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European banking after EMU

Editors' introduction

The euro is a catalyst for forces that will reshape the financial architecture of Europe. Banking markets will become increasingly competitive and will lose territory to capital markets. This is the received wisdom among many bank analysts and financial sector commentators. The purpose of this edition of the EIB Papers, and the conference from which it is derived, is to examine this thesis in more detail.

The Single Market for Financial Services was launched six years ago. Since then, only modest progress has been made towards the creation of a truly integrated European banking market. There are a variety of reasons for this. However, the restraint due to there being many different currencies throughout Europe cannot be under-emphasised. This means that the arrival of the euro may well be a watershed event for the banking sector.

The structure of this review article, together with the ordering of the papers in the document, is as follows. We start with a discussion of whether continental Europe will move towards a market-based financial system. The general conclusion is that this is inevitable, but there may be high inertia and the transition may happen slowly. In the second part, the economic consequences of maintaining the different types of financial systems are discussed. The reliability of the banking supervisory system emerges as a key topic. This is discussed in the third section. We then ask how well banks are performing, and argue that a merger wave in Europe is possible (part four). This may be driven by a push for efficiency, but also by banks wishing to maintain a dominant position in their local markets. This is reviewed in part five, together with a summary of other reasons why cross-border banking may still be slow to develop. The sixth part discusses which strategies banks could adopt in response to the changes in their environment.

European capital markets will grow steadily, but perhaps relatively slowly

It is well known that the stock and bond markets in continental Europe are substantially smaller than the securities markets in the US. One of the common predictions for the future of the European financial landscape is that the euro will foster financial disintermediation – and capital markets will grow at the cost of bank revenues.

What are the forces that could push Europe in an Anglo-Saxon direction? In the past, the key to success for investors in Europe was to get the currency and interest rate bet right on government bonds in the various EU countries. Clearly, the elimination of separate currencies within the borders of Euroland eliminates this possibility. In addition to the European Central Bank's mandate

to maintain a low-inflation environment, market perception of the credit risk of government bonds is also very small. Spreads on ten-year benchmark bonds between the lowest and highest yielding governments in Euroland have fallen to less than 30 basis points. Indeed, **Martin Brookes** (Goldman Sachs) argues that investors can no longer reach their performance target (given their risk tolerance) by only diversifying between national government bonds within EMU.

Brookes notes that there are three possible responses: Invest in fixed-income markets in the US or Japan, invest in longer-dated government bonds, or switch to European corporate bonds. The options are, therefore, either to take more sovereign risk outside Euroland, more maturity risk, or more credit risk within Euroland.

As mentioned, there has been a distinct approach by investors in the EU. The absence of credit risks (or other legal uncertainties) on government bonds allowed investors to focus on changes to macroeconomic fundamentals. Over the last decade, the steady decline and convergence of interest rates throughout Europe, has meant that investing in EU government "high-yielders" has been a profitable business. In the future, some investors may maintain a similar focus and shift portfolios to government bonds in the US, Japan and the emerging markets. However, the most important single investment group - insurance companies - are prohibited from doing so by the EU Third Life Insurance Directive. This requires insurance companies to hold at least 80 percent of their assets in the same currency as their liabilities (before EMU this restriction used to apply at the national level). In the short-term, the Asian crisis has also made many investors think again about investing in emerging markets.

Graham Bishop (Salomon Smith Barney) notes that governments are lengthening the maturity of their bond issues as they try to benefit from historically low interest rates. Several are making large liquid issues in the ten-year segment of the yield curve, and the number of 30-year bonds is increasing. This will expand the maturity choices available to investors, but will it necessarily permit the desired risk profile? If the yield curve flattens in Europe as price stability in Euroland gains in credibility, then fund managers may also find they have limited scope to increase the yield-to-risk ratio through purchasing bonds with longer maturities.

This leaves the third option - increasing credit risk - and it seems quite likely that there will be much greater interest in the European corporate bond and equity markets in the future. The US experience has shown that the capital markets can compete efficiently with the banking sector - in other words there should be a supply of corporate bonds if there is the demand to create a sufficiently large and liquid market.

