measure the potential price differential for financial services in a March 1988 study for the Commission of the European Communities. The study, reported in *European Economy*, indicated that the barriers were responsible for sizeable price differentials for similar banking services across EC countries.[6]

The Price Waterhouse Study, as it is known, estimated the country-by-country price differentials based on the percentage differences in prices of standard financial service

6. There may be a number of explanations for the pre-1993 price differentials. They may have been made possible by barriers to entry like different national requirements for a banking license, different regulatory standards, limited banking powers and varied product standards, or the differences may have at least partially arisen from different cost structures. Clearly, to the extent that barriers existed, they would have increased the cost of entry across national boundaries within the EC. With potential competition limited by these barriers, banking firms in some national markets would be shielded from vigorous competition for retail banking services.

products for each country compared with the average price for the four lowest-priced countries. Use of the average price for the four lowest-priced countries as a competitive benchmark may eliminate some distortions if "standard" services vary somewhat across borders.[7]

The Price Waterhouse benchmark may be a less-than-ideal measure of competitive prices since it is not measuring strictly comparable services. Moreover, as was shown by Neuberger and Zimmerman (1990), even when comparing similar deposit services across states in the U.S., holding service differences and cost factors constant, it is still not possible to explain a large share of the price differentials for some services.[8]

Despite these shortcomings, the study has become the benchmark for estimating potential price changes and benefits arising from the integration of the EC's banking markets. In the following paragraphs, the Price Waterhouse study provides the basis for estimating price differentials across countries, for projecting changes in interest rates and for measuring any macroeconomic impacts arising from the integration of the EC banking market.

Cecchini, et al. (1988) and Klausner and Schwartz (1989) relied on the study to illustrate the large pre-single market differences in cross-border prices for a single banking product. Both highlighted a country-by-country comparison of consumer credit prices showing that France, Germany and the UK reported prices for the same services that were more than double the average price for the four countries with the lowest prices.

Price Waterhouse estimated the price differentials for seven retail banking services: consumer credit, credit cards, mortgages, letters of credit, foreign exchange drafts, travelers checks and commercial loans. These single product prices were then used to generate the service-by-service and country-by-country price reductions for the basket of banking services (Klausner and Schwartz (1989) p. 5). The potential price changes for the basket of banking services, as well as for securities and insurance services, are shown in Table 2.

7. This benchmark also allows for estimates of both increases in prices for "low" price countries and decreases in prices for "high" price countries; a result that is not intuitive with increased competition. These estimates are presented in Table 2.

8. See Neuberger and Zimmerman (1990) for a discussion of the difficulties of measuring and explaining interstate interest-rate differentials while holding deposit service quality measures constant within a relatively uniform banking market like the United States. A sizeable portion of the interest differentials between California and the U.S on transaction-oriented accounts could not be explained, hence the existence of the "California Rate Mystery." The Price Waterhouse study tried to find comparable services and then estimate the differentials across eight countries, a much more difficult task.

Of course, these large price differentials are symptomatic of what Vives (1991) has described as markets having, "...a lack of vigorous competition" (p. 10). Elimination of cross-border barriers through creation of the single banking market was expected to reduce those differentials.

Lower Prices

The Price Waterhouse study estimated an EC-wide reduction of 21 percent in banking prices following adoption of the single market.[9] However, like the banking industries across the member states, the estimated price reductions for banking services varied dramatically across countries. The Netherlands, where the study estimated a theoretical reduction of 10 percent in the price level of the basket of banking services after implementation, and Spain, where a 34 percent reduction was calculated, represent the extremes of the changes shown in Table 2. The study projected that countries like Spain and Germany could experience price reductions of 33 percent or more for banking services as a result of the integration of the EC's banking market.

The significance of such large price reductions for the "basket of banking services" also could be expected to have a sizeable impact on bank profitability in the EC and perhaps on the speed of member state adoption of the banking directives. A 1993 survey by Gemini Consulting for the European Financial Management and Marketing Association (EFMA) suggests that European bankers are expecting deregulation and the single market to have a significant impact on their profitability as measured by return on equity (ROE) over the next decade. This survey of bankers suggests that ROE will average 10 percent in 2005, far below the 12 to 25 percent reported (1989–1991) for the top ten banks in five EC member states. The lower expected profitability is a result that is consistent with the large reductions in banking service prices estimated by Price Waterhouse (EFMA (1993) pp. 6–7).

