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Banking on the Euro: Changes and Challenges

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This paper considers the likely effects of EMU and the introduction of the euro on the fragmented European banking industry. It recognizes that transition to the euro will be expensive in terms of equipment, training, customer care etc.; and that some new products and services will be demanded (e.g. cross-border cash management systems, euro-denominated bonds etc.) while others will decline (e.g. foreign exchange hedging, commercial loans etc.). The paper refers to US experience to identify growth opportunities and discusses the current and future impact of increased competition in the new market; and strategies for surviving it.

The European banking industry has long been characterised as fragmented. It has consisted of a few large banks in each country operating mainly within their own borders. Multiple currencies, the lack of highly developed security markets, crossborder regulations, and traditions have all contributed to this industry structure. Corporate customers have relied upon domestic banks for their foreign exchange needs and for much of their debt financing.

The creation of the European Monetary Union (EMU) and the introduction of the Euro, however, are now spawning changes in European banking. A period of bank consolidation is under way. Barriers to geographic and product diversification are falling by the wayside. Banks are competing for customers in an intensifying battle that includes non-bank firms as well.

The Euro is expected to spur economic growth by reducing transaction costs and promoting price transparency. The banking industry can benefit from this economic growth; but not in its current condition and structure. For banks headquartered within the Euro-currency zone, the impact of Euro will be felt largely in operations, the products and service offerings, the level of competition across borders, and consolidation of the industry. The single market and the opportunities it implies are also inviting to financial services firms headquartered outside the Eurozone. European corporations are now reconsidering their banking needs and many of them may be expected to switch providers (Rhoads, 1998). There will be no shortage of financial institutions competing to fill those needs.

Operations

The most immediate effect of the introduction of the Euro is the large operational cost of the transition to the new currency. Investment in technology will be extensive over the next few years. First, banks must accommodate dual accounting systems that maintain customer accounts in both Euros and domestic currencies for the initial three years of the Euro (Saunders, 1998). It will be possible for a customer to maintain a savings account in a domestic currency while paying his mortgage in Euros! Second, electronic payments systems must be altered and expanded to handle the expected increase in volume. Thousands of software applications are being rewritten and staff are being retrained. The banks in the EMU will ultimately spend $12 to $25 billion on conversion costs. Payments sytems conversion will be the largest single item, followed by conversions of credit card service and automatic teller machines (Rolfe, 1998).

The introduction of new products will require much technology investment as well. For instance, corporate clients will demand pan-European cash management systems in order to benefit from the single currency market (Havoutis, 1998). Banks are becoming more aggressive in product lines such as security underwriting and distribution. The need to invest heavily in technology to accommodate both conversion and new products will affect the structure of bank competition. Small and medium size banks may not be able to afford the necessary investment in technology. This factor will add to the pressure to consolidate (Paris, 1998).

A more mundane cost facing banks will involve the distribution and handling of the new Euro-denominated notes and coins scheduled for introduction in January 2002. Initially, over 12 billion bank notes and 76 billion coins will be issued (Barnard, 1998). Equipment that handles currency and coins will need to be adjusted or replaced (Economist, 1998).

Finally, a major operating cost of the Euro introduction involves the effort to educate and reassure bank customers. Wentz and Koranteng (1998) report that major business publications are benefiting from advertising revenues generated by banks boasting of their euro expertise and capabilities. ABN Amro, Deutsche Bank, and Societe Generale are all cited. Firms from outside the Eurozone, such as Credit Suisse, Bankers Trust, and Barclays Bank, are also spending large sums on such material in order to retain and expand their client base. Most large European banks have constructed Internet web sites, published brochures, and conducted extensive employee training, all with the aim of getting Euro information to customers. All of them perceive the need to reassure existing customers and to take advantage of the opportunity to attract new clients.

Products and Services

The introduction of the Euro and the shift toward single market banking will require banks within the Eurocurrency zone to offer a new array of products and services. Foreign exchange and foreign exchange hedging have been major revenue producers for these banks. The elimination of transaction costs for non-financial companies, as eleven currencies become one is a primary economic benefit of the EMU and should enhance economic growth in the region. But by the same token it greatly reduces demand in a profitable business sector for Eurozone banks (Martin, 1998). Euro/dollar and Euro/yen trading will replace some of the foreign exchange business, but such activity will probably be a high volume, low margin proposition likely to be dominated by a few major banks (Speyer, 1998).