If capital markets do grow, this raises the question of how investors will diversify risk. Will this best be done by spreading investments across sectors (since some sectors behave in an uncorrelated manner) or across countries (since the business cycle in each country still dominates company performance regardless of sector)? Brookes reports a recent survey of fund managers

in this respect. According to the survey, almost two-thirds of fund managers intend to organise their portfolios on a sector basis, less than ten percent replied that they would rebalance by country, while the remaining one-quarter indicated a mixture of these two factors. Most managers thought that rebalancing would take place within the space of a few years. Brookes tries to quantify what may happen by calculating the capital flows needed for investors to match the sectoral composition of the aggregate euro-zone equity index (though it should be recognised that this is not necessarily an optimal diversification strategy). In this case, investors may be able to largely achieve the desired sectoral distribution in their own home market, and cross-border capital flows may not be large.

In discussing this point, **Luigi Spaventa** (President, Consob) notes that the empirical evidence suggests that, in the past, investing in capital markets on the basis of home country has offered better scope for diversification than a strategy based upon sector. Simply put, firm behaviour has depended more on the home country than on the sector itself. Of course, this may change in the future with structural changes arising from the Single Market and Monetary Union.

These uncertainties make it difficult to identify the best route to diversification, and no serious investor will wish to take risk without a sound diversification strategy. To some extent this is a secondary point since, other things being equal, the overall size of the European capital market is not affected. Nonetheless, uncertainty about the correct strategy could still slow down the rate of growth of the capital markets.

Indeed, there are many important reasons why continental European capital markets may not grow rapidly to the relative size of Anglo-Saxon markets. For example, Brookes mentions that there is still a lack of harmonisation of the tax treatment of investors and of accounting standards, and that the legal framework protecting shareholder rights varies throughout the European Union. There are many constraints to the rate in which capital markets may develop.

Which will be the leading growth sectors on the capital markets? It is sometimes suggested that the limited size of European capital markets is due to the difficulty of small and medium enterprises (SMEs) in gaining a listing. If so, releasing this constraint would be particularly beneficial for market growth. However, Spaventa believes the problem is rather that many SMEs do not want a listing because of the public disclosure of information that this requires. In any case, Brookes shows that in relative terms SMEs are not under-represented when compared to US equity markets. This means that the impact of this channel may be limited.

Bishop makes another point. A key factor in the development of US capital markets has been mortgage-backed securities issued by Federal agencies (such as the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation, or "Fannie Mae" and "Freddie Mac" as they are more colloquially known). In fact, the value of the outstanding stock of bonds

issued by US Federal agencies is the same order as that of the US government. Thus, public policy has played a critical factor in the development of the North American system. To quote Bishop: "The securitisation of mortgages was fashioned to sponsor home ownership - reflecting the political desire to build a nation. That desire is absent in Europe." In many European countries an alternative solution has been found for the financing of mortgage lending. This is the issuing of collateralised bonds by mortgage banks, or the Pfandbriefe model. However, legal differences across countries mean that it may be difficult to put mortgages from different countries together in a pan-European collateral pool. There may continue to be fragmented national markets, without the liquidity (say, EUR 10 billion or more) necessary to minimise yields relative to government bonds (the so-called Jumbo-Pfandbriefe currently have an EUR 2 1/2 billion size and still trade at more than 40 basis points above Bunds despite a triple-A rating).

On the other hand, Bishop predicts the market will grow as new issuers enter European bond markets. For example, regional governments and even large cities increasingly issue bonds. With EMU releasing the rating cap of the home nation, some of these institutions are better rated than the government (e.g. Florence is better rated than the Italian State). Other candidates are asset-backed securities (such as credit cards, car loans, and even corporate loans). However, taking stock of the major forces on both the demand and the supply side of European capital markets, there appear to be a number of reasons why things will not follow the same path as observed in the US. Progress may be relatively slow in the absence of additional public policy intervention. This may, however, be relatively indirect such as tax incentives to build up private pension assets.

Does it matter if most of Europe remains with a bank-based financial system?

The differences between countries have deep roots, and these go back to the start of industrialisation. For example, David Landes in his recent book on *The Wealth and Poverty of Nations* (1) notes that, at the early stage of the industrial revolution in Britain, investments were typically of a small-size and were financed either through the pooling of personal resources or cashflow. Therefore "banks confined themselves to supplying short-term credit or demand loans to facilitate real transactions." Continental Europe industrialised later. Investment needs had grown with technological advancement, but there were relatively fewer and smaller private fortunes. Institutions were needed to mobilise resources, and the universal bank, combining investment and commercial banking, was born. The result is that bank ownership of equity has always been much larger in continental Europe than in the UK. Different types of corporate structure have also emerged.

