

EUROPE 1992 AND THE BANKING INDUSTRY

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SANJAY ISWAR HAZARIKA

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ABSTRACT

This paper studies the move for integration in banking services in Western Europe as part of the movement toward "Europe 1992". The main conclusion is that the pressures of domestic economic and political considerations as well as changes in the character of international finance have inhibited some European Community governments in their efforts to comply with the regulations of 1992. This in turn could lead to a slowing down of the movement for European integration.

The study employs a multidisciplinary approach combining economic evaluation with political analysis. This multi-disciplinary framework is applied to a discussion of EC history and the 1992 banking regulations. Subsequently, the framework is used to examine the cases of the German and UK banking industries.

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I. INTRODUCTION: EUROPE 1992 AND THE BANKING INDUSTRY

The financial sector accounts for three percent of the gross domestic product and six percent of the employment of the twelve European Community (EC) countries.¹ The changes associated with the "movement" towards "Europe 1992" are expected to have a profound effect on this sector.² In fact, some writers consider the financial sector to be the arena where the success or failure of the movement will be determined. While this may be an exaggeration there is no doubt that the financial sector is crucial to the success of the "Europe 1992" movement.

This paper studies the potential impact of the movement towards 1992 on banking, the industry in the financial sector that is expected to see some of the most far-reaching changes. Banking presents a fascinating business case study for students of European integration, as it combines

¹ Nicholas Colchester and David Buchan, Europower (London: The Economist Books, 1990).

² Paolo Cecchini et al., The European Challenge 1992: The Benefits of a Single Market (Aldershot: Wildwood House for the EC Commission, 1988).

revolutionary competitive and strategic changes with equally fundamental alterations in business-government relations.

Not only will this most international of industries be further opened to international pressures, but the central banks that govern domestic banking environments will themselves have new roles. If the architects of 1992 are to have their way, we could even see a giant central bank that supersedes the authority of the national central banks.

In view of the multi-dimensional nature of the effects of "Europe 1992" on banking, this study attempts to combine economic analysis with a historical perspective as well as two paradigms of analysis borrowed from political science. With the help of this multi-disciplinary analysis the paper comes to the conclusion that domestic political considerations may set up major obstacles on the path to banking integration. While this is not a particularly revolutionary finding in itself, the paper will show that current events in the European financial world already show a pattern of withdrawal from the initial euphoria of European unity. In particular, the situation of the German banking industry shows clear signs that the strains imposed

by German unification have significantly altered the government's stance on a number of crucial integration issues. Similar signs appear on the UK banking scene. Changes in the attitudes of governments (especially the German government) towards the banking components of "Europe 1992" will inevitably retard the progression of the integration program.

Section II below introduces the analytical frameworks used in the study. Section III discusses the historical background of the movement towards European integration. In Section IV, an analysis of contemporary EC banking and finance legislation is provided. A discussion of modern trends in international banking is provided in Section V. Sections VI and VII study the German and UK banking industries respectively and analyze the patterns of business-government relations and competitive pressures in terms of the frameworks described in Section II. Finally, Section VIII ties the various arguments together and presents the conclusions of the study.

II. ANALYTICAL FRAMEWORKS

This section describes the four analytical frameworks used in the study. Two of these are borrowed from business analysis: Porter's "five forces model"³ and his "Diamond" of national competitive advantage.⁴ The other two are borrowed from political science: Katzenstein's "strong state/weak state" paradigm⁵ and the "policy network" model originated by Katzenstein and developed by Atkinson and Coleman.⁶

II. 1. THE FIVE FORCES MODEL

Michael Porter's five forces model is probably the most widely used framework of analysis for industry competitive

³ Michael Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors (New York: The Free Press, 1980).

⁴ Michael Porter, The Competitive Advantage of Nations (New York: The Free Press, 1990).

⁵ Peter J. Katzenstein, "Conclusion", in Peter J. Katzenstein, ed., Between Power and Plenty (Madison: The University Of Wisconsin Press, 1977).

⁶ Michael M. Atkinson and William D. Coleman, "Strong States and Weak States: Sectoral Policy Networks", British Journal of Political Science, 19 (1989).

structure, and it is especially useful for a study of the banking industry. The model posits five main determinants of the competitive position of a firm in an industry: rivalry among existing competitors, bargaining power of suppliers, bargaining power of buyers, the threat of new entrants and the threat of substitute products or services.⁷

While postponing a discussion of its applicability to specific examples until Sections VI and VII, some time can be spent here sketching in the general points of the model. "Europe 1992" is expected to dramatically effect the relative positions of banks in Europe, as falling national boundaries will alter the dynamics of competition.⁸ For example, some banks may gain through economies of scale in technology and manpower, while others will be less successful. This could lead to concentration in the industry as weaker players drop out and the survivors consolidate and expand. The movement towards 1992 may also affect the bargaining power of suppliers and customers, if a

⁷ Porter, Competitive Strategy.

⁸ Cecchini et al., op. cit.

similar concentration leaves supplier and buyer industries with stronger and bigger firms. Similarly, the threat of new entrants from outside Europe (or new intra-European rivals) will also be affected, depending on the extent of financial integration and the nature of protective legislation. Finally, banks could be threatened if investment banks or insurance companies developed the ability to poach on their preserves as the result of new legislation.

II. 2. THE "DIAMOND" OF NATIONAL COMPETITIVE ADVANTAGE

Porter's paradigm of national competitive advantage involves a "diamond" of interlinked determinants of competitiveness: firm strategy/structure/rivalry, general factor conditions, demand conditions and finally related and supporting industries.⁹ The first set of determinants can be studied with the help of the "five forces" model described in II. 1. above. Factor conditions for banking would include items such as labor, technology and infrastructure. An important consequence of 1992 will be the increased mobility of labor,

⁹ Porter, The Competitive Advantage of Nations

as immigration law is relaxed within the EC; clearly, this could have major long term consequences for banking if competition for skilled professionals goes up. Similarly, legislative changes may affect technology and infrastructure (which are crucial in the banking industry). New demand conditions could include more sophisticated and powerful customers and a rapid pace of product innovation. Finally, related industries such as information technology, insurance and investment banking will also have changing roles under the new competitive conditions after 1992.

It will be noted that neither of Porter's models mentions the influence of government. While Porter's analysis does not neglect this vital component of the business environment, this writer feels that any study involving Europe 1992 must necessarily include government in a more explicit manner. The following subsections are devoted to the political frameworks used in the paper.

