

**Rules, Economics and
Strategies: The Process of
European Financial Market
Integration.**

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1. Introduction

Even before the beginning of 1993 there were two widespread views about the single market programme, views held by many senior business executives as well as by relevant Commission staff and governmental elites. The first view was that the single market programme has been a major success, not only for the regulatory reform involved but also in changing the attitudes and then the actions of businesses. The second view, gathering pace since the late 1980's is that the programme is not enough and more remains to be done if the European Community is to have a continental economy. Perhaps not surprisingly the question of what more

needs to be done is answered very differently, moreover with responses which are often ambiguous to a point or vacuity or espouse policies which have the status of self-evident goods (better infrastructure, more coordination of R and D, more and better education and training). This has been documented most recently in the Shaping Factors, Shaping Actors study (Jacquemin and Wright, 1993).

This paper reviews single market regulation, with particular reference to the financial sector and uses this as a foundation to consider the process whereby a European market is developing. Unlike much previous analysis which has emphasized the role of state interests (neo-realism) (Moravcsik) or the role of the Commission as part of an elite process (Sandholtz and Zysman), this paper argues that the strategic decisions of firms are of primary importance. This area has been relatively neglected. For example, in an otherwise comprehensive paper by Cornett and Caporaso (1992) the issue of strategy and market behaviour is expressly not considered as part of the review of neoclassical economics. It is the general contention of this paper that the analysis of the single market regulatory change, links onward the issue of company behaviour and that the latter is not reducible to dynamic equilibrium analysis. Both of these issues in turn can be used to enhance our understanding of integration processes in the EC, particularly on the questions of market evolution, design and governance.

2. Rules Economics and Strategy

This general contention is developed through three more specific arguments which form the basis of the paper:

1. The first is that the very success of the single market policy has thrown into sharper relief the policy dilemma of promoting further market integration. There is some talk of an integrated market, and it is now generally conceded that the single market is not a unitary market. The measurement of integration via the classic indicators of trade creation and trade diversification is of limited use while general factor incomes accounts miss the genuine case for differences in returns on factor incomes. Does it matter that more European wide firms exist, or only that all domestic markets for key products are contestable? This is a crucial policy issue at a time when it is being suggested that implementation should replace innovation in the European commission's work. At its broadest, this argument focuses on the dilemma of making markets, a dilemma that becomes more acute not less so after the regulatory reforms of the single market programme.

The regulatory changes of the single market programme were considerable, though some such as the investment services

directive have become so arcane and so much the creatures of political compromise that their effects are very difficult to judge. Regardless of whether it was nation states that drove through the bargain, or whether it was a commission orchestrating the relevant business elites the outcome was a redesign of the market. This redesign, in the field of financial services, expanded the scope of exchange relations and has brought more competition and allocative efficiency into a market for financial services where this has not always been the case. However this design of the markets is partial. The actions of financial services companies, especially their strategic choices, exogenous shocks from international and sometimes global markets, variations in national implementation strategies, and the very open ended nature of the policy process all mean that markets are never finally defined or in a simple dynamic equilibrium.

2. Company strategy has been under-theorised in integration literature. It would be helpful to provide a powerful theoretical model of strategy with some of the analytical thoroughness of neo-functionalism. No such model exists or rather none has the general applicability which would be required. Much work has been done, but mainly from a North American perspective about the US, UK, and Japan ie what the French insist on calling Anglo-Saxon markets! Porter's seminal works have obviously been influential, on practionners and academics alike. However these tend to assume a centrality of position for enhanced profitability and adding to share holder value. Yet for the 44 of Europe's top 100 hundred banks which are either state

controlled or mutuels, how central is added shareholder value?