Lower Rates for Borrowers

The study also was used to generate estimates of the impact of integration on several types of loan products. Based on the Price Waterhouse results, Cecchini (1988) reported that liberalization of financial services would lower the price of credit for borrowers. Although noting that the estimates were subject to considerable uncertainty the Cecchini report concluded that consumers were expected to benefit from lower interest rates on credit for consumer purchases (about 2 percentage points) and mortgage costs

9. Commission of the European Communities (1988b) reports the results of the Price Waterhouse study.

TABLE 2

Estimates of Potential Changes in Financial Product Prices as a Result of Completing the Internal Market (For eight EC member states—changes in percent)

	Belgium	France	Germany	Italy	Luxembourg	Netherlands	Spain	UK
Banking Services:								
Consumer Credit	41	–105	–136	na	26	–31	–39	–121
Credit Cards	–79	30	–60	–89	12	–43	–26	–16
Mortgages	–31	–78	–57	4	na	6	–118	20
Letters of Credit	–22	7	10	–9	–27	–17	–59	–8
Foreign Exchange Drafts	–6	–56	–31	–23	–33	46	–196	–16
Travelers Checks	–35	–39	7	–22	7	–33	–30	7
Commercial Loans	5	7	–6	–9	–6	–43	–19	–46
Theoretical Potential Price Changes (%) by Type of Financial Service								
Banking	–15	–25	–33	–18	–16	–10	–34	–18
Insurance	–31	–24	–10	–51	–37	–1	–32	–4
Securities	–52	–23	–11	–33	–9	–18	–44	–12
Total	–23	–24	–25	–29	–17	–9	–34	–13

Source: Price Waterhouse Study, reported in *European Economy,* "The Economics of 1992," Commission of the European Communities, Brussels, Number 35, March 1988.

(about 0.3 percentage points). Businesses also would benefit from a reduction in the rate of interest on long-term credit (about 0.5 percentage points).

Macroeconomic Benefits

The EC also tried to evaluate the macroeconomic effects to the EC of the single market for financial services, including banking. Integration was expected to reduce cost differentials between domestic and foreign banks operating within the EC market, although it would not necessarily eliminate them. Some cost differentials arising from different languages, customs and local business practices likely would remain. Still, EC studies suggest that the integration of the EC financial markets would have a positive impact on the EC economy and financial services in the long run. For example, Cecchini (1988) reported combined estimated savings from three areas, banking and credit, insurance and brokerage and securities, in eight EC countries included in the study. Combined macroeconomic benefits were estimated to be on "…an order of magnitude of ECU 22 billion [about $18.6 billion, or] 0.7 percent of [EC] GDP."[10] Of course, even relatively small benefits on an annual basis may be significant within the context of the EC, given the size of the EC financial services market and the importance of the EC's financial sector (Commission of the European Communities (1988b) p. 92 and Hunter (1991) p. 17).

Winners and Losers

While the EC evidence pointed to a positive overall benefit from EC 1992, not all of the EC's 2,500 banking institutions may be beneficiaries. Table 1 provides a snapshot of the European banking system when the single market was created on January 1, 1993. As noted by Klausner and Schwartz (1989), Hunter (1991) and Vives (1991) vigorous competition in the single market likely will allow banks with technical expertise and efficient operations and mar-

10. See Annex B, page 193, of Commission of the European Communities (1988b) for a discussion of the methods used to estimate these "macroeconomic" benefits.

keting to take advantage of "deregulation."[11] More competitive markets will favor more competitive firms, while other firms may find that increased competition in overbanked or protected national markets reduces prices and profits (Klausner and Schwartz (1989) pp. 5–6).

Across countries, the impact of integration then may be influenced by the history of the existence of competitive restrictions facing the industry. Newer member states like Spain, Portugal and Greece, for example, generally have liberalized their capital markets more recently than countries like Belgium, Denmark, Germany, Luxembourg, the Netherlands and the United Kingdom. France, Ireland and Italy also have a history of competitive restrictions in the capital markets and financial services areas (Eizenga and Pfisterer (1987) pp. 338–341).