II. 3. THE STRONG STATE/WEAK STATE PARADIGM

Katzenstein's framework for analyzing the nature and causes

of state policy in the political and economic arenas is useful for a study of this type. His basic idea is to divide states into strong and weak according to whether their political infrastructures and mechanisms of control are centralized or decentralized.¹⁰ For example, Japan is characterized in this paradigm as a strong state because the government and bureaucracy are highly centralized and exercise strong control over foreign and economic policy. The US is a classic example of a weak state, owing to its lack of a centralized bureaucracy and its relatively looser control over economic and business affairs. Countries such as Germany lie somewhere in the middle of the spectrum. The UK, however, is harder to categorize: while it possesses many characteristics of a strong state, British governments no longer play a highly interventionist role in the UK business world. The paradigm fails altogether when confronted by paradoxes such as the position of the defense industries in the US and France: the US is classed as weak and France as strong, but both governments play a highly interventionist role in their defense industries.

¹⁰ Katzenstein, op. cit.

Despite these weaknesses, the Katzenstein paradigm is useful because it works as a convenient organizing principle when studying a problem such as the impact of "Europe 1992" on banking. Given the nature of the industry and its intimate connection with macroeconomic policy and national sovereignty, government responses to external factors such as pan-European integration are bound to have a profound impact on banking conditions. As will be seen in Sections VI and VII, the strong state/weak state paradigm helps to understand the nature of government policies as the UK and Germany attempt to balance domestic considerations against the forces of European integration.

II. 4. POLICY NETWORKS

The policy network paradigm (originally developed by Katzenstein) is extended by Atkinson and Coleman to supplement the strong state/weak state idea. In this system, greater attention is paid to the different levels at which the state interacts with the economy. At these lower levels, there exist "specific bureaucratic arrangements and...relationships with key societal actors which...form

the core of "policy networks" at the sectoral level."¹¹

These policy networks are the arenas within which various actors in a sector interact with each other to create government policy. For example, in the US banking industry the policy networks would include the Department of the Treasury, the Federal Reserve, Congress (with its various banking committees), bank lobbying organizations, individual banks, or any combination of these. In a country such as Japan where government-business links are very strong, individual banks and even in some cases their officers could have a significant impact on government policy. Sections VI and VII will show how banking policy in the UK and Germany can be understood in terms of these policy networks.

Having introduced the analytical frameworks used in this study, the next step is to provide a brief historical account of the development of the EC. A knowledge of the historical background is essential if the banking regulations discussed in Section IV are to be understood.

¹¹ Atkinson and Coleman, op. cit., p. 47

III. THE ROAD TO EUROPE 1992: THE HISTORICAL BACKGROUND

III. 1. EARLY DEVELOPMENTS

The postwar movement for unification in Europe can be traced back to the Economic Commission for Europe (ECE), which was founded in 1947.¹² The ECE was a UN regional organization whose purpose was to initiate reconstruction projects in Europe. Unfortunately, the cold war made it very difficult for the Commission to function effectively and it soon became moribund. In the same year, the Committee for European Economic Cooperation (CEEC) was founded under US sponsorship. This in turn led to the creation of the Organization for European Economic Cooperation (OEEC) in 1948. The OEEC was basically an aid organization that aimed at European development under the aegis of the Marshall Plan; US support of European integration was thus firm from the very beginning.¹³ The formation of the Council of Europe in 1949 marked the end of this early stage on the

¹² Dennis Swan, The Economics of the Common Market, Sixth Edition, (Penguin Books: 1990).

¹³ Stanley Hoffman, "The European Community and 1992", Foreign Affairs, vol. 68 (Fall 1989).

road towards 1992.

III. 2. EUROPEAN COAL AND STEEL COMMUNITY

The first major proposal leading to the eventual formation of the European Economic Community (EEC) was the Schumann Plan of 1950.¹⁴ The Plan proposed the pooling of France and Germany's coal and steel capacities under a supranational authority to which other nations might accede. Jean Monnet was instrumental in developing the Plan, which resulted in the treaty ratifying the establishment of the European Coal and Steel Community (ECSC) in 1952. West Germany, France, Italy and the Benelux countries were the members of the Community (the UK refused to join). By 1954, the ECSC had removed most barriers to trade in coal, coke, steel and pig iron.¹⁵ The central institution was the High Authority, which had the power to establish national quotas and fine companies that violated ECSC regulations.

¹⁴ Alan Palmer, The Penguin Dictionary of Twentieth Century History, (Penguin Books: 1982).

¹⁵ Encyclopaedia Britannica, 15th Edition (1989), s.v. "European Coal and Steel Community".

III. 3. THE FOUNDATION OF THE EEC

In 1955, the Benelux states called for the establishment of a general common market and of institutions that would provide the foundations of an "economic community". The inter-governmental Spaak Committee was set up to study the specifics of these proposals. After the Committee had presented its findings in 1956, the governments of the six ECSC countries agreed to draw up two treaties to create "a general common market and an atomic energy community".¹⁶ Following several months of negotiations, these treaties were signed by the six governments in Rome in 1957 and ratified by their respective parliaments in 1958. The EEC and Euratom (the atomic energy agency) came into being on January 1, 1958.

The immediate objective of the new organization was a customs union in which commodity tariffs between member countries would be eliminated. However, the Treaty of Rome also worked towards the broader goal of a common market in which factors of production could move freely across

¹⁶ Swann, op. cit.

borders. In addition, the Treaty recognized the possibility of an eventual economic union with its concomitant coordination of monetary and fiscal policies between nations.

III. 4. 1958-69

This period saw a fairly rapid development of the EEC system. Internal tariffs and quotas were either eliminated or gradually reduced by agreement among the member countries; they were totally eliminated in July 1968.¹⁷ The Common External Tariff (CET) was introduced by averaging member state duty rates. The Common Agricultural Policy (CAP) was another prominent initiative of the period. The members also worked towards the free movement of factors. The governing councils of the EEC, ECSC and Euratom were merged in July 1967.¹⁸

¹⁷ Gary C. Hufbauer, "An Overview", in ed. Gary, C. Hufbauer, Europe 1992: An American Perspective, (Brookings Institution, 1990).

¹⁸ Ibid.

III. 5. 1969-85

The first EMU resolution was passed at the Hague Summit of 1969. At the same time, the member heads of state declared that the Treaty of Rome objectives had been attained. This meeting also marked the solidification of the "summit" system in which major issues in EEC policy came to be debated at meetings of member heads of state. The arrangement was formalized in 1974 with the creation of the European Council, which consisted of the heads of states, their foreign ministers and selected officials. In 1979, the European Monetary System was created, along with the European Currency Unit (ECU) and the Exchange Rate Mechanism (ERM).

A significant characteristic of the period was the evolution of consensus-based decision making among members -- a single dissident country could veto a major new measure. Adopted in 1966 at the insistence of de Gaulle,¹⁹ the trend towards this mode of decision making was accentuated by the rise in the importance of the European Parliament, which had

¹⁹ Colchester and Buchan, op. cit.

gradually acquired greater power over the Community budget and was often at odds with the European Council. By the late seventies, budget wrangles were commonplace and few new initiatives arose. Europe in general was entering a period of difficult economic times, and commentators were referring to the European situation by the term "Eurosclerosis".

