Bank Mergers in Europe, the Public Policy Issues*

by Jean Dermine
INSEAD, F-77300 Fontainebleau
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Summary

A very large merger wave in the banking industry has taken place in Europe over the last fifteen years. Public policy makers need to assess how bank mergers - be they domestic intra-industry, across-industry, or cross-border - affect their mission of protecting investors and ensuring financial stability, an appropriate level of competition, and the competitiveness of national firms. Moreover, as the banking world is becoming increasingly international, there is a need to reassess the structure of bank regulation and supervision which has been assumed historically by each nation State.
Introduction

A very large merger wave in the banking sector has taken place in Europe over the last fifteen years. The number of credit institutions fell from 12,256 in 1985 to 9,285 in 1997 (ECB, 1999). This consolidation process is expected to continue and even take a more international dimension. This raises a series of public policy issues. How do bank mergers - be they domestic intra-industry, across-industry, or cross-border - affect the policy makers’ mission of protecting investors and ensuring financial stability, an appropriate level of competition, and the competitiveness of national firms. As a recent illustration of the lively debate, the Minister of Finance of Canada has blocked in the Fall 1998 two proposals to merge the four largest banks of the country into two. In the United Kingdom, a report on banking competition expresses worries about the high level of concentration (Cruickshank, 2000). Moreover, as the banking world is becoming increasingly international, there is a need to reassess the structure of bank regulation and supervision which has been assumed historically by each nation State.

The article is structured in two main sections. In the first one, the economic rationale for public intervention in banking and the international implications for supervision are reviewed. In the second section, four policy issues raised by bank mergers in Europe are discussed. They concern investor protection, systemic stability, concentration and lending to small and medium size firms, and competitiveness of national financial institutions.

One of the main observations is that European countries of smaller size, such as Belgium, the Netherlands and Switzerland, would face severe hardship should one of their large national banks defaults. Moreover, the closure of a large international bank could have substantial cross-border spillovers. This leads to the conclusion of a need for centralization, or at least European-wide coordination of the decision to bail out international banks. An enlarged ECOFIN, the European Council of Finance Ministers with participation of the European Central Bank, should be given the task to decide on the eventual need to organize and finance a Europe-wide bank bail out.
Section 1. The Economics of Banking Regulation, a Review

So as to provide an economic framework to evaluate the public policy issues related to bank mergers, it is first useful to review the potential market failures which explain the need for banking regulations and to draw from this analysis the international implications for bank supervision.

With respect to banking services, three independent explanations have been advanced for the existence of potential market failures: Imperfect (asymmetric) information which prevents the proper functioning of unregulated private markets, the potential for bank runs and the related fear of systemic crises, and excessive concentration with its potential impact on lending to small and medium-size firms. A related public policy issue is the eventual need to avoid regulatory interference which might weaken the competitiveness of domestic firms.

1.1 Imperfect (Asymmetric) Information and Investor Protection

The analysis which follows is rooted in imperfect information in banking markets, and the potential need to protect consumers of financial services.

The first and most important case of asymmetric information concerns the imperfect knowledge about the solvency of a banking firm. Depositors find it costly to evaluate the solvency of their bank. The economics literature (Kay-Vickers, 1986) recognizes that the inability of consumers to properly evaluate the quality of a product can create a market failure. This literature distinguishes three types of goods: search goods whose quality is apparent before purchase, experience goods whose quality is apparent after consumption, and trust goods whose quality is not always apparent even after consumption. An inefficiency may arise because the quality of a service is not valued properly by the market and reflected into higher prices so that there is insufficient incentives for firms to produce quality. Regulation (such as minimal qualifications in the legal or medical professions) is a way to ensure a minimum level of quality. In the context of banking, quality refers in part to the degree of solvency of an institution, with deposits falling in the trust goods category. When depositors are uninformed, there are fewer incentives to limit the riskiness of the assets of a financial institution or its degree of financial leverage (deposit-to-equity ratio). Indeed, finance theory (Merton, 1977) has shown that, whenever
The underlying intuition is that an increase in risk (variance of asset return) allows the shareholders of a firm to reap potentially large gains, while limiting the downside risk to zero because of the limited liability characteristic of equity shares. With perfect information, depositors would react by requesting an interest rate increase to offset the transfer going to shareholders. With imperfect (asymmetric) information, this would be difficult, raising a well identified and documented moral hazard problem. However, the potential existence of imperfect information per se does not yet justify public intervention. It has to be shown that private mechanisms cannot succeed.