Strategy is motivated by a number of differing but not entirely distinct or contradictory goals. Company culture, ownership, national background, all play a part in shaping these goals. Given this situation, why the emphasis on strategy? Primarily because the single market programme has reduced and will continue to reduce the barriers to competition and innovation. Firms that do not respond will lose market share, will face the growing possibility of take-over or becoming junior partners in European alliances. In this regard as David Meerscham of the HBS has noted for the Anglo-Saxon Markets,

'The old regulated simplicity of the operating environment for financial services firms no longer exists; instead strategic choice has claimed a dominant role everywhere' (Meerscham, 1991, p255)

An interesting point about corporate strategy in Europe is to be found here. Firms, particularly in the financial sector, have gone through a 'me too' phase early in the single market and are now producing strategies in a more sophisticated way. Despite the factors mentioned above firms in many sectors are obliged to provide a strategic policy. What is lagging the instruments of strategy is a sharper and clearer focus as to the measurement and assessment of strategic goals. In other words the significance of shareholder return is emerging more slowly as is a competitive market for corporate control. It is an open question how quickly these criteria for assessing strategy (the

ends as opposed to the instrumental means) will lag, and whether in fact older nationalist and cultural factors as well as newer social and other factors will play a continuing role.

3. The third central argument, involves the perhaps obligatory reconsideration of integration from the framework this revised view of the single market and the role of firms within it. Although no 'big theory' is proposed two insights about integration (which others may have made from different perspectives) can be argued. The first is that integration on this account loses teleology. The end point of a totally integrated market in which the variables affecting firm strategic choice are entirely non-national does not seem a defensible goal. Historically we can obviously say that the EC market of 1968 was more integrated than 1958 and that the market of 1992 was more integrated than 1968. We can use data from trade flows to confirm this. For now though and in the future will market differentiation always get less? The implicit teleology in much integration theory has been jolted by the response of firms in the 1985-92 period. Far from a reduction in the number of banks for example to a handful of Europe wide institutions, many small banks have survived and been more profitable than those with grand ambitions. Where mergers have taken place these have reduced competition and promoted national firms. ABN/AMRO is just one example where every major dutch bank and insurance company has merged with another Dutch firm. A more conglomerated financial set of institutions have emerged, but also a more

defensively nationalist framework.

In the past there has been much debate over whether integration has slowed, jolted forward or even at times (such as the mid-1970's) regressed. The model has always been unilinear, accepting of course that economic, political and social integration may move at different speeds (Wallace 1991). Within the market however it may well be that issues such as sunk costs in retail banking, or differences of taste in retail food will, as they have done so far continue to prevent much cross border integration. other cleavages exist and yet others may come into existence, particularly with an expanding EC.

If this line of argument is accepted, then much of the 'deregulatory zeal', of the single market programme will be of limited value for the future. This forms the basis of the second point about integration. Looking at the 'perfection' of the European Market from neo classical economics it is widely held that

'Deregulation, privatization, and broadening the scope of the market assume centrality. From this perspective, "EC'92" is first and foremost about the elimination of obstacles to a larger, unified market, and the creation of a more rational economic structure, a more efficient regional division of labour and enhanced competitiveness in the global arena' (Cornett and Caporaso 1992, p224).

While this has been true of the single market to date (though with only limited enthusiasm for privatisation), there are now clear limits to the extent to which deregulation and integration can be simply paralleled. Markets have to be governed, and governance brings public policy goals to bear on market relations. It may do this implicitly or more explicitly.

The simple deregulatory thrust of 1992 was always more for polemical purposes than a heuristic for policy making. Further progress in developing the EC economy and shaping its relations with the external world will depend in part on a politically mediated consensus. This defines public policy inputs and steers market evolution by the partial design of markets. Reaching agreement over this consensus will be achieved through the legislative processes provided under the Single European Act and the Maastricht enhancements. As such member states will continue to play a central role as well as to be major channels for interest representation.

The three arguments can be labelled as being about market design under the single market programme, the impact on strategic behaviour on integration processes, and about integration processes in the context of having achieved a single market. While the first and second look backwards the third is inevitably more speculative and forward looking. They are expanded and the interrelations between them examined in the three sections below.

3 The European Financial Area

Of the 28 key proposals in the White Paper, 24 have been adopted, and of the remaining 4, 3 have made progress to common position at Council. It would be churlish to see the situation as anything less than a success in terms of policy initiation and formulation. However the situation is less clear on implementation where national (not necessarily governmental) authorities have clawed back power. Most of the relevant proposals

are being implemented (with 75% success rate to date), but implementation is difficult to monitor and compare. Contrary to popular European demonology the documentation and complexity of EC directives is very substantially expanded at the national levels, and there are problems where EC rules simply do not square with established domestic practice. There are various other implementation problems with the single market for financial services of which two deserve mention here.