On a more optimistic note, the EEC was expanded to twelve members during this period. The UK joined (after extensive negotiations) in 1973; Ireland and Denmark joined in the same year. Greece was admitted in 1981, and Spain and Portugal were the last to join in 1986.²⁰

III. 6. THE SINGLE EUROPEAN ACT

In 1979, the first direct elections to the European Parliament were held. The move to direct election was a clear sign of the increasingly activist role adopted by this assembly, as well as the growing involvement of the national electorates of the member countries. Frustration with

²⁰ A. Bloomfield, "The Historical Setting", eds. L. B. Krause and W. S. Salant, European Monetary Unification and its Meaning for the United States, (Brookings Institution: 1973).

"Eurosclerosis" led the first directly elected Parliament to produce a draft treaty establishing a European Union that would have more far-reaching powers than the present system allowed. The Parliament adopted the European Union Treaty (EUT) in 1984.

Meanwhile, the European Council was considering a similar move. In 1981, Germany and Italy submitted a draft European Act designed to further the cause of integration; this led to the Solemn Declaration on European Union, which was signed by the heads of state at Stuttgart in 1983. The influential Dooge Committee was set up at the Fontainebleau Summit in 1984 to study how the EC's situation could be improved in the spirit of the Solemn Declaration. Following the recommendations of the Dooge Committee, an Inter-Governmental Conference (IGC) was established to negotiate a European Union treaty. In 1985, the famous Cockfield White Paper on removing barriers to trade was released by the European Commission. The White Paper identified hundreds of actions to be taken by the EC if its trade regimes were to

be liberalized,²¹ and provided an impetus to the deliberations of the IGC. The findings of the IGC were submitted at the Luxembourg Summit at the end of 1985, and were embodied in the Single European Act of 1986. This Act, which took effect on July 1, 1987, formed the basis of the movement towards 1992.

The basic purpose of the Single European Act was to revise the 1957 Treaty of Rome and provide a basis for the common future development of the EC. The first major component of the Act was a limiting of the old consensus mode of decision making to specified group of issues such as taxation and immigration.²² In doing so, the Act established the concept of supranationality as an essential component of Community-wide policy. Further, it introduced the idea of "mutual recognition", whereby all member governments had to recognize the commercial and business legislation of other member governments. Overall standards for such legislation, however, were to be set in Brussels via a majority voting

²¹ EC Commission, Completing the Internal Market: White Paper from the Commission to the European Council (Luxembourg: 1985).

²² Colchester and Buchan, op. cit.

system. The Act also strengthened the powers of the European Parliament to influence Community legislation. Another critical component was a reaffirmation of the commitment to EMU (the UK was the last of the twelve members to commit itself to the first stage of EMU -- accession to the ERM -- at the 1989 Madrid Summit).

If the spirit of the movement towards 1992 is embodied in the Single European Act, its flesh and blood can be found in the Cockfield White Paper. The White Paper is essentially a blueprint and timetable for the for the road to 1992. It lists initiatives in areas ranging from industrial standards to banking, and from food to pharmaceuticals.²³ In the years after the adoption of the Act in 1987, many of the Cockfield recommendations were transformed into policy in the form of European Commission directives that were adopted by the European Council. Section IV is devoted to a discussion of some of the EC legislation applicable to the banking industry.

²³ Hufbauer, op. cit.

III. 7. AN ANALYTICAL DIGRESSION

At this point, it is useful to recall the "policy network" paradigm described in Section II above. This framework can be applied very successfully to the events described in the earlier subsections. The original system was designed to study networks within a country,²⁴ but it can easily be extended to the EC if individual states are regarded as "sectors" within the Community. While a detailed historical analysis is beyond the scope of the paper, a few general remarks are helpful to an understanding of EC policy formulation.

The path leading up to the Single European Act provides a good example of policy networks in action. It is well known that Margaret Thatcher was opposed to most moves that sought to bring the EC closer together and reduce the veto powers of individual members (Stanley Hoffman has compared her to de Gaulle in this respect).²⁵ At the 1985 Milan Summit, she was supported in her opposition to such moves by Denmark;

²⁴ Atkinson and Coleman, op. cit.

²⁵ Hoffman, op. cit.

France and Italy formed a network in favor of a "European Union". Italian Prime Minister Bettino Craxi's call for a conference on the issue was adopted by a seven to three majority despite her opposition.

The origins of this "coup"²⁶ lay in the general aura of "Eurosclerosis" that pervaded the EC in the late seventies and early eighties. Ironically, it was Mrs Thatcher's lack of support for the CAP and her wrangles over the UK's contribution to the EC budget that provided one of the first thrusts towards what eventually became the Single European Act. The European Council responded in 1980 to the UK's objections by directing the European Commission to investigate non-farming initiatives that might be of greater benefit to the UK. The resulting Thorn Report concluded that comprehensive non-agricultural initiatives were possible only if the EC committed itself to a wide range of programs spanning technology, economic, financial and industrial policies. Although the report was not acted upon, the idea of a more integrated EC received a new lease on life.

²⁶ Colchester and Buchan, op. cit.

Another step towards the Act came in 1983 when the European Commission proposed a modification of EC voting. The objective was to dilute the consensus system and move towards a majority voting arrangement; the rationale was that with the entry of Spain and Portugal the old system had become unwieldy. Although turned down by the Council, this proposal was taken up again during the negotiations for the Single Act.

Both these examples can be interpreted in terms of the policy network paradigm. The early eighties saw a clear division of EC members into rival policy networks that opposed greater integration on the one hand (UK, Denmark) and supported integration on the other (France, Italy, Luxembourg). Negotiations between these rival networks were complicated by the interests of a third network -- the bureaucrats of the Commission. The eventual "Europe 1992" programs were the result of involved negotiations between these networks.

IV. THE LEGISLATIVE FRAMEWORK FOR BANKING

In the banking context, the Europe 1992 movement is designed to be a retail phenomenon.²⁷ The objective of the 1992 banking legislation is to create a system of "universal banking", in that customers should be free to avail of a full range of commercial and investment banking services within the EC across national frontiers.²⁸ This is in keeping with similar measures to liberalize the securities and insurance industries in the EC.²⁹ The rationale for such a system is a substantial reduction in service costs for consumers and an increase in industry efficiency that will enable EC-based banks to compete more effectively against US and Japanese rivals.³⁰ While the struggle to adopt the principle of universal banking proceeded within the European Council and the Parliament on fairly partisan

²⁷ Colchester and Buchan, op. cit.

²⁸ Carter H. Golembe and David S. Holland, "Banking and Securities", in Gary C. Hufbauer, ed., Europe 1992: An American Perspective (Washington, DC: Brookings Institution, 1990).

²⁹ Swann, op. cit.