The solutions to the imperfect information problem are threefold: Information disclosure, reputation to protect the long term value of the franchise, and the supply of risk-free deposits.

Regulation on information disclosure will reduce the degree of information asymmetry. However, it has been argued that the evaluation of bank risks is a costly activity which could create a ‘free rider’ problem. Individually, each customer may prefer not to engage in information search and analysis on the assumption that other investors will do it. In such a situation, the provision of private information could be too low. However, since information once produced is available to investors at a very low transfer cost, the evaluation of banks should not be undertaken by each depositor but could be delegated to a public agency or a private rating firm. The cost of information gathering by the individual investor would be small.

A second solution to the asymmetric information problem is that firms have commercial incentives to protect their reputation. Firms who care for the value of their franchise and long run profits have strong incentives to build internal control systems to reduce risks and fraud. However, a tradeoff will always exist between (potentially high) short term fraudulent profit and the benefits of long term reputation.

A third solution to information asymmetry is to create risk-free deposits. Since small account holders may find the cost of interpreting the rating high and/or since they care about risk free deposits only, two alternatives could be developed. The first is to have deposit insurance. The second mechanism is to create risk free institutions, that is intermediaries investing all deposits in risk free securities (the so-called ‘narrow bank’ proposal). Depositors would have the choice between institutions offering a higher but risky return and those providing quasi-risk free deposits. It would appear that the evaluation of risks is not inherently more difficult in banking than in other industries. A main difference

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1 The underlying intuition is that an increase in risk (variance of asset return) allows the shareholders of a firm to reap potentially large gains, while limiting the downside risk to zero because of the limited liability characteristic of equity shares.

2 A recent proposal by the Basle Committee on Banking Supervision calls for greater transparency (BIS, 1999).
Evidence is a strong word. In most cases, there is a social-political belief of the need to protect investors. One has to be extremely careful to avoid permanent regulatory interference which can create the 'raison d'être' of public intervention. For instance, the creation of insured deposits reduces the incentives for information gathering and the creation of risk free funds. A laissez-faire policy should not imply that there is no ground for public intervention to compensate the unlucky or imprudent investors. The argument is that discretionary and transitory transfer policies should be used in these cases rather than direct and permanent interference with the functioning of private markets (Mishkin, 1999).

This analysis has shown that the information problem can be solved privately on the market in several ways: information disclosure, reputation, and insurance. However, whenever there is evidence that the market cannot discriminate among firms, then there is a case for the government to regulate entry and ensure a minimal quality, as is done for instance in the medical and legal professions.

The possibility of competitive deregulation raises immediately the question of the need to harmonize regulations at the international level. The answer is again related to imperfect information. Competition among national regulators is desirable whenever the parties can evaluate the quality of regulatory systems. For instance, competition among regulators in Tokyo, Paris, Frankfurt, London and New York will shape the developments of local stock exchanges and the outcomes will be optimal if participants can discriminate among different regulatory systems. Harmonization of rules to ensure minimal quality would be necessary only if the market cannot discriminate. This suggests that the degree of international harmonization could vary for different activities and classes of investors, the 'informed' and the 'non-informed'. An alternative to the harmonization of prudential regulations is to grant some supervisory powers to the host state, whenever it is felt that domestic investors are not adequately protected by foreign regulation or supervision.

The economics literature has identified a first potential market failure rooted in imperfect information. It is legitimate to let countries design prudential regulations to protect the 'uninformed' investors. The implication for international trade in banking is as follows. Either, there is an harmonization of prudential rules to protect the 'uninformed', or each host country keeps prudential supervision on all banking services offered locally. This is precisely the approach adopted by the

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3Evidence is a strong word. In most cases, there is a social-political belief of the need to protect investors.
European Union which leaves to each host country the right to control foreign branches for reason of 'public interest' (Norton, 1991).

