European Integration and the Banking Sector in Southern Europe: Competition, Efficiency and Structure *

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There is already a large literature on the impact of 1992 and the removal of capital controls on the European banking sector.[1] Much of this examines the issues of competition, efficiency and structure. A number of questions are addressed here. Will 1992 entail an increase in competition or will the market imperfections which characterise banking tend to favour the continuation of market segmentation? will there be any increase in efficiency associated with 1992, thereby justifying structural changes (such as mergers) in the banking system? There are, however, a number of ways in which this literature is not automatically applicable to the southern European economies. This paper develops this theme and is based, as we shall see, on a rather different conceptualisation of the relationship between competition, efficiency and structure. In particular, we argue that for a number of reasons there are likely to be important structural changes in southern European banking and that this has important consequences which have not been adequately covered in the existing literature. The two

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* We would like to thank participants at a seminar organised by the Hellenic Centre for European Studies, especially Loukas Tsoukalis, Yiannis Stournaras and Nikos Garganas for their useful comments on this paper. We would also like to thank two anonymous referees for their helpful remarks.

[1] In this paper we focus on the provision of retail and corporate banking facilities (that is, to companies with little access to wholesale markets). Wholesale banking largely occurs through international banks operating in the Euromarkets. Since this market is already very competitive, the 1992 changes are unlikely to have much of an effect.

BNL Quarterly Review, no. 186, September 1993.

main consequences concern the extent to which radical structural changes may affect the stability of the financial system and whether the banking system that emerges from this process of restructuring will be one that best serves the interests of the real economy. For reasons of space, this paper only considers the former.[2]

The structure of this paper is as follows. In section 1, after a very brief outline of what 1992 entails for banking, we discuss two contrasting views on the consequences of 1992. The first, which is associated with the view of the EC Commission, sees 1992 leading to increased competition, which in turn will promote efficiency. As we shall see, whether this will lead to large structural changes is ambiguous. The second view stems from a number of authors who have been critical of the Commission. Nuances aside, the basic argument here is that because of imperfections in banking markets, there will be little increase in competition and thus little potential for improved efficiency. This leads them to conclude that large structural changes are not justified on the grounds of economic welfare.

In section 2 we develop two arguments to support the view that there will be structural changes in the banking sector in southern Europe. The first is that even if there are no large efficiency gains for the rest of Europe, this does not hold for southern Europe. We provide evidence on the variability of efficiency within the EC. The second argument is that, even if there are no efficiency gains to be exploited, we cannot conclude from this that there will not be restructuring. Mergers and acquisitions may occur because banks need to be large in order to compete in an EC-wide market, and this is likely to be of particular relevance in southern Europe where banks tend to be small. Indeed the activities of banks in recent years lends considerable credence to the view that 1992 has led to structural changes. We provide evidence for structural changes within countries (often promoted by national governments) as well as cross-border activity.

If our conclusion that 1992 means greater competition and structural change has some validity, then this raises the question of the impact of these changes. Thus, in section 3, we discuss the

[2] We have dealt with the latter question of the relationship between financial and real sectors of the economy elsewhere (see Gibson and Tsakalotos, 1992 and Gibson, Stournaras and Tsakalotos, 1992).

possible consequences of 1992 for the stability of the banking system in southern Europe. In particular, we focus on the possible adverse role of competition on financial stability. Finally, we conclude by examining the issue of banking supervision and the kind of measures required at the EC level to help to prevent potential instability. We argue that, as in other areas of European integration, measures for negative integration must be accompanied by more strong and imaginative measures for positive integration.

The Implications of 1992: Views from the Existing Literature

There are two crucial components associated with 1992 which could be expected to have important consequences for the banking system. The first is the removal of controls on capital movements which was agreed by EC members in 1988. While Italy and Spain have already removed capital controls, Greece and Portugal have an option to maintain them until 1995. The second is the Second Banking Directive which was put in place at the end of 1992. It is concerned with bank access to foreign markets. The Directive has two main principles, that of mutual recognition and home country control. In essence it allows a bank, once it has a licence from its home country, to undertake activities in any EC country irrespective of the regulations of the host country.[3]

To simplify for ease of exposition, we can examine two rather divergent views on the impact of these measures. The first view, which is expounded by the EC Commission, suggests that there are significant gains from the 1992 process. Apart from the usual gains from trade,[4] the Commission focuses on the welfare gains to the consumer. These follow from the increased competition resulting from 1992 leading to increased efficiency. In other words, the Com-

[3] This is certainly the spirit of the Second Banking Directive, but as we argue elsewhere, there are a number of grey areas, which have not yet been clarified (Davis and Smales, 1989; Gibson and Tsakalotos, 1992).