At the same time, there will be an increased need for integrated cash management systems that operate across borders. A bank customer operating throughout Europe will most likely want to have funds held in each country be part of a larger international cash management system (Havoutis, 1998). An option is to have a negative Euro balance in one country be offset by a positive Euro balance in another. The funds can then be easily pooled and readily available for investment in order to minimise the opportunity cost of idle balances. Though the Euro eases some of the difficulty in creating an integrated cross-border system, regulatory, tax, and legal requirements can still make it a complicated product to build. The Belgian concern, Generale Bank, has already announced the development of a cash management system that will pool corporate accounts across borders (Turton & Queree, 1998). Other banks will surely follow their lead, but they must have a presence in multiple European countries as well as the funds to invest in cash systems development to make the offering of such a product practical and profitable.

European banks will also experience a decline in their commercial loan business. Corporate clients will shift their borrowing to the newly-enlarged security markets, which will offer lower transaction costs, lower rates, and better liquidity (Islam & Knott, 1998). Traditionally, European companies have relied on bank loans for their capital needs in excess of profits. As the small fragmented security markets of the Eurozone meld into a single market, companies will find that they will have less need for bank credit. The single market will attract a larger pool of investors. European banks will face the same kind of disintermediation that the US banking industry has experienced. Companies will meet more of their financing need through commercial paper and bonds rather than commercial bank loans.

The good news for European banks is that they can go to these markets with their clients, offering them capital market services instead of bank loans. A few of them already have an extensive experience and presence in these markets. They will enjoy a competitive advantage. Other banks will likely form alliances, perhaps with American and British firms in order to operate in this market as effectively as possible. Some of these investment/commercial banks have been underwriting and distributing securities in Europe for years.

Historically, interest rates in the various European Union credit markets have reflected the monetary policy of the individual countries and the expected trends in currency exchange. As a result of security market integration, a single set of interest rates should prevail across borders with creditworthiness the sole factor in rate differentials. European banks have traditionally paid more heed to currency risks than to credit risks in their loan evaluations. (Hamer, 1998).

A commercial paper market should emerge to handle high quality short-term credits. At the opposite end of the credit quality spectrum there may be the birth of an Euro-denominated high-yield bond market. Since most banks already have established client relationships they will be in a position to help their clients find their way in these new markets. If they delay developing the needed expertise and capability, however, they will lose these clients to new competitors.

In the 1980s, US banks responded to disintermediation, in part by extending credit to risky borrowers in foreign markets. The same temptation may arise for European banks, which may look to Eastern Europe for new loan business (Speyer, 1998). They will be wise to tread slowly in these foreign markets until they are better able to evaluate credit risks. US banks wrote off billions of dollars in bad debt to Latin American borrowers while learning this lesson.

Other American-style growth opportunities may beckon to Eurozone banks. Economic growth and prosperity will create a demand for mutual fund distribution and asset management. Paribas has already reached agreements with three large Italian banks to distribute their mutual funds (Global Fund News, 1998). It expects Italians to invest the equivalent of US$ 1 billion annually. Merrill Lynch also has made agreements with banks in Milan and Rome (Wall Street Letter, 1998). With greater monetary stability, there is greater interest in saving by the people of this region. Domestic banks have the selling networks in place to benefit from this development and have done so by forming partnerships with mutual fund firms.

The new found interest in saving and private investments also provides an opportunity for banks to be active in asset management. A shift toward private pension plans and the lessening of cross-border investment restrictions add to the impetus (Speyer, 1998). The rapid expansion of the equity and corporate bond markets will present many opportunities for money managers to sell their services.

Asset management, however, is not an easy business to enter. It requires the bank to establish a research and back office capability to support the investment managers. It also requires a marketing capability whether the target is individuals or institutions. Of further concern for banks contemplating this business is the intense competition they will encounter from non-bank institutions. Insurance firms and foreign-based investment companies have money management capability in place and will be attempting to capture this business as it develops.