³⁰ Cecchini, et al., Completing the Internal Market.

lines, economic considerations emerged as a deciding factor.³¹ An influential EC study published the following estimates of potential consumer savings:³²

TABLE 1

POSSIBLE IMPACTS ON THE PRICES OF FINANCIAL PRODUCTS THROUGH
COMPLETION OF THE INTERNAL MARKET

COUNTRY	POTENTIAL THEORETICAL PRICE REDUCTION (PERCENTAGES)
SPAIN	34
ITALY	29
FRANCE	24
BELGIUM	23
GERMANY	25
LUXEMBOURG	17
UNITED KINGDOM	13
NETHERLANDS	9

³¹ Financial Times, April 14, 1991.

³² Michael Emerson, et. al., The Economics of 1992 (Oxford: Oxford University Press, 1990).

A prerequisite for such a system of liberalized universal banking is the absence of restrictions on capital movements across EC borders. As of 1990, eight EC nations have lifted most of their exchange restrictions. Spain and Ireland have the right to retain theirs until 1992, and Spain and Portugal have until 1995 to do away with them. In this section the EC legislation governing the banking component of the 1992 agreements will be described. The first subsection briefly details some pre-1992 measures, after which the Banking Directives and EMU are described in the subsequent subsections.

IV. 1. PRE-1992 MEASURES

The Treaty of Rome and its subsequent amendments have paid specific attention to the financial sector by relaxing various capital restrictions.³³ A gradual process of relaxation by individual countries was crowned in 1979 by

³³ EC Commission, European File: Towards a Big Internal Market in Financial Services (Luxembourg: 1987).

the UK's relaxation of all exchange controls.³⁴

The EC Directive of 1973 abolished certain restrictions on banking services. The First Banking Directive of 1977 was the first move to establish EC-wide standards for the industry.³⁵ The Directive suggested that minimum capital requirements and reserve ratios be set up for banks. The 1983 Consolidated Supervision Directive required members to become involved in a process of mutual supervision. In addition, it specified that the accounts, exposure and management of banks should be reviewed on a consolidated basis every year (thus extending its coverage to bank holding companies). The main stress of pre-1992 banking legislation was to create "universal" standards that all EC members were to follow; as could be expected, the member countries found it hard to agree on standards.

³⁴ By 1989 countries such as the Netherlands, UK and Germany had removed all capital movement restrictions; the EC Directive of 1988 (which came into effect on July 1, 1990) was designed to remove all other restrictions.

³⁵ Golembe and Carter, op. cit.

IV. 2. PRINCIPLES OF THE 1992 MEASURES

As described in section three, the 1992 program had its immediate origin in the White Paper of 1985. In the banking context, the White Paper recognized the problems of imposing universal standards for banking and switched to a concept of "mutual recognition".³⁶ According to this concept all EC members had to recognize each others' banking standards, and there would be no attempt to impose regulations on the EC as a whole (although certain "core" or basic standards were to be established to protect investors, depositors and consumers). However, this relaxation was theoretically just an intermediate stage on the ultimate road to universal regulations.

IV. 3. THE 1989 BANKING DIRECTIVE (Second Banking Directive)

The Second Banking Directive is the heart of the 1992 banking program. Taking the First Banking Directive, the Consolidated Supervision Directive and other pre-1992 measures as a base, the Second Directive concentrated on the

³⁶ EC Commission, Completing the Internal Market.

"single license" concept and set out the full spectrum of banking activities that are to be regulated under the 1992 program. The Directive was adopted by the European Council on June 19, 1989 and is scheduled to come into effect on January 1, 1993.³⁷

The "single license" concept builds on the mutual recognition idea of the 1985 White Paper and the Single European Act. According to this concept, a bank (described in the Directive as a "credit institution") licensed in one EC country is automatically allowed to operate and establish branches in the other member countries. In other words, in order to receive permission to operate a bank on an EC-wide basis, a single application in one member country is all that is required. While the home country retains primary supervisory responsibility, the host countries can oversee the activities of "foreign" EC-country banks and regulate their liquidity, risk profile and other operational details. The commitment of the EC heads of state to the "single

³⁷ EC Commission, The 1992 Banking System (Brussels: EC Commission, 1991).

license" idea was reaffirmed in the Rome Communique of 1990.³⁸

The Second Directive describes the banking activities under its jurisdiction in considerable detail. These activities include conventional banking operations such as the acceptance of deposits, payment systems such as credit cards and travellers' or bankers' checks, custody services, credit reference services and the making of loans in consumer, mortgage or other areas. In addition, the Directive explicitly includes trading (on own or client account) in areas such as spot and forward foreign exchange, foreign exchange futures and options, financial futures and options and various forms of corporate securities. It also covers share issuance activities, portfolio and risk management as well as other brokerage services.³⁹ Furthermore, the Directive gives the EC Commission the power to include more categories of business if necessary. It is important to note that the single license freedom does not apply to institutions that are involved in one or more of the

³⁸ Financial Times, March 4, 1991.

³⁹ EC Commission, The 1992 Banking System.

activities covered by the Second Directive but that do not have the status of a credit institution in at least one of the member countries. The Directive requires a corporation to have a minimum initial capital endowment of five million ECU in order to qualify as a parent credit institution. However, once the parent has been set up no further deposits are required to set up branches in the home country or the host countries (this is a significant change).⁴⁰

The Directive is regarded by some observers as being supportive of the trend towards mergers that is currently occupies the European banking scene.⁴¹ This is not very far from the truth, as the Directive is quite vague on the subject of bank holding companies and the approval process for acquisitions and the creation of subsidiaries. It does not establish any guidelines to govern corporate eligibility requirements for bank ownership, nor does it set out rules governing the foundation of subsidiaries.

The Directive also has important implications for non-EC

⁴⁰ Ibid.

⁴¹ Financial Times, February 23, 1991.

banks. In particular, it does not cover branches established by banks based in non-EC countries, unless the banks operate a fully incorporated subsidiary within an EC country. In order to be able to establish such a subsidiary and be in a position to benefit from the single license provision, a non-EC bank must seek permission from the host country. This permission, however, can only be granted if the host country meets the EC's "reciprocity" requirements.⁴² These require the non-EC host to provide a range of equivalent banking privileges to EC-based banks, in areas such as market access, equality of regulation and a "level playing field" in terms of general competitive conditions. The European Commission provides guidance to the EC members on the question of whether a given country meets these reciprocity requirements, although the final decision rests with the EC Council of Ministers. It should be noted that the reciprocity concept does not apply to direct branches of non-EC banks. This implies that a non-EC bank can open a branch in an EC host if the host grants permission without reference to the European Commission; the reciprocity concept (and Commission oversight) is applied

⁴² EC Commission, The 1992 Banking System.

only if the bank in question seeks the benefits of the single license freedom.