Within countries, actions and opportunities may depend on a bank's size and situation and ability to diversify. In Germany for example, Deutsche Bank, that country's largest bank, has already taken actions to expand its banking and financial services and to broaden its competitive position in the EC. Other large EC financial institutions also have expanded their activities to coincide with the move to a single market. In contrast, the potential price reductions estimated by the Price Waterhouse study suggest that many small German banks may find that their competitive positions deteriorate as barriers to entry into the German retail banking market are removed and new entry occurs. This is not unlike the occasional splits in the U.S. banking industry, when large and small banks may face differing prospects as a result of a policy change.

With respect to the type of banking firms that likely will prosper in the integrated banking market, the European Financial Management and Marketing Association (EFMA)'s "European Banking: A View to 2005" suggests several types that European bankers believe are likely to successfully adapt to the single market. Their list of "winners" (with the percent of banks providing this response) includes European banks (70%), large banks (68%) and specialist banks (55%). Regional banks and insurance companies were expected to be the major losers. Furthermore, 68% of the bankers surveyed believed that by 2005 the European retail banking market would be dominated by about fifteen to twenty major retail banks, a forecast that would foreshadow a major consolidation in retail banking in the EC nations.[12]

Getting Ready

With the 1989 passage of the Second Banking Directive for implementation on January 1, 1993, EC banks had several years to prepare and position themselves for the single banking market. During that period a number of major EC banks had been involved in mergers and acquisitions, some increasing their presence in other EC nations, some adding insurance or securities firms to their product lines. Other EC banks, some faced with the high cost of new entry, have entered into cross-border "alliances" with banks in other countries as a way to improve their competitive prospects. These alliances typically involved cross-border participation agreements that allowed the participants to cooperatively provide services over a broader market area than would be possible individually.[13] The established universal banks of the EC played a prominent role in this jockeying for competitive position prior to implementation of the single market in 1993.[14,15]

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11. Klausner and Schwartz, page 6, point out that there will be both winners and losers as a result of EC 1992. Some banks that had been "protected" may find that they experience serious margin pressure from more efficient competitors and they will find that their share values will erode along with their protection. Vives (1991) also notes that the benefits may be "overstated" because the single banking market will not become "perfectly competitive." Language and cultural barriers will remain, and depositors face costs of "switching" from bank to bank as well.

12. EFMA (1993). This survey of bank executives from fifteen European countries was conducted by Gemini Consulting for the EFMA.

13. The Bray (1993) article describes several types of alliances, such as Societe Generale's bilateral cooperative agreements with banks in several markets, or agreements where banks share office space and refer business to each other and share in the proceeds from that business. BNP (France) and Dresdener Bank (Germany), Commerzbank (Germany) and Central Hispano (Spain), Banco Popular Español (Spain) and Rabobank (the Netherlands), Bayersiche Hypotheken- und Wechselbank (Germany) and Banco Commercial Portugues (Portugal) have entered into cross-border agreements. Banks from Spain, the U.K., Portugal and France are establishing a joint real-time, cross-border payments system.

14. Deutsche Bank, Germany's largest bank, France's largest bank, major UK banks, and Dutch and Belgium banks have expanded their financial services activities during this period. Since 1990 banking leaders like Deutsche Bank acquired Gerling Konzern, an insurance firm, Crédit Lyonnais acquired BFG Bank, while Cassa di Risparmio purchased large interests in Banco di Roma and Banco di Santo Spirito. See *European Economy*, "Evolution of Mergers in the Community," number 57, 1994.

15. Over the 1991–1992 period, EC documents indicate that cross-border mergers accounted for almost half of the total mergers, and a number of these mergers involved financial institutions. The report noted the following significant patterns in banking and finance mergers: Belgian and French institutions were likely purchasers, Spanish institutions were likely sellers, and Irish institutions were active both as purchasers and sellers.

While there were a number of well publicized mergers, acquisitions and strategic alliances that took place in anticipation of the enactment of the single market, the severity of the European recession between 1991 and 1993 hurt many EC financial institutions and therefore likely slowed the pace of consolidation. During this period, many banks also were constrained by more stringent capital and risk-based capital standards that limited their ability to expand.

Now that we have examined some of the actions taken by the banking industry in Europe in anticipation of the single market, let us move to the crucial actions taken by the member states to implement the single market reforms.