[4] Krugman (1987) offers a useful distinction of such gains in financial markets, distinguishing between gains of the inter-industry trade type and those of the intra-industry trade type. The latter entail the two-way flow of capital to allow for diversification, specialisation, and so on.

mission looks at the financial sector in much the same way as it looks at other economic sectors with no particular attention to its specificities. This approach is reflected in the Price Waterhouse (1988) study. The central assumption of that study was that price divergence is to a large extent the result of a lack of competition, thereby justifying a convergence of price to the average of the four cheapest countries following the 1992 change.[5] Given these price reductions, Price Waterhouse calculated the expected consumer surplus gain. As can be seen from Table 1, in some cases this was substantial and

TABLE 1

PRICE WATERHOUSE - GAINS FROM 1992 IN THE FINANCIAL SECTOR

(a) Proposed price reductions[1]

	Belg	Ger	Spa	Fra	Ita	Neth	UK
Banking	8.0	13.0	20.0	13.0	9.0	5.0	9.0
Insurance	16.0	5.0	19.0	12.0	26.0	0.5	2.0
Securities	26.0	6.0	26.0	12.0	17.0	9.0	6.0
Financial services (Average)	11.0	10.0	21.0	12.0	14.0	4.0	7.0

(b) Estimated gain in consumer surplus[2] (millions of ECUs)

Belgium	685
Denmark	4619
Spain	3189
France	3683
Italy	3996
Netherlands	347
UK	5051
Average gain (% of GDP)	1.5%

[1] These percentages represent the 'indicative' or 'assumed' price reductions (and not the theoretically potential reductions which are much larger). On average the indicative price reductions are 40-60% of the theoretically potential price reductions.

[2] This gain results from price falls in the three areas of banking, insurance and securities and are calculated on the basis of the weighted averages in part (a).

Source: Price Waterhouse (1988).

[5] For the precise details of the methodology followed see Price Waterhouse (1988) and the notes accompanying Table 1.

this is certainly the case for Spain and Italy. Greece and Portugal were not included in the study, but presumably there is little reason to doubt that, on the same methodology, there would be similar gains in these countries. The implications for structural change in the banking system from these results is ambiguous, and neither Price Waterhouse nor the Cecchini Report (1988) offer any detailed discussion of this issue. What is important in their analysis is that the threat of entry or takeover will promote efficiency. The extent to which structural changes, such as takeovers, will actually take place in practice presumably depends on the capacity of the existing banks to respond to the increased competition.

The underlying optimism of this approach is not universally shared and a number of authors[6] have suggested that 1992 may turn out to have rather less of an effect on European banking. Behind the various arguments here lies a different conception of the relationship between competition, efficiency and structure.

This suggests that because banking markets are always characterised by imperfect competition, 1992 may not automatically lead to more intense competition. Thus there may be no increase in efficiency and therefore little rationale – at least in terms of economic analysis – for structural changes. We can briefly examine five major arguments along these lines. Moreover, these arguments can to a large extent be seen as complementary.

The first argument addresses the question of whether there are unexploited economies of scale and/or scope in European banking – if there are, then they might provide some rationale for structural change. Studies of economies of scale have generally proved to be inconclusive and the optimal bank size is still unknown.[7] Thus there is no clear evidence that mergers/takeovers at the European level would lead to efficiency gains and if there are no efficiency gains, then there is no rationale for any structural changes in European banking.

Secondly, there is the question of whether 1992 might generate allocative efficiency gains. At present, national banking markets tend to be oligopolistic and as such are characterised by non-price compe-

[6] See, for example, Neven (1990), Grilli (1989a, 1989b), Vives (1990) and Branson (1990).

[7] There are a number of reasons why these studies have been inconclusive, not least of which are the problems associated with measuring bank output. For further discussion of these issues, see Benston (1972), Greenbaum (1967), Baltensperger (1972), Stillson (1974), Benston *et al.* (1982) and Gilbert (1984).

tition and cross-subsidisation. If 1992 reduces the tendency for price fixing, then we might expect greater price competition and greater allocative efficiency. Neven (1990) and Vives (1990) do not believe that there are large gains here because of market imperfections which characterise banking. Firstly, there are important entry barriers such as large set-up costs. These can prevent the breakdown of oligopolistic structures. Secondly, there are large switching costs which reduce the incentives for customers to switch to banks which offer a more efficient service. This in turn reduces the incentive for inefficient banks to change their behaviour since they are unlikely to lose customers as a result of their inefficiency.

Thirdly, Neven (1990) argues that inducements to productive efficiency are also weak in the banking sector and that 1992 will not change this. Normally, the threat of bankruptcy and the threat of takeover or entry provide some incentive for firms to be productively efficient. In the case of banking, however, these mechanisms may be weak and ineffective. Banks cannot be allowed to fail because of the social costs involved. Takeovers will still be subject to monetary authority approval and hence the threat of takeover is unlikely to be large.[8]

The fourth argument relates to the issue of differential tax regulations and secrecy laws which operate in EC countries. As we argued above, one way in which greater efficiency may be promoted is through depositors switching banks. However, Grilli (1989a, 1989b) argues that if any switching does occur, then it is likely to be for the wrong reasons. That is, funds are likely to flow not to banks which are more efficient, but to banks which are located in countries where taxes are low and secrecy laws tight.

The final argument draws on the literature on local intermediaries (Branson, 1990). Since information is imperfect and costly to gather, existing local financial institutions have an informational advantage, being 'close to the ground'. This makes it difficult for other institutions to enter local markets and hence provide the competition required for greater efficiency. This final argument seems to us rather weaker than the rest since it does not explain why financial intermediaries outside the local area cannot simply take over existing intermediaries and thereby gain access to the information.