1.2 Bank Runs and Systemic Risks

The second market failure is the potential for bank runs and systemic crisis. Banks are special because the financial contract that emerges -illiquid loans funded by short-term deposits- creates a potential market failure and a need for public intervention (Rajan, 1998). The financial contract creates the risk that depositors run to withdraw their funds. A run can be triggered by a bad news about the value of bank assets or by any unexplained fear. In both cases, there may be a loss since illiquid assets will be sold at a discount. Moreover, a bank failure could eventually trigger a signal on the solvency of other banks, leading to a systemic crisis. Here, a distinction should be drawn between 'domino' effect and systemic crisis.

A 'domino' effect exists if the failure of one bank would directly endanger the solvency of other banks. This risk is substantially reduced today since banks are systematically measuring and controlling their counterparty exposure through, for instance, netting arrangements. A pure case of systemic run could occur if, lacking information, there is a run by depositors on a significant number of banks.

This market failure explains banking regulations and the establishment of safety nets to guarantee the stability of banking markets. They have taken the form of deposit insurance, lender- of-last-resort interventions, and public (treasury-led) bail outs. Deposit insurance funds are unlikely to contribute much to reducing systemic risk because they cover small deposits only\(^4\). Runs are likely to be initiated by large firms or financial institutions. Therefore, lender-of-last-resort interventions by central banks or public bail out remain the most likely tools to avoid bank runs and systemic crises. Banking history shows that public bail out is most often the case given the need to call on tax payers to finance credit losses (Goodhart-Schoenmaker, 1993).

Lender-of-last-resort or public bail out create a major issue in international banking. Since the lender-of-last-resort and the treasury will be concerned primarily with their domestic markets and banks operating domestically\(^5\) and since they will bear the costs of a bail out, it is legitimate that the insurers keep some supervisory power on all institutions (branches and subsidiaries) operating domestically. That

\(^4\)Deposits are covered up to a maximum of euro 20,000 (Directive 97/9/CE).

\(^5\)It is well known that the Bank of Italy did not intervene to prevent the collapse of the Luxembourg-based Banco Ambrosiano Holding, because it created little disturbance on the Italian financial markets.
is, host country regulation could apply to limit the risks taken by financial institutions and the exposure of the domestic central bank or treasury in cases of bailing out. To foster accountability, it appears necessary to implement a matching principle according to which supervisory powers should be given to those who bear the cost of a default. In the context of international trade in banking services, this view is consistent with the General Agreement on Trade in Services (1994), i.e. the right for local authorities to enforce prudential solvency standards on both local and foreign firms offering services.

An issue related to financial stability concerns the costs incurred with bank failures. As the recent financial distress cases of Crédit Lyonnais in France or of the major Swedish banks have shown, it appears very difficult to put a large bank into default. The issue is not so much the fear of a domino effect whereby the failure of a large bank would create the failure of many smaller ones; strict analysis of counterparty exposures has reduced substantially the risk of a domino effect. The fear is rather that the need to close a bank for several months to value its illiquid assets would freeze a large part of deposits and savings, causing a significant negative effect on national consumption. The proposal is to accelerate the bankruptcy process for large financial institutions quoted on a stock exchange. Since the valuation of illiquid assets will take time, it suggests to close a bank for very few days and force an exchange of part of deposits for equity shares (debt for equity swaps). The bank would be reopened and the shares would be priced on financial markets. The shares being tradable, investors will have the choice to keep their shares or to sell them. As the correct valuation of assets would take time, shareholders could have incentives to hold to their position, but illiquid investors could sell to resume consumption. The need to scrutinize more carefully the bankruptcy process for large

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6 Bailing out would occur if the failure of a branch of a foreign bank leads to a run on domestic banks.