III. Implementation Process

Banking is only a small part of the single market, and it may not be the driving force behind the move toward EC integration. Thus, the actions of the member states with respect to the impact on their domestic banking industry also may play a role in the implementation process and the speed of integration. Given the infringement process, member states that expect to experience large adjustments to a particular industry, like banking, may drag their feet on the implementation of the banking directives.

The Price Waterhouse results identify which of the member states (in this case, Germany and Spain, and perhaps France) might be expected to experience especially large adjustments that could make them strong candidates for a more “relaxed” pace of adoption. In the remainder of this paper, the pattern of adoption of EC banking directives is analyzed.

The speed and extent of implementation of the ten banking directives by the member states can be used as a way of measuring the success of the integration of the EC banking industry.

Single Market Implementation

By early 1993 most of the EC (directives and regulations) legislation necessary for the creation of the single market had been passed by the European Council. The Commission of the European Communities 1993 report, *The Community Internal Market,* noted that by the end of 1993, 265 of the 282 White Paper measures had been adopted by the European Council. This represents a 95 percent passage rate for the single market directives. The next stage is more difficult.

Progress has been somewhat slower at the national level, where each of the member states, including the three new members, must take actions to adopt the EC directives necessary to implement the single market. Of the White Paper measures that have taken effect, 222 required adoption or implementation by the member states. Implementation rates vary, both across countries, markets, and products. The progress in implementing the entire single market is often evaluated using the percentage of EC directives transposed into legislation by the member states.[16]

EC documents point out that at year-end 1993, only about half of all the single market measures (including banking) had been enacted in all twelve member states (Austria, Finland and Sweden did not become members until January 1, 1995 and are not evaluated in the measures that follow). Still, about three-quarters of the measures had been enacted in at least ten of the twelve member states. At year-end 1993, Denmark and the United Kingdom, two countries that at times have been less than enthusiastic about the EC, were the leaders in converting EC directives into national legislation. Both had implemented over 90 percent of the measures. At the other end of the scale, Greece, France, Spain and Ireland had adopted less than 83 percent of the necessary measures. Based on these adoption rates, by 1993 the EC was making significant progress in its goal of creating a single market.

The Single Market for Banking

In the financial services sector, the adoption rate has been relatively fast with respect to laws designed to free the movement of capital and for the adoption of a single market for some types of financial services. The 1993 Commission Report notes that the implementation of the banking-related single-market measures has been good (Commission of the European Communities (1994c) p. 7).

At year-end 1993, the twelve member states were evaluated on the implementation of ten key banking directives.[17] Of the 120 possible implementations (ten measures times twelve member states), in 98 cases (about 82 percent) the banking directives were properly transposed into national statutes. As shown in Table 3, by April of 1994, the number transposed rose to 107, a transposition rate of 89 percent. Still, in 13 cases, or 11 percent, the countries had not implemented the measures, in some cases several years after the deadline. The European Commission has begun “infringement proceedings” in the cases where member states have failed to transpose the directives into law

16. The EC and others commonly use these measures to evaluate the progress of the single market, both by sectors and overall. See *The Economist* (1993) p. 72.

17. The Deposit-Guarantee Directive was not implemented until 1994 and member states are now in the process of transposing the legislation, so it is not included in the measured adoption rate used here.

TABLE 3

SUMMARY OF THE IMPLEMENTATION OF BANKING DIRECTIVES

EU MEMBER STATES:	B	DK	D	GR	E	F	IRL	I	L	NL	P	UK		
DIRECTIVE: IMPLEMENTATION:														
First Banking Directive														
Dir. 77/780 12–16–79	I	I	I	I	I	I	I	I	I	I	I	I	12 of 12	100%
Second Banking Directive														
Dir. 89/646 1–1–93	I	I	I	I	IR	I	I	I	I	I	I	I	11 of 12	92%
CONDITIONS AND PRUDENTIAL RULES														
Own Funds														
Dir. 89/299 1–1–91	I	I	I	I	I	I	I	I	I	I	I	I	12 of 12	100%
Dir. 91/633 1–1–93	I	I	I	I	I	I	I	I	I	I	I	NN	12 of 12	100%
Solvency Ratio														
Dir. 89/647 1–1–91	I	I	I	I	I	I	I	I	I	I	I	I	12 of 12	100%
Derogations –Year			D–96	D–96	D–00									
Consolidated Supervision														
Dir. 92/30 1–1–93	I	I	IR	IR	I	I	I	I	I	I	I	I	10 of 12	83%
SUPERVISION AND ACCOUNTS														
Annual and Consolidated Accounts														
Dir. 86/635 12–31–90	I	I	I	IR	I	I	I	I	I	I	I	I	11 of 12	92%
Publication of Annual Account Documents														
Dir. 89/117 1–1–91	I	I	I	IR	I	I	I	I	I	I	I	I	11 of 12	92%
Prevention of Money Laundering														
Dir. 91/308 12–31–92	I	I	IR	IR	I	I	IR	I	I	I	I	IR	8 of 12	67%
Controlling Large Exposures														
Dir. 92/121 1–1–94	IR	I	IR	I	IR	I	I	I	I	I	IR	I	8 of 12	67%
Number Adopted (of 10)	9	10	7	6	8	10	9	10	10	10	9	9	107 of 120	
Adoption Rate (%)	90	100	70	60	80	100	90	100	100	100	90	90		89%