Another area of change and opportunity is in payment clearing systems. Currently, each nation has its own clearing system for cheques and other methods of payment (Teixeira, 1998). Given the size of the market and the use of a single currency, the existing payment systems will become redundant. This business is well suited to economies of scale. Thus, profits will be sufficient only for a few major players. Some banks may specialise in clearing activities; others will outsource the work. ABN Amro, the large Dutch bank, has developed a system it is willing to sell to other banks and to set up in the purchasing banks' back offices (Mandaro, 1998). It also will offer clearing services to banks that do not have the volume to justify the expense of their own system. The German clearing system, German Electronic Access Frankfurt, is striving to be the leading clearing system in the Eurozone (Teixeira, 1998). It plans to specialise in Euro clearing, but will also clear other currencies as needed. The European Bankers Association (EBA) private net settlement system created for the old European Currency Unit is being converted to a euro clearing system. It will compete with the European Central Bank's TARGET system. The EBA's system is better geared for private transactions, but it will need to handle about 100 times its current volume. TARGET will probably be more expensive to operate than the privately owned clearing systems. It will probably be used only at a later stage of the clearing process or for certain specific types of transactions.

At the retail level credit cards will see a major boost. The advantage here is that under any Euro scenario customers can continue using their existing cards. The Visa and Europay/Master Card payment systems simply process the Euro as an additional currency. The individual issuers determine precisely how Euro and national currencies are shown on cardholder statements.

On a practical level, the only way for individuals to transact in Euros at the point of sale will be by payment card or cheque. Card payments will promote the Euro; in turn the Euro will promote card payments (Rolfe, 1998).

Can all banks compete effectively in all these product markets? It is unrealistic to think that one firm will be the leader in payment systems, security distribution, cash management, asset management, retail banking, and commercial lending. Banks will need to recognise in which product and geographic markets they can have a competitive edge and position themselves accordingly. Langohr (1998) asserts that the successful banks will be the ones that specialise and that avoid the temptation to become as large as possible by competing in all business sectors. There is room for only a few full-service global financial firms. The rest will need to find a niche in which they can exploit a competitive advantage.

Competition and Consolidation

The heightened competition resulting from the enlarged currency market will have an impact on bank structure and strategy. Banks will be unable to rely on the loyalty of their corporate customers and the protection of their governments. Each firm must develop a strategy that exploits its own particular advantage or it risks being acquired by another bank. Euromoney (1998) reports that banks in Portugal are aggressively seeking market positions in retail banking. Many European bankers expect retail (consumer) banking will be relatively immune to competition from across borders. Foreign-owned banks may be less sensitive and less responsive to local needs. It is usually more difficult to enter a market de novo than to acquire a bank that is well entrenched there - one that comes with an established customer base.

The battle for retail banking position in Portugal has already resulted in some consolidation. Observers expect that the six large Portuguese banks that remain will engage in more mergers and acquisitions when equity market conditions make takeovers more feasible. Portuguese banks are also extending their presence and influence in their former colonies, Brazil and Mozambique (Euromoney, 1998). They see this positioning as the competitive advantage they can maintain relative to foreign banks. They should be able to offer superior service to corporate clients seeking to do business in these countries.

Jockeying for competitive position is also apparent in Germany. Bayerische Vereinsbank has agreed to merge with Bayerische Hypotheken and Wechsel-Bank AG to create Germany's second largest bank with a pan-European presence (Kraus, 1998a). Managers expect to focus on project finance, asset-backed securities, trade finance and capital market transactions for US subsidiaries of German companies. They will also focus on serving US companies with operations in Germany. Such plans denote consolidation, but also an effort to specialise both in products and region.

In Austria, the major reaction to the coming competition has been to push through the merger of Creditanstalt, which has an established reputation in investment banking, with Bank Austria (Economist, 1997a). This combination creates Austria's largest banking firm. Plans are underway to shift control from government to private shareholders over time. The apparent strategy for the new firm is to dominate certain domestic markets, such as corporate lending and cash management, and establish a presence in nearby Eastern European markets in investment banking. A key to the success of this strategy will be whether the government and Austrian traditions will allow all the potential benefits of the merger to occur. A government stipulation requires Creditanstalt to remain a separate entity for several years and prohibits cutting staff on a significant scale. Employees in some areas of the bank are currently finding that there are two people now to do the work of one. If the combined bank cannot realise some scale economies, it will lose out to new, leaner competitors in their markets.