7 One will notice that the European Union has accepted this matching principle when deposit insurance was reorganized on a consolidated basis (directive 97/9/CE). The deposit insurance system of the parent bank covers deposits booked domestically and in foreign countries and the home country principle grants solvency supervision to the regulator of the parent bank.

8 Deposit insurance with a rapid access to insured deposits could mitigate the impact of bank closure on consumption.

9 To reduce the deposit insurance liability and the danger of moral hazard, the nature of the insured deposit contract could be altered. Baltensperger-Dermine (1987) recommended to change the nature of the liquid deposit contract by allowing regulators to go after depositors even if they had run. As losses due to bank default would be shared by both current depositors and by those who had run, the incentives to run would be substantially reduced. An alternative is to render insured
The analysis of the second type of market failure, bank runs and systemic crises, leads to the following conclusion. Since domestic central banks and treasury will be primarily concerned with the stability of their domestic markets, they should have the right to control the solvency of banks (subsidiaries and branches) operating in their domestic market. Since in many cases, the solvency would depend on the solvency of an entire group, joint supervision by the home and host country authorities is recommended. The case for sole 'home country' supervision is weak as long as sovereign countries remain responsible for the stability of their national financial markets. As the EU Second Banking Directive has delegated the solvency supervision of branches to the supervisor of the parent bank, the relevance of the above discussion should apply in those sole cases when the supervision of solvency by the parent regulator is deemed inadequate by the host country, a principle fully compatible with the ruling of the Bale Committee on Banking Supervision or the EU public interest criterion.

1.3 Concentration

The third source of market failure, which is not specific to banking, is the issue of concentration and the fear that products would not be priced at their marginal cost, creating a well identified welfare loss. Moreover, concentration can lead to a lack of efficiency and innovation of managers under the ‘quiet life’ hypothesis (Berger-Hannan, 1994; Cruickshank, 2000). Recent studies have put into question the structure-competition-performance paradigm on the ground that concentration might not lead to oligopoly profits if, for instance, the markets are contestable (Cetorelli, 1999). If deposits can be replaced by money market funds and loans to large corporations by bond or commercial paper issues, access to the payment system and access to loans might be more limited for households and small and medium size firms. Moreover, a fear has been raised in the United States that large banks will reduce their services to small and medium size corporates (Berger et al. 1998). These issues are addressed in the next section.
1.4 Competitiveness

The last public policy issue identified for instance by the Canadian task force (MacKay, 1998) is to analyse how regulatory interference needed to mitigate some of the market failures identified above does affect the competitiveness of domestic financial institutions.

Section Two: Mergers and Acquisition in Europe, Four Public Policy Issues

Four public policy issues raised by bank mergers in Europe will be analyzed in the light of the above review. These include protection of investors, safety and soundness (systemic stability), concentration and its potential impact on lending to small and medium size firms (SME), and international competitiveness of financial firms.

2.1 Investor Protection

A first potential source of public concern is investor protection in case of the acquisition of a domestic bank (let us say a Danish institution) by a foreign bank (a Swedish bank for instance). A problem could arise if the Danish component becomes integrated as a branch of the new group. Indeed, it could be that the new entity supervised by the foreign Swedish regulator (home country control) does not meet the Danish prudential standards. According to the earlier discussion, such a case would provide an argument for the Danish regulator to step in for reason of protection of the ‘uninformed’ investors (public interest argument). Regulations on conduct of business (such as disclosure of information, liquidity ratios, application of contract law, marketing practices ...) being regulated by host countries, the issue concerns essentially the solvency regulation of branches of foreign banks. This issue will increase in the future with cross-border mergers and investor protection needs therefore to be monitored.