LEGEND: I=Implemented, IR=Infringement, NN=No Measure Necessary, NI=Not Implemented, D=Postponed. April 30, 1994.

within the allotted time span (Commission of the European Communities (1994c) pp. 137–139).

Across Countries

The progress in adopting the EC banking standards since 1991 has varied significantly across countries as can be seen from Table 4. By April of 1994, five of the twelve member states had adopted all of the banking directives. Those states included Denmark, France, Italy, Luxembourg and the Netherlands. Belgium, Ireland, Portugal and the United Kingdom had adopted all except one. As of April 1994 Ireland and the UK had not yet implemented the Directive on Money Laundering, while both Belgium and Portugal still needed to transpose the Directive on Large Exposures.

At the other end of the spectrum, as of April 1994, Spain had yet to implement the key Second Directive and the Large Exposures Directive. Germany had yet to implement three directives, Large Exposures, Money Laundering, and the critical Consolidated Supervision Directive, while Greece needed to implement four directives, including Consolidated Supervision (Commission of the European Communities (1994c) pp. 137–139).

TABLE 4

PERCENT OF KEY BANKING DIRECTIVES IMPLEMENTED, BY COUNTRY

	1991	1992	1993	1994
COUNTRY:				
Belgium	60%	100%	90%	90%
Germany	40%	50%	70%	70%
Denmark	80%	88%	90%	100%
Spain	60%	63%	70%	80%
France	100%	88%	80%	100%
United Kingdom	60%	50%	90%	90%
Greece	20%	50%	60%	60%
Italy	40%	100%	90%	100%
Ireland	60%	88%	80%	90%
Luxembourg	20%	63%	90%	100%
The Netherlands	60%	63%	80%	100%
Portugal	100%	88%	90%	90%
EU TOTAL	58%	74%	82%	89%
Directives:				
Total Implemented	35	71	98	107
Total	60	96	120	120

In cases where member states have not yet implemented directives, there often were actions in progress to do so. In 1994 Germany was evaluating proposals on the Directives on Consolidated Supervision, Large Credit Exposure, and Money Laundering. In Greece, the Directive on Consolidated Supervision was scheduled for implementation later in 1994. And the United Kingdom was in the process of adopting EC-based money laundering legislation in 1994.[18]

The pace of adoption across countries appears to be negatively correlated with the expected reduction in prices in the banking sector reported in the Price Waterhouse study. Of the eight countries where post-single-market price reductions were estimated, the six showing price reductions in the range of 10 to 25 percent had adopted either all, or all but one banking directive by April 1994. In contrast, the two member states, Spain and Germany, where prices were estimated to fall the most (34 and 33 percent, respectively), have been much slower to implement the directives.

Moreover, since 1992, three countries, Germany, Spain, and Greece, have lagged well behind the other member states in implementing the banking directives, as can be seen from Table 5. The banking industries in all three nations likely face relatively large adjustments to the single market.

Price differentials were not estimated for Greece, a newer EC member, however, its banking industry has had protection from competition through capital controls and other barriers. Although those barriers are now being removed, the Greek banking industry also remains relatively highly concentrated, both factors that are consistent with a slow adoption pace (*Financial Times* (1991) pp. 152–156, and Hawawini and Rajendra (1989) p. 20).