[8] However, as we shall see later, there is some evidence that monetary authorities in some European countries are allowing takeovers and promoting structural changes in the run up to 1992.

Thus the conclusion of the above authors is two-fold. Firstly, 1992 is unlikely to lead to an increase in efficiency because banking markets are inherently characterised by imperfect competition. Secondly, since there are no obvious efficiency gains from 1992, there should be no change in the structure of EC banking markets.

2. 1992: The Scope for Structural Change in Banking in Southern Europe

Of the two views discussed so far, the second seems to offer more insights, not least because it looks at the specificities of the banking sector in a way that the Price Waterhouse approach, as we have seen, does not. However, it does not follow from this that we need to accept the major implication of this body of literature – namely, that we should not expect major structural changes in European banking. The first reason for this has to do with the relatively low levels of efficiency in southern European banking. The second reason is more complex and entails a rather different conceptualisation of the relationship between competition, efficiency and structure. The argument here is that we cannot easily proceed from the premise that there may be no large efficiency gains to be exploited in banking to the conclusion that there will not be large structural changes. In short, the second view discussed in section 1 may be good normative economics but may not be good positive economics. In other words, there may be structural changes even if there is no efficiency rationale.

TABLE 2

EVIDENCE ON EFFICIENCY OF SPANISH BANKING

	Operating expenses/ assets	Staff costs/ assets	Credits per worker[a]	Interest rate spread[b]
Spanish banks	3.00	2.10	632	6.1
EC average[c]	2.23	1.44	1348	4.1

[a] Thousands of ECUs
[b] 1988
[c] Operating expenses and staff costs include all EC countries except Denmark, Greece and Ireland. Credits per workers and interest rate spreads refer to all EC countries.
Source: Caminal *et al.* 1990, Table 8.5.

Let us turn first to the question of efficiency variation in European banking especially between southern Europe and the rest of the EC. Too much of the literature seems to be based on the larger economies of the EC. Of course evidence on bank efficiency is difficult to find because figures on costs and margins in banking are often unreliable. This results from the fact that banks do not give detailed breakdowns of the costs of individual services and undertake extensive cross-subsidisation. Therefore the evidence should be seen as indicative.[9] Table 2 gives some evidence from Spain. The first two items show that production costs in Spain are high, perhaps because Spain is over-branched.[10] Operating costs are also high in Greece, where 80% of operating costs consist of staff costs compared to an OECD average of 66%. Furthermore in the 1980s, employment in banking grew at around 4% p.a. (Katseli, 1990).

The third item in Table 2 (credits per worker) seeks in some way to capture productivity and to this extent shows that Spanish banking is generally less productive than the EC average. The fact that the interest-rate spread is high suggests that Spanish banks can pass on this relative inefficiency to their customers. Indeed, Spanish banks seem to be highly profitable – a factor which may be of some importance given our discussion in section 3 concerning the stability of the banking system in the future. While Portugal and Greece have also had high interest margins in the 1980s, the profitability of their banks is less secure. In both countries there is a large number of non-performing loans. In Portugal for the whole banking sector, such loans were three times equity in 1986 (Braga de Macedo, 1990a). In Greece the absence of good methods of commercial risk analysis in the banking system and the existence in the 1980s of a large number of highly indebted 'problematic' firms have also led to a large volume of non-performing loans in banks' balance sheets (Tsakalotos, 1991, chapter 7).

To some extent the relative inefficiency of southern European banking is the result of the degree of financial repression that characterises these economies. This financial repression has been quite

[9] The evidence presented below is based on a number of sources. For Spain, see OECD (1988); Vinals (1990); Caminal *et al.* (1990). For Portugal, see Borges (1990); Braga de Macedo (1990a, 1990b). For Greece, see Katseli (1990).

[10] There is one branch for every 2342 people in Spain compared with 4988 in the rest of the EC (Caminal *et al.*, 1990).

extensive including controls on interest rates, selective credit allocation and forced financing of government deficits.[11] While all the southern European economies have gone some way to liberalising their economies in the 1980s, a major factor which still hampers the ability of banks to compete in an integrated European financial area is the implicit taxes resulting from forced financing of government deficits. These taxes take two main forms. First, reserve requirements are higher in southern European countries than elsewhere in the EC. At mid-1988 Italy's reserve requirements were 25%, the highest in the EC: the corresponding figures for Greece, Portugal and Spain are 7.5%, 15% and 18.5% respectively compared with an EC average of 7.5%.[12] Secondly, banks are forced to hold a certain percentage of their liabilities in the form of Treasury bills. For example, in Greece the figure at the end of the 1980s was 40% and in Spain 10% (Gibson and Tsakalotos, 1992). Of course southern European governments have intervened to increase the efficiency of their banks by speeding up the process of liberalisation. For example, in 1990, Spain abolished the reserve requirements on banks and replaced them by a 5% cash requirement to be held with the Bank of Spain, a figure which is clearly more in line with the European average. Italy has also recently reduced reserve requirements from 22.5% to 17.5% (February, 1993). Greece introduced in 1991 a phased reduction in the proportion of new bank deposits to be held as Treasury bills – by mid-1993, banks were no longer obliged to use new deposits to buy Treasury bills. However, controls remain and to the extent that they are still more onerous than controls in the rest of the EC, so the relative disadvantaged position of southern European banking will continue.[13]

We can now turn to the issue of why we might expect changes in the structure of European banking even if there are no large efficiency gains to be exploited. The argument here is that mergers may occur because it is important that banks are big and that, within limits, whether efficiency is increased through such mergers may not be a central consideration. Revell (1987, 1988) gives two reasons for

[11] See Gibson and Tsakalotos (1992) for an extensive discussion of this issue.