The Second Banking Directive will not come into effect until the Own Funds Directive and the Solvency Ratios Directive have been fully complied with. This is in keeping with the 1992 program's objective of harmonizing core or essential regulations. The Own Funds Directive establishes a standardized definition of bank capital, while the Solvency Ratios Directive calls for "a minimum ratio of eight percent between bank capital and risk-weighted assets".⁴³

An interesting potential effect of the 1992 banking program is the creation of competition between the banking environments of the various EC members. The temporary abandonment of the old drive for harmonization of regulations has created a situation where multiple legal frameworks are allowed to exist in the face of mutual recognition of regulations. EC banks are free to operate in member countries without fear of nationalist barriers to entry. This could create an incentive for national

⁴³ Golembe and Holland, op. cit.

governments to create legislation that is attractive to foreign banks in an attempt to lure them into establishing domestic branches or subsidiaries. In some cases, a bank might even be persuaded to move its entire organization. One resulting scenario could be an international specialization by product or industry. For example, London might come to dominate securities markets while Frankfurt controlled longer term finance. The potential trend towards competition between national legislative systems could complicate the EMU drive for a European central bank. This is because aggregative macroeconomic policy making could be complicated by rapidly changing and competing regulatory environments in the member countries.⁴⁴

IV. 4. THE THREE STAGES OF ECONOMIC AND MONETARY UNION (EMU)

The EMU is expected to provide the backdrop for most economic activity in Western Europe after 1992. While separate from the actual 1992 agreements, the EMU is intended to be an integral component of the movement for

⁴⁴ "A European Central Bank?" (Cambridge, MA: Harvard Business School Case 9-390-185, 1990).

unification in Western Europe. Countries such as Italy and France are proponents of this activist program, while others such as Germany and the UK remain cautious. The EMU process of economic integration is divided into three stages:

(i) The Exchange Rate Mechanism (ERM): This is an arrangement under which all eleven EC currencies are pegged to the deutschmark. The ERM establishes a band of fluctuation around the base peg (plus or minus six percent for the pound and peseta, plus or minus 2.25 percent for the rest).⁴⁵ The actual parity value for each currency is adjusted periodically through an EC negotiating process. The UK was the last to join on October 8, 1990,⁴⁶ and the first phase of EMU is regarded as having been successfully completed. A descendant of the old "snake" and the European Monetary System (EMS), the current ERM has been remarkably successful.

(ii) Monetary and fiscal coordination: This second stage of EMU is scheduled to be established by December 31, 1994.

⁴⁵ Financial Times, March 11, 1991

⁴⁶ The Economist, March 9, 1991.

The European Commission and countries such as France and Italy favor the establishment of a "Eurofed" in this phase, but the UK and Germany want this to occur in the third phase. The European Council's 1990 Rome Communique lists the tasks of a potential Eurofed as including the coordination of national monetary policy, the development of monetary instruments for a future single monetary policy, and the promotion of the ECU.⁴⁷ This phase is also expected to see the completion of the adjustments required by the Banking Directives.

(iii) Establishment of a single currency: This is to be established by 1997.

⁴⁷ Financial Times, March 20, 1991.

V. TRENDS IN MODERN INTERNATIONAL BANKING

This section addresses some important trends in the competitive situation of the international banking environment. The main ideas discussed here involve new forms of bank organization and the movement towards disintermediation in international financial markets. These trends have a significant impact on the EC in general and the UK and Germany in particular. The discussion is intended to fill out the study from the perspective of the two Porter models introduced in section II.⁴⁸

V. 1. CHANGES IN BANK ORGANIZATION

The increasing specialization and sophistication of financial activity has created a difficult situation for traditional banks. The complexities of finance and information technology have created a business environment where smaller and more focused firms are leveraging off specialist skills to erode the competitive positions of

⁴⁸ Porter, Competitive Strategy and The Competitive Advantage of Nations.

their larger rivals.⁴⁹

The response of major banks to this new threat has been to attempt to create more advanced in-house skill levels, resulting in fierce competition for scarce skilled labor. However, a larger and more ponderous organization usually finds it hard to compete on a one-on-one basis with small specialist competitors. For example, many European banking giants have lost out to US investment banking specialists in getting a share of the new surge in merger deals in Western Europe.⁵⁰

Some observers have suggested that in order to compete the large European retail banks will have to adopt a "federated" structure in order to capture the gains from smaller and more focused firm organization.⁵¹ This would involve "creating separate business units in areas where specialization is the best way to compete, while keeping

⁴⁹ Lowell L. Bryan, "The Role of Banking in Society", McKinsey Quarterly, (1990/3).

⁵⁰ Financial Times, October 4, 1990.

⁵¹ E. von Lohneysen, et al., "Emerging Roles in European Retail Banking", McKinsey Quarterly, (1990/3).

selected functions at a central level where their centralization adds value."⁵² This implies creating fairly autonomous subsidiaries along functional or product lines, while restricting large volume and low margin operations to the corporate level.

This trend has differing impacts on different countries. The UK and the US are better equipped to take advantage of specialization, owing to their more competitive and flexible industry structures. Countries such as Germany and France, however, have a more traditional banking environment that is less receptive to the "federated banking" trend. In these countries banking tends to be more intermediary based and less flexible. As the following subsection will show, modern banking trends have placed traditional banking systems at a competitive disadvantage. With the entry of the 1992 program, traditional banking environments become even more vulnerable as they can no longer rely on national regulations to keep more flexible rivals out of their markets.⁵³

⁵² Ibid.

⁵³ Emerson, et al., The Economics of 1992.

V. 2. SECURITIZATION AND DISINTERMEDIATION

The trend towards changing bank organization is accentuated by the concomitant shift towards securitization and disintermediation in international financial markets. Before discussing these trends, however, it is useful to consider two "systems" of classifying national banking environments. The first of these was introduced by John Zysman.⁵⁴ According to Zysman, national banking environments could be classified as either market driven or "administered credit" systems. The former is characterized by short-term perspectives, arms-length transactions and highly competitive capital markets. The US, and to a lesser extent the UK are good examples. An administered credit system, on the other hand, typically has a longer term business outlook that relies on long-standing client relationships rather arms-length transactions. Capital markets tend to be less well developed and more oligopolistic. The French and German banking industries fall into this category.

⁵⁴ John Zysman, Governments, Markets and Growth: Financial Systems and the Politics of Industrial Change (Ithaca, New York: Cornell University Press, 1983).

An alternative classification is provided by Alabanese, Lessard and Perotti.⁵⁵ They classify financial systems as security market systems and intermediary-based systems. The former has a "relatively strong reliance on external finance through markets with limited government intervention."⁵⁶

There is a clear separation between industry and finance and relationships tend to be short-term. Again, the US and UK systems fall into this category. The market based system is regarded as more sophisticated than the intermediary-based system, as its more competitive character implies fewer barriers to entry and a more efficient mechanism to spread risk and mobilize capital. In the intermediary-based environment industry and finance are more closely linked through informal and institutional relationships that stress a longer term perspective (as in Zysman's administered credit system). Banks often take on equity positions in their client firms, and have a much stronger influence on company operations.