The first concerns the possibility of nations imposing different standards about the minimum EC levels. A simple example is the proposal for a 5% tier one capital requirement for banks in Germany proposed by German Parliamentary Committees. A more complex example, also in Germany is revaluation reserves which are included in the EC and Cooke proposals as part of tier II capital are frowned on by the Bundesbank and the Banking

supervisory Office. The German authorities are therefore in danger of 'penalizing German banks' by their more onerous rules (Rudolph, 1993, p383). Of course different national standards above the minimum are perfectly compatible with the single market, providing they are not imposed upon banks from other EC states operating under the single passport.

A second implementation problem has occurred because financial institutions are breaking away from traditional functional and geographical divisions. It is this era of conglomerization- a natural product of the single market programme- that can give competitive advantage to certain classes of credit institution. A good example here is mortgage banks whose loans, because of the security involved, require half the capital to be provided of standard consumer loans. This has caused sections of the financial services industry to fear competitive disadvantage from other sections and lobby accordingly.

Implementation has rendered the key principles much more complex in application. Harmonization and mutual recognition have become the source of domestic policy conflicts and may yet re-emerge as intra-EC conflicts. For example late in 1992 it is widely accepted that the French government moved to stop Barclays Bank offering interest bearing credit accounts in France as a quid pro quo to the French Banking industry for their support in the maintenance of the franc fort policy within the ERM. Although the French government subsequently relented it has only offered

Barclays a quota of such accounts (allegedly 15000), a very French solution to competitive imports!

The more general case of wariness to the single market, a concern which was in the original Cecchini Report concerns companies which would loose out in a more competitive environment and those countries (Italy and Spain especially for banking) which contain a relatively high preponderance of such firms. Standard market analysis is both too simplistic to explain the process of financial market integration in Europe and methodologically blind to the considerable transfers in ownership and economic power in which it could result. A recent report by Mckinsey, despite its optimistic tone found precisely these differences (Jacquemin and Wright, 1993, chapter 3). Countries such as Italy and Spain do seek to maintain a domestically owned industry, and have so far made sure this happens.

The design of Europe's markets remains nationalistic in many regards despite the successes of the single market programme and financial firms still have to grapple with national rules as well as national governments making one off decisions. Markets are more open and more competitive (as the next section will show in greater detail) but that is all. The European market still has national components in terns of the rules that constitute it.

A final point to this section is that such a situation may disappoint integrationists, but it is welcome to some financial

intermediaries. The closer you come to an integrated market the more the products on offer by firms can only be differentiated by price. If however some sets of rules remain very much a national preserve then these offer opportunities for high value added services by firms which have the expertise to build transactions that maximise returns for clients. The obvious example here is taxation. As a recent article in Euromoney put it

'... tax is an area where the demons of convergence and harmonisation are at their most powerless. Tax forms part of the legal and cultural structure of a society. Tax legislation is the product of centuries of regulation and re-regulation and differs vastly from one country to another'. (Euromoney, December 1991, p28)

Tax differences are not arbitrated away by markets because they are regulations not simple price differences. It may yet be that the single market programme in financial services will reach a point when the major players are indifferent to further deregulation and most of the rest would be too small to benefit from it anyway.

4 Competition and Contestability

The single market programme made much of competition as the driving force for change, and implicitly acknowledged that

deregulation was really, at best , about creating potential competition. The particular interplay of competitive forces could not be designed into the market by regulatory change or injunction.

Promoting change through straight forward deregulation such as the Capital Movements Directive (88/361) or through the re-regulation of the Capital Adequacy Directive (Com (91) 141) which provides rules to deal with different kinds of market exposure by firms providing investment services are both aimed at providing for competitive markets.