2.2 Systemic Risk

Systemic risk could occur because a single bank is deemed too large to fail. Fears of contagion to other banks (systemic risk) or fear of negative impact on consumption or investment could create an argument for a bail out. In the specific context of banking M&As, three separate cases need to be analysed. Firstly, a Dutch bank becomes very large with a significant portfolio of risks located abroad. In case of bank failure and partial or complete bail out, this could entail a very large cost for the Dutch treasury
or the Dutch deposit insurance. To assess the potential cost of a bail out, we report in Table One the level of equity (book value) of seventeen European banks as a percentage of the GDP of the home country. Not surprisingly, the highest figures are found in Belgium, Switzerland and the Netherlands. The equity to GDP ratio is 8% for the recently merged United Bank of Switzerland, 4.6% for ABN-Amro, as compared to 0.89% for Deutsche Bank. For sake of comparison, the equity of Bank of America and Citigroup represent 0.55% and 0.48% of US GDP. If one takes as a reference point that the bailout of Crédit Lyonnais will cost the French tax payers twice the book value of its 1993 equity (admittedly an arbitrary case), the cost of bailing the largest Swiss bank could amount to 16% of Swiss GDP, as compared to 1.8 percent of German GDP in the case of a Deutsche Bank case.

[insert Table One]

The second case is the creation of a Dutch financial conglomerate as a bank decides to expand domestically into a set of other financial services. Financial conglomerate of this type creates potentially two problems. The first one is that, in case of bail out, it could again create a large cost for the Dutch treasury. The second is that it can distort competition if the newly acquired business benefits from the implicit bailing out guarantee. In principle, these effects can be mitigated by creating effective fire walls between the entities, through for instance the creation of separate legal units owned by a holding company. However, this type of separation could prove difficult to implement in case of the failure of one of the subsidiary as, in a world of imperfect information, a reputation effect could lead to run on other parts of the group, forcing the bailing out of the entire group.

In the first two cases discussed above -cross-border expansion or domestic across-sector move-, diversification of risks could reduce the probability of a (costly) bail out as long as the level of equity is not reduced and the efficiency of management is not hampered by complexity. Adequate control of risk management systems (ex ante supervision) and frequent and conservative valuation of the equity of the group (ex post supervision) would facilitate early intervention and minimize the cost of a bail out.

The third case illustrates the inadequacy of current European supervisory institutions. It involves one large foreign bank buying a Dutch bank. The Dutch treasury could be forced to bail out for internal stability reason, but would not have the right to supervise the branch of a foreign bank because of home country control. As in this case, the Dutch treasury would keep financial responsibility, it should be able to retain supervisory control. That is to say, home country control has to be complemented by some form of host control as long as a the cost of bailing out remains domestic. In this last case, since the
default of a large international bank could affect several countries, the decision to bail out should be transferred to the European level or should at least require coordination among these countries\(^{\text{10}}\).

The current institutional arrangements in the European Union are not satisfactory. Indeed, there are currently two potential forum for coordination. In the \textit{EU Contact Group}, national supervisors of banks meet regularly to exchange information. At the European Central Bank, the \textit{Banking Supervisory Committee} (BSC) works in the context of the Eurosystem’s task of contributing to the smooth conduct of polices pursued by the competent national authorities relating to the supervision of credit institutions and the stability of the financial system (article 105 (5) of the treaty establishing the European Union). The reason why any of these two committees should not coordinate an international bail out is that, in most cases, a bail out is a public finance problem with the cost beared by tax payers. In this context, it would seem that the appropriate forum to take a decision to bail out an international bank should be ECOFIN, the European Council of Finance Ministers, with participation of the ECB. A tale of how European supervisory coordination and centralization is likely to develop is as follows. During a weekend, the BSC meets in Frankfurt to consider the need to launch a bail out of a large international bank. As it will become rapidly evident that the ECB should not increase the money supply to restore the solvency of that bank and that tax payers money will be needed to finance the bad debts, ECOFIN will be invited to take the decision to bail out. On the next Monday, due to public outcry that supervision of the problem bank had not been handled properly by the national supervisor, a decision will be taken to transfer supervision to a European agency supervised by ECOFIN. Again, the \textit{matching principle} will be at work. Those who bear the costs of a bail out will want supervisory control. An alternative development which we favor would be to take anticipatory action, that is to transfer the supervision of international banks to a European regulatory agency and to make it public that an eventual decision to bail out will be taken by ECOFIN. An international bank would be defined either by its size relative to the GDP of one country (say 2\%) or by the market share in a foreign country (say 10 \%). It must be noted that the Treaty on European Union (article 105 (6)) allows the Commission to initiate, with the unanimity of vote of the European Council, a transfer of banking supervision to the ECB. However, in its last two annual reports, the ECB has explicitly stated that such a transfer is not necessary at this stage (ECB, 1998, p. 96; EMI, 1997, p. 63). The tale could well become a forecast of the likely development of European supervision.