⁵⁵ Tomaso Alabanese, Donald Lessard and Enrico Perotti, "Strategic Responses to the Integration of European Financial Markets: Cross Border Mergers, Acquisitions, and Alliances in Commercial Banking", [Draft], Massachusetts Institute of Technology, March 1991.

⁵⁶ Ibid.

One of the most important trends in international finance is the shift towards securitization. This involves moving away from intermediary-based banking relationships towards direct access to security markets. More and more firms choose to solicit funds by issuing securities on the open capital markets rather than through loans from banks that are based on collateral, frequent renegotiation and long-term rollovers.⁵⁷ Securitization is catching on because it allows "greater diversification and liquidity and diversification of corporate assets."⁵⁸ This trend has also accentuated the trend towards greater financial specialization, as new financial technologies are developed to meet the wide variety of consumer needs on the international markets. The process of securitization is accompanied by a complementary process of disintermediation, as more traditional banking relationships are discarded in favor of short-term, transaction-based banking relationships.

⁵⁷ Donald Lessard and Enrico Perotti, "Moving Towards 1992: Managing the Internationalization of Ownership and Corporate Finance" in Lessard and Antonelli, eds., Managing the Globalization of Business (Milan: 1990).

⁵⁸ Albanese, et al., op. cit.

Increased financial specialization combined with the trend towards securitization and disintermediation has placed traditional intermediary-based banking systems at a competitive disadvantage.⁵⁹ As mentioned earlier, these factors are accentuated by the 1992 programs as well as by the longer term effects of the EMU. In a country such as Germany the banking industry will have to substantially alter its business practices if it is to compete against smaller and more specialized rivals who are no longer kept out by government regulations on the national level and long-term relationships on the industry level.

⁵⁹ Lessard and Perotti, op. cit.

VI. THE GERMAN BANKING ENVIRONMENT

Germany is an interesting country to study in terms of the policy network and strong state/weak state frameworks. In terms of Katzenstein's classification,⁶⁰ Germany would probably fall in the intermediate zone between the US and France. However, in the banking area the government's control seems much stronger. This finding is corroborated in the policy network context:⁶¹ as will be seen later, the Bundesbank, Ministry of Finance and the major banks are closely linked by informal ties. The independent central reserve bank (Bundesbank) is one of the most influential players on the German financial scene.

As Section V indicated, German banking is expected to undergo profound changes in the near future. The drive towards securitization and disintermediation will inevitably influence the major German banks, their smaller rivals as

⁶⁰ P. Katzenstein, "Introduction" and "Conclusion" in Katzenstein, ed., Between Power and Plenty (Wisconsin: 1978).

⁶¹ M. Atkinson and W. Coleman, "Strong States and Weak States: Sectoral Policy Networks", British Journal of Political Science, 19 (1989).

well as the Bundesbank. This will be reinforced by the increasing sophistication of financial and information technologies. If the accompanying trend towards "federal" banking⁶² also influences Germany, the overall result could be a complete alteration in the way German banks do business.

The traditional German banking environment is an administered credit or intermediary based system.⁶³ Banks tend to have long established relationships with their clients (in some cases going back to the nineteenth century), and the financing relationship resembles a partnership between industry and finance. There are significant entry barriers for less well established banks, and lesser known customers can have a difficult time accessing financing. Capital is generally provided on a frequently renegotiated, rollover basis. Banks often assume equity positions in their clients' companies, and both industry and finance have close formal and informal links to

⁶² von Lohneysen, et al., "Emerging Roles".

⁶³ Zysman, op. cit. and Alabanese, et al., "Strategic Responses."

government authorities. However, as the following subsections will show, this established pattern appears to be changing. In order to understand why, it is first necessary to consider Germany's unusual macroeconomic situation.

VI. 1. MACROECONOMIC BACKGROUND

The major "new" factor in Germany is obviously the unification of the Federal Republic and the GDR. The costs of integration have resulted in a current account deficit equal to three percent of GDP as of February 1991.⁶⁴ The deutschmark is under severe pressure, and inflationary tendencies are building. High unemployment and inflation have already appeared in the east, and the Bundesbank has driven up interest rates in response. Unification is expected to cost the federal government between \$147 and \$586 billion over the next ten years.⁶⁵

The weakness of the deutschmark has reduced the ability of

⁶⁴ Financial Times, April 13, 1991.

⁶⁵ Euromoney, April 1990.

the other ERM countries to reduce interest rates, which has created frictions in EC ranks (especially with France).⁶⁶ These frictions also arose in the recent G-7 meeting in April, when the US expressed disapproval of the Bundesbank's independent decision to prop up interest rates in spite of the German federal government's reluctance.⁶⁷

VI. 2. INSTITUTIONAL BACKGROUND

In general, Federal banking laws are far more liberal than the US or UK, although there is a very strict accreditation process and legal penalties are very severe. There is no German equivalent of the US Glass-Steagall Act, so that banks are free to pursue most lines of business in the financial markets.

The equity markets are relatively under developed and are largely controlled by the major credit banks. An interesting measure of bank influence on equity markets is

⁶⁶ Financial Times, March 6, 1991.

⁶⁷ Peter Norman, Stephen Fidler and Peter Riddell, "US, Germany Fail to Solve Dispute Over Interest Rates", Financial Times, April 29, 1991.

the proxy voting practice followed by many individual and institutional investors in corporate securities. In this system, the owners of securities allow their banks to vote by proxy on the shares they own. This dramatically increases the influence of the banks on corporate policy, as they control not only their own shares but also those of many third-party investors. The major credit banks also have significant cross-holdings in each others' shares, enabling them to present a fairly unified front on policy issues.

The banking system is divided into three groups of banks: the credit banks, the savings banks and the cooperative banks. A small fourth category -- that of specialty banks -- concentrates mainly on rich individual investors.

The private sector credit banks are closely monitored by the Bundesbank. A large number of trade associations and lobbying groups link them with the Ministry of Finance and the Bundesbank. A complex system of interlocking directorships links the major banks and results in a high

degree of cohesion on political issues.⁶⁸ The "Big Three" credit banks are Deutsche Bank, Commerzbank and Dresdner Bank. There are 163 regional credit banks, 57 branches of foreign banks and 86 other private banks registered in the country.⁶⁹ The credit banking market has high barriers to entry, both for foreign banks as well as for new domestic banks (owing to the strictness of the accreditation procedures and the informal barriers created by inter-relationships between established banks, their clients and the government).