[12] This average hides a high dispersion. The figures for each EC country are: Germany 6.6-12.1%; France 2.5-5%; UK 0.5%; Ireland 10%; Belgium, Denmark, The Netherlands and Luxembourg all have no reserve requirements (Bruni, 1990).

[13] No-one, to our knowledge, has undertaken a detailed study of the costs that such government regulations impose on these banks and the implications of their gradual removal. We discuss the implications of the fast removal of controls for macroeconomic stability in Gibson and Tsakalotos (1991).

this. The first is that if banks are to be able to diversify, they need to be large in order to enable them to provide services for their large corporate customers. Secondly, size provides some protection against takeover. While Revell does not provide theoretical justification for this, it is not difficult to do so. In an ideal world, if someone can run a company – however large – more efficiently than the current management, then they should be able to raise the funds to purchase it. However, the existence of imperfect credit markets results in very real limits on the amount of funds that can be borrowed (Stiglitz and Weiss, 1981). In short, it may be more difficult to take over a large firm than a small firm.[14] A third argument of why size may be important is given by Feldstein (1991) in his discussion of US banking. He argues that US regional banks have been badly hit by regional recessions in the US (*e.g.* Texas oil problems) because they have not been sufficiently diversified. In Feldstein's view this lends support for the promotion of national banks in the US. In a more closely integrated Europe such arguments may apply. If the European 'regions' are subject to asymmetric shocks, then banks which have only a 'regional' base may be adversely affected. There is a case therefore for larger more EC-wide banks which can benefit from reduced exposure to asymmetric shocks through diversification.

Revell provides evidence for the importance of size in mergers from the recent activity in the Spanish banking sector. He analyses the economic rationale for two Spanish mergers – between Banco de Bilbao and Banco de Vizcaya (1987) and between Banco Central and Banco Español de Credito (Banesto). Before 1987 the Spanish banking system had 7 major banks – 4 small banks which were more efficient and 3 large banks which were relatively inefficient. Revell suggests an efficient strategy from an economic point of view would be for efficient banks to merge with inefficient, so long as the new merged bank is run by the efficient management. On the contrary, the two Spanish mergers were between two efficient banks in the first case and two of the larger, inefficient banks in the second. Indeed Revell (1988) suggests that the second merger had "only sheer size to

[14] On the general importance of size on the probability of being taken over, see Cosh, Hughes and Singh (1990). Even in the 1980s in the UK and US, where large takeovers were not uncommon, companies taken over still tended to be outside the Top 100.

recommend it". While the latter merger eventually collapsed, this had nothing to do with the question of efficiency.[15]

Table 3[16] shows that this argument regarding the importance of size is likely to prove particularly significant in southern Europe. On the whole banks in Greece and Portugal are small with respect to the rest of the EC and this is also true, albeit to a lesser extent, in the case of Spain. In Italy, there are a number of large banks, but also numerous medium-sized regional banks.

TABLE 3

THE TOP 500 EUROPEAN BANKS – RANKING BY CAPITAL BASE
(at end December 1990 or March 1991)

	Total	Top 100	101-200	201-300	301-400	401-500
Greece	9	1	2	3	2	1
Portugal	13	1	2	4	3	3
Spain	50	10	9	11	13	7
Italy	103	20	18	21	22	22
France	26	12	4	3	4	3
Germany	89	17	23	11	17	21
UK	35	10	4	11	5	5

THE TOP 1000 BANKS – RANKING BY CAPITAL BASE
(at end December 1991 or March 1992)

	0-100	101-500	501-1000	Total
Greece	0	4	4	8
Portugal	0	2	8	10
Spain	5	14	26	45
Italy	10	29	56	95
France	9	10	8	27
Germany	9	32	46	87
UK	7	9	18	34

Source: The Banker, September 1991 and July 1992.

[15] The collapse was the result of disagreements between major shareholders of the two banks.

[16] The rankings in Table 3 are by Tier 1 capital base (as defined by the Basle capital adequacy regulations). Bank size can also be ranked by asset, but this does not alter our conclusions to any significant degree.

Thus for the above reasons, we see good grounds for expecting important structural changes as a result of 1992. Furthermore, this is backed up by the evidence of the last few years.[17] In some EC countries, governments, in an attempt to prepare their banks for the consequences of 1992, have been taking strong initiatives to promote and facilitate structural changes in their banking systems.

In Italy, the Amato Law (February 1990), which allowed private capital into Italy's publicly-owned banks, was passed partly to facilitate restructuring of the banking system without requiring public funds. Branch rules were also liberalised in 1990 to allow banks to extend their branch networks throughout the whole country. As we can see from Table 4, there have been a number of mergers between Italian banks. On the whole, these mergers have not created large banks and have been between small regional banks. Italy is widely thought to be a country which is overbanked and underbranched (Bruni, 1990; Table 3 above) and the mergers can be seen as an attempt to reduce overbanking and create banks with a greater degree of national coverage.