Competition takes place between firms to a degree but many financial services markets are mature with oligopolistic structures and high sunk costs. Linked to these established practices, cultural, and language make market entry difficult in many cases and impossible in some. Disentangling the different barriers to competition some are clearly nationally imposed such as the Spanish concern to avoid the take over of the spanish banking industry by non-spanish firms. Some barriers are nationally imposed, such as traditional Italian restraints on branching, but are not specifically anti --foreign banks.

These barriers to competition are not the only ones at work however. Sunk costs and the related need to provide a network have done much to prevent banks entering already established retail markets. These costs and indeed many other features of the

market are 'innocent' barriers to entry, barriers to which strategic barriers to entry can be added by incumbents acting separately or to a limited degree collusively.

The structure, conduct, performance paradigm of measuring markets has been shown wanting particularly in areas like financial services and much reference is made to the theory of contestable markets. Contestability treats industrial structure as a function of industry characteristics and argues, as Bumble, Panzar and Willig did in a famous book that intense competition is possible in the presence of few competitors and high concentration (1982). The notion of contestability has been interpreted differently. originally Stigler saw barriers to entry solely via cost function analysis (1968) but others have pointed to the role of economies of scale in the use of capital.

Contestability is relevant and a great many firms as well as whole industries (Italian Banking) have changed working practices and cost structures in response to the threat of competition from other EC banks. Contestability also helps to explain why relatively few banks have developed EC wide networks, for retail or corporate banking. Markets that are contestable may not be worth contesting, for a range of economic reasons.

Using 1992 annual reports as a data base we find that a major bank like Commerzbank has no major presence in any EC country and only 1 branch in the UK. BNP with over 2000 domestic branches has 72 in Spain and no major presence in any other EC country with

the exception of an investment banking presence in London. The largest bank in Europe, Credit Agricole, has very limited market presence in some EC countries and none in the rest. Deutsche is strong in Italy while Barclays comes second to Credit Lyonnaise, a state owned bank, in terms of European presence if that is measured in branches.

A related point may be some simple, but is nevertheless important. Financial firms do not seek competition for competitions sake. This is especially so in mature markets where homogenous products are sold largely on price, and to a lesser extent administrative efficiency. Rather they seek to establish, using Meershwams phrase 'distinct advantage' (Meerschwam, 1991) so that they can exploit relationships at the corporate and/or retail level that will enable the creation of more added value. this trend has been encouraged with the introduction of risk based capital adequacy regulation for bank, a type of regulation that is written into the single market programme.

Financial firms undertake varying amounts and kinds of competition and Governments may intervene for various and usually nationalistic goals. Financial Centres constitute another level of competition however and point to a link into the global economy. London is a clear market leader as regards European financial centres both as regards capital markets and bank lending. Paris however has particular strengths such as its ECU dealing capacity and its settlement procedures while Frankfurt has recently forced through the integration of its regional bourses. Frankfurt and Paris have also signed limited cooperation

agreements. In other words there is competition between financial centres in Europe as centres for financial sector companies, markets and jobs.

A recent interim report Commissioned by the Corporation of London from the London Business School argues that London's real competition is New York and Tokyo . Being part of the single market was not cited as a major benefit for London, but benign regulation, the time zone factor, language and the low cost structure were. Interestingly there was great stress on London's comparative advantage as being even more international than New York and Tokyo, and advantage that could be seriously threatened by 'the shift in decision making on regulation and tax to the EC' (LBS, 1992, p7). The single market was seen if anything as something that could drive business out of Europe, a case which while it may well be overstated brings home that competition within Europe is not necessarily between firms and that its consequences could be a relative weakening of financial centres in Europe vis-a vis other parts of the world. In this light market design becomes an especially contentious issue as does the attempt to push through a particular conception of integration without recognising the benefits of diversity.

5. Strategic Actors

The design of markets and the nature of competitive forces acting

on firms both have a considerable impact on firms. In certain cases they can foreclose types of action. For example there are now EC rules on what percentage of total assets a bank can lend to any one client, and it is now agreed in principle that across the EC insider trading is illegal. Market design and the actions of national governments are very relevant but financial firms are not caught in a matrix from which by reading off competitive pressure against regulatory ones a firms strategy can only be one thing.