\(^{\text{10}}\)An additional issue not discussed in this paper is the ability of the ECB to coordinate a central bank-led resolution of a short term liquidity crisis (Prati-Schinasi, 1998).
2.3 Concentration and Lending to SME

The third public policy issues concern concentration and the fear of a lack of competition. Data on market shares for deposits and loans are reported in Table Two. Not surprisingly, they show relatively high concentration in small countries such as Sweden and the Netherlands with the five largest banks capturing more than 80 percent of the market, as compared to 14 percent for the case of Germany. However, one has to be careful with concentration figures as they might not be a good predictor of market power and large interest margins. According to MacKay (1998), margin on personal loans over the years 1990-1996 have been close to 400bp in Germany as compared to 100 in the Netherlands. Margins on mortgage loans have been on average 373 bp in Italy as compared to 127bp in the Netherlands. Finland is an interesting test case as concentration has increased substantially over the last ten years due to domestic mergers. One observes that margins on deposits have decreased form 8 % in 1986 to 1.4 % in the last two years, while margins on household loans have increased form 0 % in 1990 to 2.7% in the last two years (Vesala, 1998).

To assess the impact of concentration on margins, one must take into account two factors: The presence of co-operative banks and the degree of contestability. As Table Three indicates, several European countries have a very large segment of non-profit oriented financial institutions, savings banks or co-operative banks. It is well known that in Germany, France or Spain these institutions competing for size tend to reduce the margins charged by private profit-oriented banks. This situation could be evolving as these institutions could change their legal status, a case observed in the United Kingdom with large building societies becoming plcs. Secondly, one has to analyze the degree of contestability, i.e. the ease for a new player to enter a profitable market segment. For instance, the creation of money market funds has reduced the ability of banks to raise margins on deposits. Similarly, access by large firms to the capital markets with commercial paper or bond issues reduces also the potential impact of concentration on loan margins. However, some specific financial services appear to be less open to contestability. The reviews of the financial services sector in Canada (MacKay, 1998) and in Australia (Wallis, 1997) and the report on competition in UK banking (Cruickshank, 2000) point out that the demand for cash and payment services and the access to credit by small-medium size enterprise is primarily served by local branches of banks. Moreover, although diminishing, there is evidence of clustering, that is consumers acquire products in bundle rather than individually (for instance, 70 % of Canadians buy mortgage and credit cards from the institution in which they do their primary banking services). In the United States (Kwast, 1999), the primary financial institutions for 93 % of household
is a local depository institution. For small businesses, the primary institution is local for 88%. This leads to the conclusion that the fear of excessive concentration should focus on very specific banking services such as payment and credit to small and medium size firms. Vesala (1998) and Cruickshank (2000) reach similar conclusions in the case of the highly concentrated market of Finland and the United Kingdom. An interesting corollary of this analysis (and a proposal in the Canadian MacKay review) is the suggestion to open payment services not only to banks but also to insurance firms and fund managers as a way to reduce concentration and increase competition. Such a move would blur the remaining differences between banks and other providers of financial services.