Colin Mayer (Oxford University) notes that major differences in structure remain today. In Continental Europe, ownership of quoted companies is appreciably more concentrated than it is in the UK or US, and frequently stock is held in the form of pyramid holdings. Pyramids

1) Published by Little Brown in 1998.

allow shareholders at the top to exert disproportionate influence by bringing in equity lower down the pyramid. While this situation is changing (new listings on Continental stock markets are growing strongly, and minority shareholders are becoming increasingly vocal) it may take time for new sources of external finance to be pursued if they influence ownership structures to the detriment of some dominant shareholders.

Does this have implications for economic growth? There is a large literature showing the link between financial development and economic growth. However, Mayer argues that for countries that are already highly developed, such as those in Europe, "financial and corporate systems may have more relevance to the composition rather than the overall level of economic activity". Typically, stock markets should be well adapted for uncertain high-technology investments. In contrast, more traditional manufacturing activities should benefit from the long-term relationships that banking intermediaries can provide.

Mayer takes this point one step further and argues that having different financial systems across Europe may be beneficial. There would be competition between countries (or financial systems) to serve as the location for companies. No single winner would emerge since different regions could specialise in different types of finance. Corporations would then benefit from the diversity in financing choices available.

The problem with this logic is that it ignores geography. If it is the case that manufacturing industry flourishes within bank-based systems, linguistic and cultural barriers still mean that a company must find an appropriate bank near-by. Likewise, it will be more difficult for a German entrepreneur to sell her idea to a British venture capitalist than to someone from her own country. If it is true that each type of financial institution actually does provide a comparative advantage to certain customers, then a geographic segmentation of financial systems will also strengthen the spatial segmentation of the corporate sector. It is doubtful if this is an optimal outcome. Ideally, financial markets should become sufficiently integrated that all options are available everywhere, and there is no real reason why this should not be the case.

Spaventa also doubts the value of competition between financial systems. Regulatory differences could mean that companies could relocate to jurisdictions with the most lax rules of conduct. In this case, investor protection could be compromised. This means that harmonisation is needed at the EU level. While such harmonisation does not preclude having different systems in different countries, it will minimise the scope for countries to develop "niches".

Are there other economic consequences of the different financial systems? One point made by **Daniel Gros** and **Karel Lannoo** (Centre for European Policy Studies) is that external financial shocks may affect a market-based financial system and bank-based system differently. In particular, corporate bond markets may be more volatile than bank systems, with credit spreads reacting strongly to bad news. These swings in sentiment may be unnecessarily large

due to a lack of information by investors of what is actually happening. Obviously, this has implications for investment and subsequently economic growth.

On the contrary, regions with a large banking sector should be better in coping with a transitory adverse shock, since banks are better informed of the strengths and weaknesses of their borrowers. This means they can better identify creditworthy companies even in times of financial turmoil. They should continue to lend to these companies on similar terms as before. A credit crunch can be more easily avoided, and so the overall consequences of an economic downturn are mitigated. The other side of the coin is that problems may accumulate within the banking sector until they reach critical dimensions. The fact that loans are recorded as assets at their book value rather than their true economic value means that it is difficult for outsiders to know what is going on. For example, many European banks have been very active in lending to emerging markets. As a result, they may be exposed to important financial risks that have yet to be fully recognised. Thus, one advantage of traded instruments is that they permit marking-to-market and much greater transparency.

It is critical for bank-based financial systems to have sound regulation and supervision if potentially very serious economic problems are to be avoided. Japan is a current extreme example of what can go wrong, but **Clas Wihlborg** (Göteborg University) also list a number of other cases where large volumes of tax-payers money have been used to bail-out insolvent banks. Indeed, Wihlborg also doubts the stabilising feature of a bank-based system. On the contrary he sees the potential for "stop-go" banking. In the "go" period banks lend rashly since they believe that they will be bailed-out if things go wrong. In the "stop" period, there is a shock that causes losses throughout the banking system. Banks suddenly stop lending as they try to rebuild their capital, and many borrowers are unnecessarily forced into bankruptcy when they cannot rollover loans. Wihlborg argues that this is what happened in Sweden during the early 1990s. How does the EMU system fare in this regard?

Weaknesses - or not - in bank supervision in Europe

A number of possible weaknesses with the EMU system have been identified by Gros and Lannoo, Wihlborg, Alessandro Prati and Dirk Schoenmaker (2) among others. The regulatory system in the EU is based upon mutual recognition of national supervisors. This operates within a set of harmonised rules regarding the minimum acceptable capital structure of banks (e.g. solvency ratios and large exposures), and an agreed approach to the design of the safety-net for the banking system (e.g. deposit insurance and lender of last resort facilities).