In Spain, the government commissioned an independent study of the changes required to enable banks to compete after 1992 (see Revell, 1987). The report recommended mergers and the Spanish monetary authorities have encouraged them. Table 4 lists those mergers which have occurred. The interesting aspect of Spanish government activity is that they themselves have actually taken the lead. Following the failure of the merger between Banesto and Banco Central, private banks were reluctant to attempt any further consolidation of the banking system. Thus in April 1991 the government announced that it was merging all the state-owned banks and credit institutions into one financial institution – the Corporacion Bancaria de España (Argentaria). This is widely thought to have triggered the merger between Banco Central and Banco Hispano Americano later in 1991. The resulting merged bank is now the largest bank in Spain (if banks are ranked by deposits).

Finally, a major restructuring of the banking system in Portugal is being undertaken. The vast proportion of Portuguese banks are nationalised and the government is currently seeking to undertake their privatisation. Moreover, it is allowing foreign banks either to

[17] Evidence here has been gathered mainly from the *Financial Times*, in particular its country surveys on "European finance and investment".

TABLE 4

MERGER ACTIVITY BETWEEN BANKS IN THE SAME COUNTRY

Country	Year	Merger
Italy	1989	Cassa di Risparmio di Roma acquired Banco di Santo Spirito
	1990	Banca Commerciale Italiana (BCI) merged with Credito Italiano
	–	Banca Commerciale Italiana (BCI) acquired 51% of Banca Sicula
	1990	Banco Ambrosiano Veneto acquired 92% of Citibank Italia
	1990	Cassa di Risparmio di Roma acquired 65% of Banco di Roma
	1991	Banco di Santo Spirito and Banco di Roma (both owned by Cassa di Risparmio di Roma) merge to form Banca di Roma
	1991	Istituto Bancario San Paolo di Torino acquired Crediop
	NEG.	Istituto Mobiliare Italiano (IMI) possible merger with Cariplo
Netherlands	1989	NMB merged with Postbank to become NMB-Postbank
	1989	VSB and Amev (Dutch insurance company) take a 15% mutual shareholding
	1990	Algemene Bank Nederland (ABN) merged with Amsterdam Rotterdam Bank (Amro)
	1990	Rabobank made an alliance with Interpolis (Dutch insurance company)
	1990	Rabobank made an alliance with Robeco (Dutch Fund Managers)
	1991	NMB-Postbank merged with Nationale Nederlanden
	1992	Pierson, Heldring & Pierson and Bank Mees & Hope (merchant banks) merge
Spain	1987	Banco de Bilbao merged with Banco de Vizcaya
	1991	Banco Hispano Americano merged with Banco Central
	1991	Merger of all state-owned banks into Corporacion Bancaria de España (or Argentaria)
Denmark	1990	merger of Den Danske af 1871, Copenhagen Handels and Provins
	1990	merger of SDS Bank, Privatbank and Andelsbank
Germany	1992	merger of Berliner Bank, Landesbank Berlin and Berliner Pfandbrief-Bank
	1992	WestDeutsche Landesbank and Sudwest Landesbank acquire 50% of Landesbank Rheinland Pfalz
	1993	WestDeutsche Landesbank takes 40% stake in Landesbank Schleswig-Holstein

NEG. = under negotiation at end December 1992.
Source: Financial Times.

TABLE 5

CROSS-BORDER ACTIVITY BETWEEN EC BANKS

ACQUISITIONS		
Banco Bilbao Vizcaya (Spa)	Lloyds (Port)	1991
Barclays Bank (UK)	L'Européenne de Credit (Fra)	1990
	Merck Finck (Ger)	1990
Credit Lyonnais (Fra)	Banco Commercial Español (Spa)	1990
	Banco Jover (Spa)	1991
	BfG Bank (Ger)	1992
Deutsche Bank (Ger)	Banca d'America e d'Italia (Ita)	–
	Banco Commercial Transatlantico (Spa)	1991
	Morgan Grenfell (UK)	1989
	Sociedade de Investmentos (Port)	–
	Banco de Madrid	1993
Istituto Bancario San Paolo di Torino (Ita)	Banca Catala de Credit (Spa)	1991
National Westminster (UK)	Banco March (mainland operations, Spa)	1991
	F van Lanshot Bankiers (Neth)	1990
Rabo Bank and Hanwha First Investment (Neth)	Bank of Athens	1993
Credit Commercial de France (Fra) and Berliner Handels- und Frankfurter Bank (Ger)	Charterhouse (UK merchant bank)	1993
MINORITY SHAREHOLDINGS		
Banco de Santander (Spa) and Royal Bank of Scotland (UK)	Banco Commercio e Industria (Port)	1990
Banesto (Spa)	Banco Totta & Acores (Port)	1991
Berlin Handels- und Frankfurter Bank (Ger)	Halder Holdings (Dutch)	1991
	Pastorino and Partners (Ita, Stockbroker)	1991
Bank of Scotland (UK)	45% of Finanziaria Italiana Mutui (Ita)	1992
Banque Nationale de Paris (Fra)	5% of Kleinwort Bensen	1991
MUTUAL SHAREHOLDINGS		
Banco Central Hispano-americano (Spa)	Commerzbank (Ger)	10% 1991
	Banco Commercial Portugues (Port)	10% and 2% 1993
Banco Hispano Americano (Spa)	Banco di Roma (Ita)	5% 1991
Bayerische Vereinsbank (Ger)	Banco de Sabadell (Spa)	1990
Dresdner Bank (Ger)	Banque National de Paris (Fra)	1991/92
Generale Bank (Belg)	Amsterdam Rotterdam Bank (Neth)	25% 1988
Royal Bank of Scotland (UK)	Banco de Santander (Spa)	2.5% and 10% 1989