In several countries, such as the United States, Canada or Australia, there has been the fear that the creation of large banks would have a negative impact on the access to bank credit by small and medium size enterprises (SME). Although the argument runs against common economic logic according to which any profitable services would be provided by the market, the perception is that large banks would concentrate their activities on large corporate firms at the expense of small and medium size firms. Three empirical studies document the impact of bank merger on small business lending in the United States. They reach a similar conclusion that the impact is unlikely to be significant (Berger et al. (1998), Peek-Rosengren (1999) and Strahan-Weston (1999)). In view of this empirical evidence, with competitive products offered by non-bank financial companies or simply trade credit, and in view of the fact that more and more banks are using credit scoring models to evaluate small business loans (69% of US banks in 1997), one can take the view that the impact of bank merger on small business lending will not be so significant. In Europe, Cruickshank (2000) reports the absence of credit rationing for small and medium size British enterprises. To the best of our knowledge, no such study exists in continental Europe, and a task of central banks should be to monitor both the quantities and prices of services to retail clients and small medium size companies.

2.4 Competitiveness

A final role for public authorities is to facilitate the creation of competitive domestic firms. The banking literature (Berger et al. (1999) and Dermine (1999)) has reviewed the various arguments for bank mergers. If economies of scale do seem significant in specific segments of the investment banking industry (such as bond and equity underwriting, or custodian activities), scope economies resulting from financial diversification or the search for efficiency through the closure of branches appear relevant in retail banking. Moreover, there is the untested argument that the future with e-banking will demand banks of larger size. The argument of diversification is particularly relevant in the context of the euro
(Dermine, 1996b). If currencies cannot be devalued, a country experiencing a severe economic crisis not shared by the majority of countries might suffer from a too strict monetary policy. In such a case, the recession and bank losses could be more severe than what has been experienced in the pre-euro era, creating the need of a more complete international diversification of loan portfolios. To foster competitiveness, policy makers will want domestic firms to reach an optimal size and European coverage. In this case, there appears to be a trade off between the benefits of large successful domestic firms and the ‘low probability’ event of a very costly bail out. As discussed above, this trade-off appears particularly acute in smaller countries. A transfer of banking supervision to a European entity would eliminate this issue.

**Conclusions**

Mergers & Acquisitions in banking are raising policy issues for three major reasons. One is concentration, market power and too large interest margins which hurt the real economy. Since many financial services are contestable, the worry about concentration should focus on lending to small & medium size firms and on the supply of payments services. As concerns the latter, payment services could be open to new financial players, such as mutual funds or insurance companies. Moreover, competition from the co-operative mutual banking sector in some countries can reduce the impact of concentration. As concerns lending by large banks to small & medium size firms, recent US and British evidence puts this argument into doubt by showing that, if larger banks focus less on the retail sector, this opens opportunities to other financial services providers. The most significant issue in the author’s view is systemic stability, in particular in small countries that have generated very large institutions,

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11Note that Danthine et al (1999) offers an opposite view. Building on the 1979-1992 regional employment study by Fatas (1997), they argue that diversification of credit risk at the national level will be sufficient and that not much has to be gained by international diversification. We disagree with their conclusions for four reasons. The first one is that historical data might not be a good guide for the future as we move into a new single currency regime. The enlarged market could induce a more specialized industrial structure in a particular country and, with fewer industries being represented, there would be less room for diversification of credit risk at the national level. Secondly, the concern with credit risk is with very large (quite rare) domestic shocks that can not be mitigated by national monetary policies. The 1982 devaluation of the Belgian Franc, the 1990 devaluation of the Finnish Markka, and the 1992 devaluation of Sterling and the lira have no doubt reduced the extent of severe recessions. This policy tool will not exist under a single currency regime. Thirdly, the volatility of domestic loan losses of banks in Finland, Sweden, France, or Switzerland (ECB, 1999) does indicate substantial potential for risk reduction through international diversification. Fourthly, employment data could be a very poor proxy for corporate credit risk.
namely Belgium, the Netherlands and Switzerland. Under the premise that the default of a large bank would be costly (or that a costly bail out would be necessary), it would appear that small countries are facing a comparative disadvantage, as the cost of public bailout will be spread among a smaller population. With a similar degree of risk aversion, one would find it more efficient to spread the bailing cost across a larger European population base. Moreover, since the default of a large international bank could affect many countries, the decision to bail out should be coordinated. These arguments suggest the need for both a European bail out authority and a European banking supervisor. The matching principle which allocates the supervisory mission to those who bear the costs suggests that the decision to bail out an international bank should be taken by ECOFIN, the Council of Finance Ministers, and that it should monitor the quality of supervision of international European banks. However, this state of the world cannot be reached as long as nations want to retail full control of their public spending and banking supervision. In this second best world, smaller countries will have to carefully balance the benefits of large and competitive financial groups with low probability costly default. To improve the odds, they will need to develop superior supervisory systems in three directions. The first will be to check the ability of financial institutions to control risk ex ante. Secondly, they will need to be able to value frequently and conservatively the solvency of financial institutions to be able to step in before a large shortfall arises. Finally, they will need to improve their bankruptcy proceedings to facilitate the closing of financial institutions in those very rare cases of insolvency.
Table 1 Bank Rankings