Performance by Directive

The community-wide adoption rate for the banking directives is similar to that for the securities directives. And, both are much higher than that experienced for the combined insurance directives (Third Insurance Directives for Life, Nonlife and Motor Vehicles).[19]

Four of the ten banking directives have been adopted by all twelve member states, as can be seen from Table 3. These include the First Banking Directive, and the two Own Funds Directives and the Solvency Directive, which deal with bank capitalization. Three other directives have been adopted by eleven of the twelve member states; they include the critical Second Banking Directive and the two accounting standards directives, the Directives on Consolidated Accounts and Publication of Account Data. Spain's failure to adopt the Second Banking Directive is the most serious setback to the completion of the single banking market.

18. The efforts to revise legislation and regulatory requirements to meet the EC standards has not been limited to the member states alone. Even before their entry into the EC in 1995, EFTA (European Free Trade Association) members had begun to conform their banking legislation to EC standards. Austria, in anticipation of EC membership adopted most of the key directives during 1994. Finland has taken similar steps, and Sweden is planning to do so in 1995. See Institute for International Bankers (1994).

19. Only three member states have adopted the life and nonlife directives. Moreover, a number of significant tax and premium treatment issues appear likely to continue to slow the creation of the single market for insurance. As of April 1994, nine member states had adopted the directive on motor vehicle insurance that was targeted for adoption by December 31, 1992. By December 31, 1993 both the third life and nonlife directives should have been implemented; however, by April 1994 only one member state had adopted the key third life assurance directive and only two the third nonlife directive. In contrast, the six securities-related directives covered had been adopted by either 11 or 12 member states. See European Commission (1994a) pp. 36–65.

TABLE 5

TRANSPOSITION RATES FOR BANKING DIRECTIVES, 1992 TO 1994

	—MEMBER STATES—				
	OTHER NINE	ALL TWELVE	SPAIN	GERMANY	GREECE
1992	81%	74%	63%	50%	50%
1993	87%	82%	70%	70%	60%
1994 (April)	96%	89%	80%	70%	60%

The slow adoption of the important Consolidated Supervision Directive, which is a key to the single banking market supervision by home country regulators, also is a key concern, especially since the largest member and community leader, Germany, is one of the two member states lagging in the adoption of this key part of the integration process. This is another area of concern for regulators, since home country supervision is a key to regulation of multi-state EC banking institutions.

IV. CONCLUSIONS AND OBSERVATIONS

Despite these shortcomings, the EC has come a long way toward creation of the framework for a single banking market in Europe. The critical directives have been implemented, or are in the process of adoption by almost all the member states, both overall and for the banking industry. The EC describes a "profound change in the nature of cross-border competition" as a positive impact of its efforts in the financial services area (Commission of European Communities (1994c) p. 18).

The retail banking services market has been opened to competition from banks in other member countries. The "single passport" and companion directives now make it possible for banks to provide retail banking services throughout the EC based on business, rather than regulatory, considerations. This was a fundamental goal of the single market.

Harmonized regulations are now in place authorizing banks to operate outside their home country with a wide array of financial service powers determined by the EC and their home country. Standards for capitalization, solvency, risk exposure, supervision, disclosure, and money laundering are all in place in most member states. Furthermore, almost 90 percent of the major banking directives have been implemented, and most of the remaining cases are likely to be resolved by EC and member state efforts already underway.

While cross-border activity has been slowed by the European recession, EC financial institutions actually began taking steps toward an expanded market once the EC approved the proposal for a single market, well before its January 1, 1993 implementation date.

One area of concern is the continuation of efforts to minimize barriers, like "technical standards," that limit cross-border banking competition. Some of these types of barriers may exist even after the passage and adoption of all the single market legislation at the member state level. To some extent that reflects the difficulty of standardizing and harmonizing over many nations; however it may also reflect the powerful incentives some industries and firms may have to continue to protect themselves from competition. EC efforts to eliminate such protection can be a time-consuming process, but they are an important next step.

The EC has plans for a study of the effectiveness of the single market reforms in 1996. The plan reflects the EC's concerns about the progress of the single market and its potential remaining barriers. The study also is a way for the EC to try to evaluate the progress it has made since the White Paper of 1985 and since the creation of the single market on January 1, 1993. Clearly, the study also should identify areas where the EC needs to take further action to speed up implementation by member states that are lagging behind and to reduce the residual barriers that may be limiting the extent of cross-border activity and competition.