Source: Financial Times.

buy state banks or to set in branches in Portugal. A condition for entry is that foreign banks made some payment for the bad debts of nationalised banks. For example, a foreign bank wishing to open a new bank must pay 900 million escudos ($6.5 million) to Finnagest, the state-owned institution responsible for dealing with bad debts in the banking sector.[18] In this way, the Portuguese authorities hope to strengthen their banking system and improve its efficiency. Whether this will lead to a reduction in concentration in the structure of Portuguese banking remains to be seen.

Given all this activity in southern Europe, Greece must be marked down as something of an outlier. Although privatisation of certain small banks as well as some foreign entry has taken place recently, there is no declared strategy of how best to help Greek banking prepare for the consequences of 1992.

In addition to within-country merger activity, there has also been cross-border activity. Cross-border activity can take a number of forms. Firstly, banks can set up in other countries on greenfield sites. The disadvantage of this approach are the high costs involved. Thus not surprisingly there has been little activity of this type.

Secondly, a bank could expand into another country through takeover or acquisition, that is through buying an existing set-up. The advantage of this approach is that the bank immediately acquires an existing customer base as well as human capital, allowing it to overcome the problems of information highlighted by Branson (1990). Table 5 shows some activity in this area with large banks, on the whole, buying up smaller banks.

The third possible type of cross-border activity which we wish to highlight here is mutual shareholdings and co-operative agreements. The former involves two (or more) banks taking shareholdings in each other, with the aim of jointly providing certain services. The latter involves a loose agreement between any number of banks to co-operate in the provision of services. Such co-operative agreements may lead to mutual shareholdings and even mergers in the future. The aims of these activities include, among others: to provide access to each others' customers; to engage in joint lending, for example, by one bank using the others' branches to sell a type of loan in which it

[18] The other charges are as follows: Esc 250 million ($1.8 million) to change status from a branch of a foreign bank to a locally incorporated bank; Esc 40 million ($0.3 million) to set up a new branch in Lisbon and Oporto; and Esc 20 million ($0.15 million) to set up a new branch elsewhere.

specialises; to allow banks to provide a wider set of services to its customers. Table 5 indicates that there have been a number of mutual shareholdings in recent years.[19]

Thus, in conclusion, there is evidence that structural changes are taking place both within EC countries and at the European level. Moreover, for the reasons outlined above, we might expect such changes to continue.

3. 1992: Competition and Stability

It is clear that 1992 will not promote a move towards *perfectly* competitive banking markets in the EC. Critics of the Price Waterhouse Report are therefore correct to emphasise the fact that banking markets are inherently imperfectly competitive. However, this does not imply that there will be no increase in competition. Indeed, behind our argument in section 2 is the idea that 1992 has brought increased competition to banking markets, at least in southern Europe – it is the increased competition or the potential for increased competition that has been promoting both within country structural change and cross-border changes. Within country changes are being encouraged by the authorities themselves whilst cross-border restructuring represents attempts by European banks to establish themselves in other EC countries and hence take advantage of the changes that the Second Banking Directive have brought. One aspect associated with this increased competition, which has received

[19] Examples of co-operative agreements include the following:

(i) Commerzbank (Ger), Credit Lyonnais (Fra), Banco di Roma (Ita) and Banco Hispano Americano (Spa) had an informal banking consortium. This was abandoned in July 1991 following Credit Lyonnais' decision to move into Spain alone. However, there is still the potential for a mutual shareholding between Commerzbank and Credit Lyonnais.

(ii) Rabobank (Neth) has formed a cooperative alliance with Cera Spaarbank (Belg) and Banco Populare (Spa).

(iii) TSB (UK) formed a strategic alliance (with the potential for a mutual shareholding) with Cariplo (Ita) in December 1991.

(iv) Credit Agricole (Fra), Rabobank (Neth), Banco Ambrosiano (Ita), Lloyds Bank (UK) and Bayerische Vereinsbank (Ger) have agreed to a pooling of resources to allow each others' customers access to their branches.

(v) Banco Commercial Portugues (BCP, Port) and Banco Popular Español (Spa) have joined forces to create a new bank in France (Banco Popular Commercial).