Bank consolidations are not just occurring within domestic markets. The additional twist attributable to the onset of the Euro is the prospect of cross-border mergers. In November 1997, the Dutch banking and insurance firm, ING announced a bid for the Belgian concern Banque Bruxelles Lambert (Economist, 1997b). If banks hope to position themselves as pan-European firms and be ready to serve their customers across the single market, surely there will be more mergers and acquisitions to come.

A few firms are attempting to become true global banks. ABN Amro and Deutsche Bank, both based in the Eurozone, appear to be following this strategy (Steinmetz, et al., 1998). ABN Amro has made acquisitions in North America and Asia to complement its European expansion. Deutsche Bank had already generated about half its profit from foreign operations prior to its acquisition of Bankers Trust. With the purchase of this major US bank, Deutsche Bank now has a significant North American presence and more strength in Europe. Bankers Trust had been well positioned to expand its investment banking and securities custody business in Europe prior to the merger (Kraus, 1998b).

Other global competitors based outside the European continent are also seeking to compete in the Euro market. The Midland Bank has opened up Euro accounts for its corporate and individual customers. The American firm Chase Manhattan Corp., J.P. Morgan & Co., BankAmerica Corp. and Citigroup are leading a contingent of banks gearing up for the new European opportunities (Kraus, 1998b). All of them have significant pan-European networks in place, unlike most of their European counterparts. They have expertise in security market services that will make them formidable competitors to European banks. US banks also have a head start,in offering asset management, securities custody, cash management, and merger and acquisition assistance. Finally, they have the financial strength to compete aggressively as margins narrow.

The merger of Swiss Bank with Union Bank of Switzerland represents another major factor in the changing European banking markets (Kraus, 1998a). The resulting United Bank of Switzerland is the second largest bank in the world, with specialties in asset management, private banking, and investment banking. While Switzerland remains outside the European Union, most of that nation's trade and international finance is with EMU countries. The Swiss banks have to be major players in the new Eurozone, since they will be conducting much of their business in Euros. The Swiss/UBS bank merger is expected to cut costs in part by eliminating 13,000 jobs (Peterson & Capell, 1998). The goals of expanding geographically and cutting costs will be attractive to many industrial and commercial European firms. The single currency and breaking down of regulatory barriers should result in extensive merger activity among European companies for years to come. UBS intends to compete aggressively for this merger and acquisition business. Their size will permit them to finance almost any deal. Meanwhile, their experience and expertise in private banking will allow them to remain a leader in this profitable market segment.

Summary and Conclusion

The introduction of the Euro and the emergence of a single market have important consequences for the business strategies and structure of European banking. Initially, banks will incur heavy operational and technology costs as they switch to the new currency. More significant will be the changes in the products and services that banks must provide to be competitive in a single market. Foreign exchange trading and hedging will cease to be important revenue generators for most banks. The importance of commercial lending will decline as those borrowers seek lower costs in the security markets. To survive, European banks will have to develop further expertise in security markets, asset management, and other product growth areas. Furthermore, they will have to establish a geographic presence and a size that complements the product markets in which they choose to compete.

In some respects the results may be compared with the experience in the US market, which has seen banks clamour to enter new product and geographic markets amid significant consolidation. Deregulation and increased competition in the United States have created some problems. Some bank financial conditions have suffered and a number of failures have resulted from excessive risk taking.

An over-riding question is whether bank supervisors in Europe will be prepared to deal with the problems that result from too rapid an expansion into new product and geographic markets under intense competitive conditions. They will have the added challenge of dealing with institutions whose operations are significantly spread over several countries.

The Euro ushers in an era of major opportunities for the banking industry. But it also brings risks. Banks must adapt to the changing market environment if they are to prosper or even to survive. But they must be well prepared and proceed with caution.

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