The non-profit savings banks (often associated with individual towns) operate under the supervision of their own central bank, and have stringent lending policies. There are ten branches of the savings central bank in the German states (lander), and 585 registered savings banks around the country. The cooperative bank system is also supervised by its own central bank, and approximates the functions of

⁶⁸ Chris Allen "Democratic Politics and Private Investment: Financial Regulation in the Federal Republic of Germany and the United States," (American Center for Contemporary German Studies: Research Report #2, November 1990).

⁶⁹ Figures on numbers of German banks are taken from the Bundesbank's 1990 Annual Report.

savings and loans institutions in the US. There are five regional branches of the cooperative central bank and 3358 registered cooperative banks.⁷⁰

VI. 3. COMPETITIVE SITUATION

The "Big Three" of German commercial banking have long enjoyed a comfortable oligopoly position. As of September 1990, their assets stood at DM 350 billion, DM 248 billion and DM 180 billion respectively and they controlled 33 percent of the volume of financial transactions on the German markets.⁷¹ In recent months, however, this has changed as unification and the prospect of EC 1992 have altered the competitive scene for German banks. The Big Three are competing fiercely in their attempts to expand in the east, and have taken short term losses that have enabled their smaller domestic rivals to catch up. Dresdner Bank and Commerzbank reported very small gains in 1990 net operating profits, and Deutsche Bank took a loss.⁷² In

⁷⁰ Ibid.

⁷¹ The Economist, September 1, 1990.

⁷² Financial Times, April 15, 1991.

contrast, the next eight largest banks saw their average operating profits rise by 20 percent.⁷³ The following table shows some of these 1990 results (the figures represent total rather than net operating profits):

⁷³ Ibid.

TABLE 2

1990 GERMAN BANK RESULTS (DM)

BANK	TOTAL OPERATING PROFIT	NET INCOME
Deutsche Bank	5.13b	1.07b (-20.4%)
Dresdner Bank	na	921m (+42%)
Commerzbank	na	557m (-.01%)
Bayerische	na	360 (+21.3%)
Vereinsbank		
Bayerische Hypo	1.07b	313m (+10%)

Note: Dresdner Bank's figures reflect the reacquisition of prewar assets in the east.

SOURCE: FINANCIAL TIMES, APRIL 15, 1991.

The increased competitiveness has spread to retail areas affected by the Second Banking Directive (such as credit cards).

As of August 1990, the Big Three had \$20b in loans to the former GDR lender.⁷⁴ This eastern expansion shows no sign of abatement. Deutsche Bank paid one billion deutschmarks for an 85 percent stake in a joint venture with Deutsche Kreditbank (formerly part of the Staatsbank, the GDR's commercial bank monopoly).⁷⁵ It also paid a hundred million deutschmarks to acquire 18 former Staatsbank branches under its own name. Dresdner Bank and Commerzbank have similar ventures. This new competitiveness has also entered their more conventional businesses: for example, the credit card area has seen new marketing and brand-name initiatives. It is interesting to note that the difficulties of the Big Three have resulted in a decline in their stock prices since January 1991.

Another interesting competitive development is the extension of the Big Three into new lines of business. A prime example is their foray into the field of insurance (allfinanz). Deutsche Bank has a new life insurance subsidiary called Deutsche Lebensversicherung. Dresdner

⁷⁴ Euromoney, January, 1991.

⁷⁵ The Economist, September 1, 1990.

Bank has allied with Allianz, Germany's largest insurance company (Allianz has acquired an undisclosed share in Dresdner Bank).⁷⁶

VI. 4. EC-LINKED CHANGES

As the EC nations begin complying with the liberalizations called for by the Second Banking Directive, new international rivals have begun to threaten German banks. In response, the German banking lobby has successfully pressurized the Finance Ministry into allowing banks to enter other businesses in a big way; as described earlier, insurance is a primary example. In other areas, the banking lobby has been equally assiduous in opposing new legislation. For example, the German banks fiercely oppose legislation legalizing money market funds; if successfully adopted this legislation could potentially halve banking profits and expose the banks to international competition in an area where they have relatively little experience.⁷⁷ At the same time, some of the major German banks are taking

⁷⁶ The Economist, September 1, 1990.

⁷⁷ Ibid.

advantage of newly relaxed legislation in other EC countries to enter strategic partnerships. For example, Dresdner Bank plans a cross shareholding arrangement with France's Banque Nationale de Paris (BNP) and Commerzbank is considering a similar deal with Credit Lyonnaise.⁷⁸

In general, German banking circles seem rather wary of the entire EC 1992 program. Some writers have interpreted this as a fear of the process of "disintermediation" that is expected to accompany it.⁷⁹ This conservatism appears to be shared by the Bundesbank and its former chairman. Otto Pohl recently compared EMU to its avian namesake, describing it as slow moving and incapable of flight.⁸⁰ The Bundesbank's wariness has been reinforced by Germany's recent macroeconomic problems as well as internal political difficulties (Pohl was reputed to disagree with Kohl and Hans Dietrich Gentscher on EC issues; in addition, his move to reduce the number of lander central banks was under

⁷⁸ Financial Times, April 15, 1991.

⁷⁹ Donald Lessard and Enrico Perotti, "Moving Toward 1992: Managing the Internationalization of Ownership and Corporate Finance," in Lessard and Antonelli, eds., Managing the Globalization of Business (Milan: 1990).

⁸⁰ Financial Times, May 1, 1991.

considerable fire).⁸¹ The Federal government has supported its banking circles in opposing rapid reform on the EMU front; in particular, it is opposed to the setting up of a "Eurofed" in the second phase of EMU.⁸² Former Bundesbank chairman Pohl went on record stating that the existing EC committee of central bank governors could fulfil the role of a central bank for the time being.⁸³

⁸¹ Financial Times, April 15, 1991.

⁸² Financial Times, March 6, 1991.

⁸³ Financial Times, March 20, 1991.

VII. THE UK BANKING SCENE

Like Germany, the UK probably falls in the middle ground of Katzenstein's strong state/weak state spectrum. Another point of similarity lies in the closeness of the policy networks, as will be seen below. However, the fundamental difference between the two systems is the fact that the UK has a market based (securities market) banking regime. The British financial markets are far more short-term oriented and transaction driven than their German counterparts. As a result, the UK banking system is near the leading edge of the trend toward securitization and disintermediation. Another point of difference is the fact that the Bank of England is not an independent entity like the German Bundesbank, as its activities are controlled by the Chancellor of the Exchequer.

VII. 1. MACROECONOMIC BACKGROUND

The UK is almost chronically stricken by recession, rising unemployment and sticky interest rates. In addition, inflation is picking up again and the budget has gone back

into deficit. These problems are complicated by the demand for more liberal fiscal policies in the wake of Mrs Thatcher's departure.