(vi) Banco Commercial Portugues (Port) and Cariplo (Ita) set up a new housing finance bank in Portugal (1992).

little attention in the literature, is its impact on financial stability.[20] Most authors emphasise the link between competition and efficiency. If, however, there is also a link between competition and stability, then a trade-off is likely to emerge between efficiency and stability. Increased competition may be beneficial in terms of increased efficiency, but will it be at the cost of increased financial fragility? It is this link between competition and stability which we focus on in this section because it represents the relatively neglected aspect in the literature on the impact of 1992 on banking. Moreover, our argument here that structural change has been and will continue to feature as a consequence of 1992 suggests that the question of stability is a critical one for the 1990s.

There are many theories of the causes of financial crises and their transmission to other parts of the economic system. Here we concentrate on only one approach which highlights the link between competition and stability.[21] This takes as its starting point bank behaviour under imperfect information and draws on the theories of Stiglitz and Weiss (1981) and Eaton and Gersovitz (1981a, 1981b). In their models of bank behaviour crises are not generated because banks ration credit as a crisis prevention strategy. Gibson and Oppenheimer (1992) develop these models by considering the impact of market structure and the degree of competition. The combination of market imperfections (imperfect information) and a highly competitive environment can generate increased financial fragility and crisis.

If banks are risk averse then they will want to be compensated for taking on extra risk, that is increased risk should imply an increased expected return. One seemingly obvious way to ensure a higher return is to charge a higher rate of interest on loans which the

[20] The issue of financial stability is a contentious one and therefore it is useful here to define what we mean by financial instability. Normal commercial failures are not usually referred to as instability. But in financial markets the failure of even one institution can promote instability, since the consequences of that failure spread throughout the whole economic system. Moreover, the effects of the failure are magnified rather than dampened. This arises because the importance of banks in organising the payments system, in allocating resources for investment and in affecting the overall level of economic activity means that the social costs of their failure are large (and indeed larger than the private costs). It is for this reason that we believe the concept of financial instability is meaningful.

[21] There are a number of theories of financial market behaviour which deal with the possibility of crisis. These include the monetarist approach, the Minsky-Kindleberger approach and the rational speculative bubble literature (see Gibson and Oppenheimer, 1992, for a review of this literature).

bank considers to be riskier. However Stiglitz and Weiss (1981) argue that in the presence of imperfect information the interest rate is an inefficient and indeed ineffective way of compensating for extra risk. If banks use only the interest rate then at some point increased risk will be accompanied by a fall in the expected return because of two effects. The first is the adverse selection effect. As banks increase the interest rate they will lend at, they attract riskier borrowers who are less concerned about repayment and are therefore more likely to default. Secondly, there is the incentive effect. As the interest rate charged by the bank rises, so the net present value of all projects declines. Those projects which are no longer profitable (because their net present value has turned negative) will be the least risky projects. Thus the overall riskiness of projects which banks finance increases with the rate of interest. These two effects result from the fact that banks cannot identify the riskiness of borrowers because of incomplete information. If they could, then they could design a portfolio which gave them the appropriate risk-return relationship. The implication of incomplete information is that the banks should practice credit rationing, that is, they should limit the quantity of funds they are willing to lend to any borrower, irrespective of the interest rate that the borrower is willing to offer.[22]

Thus Stiglitz-Weiss and Eaton-Gersovitz argue that banks will manage the riskiness of their portfolio through both differential interest rates and credit rationing. They appear to be making a point in positive economics: banks *do* act in this way in order to control risk. However, recent experience suggests that this is better normative economics (banks *should* act in this way).[23]

Gibson and Oppenheimer argue that the reason why banks might not act as the Stiglitz-Weiss and Eaton-Gersovitz models suggest is because of the influence of market structure. In a competitive environment, where banks are concerned about maintaining (if not improving) market share in traditional areas of business as well as entering new areas in an attempt to keep up with their competitors,

[22] The question which arises here is what these limits should be. Eaton and Gersovitz (1981a, 1981b) suggest that banks should lend until the costs of default to the borrower are equal to the benefits of default to the borrower. Clearly, at a practical level, this is difficult to determine.

[23] There are a number of examples where banks appear not to have practised credit rationing successfully. These include the LDC debt crisis, the over-lending by both US and UK banks in the property and consumer credit sectors in the 1980s and the recent Scandinavian banking crisis.

increased potential for instability is likely. This results from the fact that increased competition (and possibly confidence in new lending areas) can lead to both declining risk premia (including a reduction in the dispersion of risk premia between high-risk and low-risk borrowers) and loosened credit limits. The latter results in both excessive aggregate lending by banks to a particular sector as well as excessive concentration of loans to a particular risk category by individual banks. These tendencies are reinforced by herd behaviour and by attempts to cut costs to maintain competitiveness. Cost-cutting may lead to worsening bank balance sheets since it may take the form of a reduction in the amount of information gathered about potential borrowers. The result is increased financial fragility, clearly an undesirable outcome given the social costs associated with bank failure.[24]

There is much evidence of such behaviour in the 1970s and 1980s. The recent Scandinavian banking crisis is widely thought to have resulted from increased competition in the wake of deregulation in the early 1980s (Fossli and Burton, 1991; Preston, 1991). Banks, particularly in Norway, overlent to both the personal and business sectors and now face large losses (and in some cases bankruptcy) since many of these loans are now non-performing. The developing country debt crisis can also be seen in this light. The highly competitive environment of international banking after 1970 in combination with the view that sovereign borrowing was inherently low-risk because 'countries could not go bankrupt' caused banks to overextend themselves to countries that ultimately could not repay.[25]

To conclude, therefore, there are good theoretical reasons as well as some empirical evidence that increased competition can help to increase financial fragility and hence the potential for financial crisis. Thus the EC may face a trade-off between increased efficiency and increased instability.