<table>
<thead>
<tr>
<th>Country</th>
<th>Bank</th>
<th>Equity (book value) euro Million, 1998</th>
<th>Equity/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>HSBC</td>
<td>29,352</td>
<td>2.12 %</td>
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<tr>
<td>F</td>
<td>Crédit Agricole</td>
<td>25,930</td>
<td>1.81 %</td>
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<tr>
<td>F</td>
<td>BNP-Paribas</td>
<td>23,471</td>
<td>1.64 %</td>
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<tr>
<td>CH</td>
<td>UBS</td>
<td>20,525</td>
<td>8.02 %</td>
</tr>
<tr>
<td>DE</td>
<td>Deutsche Bank</td>
<td>18,680</td>
<td>0.89 %</td>
</tr>
<tr>
<td>CH</td>
<td>Crédit Suisse</td>
<td>17,579</td>
<td>6.87 %</td>
</tr>
<tr>
<td>NL</td>
<td>ABN AMRO</td>
<td>17,471</td>
<td>4.6 %</td>
</tr>
<tr>
<td>UK</td>
<td>RBS-Natwest</td>
<td>16,334</td>
<td>1.18 %</td>
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<tr>
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<td>Bayerische Hypo</td>
<td>15,195</td>
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<tr>
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<td>Rabobank</td>
<td>14,688</td>
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<tr>
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<td>14,919</td>
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<tr>
<td>UK</td>
<td>Barclays</td>
<td>13,495</td>
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</tr>
<tr>
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<td>Dresdner</td>
<td>13,042</td>
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<tr>
<td>NL</td>
<td>ING Bank</td>
<td>12,961</td>
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<td>Société Générale</td>
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</tr>
<tr>
<td>B</td>
<td>Fortis</td>
<td>6,875</td>
<td>3.03 %</td>
</tr>
<tr>
<td>B</td>
<td>KBC</td>
<td>5,442</td>
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<tr>
<td>USA</td>
<td>Bank of America</td>
<td>47030</td>
<td>0.55 %</td>
</tr>
<tr>
<td>USA</td>
<td>Citigroup</td>
<td>40794</td>
<td>0.48 %</td>
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Source: The Banker (1999), author’s calculations.
Table 2: Market Concentration (C5, five largest firms)

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<tr>
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<td>75</td>
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<tr>
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<td>15.1</td>
<td>25.9</td>
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<td></td>
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</table>

Source: ECB (1999)
Table 3 Market Shares (%) in the Credit Market (1995)

<table>
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<tr>
<th>Institutions</th>
<th>France</th>
<th>Germany(^1)</th>
<th>Spain</th>
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<tbody>
<tr>
<td>Private Commercial Banks</td>
<td>64 %</td>
<td>24 %</td>
<td>62 %</td>
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<tr>
<td>Savings Banks</td>
<td>7 %</td>
<td>37 %</td>
<td>38 %</td>
</tr>
<tr>
<td>Co-operative Banks</td>
<td>29 %</td>
<td>14 %</td>
<td></td>
</tr>
<tr>
<td>Mortgage Banks</td>
<td>20 %</td>
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<tr>
<td>Others</td>
<td>5 %</td>
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</tbody>
</table>

\(^1\) 1997 data for Germany

Source: OECD, Financial Times (Dec. 9, 1998)
References