In fact firms could do many things and chose to do only a few. Although rational actors, they are constrained by market forces, their own ,self imposed strategic parameters and the nature of the regulatory environment . All of these factors help to determine strategy, but each of them in a deregulated market economy under determines strategy. There is a real issue of agency and a bias in most political economy in favour of defining agency solely through political actors and institutions. functionalist explanations are less fault ridden here than either neo-realist explanations with there causal primacy for nation states or neo-liberal institutional models with their stress on politically mediated regime structures. Even with functionalist arguments technical spill over is conceived as an unintended outcome of the interactions of firms in the market place. Political spill over, may be orchestrated in part by business elites, but the language and the process is governmental. That is to say we are dealing with the issue of governance even when

national governments are being circumvented.

The same point can be made slightly differently through a distinction made by many integration theorists, recently William Wallace, (1990) (who probably made it in the first place). The distinction is between formal and informal integration, which when expanded is made between a discontinuous decision led process and a continuous matter of flows and interaction. This gives informal integration an automaticity and non-governmental character, enforced by a buttressing sub-distinction between proactive and responsive formal integration. It is at the level of proactive formal integration that there is a political aim:

'to redirect informal flows into patterns other than those which market forces or social trends might independently have created'.

It may be unfair but this is saying that the really important integration, which has primacy as an object of study is governmental. The objective consequences of market interaction and of expanding 'the boundaries of mutually improving exchange' (Cornett and Caporaso, 1992, p224), may result in 'intense patterns of interaction' (Wallace, 1990, p54) but it reads as the background, the environment for the primary political integration.

Firms and micro-economics are recognized by most as important. Often it is argued that, as Wallace notes later on, there is debate about which is the dependent and which the independent variable. Market integration at the micro level remains , but it

is driven by market laws which prescribe outcomes, outcomes as much influenced by technological change as regulatory change.

This view however is not well supported by empirical evidence. Firms, are a heterogenous group, and can be differentiated by many variables. Ownership, nationality, strategic goals, management quality, capital strength and others all have a role to play in explaining why firms make certain specific strategic choices.

Governments in the past had a clientistic relationship with banks and insurance companies. They sought to nurture and protect firms which were often state owned have prevented firms from making the adjustments necessary to compete within Europe , let alone outside it. (Of course there are a great many industries where this has been a problem, such as automobiles, and steel).

As mentioned above some French banks have been relatively more expansionist than those from other countries, in part explained by state ownership with a consequent need not to make a return on capital commensurate with some Anglo-Saxon based institutions. Other factors are undoubtedly relevant and a research project is currently under way based at London Guildhall University to establish what they are. It contrasts starkly with the strategic decisions of the two most profitable banks in the UK. Lloyds was the oldest and one of the best established foreign banks in Portugal at the beginning of the single market, it has now sold its operations there and left. the royal bank of Scotland had a

sound merchant bank (Charterhouse plc) with genuine European links. It has now sold 90% of Charterhouse to a French Bank and a German Bank. In so far as these two banks are now looking to expansion it is not within the single market.

Strategy has sometimes meant doing nothing about Europe. Empirical surveys of 70 UK life insurance firms have recently been undertaken by researchers. They were given a number of factors affecting their business (demographic, the Financial Services Act, new products, IT, etc) and asked to weight them. Europe came out surprisingly low (Gardener 1993). It looks as if firms are still deterred by uncertainty as to the benefits of European expansion. However many of their central concerns such as distribution have a European aspect to them, particularly as Bancassurance is a strategy linked to the single market.

Strategy has often meant alliances and agreements as firms struggle to expand their presence without the capital or management expertise to achieve this goal. Whereas takeovers such as Societe Generals of BfG Germany's 7th largest bank are rare alliances are more common. There are for example, links between Dresdner Bank and BNP, Credit Agricole and Rabo Bank, Commerzbank, Credit Lyonnais, Banco di Roma and others, and Banco Santander and RBS.

6. Concluding Thoughts

A wide variety of strategies has been adopted by firms and these have determined the pace and dimensions of European financial market integration. These strategies, even when we may criticize them for their effectiveness in a particular case, are as important to the process of financial market integration as the partial design of the market through re-regulation, the interplay of economic forces or the actions of governments.