2) Alessandro Prati of the IMF and Dirk Schoenmaker of the Netherlands Ministry of Finance also made presentations on this topic at the conference.

Banks may be increasingly operating throughout Europe, but this in itself does not mean that the national supervisor at the head office of a particular bank should be in a worse position than one based anywhere else. For us, the more powerful criticisms of the current system are that:

- *the lender of last resort facilities may not work correctly; and,*
- *the current supervisory rules may distort the behaviour of bank managers.*

Let us start with the lender of last resort issue. Since the loans made by banks are illiquid, the situation can arise where a solvent institution has a temporary liquidity problem. This applies to other corporations as well, but the problem for banks is that the temporary problem of one bank could spread through the payment system to other banks, and thus lead to a sector-wide crisis. To avoid this, the central bank stands ready as the lender of last resort.

Under the EMU system, the National Central Bank (NCB) is able to provide liquidity against acceptable collateral to banks under its jurisdiction. If the NCB gets it wrong, and actually lend to an insolvent bank, this should remain an issue for that NCB and local taxpayers. The main problem that has been pointed out relates to the situation where there is a crisis of sufficient magnitude that liquidity must be injected on a system-wide basis. A frequently quoted example is Black Monday in 1987 on the New York Stock Exchange. Such liquidity injection must be done by the European Central Bank (ECB) since it is sufficiently large to increase the money supply. Critics argue that the information flows and decision-making processes are too unwieldy for the ECB to respond rapidly to such problems. The ECB counters that it is indeed ready to react in a timely manner. There are no theoretical reasons why this should not be the case - it is a question of faith, or lack of it, in the institutional structure of the European System of Central Banks. The problem is that, until the system has been tested, doubts will remain.

The second point mentioned above has two dimensions. One issue is that ambiguity regarding bailouts creates moral hazard problems. This can lead to the "stop-go" banking of before, or simply that problems build up before there is a crash. A second issue is that capital adequacy rules are black-and-white. Either a bank is above the minimum, in which case it is "good", or it is below, and is "bad". This could lead to abrupt changes in lending policy by banks as they pass the threshold. The US solution has been "Structured Early Intervention", where the involvement of the supervisor in a particular bank increases in a number of steps as the bank's capital adequacy deteriorates. Wihlborg argues that the European Union should adopt such an approach, and proposes other associated rules to increase transparency. These are intended to "make it possible to credibly state that insolvent banks will be allowed to fail and be liquidated."

For us, the critical issue for a sound banking system in the long run depends first and foremost on the competence of the national banking supervisors rather than a reorganisation of current institutions into central bodies. In this context, Tommaso Padoa-Schioppa (3), in a recent speech to the London School of Economics, has observed that the EU regulatory system is "heavy", in that many provisions are included in Community primary legislation. The EU legislative process is slow and it can take many years to pass new Directives. There is, therefore, the question of the ability of the regulatory framework to adapt sufficiently quickly to a changing world.

However, the approaches outlined by Wihlborg are worth considering further. For one thing, the bailout of insolvent banks simply because they are the "national champions" is unacceptable from a competition point of view. And as competition increases in the banking sector, it would be normal to see more banks having difficulties.

The state of banking in Europe, and the coming merger wave

How well will banks be able to cope with greater competition? The banking markets in Europe have evolved in various directions. For example, Austria, Germany, Italy and Spain have relatively many savings banks (more than 40% of the total) compared with the other EU countries. We must, therefore, be careful in drawing conclusions from a sketch of the industry at an aggregated European level. Comparisons between Continental Europe and the US are also complicated by the fact that structure of the balance sheet varies widely between these regions. For example, US banks provide relatively more loans to corporations and consumers, and have essentially no interbank lending. On the contrary, as much of one-quarter of Euroland assets are due to interbank business. Moreover, European universal banks are involved in a range of activities, such as insurance, that are prohibited to their peers in North America.