VII. 2. INSTITUTIONAL BACKGROUND

Banking and securities activity in the UK is regulated by the Securities and Investment Board (SIB), which has a role similar to the SEC (although the SIB has much wider jurisdiction). The SIB sets up Self Regulating Organizations (SRO's), and every bank must belong to an SRO. These bodies act as policy networks in miniature, as their membership remains fairly constant and has representatives from the banks, the SIB and the government. In general, the pattern of regulation has been fairly loose, and UK financial policy has usually favored City of London interests. Historically, finance-industry relationships have been short-term oriented and the industrial sector has frequently complained about the lack of "patient capital". In addition, the UK government has traditionally supported the financial sector's desire for a strong pound sterling with its notorious "stop and go" macroeconomic policies,

which have hindered the ability of UK businesses to compete internationally.⁸⁴

The banks themselves are divided into commercial banks, merchant banks and building societies (these societies serve the same function as thrifts in the US). The five largest commercial banks⁸⁵ are known as "clearing banks" (the equivalent of "money center" banks).

VII. 3. COMPETITIVE SITUATION

UK banks are going through a tough period. In 1990, the top twenty banks all reported losses or declining profits from their core businesses.⁸⁶ Many of them are seeing staff cutbacks, and bank stocks are not doing well. Midland Bank was forced to announce a 50 percent cut in dividends, and its chairman had to step down.⁸⁷ Big banks like National Westminster, Barclays, Lloyds & Midland are losing business

⁸⁴ The Economist, September 8, 1990.

⁸⁵ Lloyds Bank, National Westminster (Natwest), Barclays Bank, Midland Bank and Abbey National Bank.

⁸⁶ The Economist, March 9, 1991.

⁸⁷ Financial Times, March 6.

to leaner & smaller rivals in core consumer businesses. Newer rivals such as Abbey National (the newest of the clearing banks) are building market share in traditional consumer areas such as mortgages and personal finance at the expense of the Big Four clearing banks.⁸⁸ The competitive situation of the banking sector is also being hampered by falling interest rates following the recent cuts in the Bank of England's base rate.⁸⁹

VII. 4. EC-LINKED CHANGES

The British members of the European Parliament (EP) have traditionally been liberal in their political inclinations, and public opinion has tended to be more pro-EC than the government would have liked. One important consequence of this has been the public debate over the role of the Bank of England (BOE) in the new European situation. Many people (including prominent members of the EP) appear to support an enhancement in the Bank's powers, in the belief that a stronger central bank will facilitate the UK's integration

⁸⁸ Financial Times, March 2/3, 1991.

⁸⁹ Ibid.

into the EC. The governor of the BOE heated up the debate recently by breaking ranks with the government and publicly calling for greater independence for the Bank.⁹⁰ This trend is ironically supported to some extent by the Conservative government, which has engaged in liberalization measures in the financial sector since the mid-eighties.

The UK's bankers appear to be less fearful of the 1992 program than their German counterparts. This is probably because their businesses are in a better position to take advantage of the changes brought about by securitization and disintermediation in the banking industry than their continental counterparts. Banking circles have been vocal in their support for the EMU (Lord Alexander, chairman of Natwest, stated his support for the establishment of the European central bank in London, and called upon the government to actively cooperate with 1992 measures and the EMU).⁹¹ City forums have engaged in high profile discussions of how London could benefit from 1992 (a good example is the new committee founded by the BOE to look into

⁹⁰ "Eyebrow Raiser", The Economist, March 30, 1991.

⁹¹ "European Bank Plea", Financial Times, April 29, 1991.

the legal ramifications of financial liberalization in Europe).⁹² In addition, there is a concerted effort to reform existing legislation that threatens to harm the UK's potential as a financial center in an integrated Europe. Two areas receiving prominent coverage are the Financial Services Act (which is estimated to cost UK banks over 300 million pounds a year) and IRS regulations.⁹³ On the business front, UK banks have been quick to take advantage of falling barriers in other EC countries. For example, Lloyds has allied with Credit Agricole of France and three other continental banks in an arrangement that would allow their customers to tie in with each other's branches.⁹⁴

Nevertheless, the UK government remains cautious about the EC 1992 banking programs as well as the EMU. The government joined the government of Germany and Spain in stating that the gap between the economic performance of member states would have to be narrowed before the second and third stages

⁹² David Lascelles, "Bank Defends London's Role As Hub", Financial Times, April 29, 1991.

⁹³ Euromoney, June 1990.

⁹⁴ "Lloyds Links With Continental Banks", Financial Times, March 17, 1991.

of the EMU could be completed.⁹⁵ John Major (then Chancellor of the Exchequer) went on record calling for "clear and objective performance criteria" before further progress on banking integration and the EMU could be made.⁹⁶ Sir Leon Brittan, the UK's senior EC Commissioner, supported this stance by stating that the UK could "in good faith sign an EMU treaty setting up the institutions needed for a low inflation single currency throughout the EC, but Parliament could decide nearer the time of implementation whether Britain should actually participate."⁹⁷ He drew a parallel with the European Monetary System (EMS), which was set up in 1978 with UK support, but which the UK did not formally join until 1990.

⁹⁵ Financial Times, March 6, 1991.

⁹⁶ Financial Times, March 13, 1991.

⁹⁷ Ibid.

VIII. CONCLUSION

The main ideas behind this paper are that important domestic considerations have the potential to retard the banking industry's liberalization as envisaged by the 1992 programs. Once the euphoria of the Single European Act and the 1992 movement began to recede, the EC banking industries and their home governments had to come to terms with the profound changes in business practices and political control that the 1992 programs and the EMU required. This trend is especially strong in Germany, where political and historical as well as economic factors serve to make banking circles suspicious of 1992. In particular, the problems of unification and the threats of securitization and disintermediation have placed the major German banks at a competitive disadvantage.

In the UK the trend is somewhat less clear, with the government remaining skeptical but the banking industry coming round in support. Here, the banking industry is more comfortable with the approaching changes in the international financial markets owing to its greater market

orientation. In both cases, existing policy networks and individual actors are being forced to adjust to a comprehensive and potentially far-reaching set of economic programs that threaten to become a reality in the very near future. The critical importance of the changing banking environment lies in the fact that the success of all the other integrative moves in Europe will depend heavily on the outcomes of the banking "struggles" described in this paper.

APPENDIX:

ABBREVIATIONS

CAP	Common Agricultural Policy
CEEC	Committee for European Economic Cooperation
CET	Common External Tariff
EC	European Community
EP	European Parliament
ECE	Economic Commission for Europe
ECSC	European Coal and Steel Community
ECU	European Currency Unit
EEC	European Economic Community
EMS	European Monetary System
EMU	Economic and Monetary Union
ERM	Exchange Rate Mechanism
EUT	European Union Treaty
IGC	Inter-Governmental Conference
OEEC	Organization for European Economic Cooperation

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