Finally, in the post-1992 EC banking environment in Europe, cross-border activity and financial services consolidation are likely to accelerate. Larger, well capitalized, better diversified and/or more efficient banks are likely to be able to take advantage of market opportunities to increase their activities. Less efficient banks, especially those that had been shielded from cross-border competition by "national" protection, must adapt to the new situation. Whether or not the projection of fifteen to twenty large banks dominating the retail banking industry in Europe over the next decade is correct, the single market has the potential to make major changes in the financial services industry in the European Community. It should revitalize the European financial system and it should cause the U.S. to reconsider again the future competitive and regulatory environment of our own banking and financial services industries.

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APPENDIX

TABLE A1

PERMISSIBLE ACTIVITIES FOR BANKING ORGANIZATIONS

	—BY ACTIVITY—	
	SECURITIES	INSURANCE
COUNTRY:		
Austria	Permitted	Permitted through subsidiaries
Belgium	Permitted, some activities through subsidiaries	Permitted through subsidiaries
Denmark	Permitted	Permitted through subsidiaries
Finland	Permitted	Sales as an agent permitted
France	Permitted	Permitted, usually through subsidiaries
Germany	Permitted	Permitted, through insurance subsidiaries
Greece	Underwriting permitted by certain credit institutions; B&D permitted through subsidiaries	Permitted to hold shares in insurance companies subject to limitations based on capital
Ireland	Permitted, usually through subsidiaries	Permitted agency and certain life insurance activities through an independent subsidiary
Italy	Permitted, but not permitted to operate directly on Stock Exchange	Permitted, but limited by own funds and aggregate investment
Luxembourg	Permitted	Permitted through subsidiaries
Netherlands	Permitted	Permitted through subsidiaries
Portugal	Generally permitted, mutual funds only through a subsidiary	Permitted through subsidiaries
Spain	Permitted; banks may own up to 100% of stock exchange members	Permitted through subsidiaries
Sweden	Permitted	Permitted
United Kingdom	Permitted, usually through subsidiaries	Permitted through subsidiaries
AUTHORIZATION:		
Permitted:	15	15
By Subsidiaries:	5	11
With Limitations:	2	4

SOURCE: Institute of International Bankers, 1994

TABLE A2

PERMISSIBLE BANK OWNERSHIP

	BANK INVESTMENTS IN INDUSTRIAL FIRMS	INDUSTRIAL FIRM INVESTMENTS IN BANKS
COUNTRY:		
Austria	Permitted, with limits	Permited, with limitations
Belgium	Permitted, with limitations	Permitted, subject to prior approval
Denmark	Permitted, with restrictions, permanent control prohibited	Not prohibited, but rare
Finland	Permitted, with limitations	Permitted
France	Permitted, with regulatory approval if greater than 10%	Not prohibited
Germany	Permitted, with limitations	Permitted, subject to regulatory consent
Greece	Permitted, subject to the EU directive on qualified holdings	Permitted, subject to the EU directive on qualified holdings
Ireland	Permitted, subject to approval of Central Bank if greater than 10%	Permitted, subject to Central Bank prior approval if acquisition is of more than 10% of bank shares
Italy	Not permitted	Permitted up to 15% of shares of bank subject to Bank of Italy approval
Luxembourg	Strictly limited	Investment may not exceed 50% of banking capital
Netherlands	Permitted, subject to regulatory approval for voting shares greater than 10%	Permitted, subject to regulatory approval for voting shares greater than 5%
Portugal	Permitted, but subject to limitations on own funds and voting shares	Permitted, subject to regulatory approval for acquisition of large shares
Spain	Permitted, subject to capital-based limits	Permitted, subject to approval of the Bank of Spain if 5% or more
Sweden	Limited	Not prohibited, but such investments are rare
United Kingdom	Permitted, subject to consultations with the Bank of England	No prohibitions contained in The Banking Act of 1987
European Union	Each 10% or more shareholding may not exceed 15% of the bank's own funds and such shareholdings on an aggregate basis may not exceed 60% of own funds	No general restriction; does not allow investments of 10% or more if home country supervisor is not satisfied with the suitability of the shareholder.
SUMMARY ACROSS EC MEMBER STATES		
Permitted:	14	11
With Limitations:	14	10
Not Prohibited:	0	4
Not Permitted:	1	0

SOURCE: Institute of International Bankers, 1994