*With the caveat that there are these important differences, **Christopher Hurst, Eric Perée** and **Mireille Fischbach** (EIB) examine a number of balance sheet and profit and loss ratios to see what can be said about performance. The overall conclusion is that Euroland banks are more oriented towards lower-risk, but also lower revenue activities. The share of income from non-interest sources has increased everywhere, but the reasons for this are quite different. In Europe it is due to a falling interest margin (i.e. the revenue earned from borrowing and lending activities), while in the US it is due to the relative growth in fee-related business and own-account trading.*

Given the asset composition of European banks, costs seem relatively high, and the share of costs absorbed by staff is greater than elsewhere. Though the volatility in earnings of banks in the Anglo-Saxon countries is higher than in Euroland, they also earn a substantial higher return on equity (ROE) on average. In 1996, the average ROE exceeded 20 percent in the US and the UK, but the corresponding figure in Euroland was stuck at a humble 6 percent.

3) Member of the Executive Board of the European Central Bank. The speech was given on 24 February, 1999, to the Financial Markets Group.

*There are many factors that could potentially explain the poor performance of Euroland banks, and it is extremely difficult to quantify them with any precision. On the one hand, Euroland banks may have inadequate product mixes and pricing strategies for corporate clients, together with a lack of understanding of cross-subsidies. On the other, managers in European banks appear to fail in controlling costs. This latter topic is also examined in more detail by **Rien Wagenvoort** and **Paul Schure** (EIB).*

Poor management decisions (e.g. over-branching, over-staffing, inappropriate technological choices, inefficient purchasing, etc) move a bank away from best practice. This is the so-called "X-inefficiency". Other sources of inefficiency can be due to size (i.e. whether a bank is of the right scale to minimise costs) and product mix.

Wagenvoort and Schure assess a range of efficiency measures for almost 2000 credit institutions in the EU. To do this, a cost frontier is estimated to distinguish those banks which provide the highest level of financial services given their resources and input prices. X-inefficiency is found to be of the order 15 to 20 percent for the overall European banking industry. This means that "wastage" due to poor management is over one-third of gross profits for the sector as a whole. Many studies show similar management shortfalls in the US, so there are substantial possibilities to reduce costs on both sides of the Atlantic. Indeed, the estimated gains for the European banking sector from raising X-efficiency dominate by far the possible cost reduction effects from changing size or the type of bank.

Scale economies are exhausted at a balance sheet total of about EUR 600 million, and so big is not necessarily better. Of course, these econometric results have their limitations. A very simple three-input/five-output model of a bank is estimated, and a number of proxies must be used to estimate the actual level of services produced by banks. Moreover, there could be systematic differences across countries that distort the results. Still, our conclusion is that, once a very small size is passed, average costs do not seem to either decrease or increase with size. This means that banks can consolidate without necessarily gaining or losing in competitive edge. In some cases, overlapping networks between two merging banks can be cut, and this reduces costs. However, the key test for a successful merger is that management is improved (and X-inefficiency reduced). This would normally happen when an efficient institution acquires a poorly performing one. In fact, Hurst, Perée and Fischbach argue this is the way in which the sector should respond to greater competition, and, as a result, Europe will see a merger wave in the coming years. The alternative of trying to drive competitors out of business is usually too costly in the banking industry. Concentration in banking markets will increase, though this has nothing to do with pursuing size for its own sake.

Defensive strategies, and other barriers to cross-border banking

On the other hand, many mergers will not be successful, or even driven by profit motives. Bank managers may go for scale since compensation packages and prestige are linked to bank size. And they may seek to merge with other banks in an attempt to shore up a dominant position in their local market. Thus, increasing concentration in the sector does raise the question of whether this might not also be a poor deal for customers.

Philip Molyneux (University of Wales, Bangor) argues that there is less and less scope for banks to have market power. Molyneux believes that European banking markets are increasingly "contestable" in the sense that monopolists are vulnerable to a hit-and-run by new competitors. For example, banks face growing competition from non-traditional rivals, such as internet banking, credit card operators, consumer finance firms and venture capitalists. Incumbents should, therefore, behave as though they were in a competitive environment in order to forestall these new incursions.

To us it seems premature to see European banking markets as contestable. Firstly, large investments in information technology and marketing are required to enter the business. This brings along high sunk costs. Secondly, although large corporate borrowers may indeed tap other financing sources, the range of options for small and medium enterprises and retail customers are much more limited. These customers have high switching costs, and the fact that their credit history is privy to their bank may tend to lock them into a particular banking relationship. The possibility of defensive strategies that build upon this market inertia mean that there will be many false starts on the path to an efficient banking sector.

Many banks in Europe are either mutuals or within the public sector. These institutions may not feel the same urgency to react as private banks with shareholders. The role of the state in banking will come under increasing scrutiny in the post-EMU environment (for example, the government guarantee of some public sector banks is currently being challenged as distorting competition), and privatisation is also on going. Still, one feature of the US experience has been the mopping-up of very small banks into larger organisations. In the case of Europe, this may require demutualisation first, and this is unlikely to happen over-night.

There are other constraints to restructuring even when suitable merger opportunities are correctly identified. For example, staff reductions - often a key element of the restructuring process - may be difficult due to labour legislation. Cross-border business may also be hindered by the continued existence of tax and legal differences throughout Europe. Since successful mergers normally require that a better management culture is transferred from one organisation to another, general linguistic and cultural barriers are also extremely important.

Our conclusion is that banks will exploit merger and acquisition possibilities in national markets before going cross-border. Exceptions could be banks with a large market share in their own countries, and that see limited prospects nationally - such as Nordic and Dutch banks.

Banking strategies post-EMU

*How should banks best react to the new more competitive environment? **Jean Dermine** (INSEAD) sees three key factors that determine the strategic choice. EU legislation has established the universal banking model for Europe - commercial banks can also undertake investment banking, insurance, and fund management. Dermine argues that home country advantage of banks will disappear in a variety of non-lending market segments, such as bond and equity underwriting and trading, and fund management. A second issue is that there are economies of scale in some of these markets. The final factor is that it will be better to diversify throughout Europe. This will allow banks not only to spread credit risks across several regions, but also to stabilise the demand for services in capital markets. Putting these three elements together, a pan-European growth strategy is optimal.*

***Ingo Walter** (New York University) takes a somewhat more nuanced view. For him it is clear that "the fabled economies of super-scale, like the abominable snowman, have unfortunately never been observed in nature". Walter also notes that pan-European mass market branding is not easy to achieve. So far, successful cross-border retail business in Europe has been limited to special cases (such as private banking), with broader-based incursions being very rare. However, different product lines and customers do exhibit different features. Mayer's earlier point about the comparative advantage of different financial systems, can also be argued at the level of the institution. Thus, the range of strategic options for firms is very large, and there is "room for firms that range from large to small and from universal to specialist".*

Should many business lines be grouped together in one institution? Universal banking does allow banks to pursue strategies based upon diversification to other markets. However, the benefits of cross selling are often offset by corporate culture clashes. For example, there are considerable differences between a commission-drive sales force selling insurance products, and bank staff offering bank accounts and related services. If separate organisations are maintained with the same corporate conglomerate (and this is often the case) then the only economies of scope would come from integrated marketing and brand loyalty by customers.

Universal banking may seriously compromise other strategic choices due to conflicts of interest. This comes about if managers no longer dispense dispassionate advice to clients, but push "house" products. Indeed, they may even use private information gained from one activity to the disadvantage of customers in other business streams. In Euroland, few "Chinese" walls exist between different businesses to deal with this problem, and there appears to be a reliance on the loyalty and professional conduct of employees. Unfortunately, these can come under pressure

as competition increases, and short-term results are boosted at the expense of long-run returns. As Walter notes, "the conflict of interest issue may seriously limit effective strategic options. For example, inside information accessible to a bank as lender to a target firm would almost certainly prevent it from acting as an adviser to a potential acquirer. Entrepreneurs are unlikely to want their private banking affairs dominated by a bank that also controls their business financing. A mutual fund investor is unlikely to have easy access to the full menu of available equity funds though a universal bank offering competing in-house products. These issues may be manageable if most of the competition is coming from other universal banks. But if the playing field is also populated by aggressive insurance companies, broker-dealers, fund managers and other specialists, these issues will prove to be a continuing strategic challenge to management."

Walter also notes that research work has shown that industrial conglomerates tend to use capital inefficiently due to over-investment in marginally profitable activities and cross-subsidisation. As mentioned before, we believe one of the problems of the poor performance of banking in Euroland is exactly due to this lack of transparency in choosing product mixes and setting prices. In sum, the attraction of conglomerates may wane, and shareholders may increasingly feel that the sum of the separate parts is greater than the whole.

The growth of capital markets is a competitive threat to banks, but it is also provides opportunities. By this we do not mean that banks will be able to develop capital market business, though some will do that. Rather it will allow banks in general to better manage their balance sheets through the sale of securitised loans. Mergers and acquisitions must also be financed in some way, and a more efficient European-wide stock market will make it easier for those banks with sound acquisition strategies to get the deal done.

*Christopher Hurst and Rien Wagenvoort,
The Editors*