[24] The actual triggering of the crisis can take a number of forms. It may arise from the inability of one borrower to repay, from evidence of fraudulent activity or from the announcement of large losses by a major participant in a certain business area. Whatever the trigger, bank reactions usually intensify it as all banks seek to withdraw from the business area which is now perceived as being too risky.

[25] On the role of competition in the developing country debt crisis, see Gibson (1989) and Gibson and Oppenheimer (1992). The Savings and Loan crisis in the US can also be seen as a consequence of increased competition following deregulation, although it is true that other factors such as the existence of a 100% deposit insurance scheme and a complete lack of supervision were at least partly responsible (see White, 1991).

4. The Policy Implications of 1992

We have examined in this paper the implications of the Second Banking Directive for banking in southern European economies. We began with the existing literature which has somewhat conflicting views on the effects of the Directive. On the one hand, there is the Price Waterhouse Report which argues that since the Directive is designed to facilitate competition between banks of different EC countries, it will ensure an increase in efficiency (presumably via the threat of takeover or actual takeover). On the other hand, Neven, Vives and Grilli, amongst others, have argued that the imperfect nature of competition within banking means the Directive is unlikely to have much of an impact – banking within the EC will remain as segmented as before. Competition and hence efficiency are unlikely to be much altered. In this paper we have argued that neither of these conclusions seems applicable to southern European economies. Instead, we have argued that although competition between banks is imperfect, the Directive has led to greater competition. The implications of this are two-fold. Firstly, southern European banking systems are likely to experience (and indeed have experienced) structural changes. These changes may result from a desire by banks to become more efficient. However, even if there are no efficiency gains, structural change may stem from the need for southern European banks to grow bigger and hence protect themselves from takeover by their much larger northern European rivals. Secondly, even if increased competition improves efficiency and in particular the service and choice of financial instrument offered to customers, there is a possible cost in terms of the potential for increased instability. This cost has not been highlighted in the literature and hence we have chosen to focus on it in this paper.

If we are correct in our prediction that there will be important structural changes and increased competition in southern European banking in the 1990s, and if furthermore our concern over the implications of this for financial stability is justified, then certain clear policy implications suggest themselves. Our argument is that, as in other areas of European integration, the EC has progressed more with the negative integration aspects of its policy than with the positive integration aspects.

For reasons that may already be clear, these policies will largely have to be at the level of the EC. The Second Banking Directive emphasises the removal of barriers to allow banks to compete across the EC. However, it contains very little on the establishment of institutions to ensure proper supervision of European financial institutions – that is to remain largely with the national supervisory authorities. Since, as we have argued, these institutions are likely to be characterised by restructuring in the 1990s, this is particularly problematic. If restructuring tends to create European-wide banks (or at least banks which operate in a number of EC countries), then supervision on a national basis becomes difficult and less effective – since it is largely recognised that banks should be supervised on a consolidated basis.[26] Moreover, the single licence aspect of the Second Banking Directive has led to fears of competitive deregulation. That is, banks will tend to acquire their licences in EC countries where the rules are less onerous and then operate anywhere in the EC, bound only by the regulations of the country in which they received their licence. Thus there will be a tendency for the standards of supervision to fall to the lowest level within the EC. It could be argued that this tendency may be halted by bank customers conducting business only with banks which they consider to be safe. However, such an argument fails to consider the importance of information imperfections – bank customers are simply not in a position to judge the soundness of a bank, not least because of a lack of published information on bank portfolios.[27]

The Second Banking Directive calls only for a minimum of regulations: new banks require a minimum capital base of 5 million ECUs; the home country (that is the country from which the bank received its licence) is responsible for solvency issues; and the host country (that is the country where the bank is located) is responsible for liquidity.[28] More specific supervisory issues have been tabled by the Commission as recommendations. There are three main recommendations which we can mention here. Firstly, the liquidation of

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[26] The Basle concordat of the early 1980s recognises this; moreover the recent failure of BCCI in the UK highlights the desirability of consolidated bank supervision.

[27] This informational aspect may be seen to differentiate the financial sector from other sectors where there may indeed not be a tendency to arrive at the lowest common denominator. Thus, for instance, information about engineering products, say, may be more easily acquired and consumers may prefer products with better technical standards.

[28] We can note that these last two points follow the procedure adopted by the Basle Committee on Banking Regulations and Supervisory Practices in its 1975 Concordat.

banks should be undertaken by the country in which the bank has its headquarters. Secondly, the Commission wishes to harmonise the minimum requirements for deposit insurance which operate in EC countries. Thirdly, large exposures should be limited to less than 40% of own funds.

The most substantial supervisory issue that has been agreed in recent years is the Basle Capital Adequacy Agreement (1988). The EC has adopted the capital adequacy rules agreed there. In the Agreement, capital is defined in two Tiers, with at least 50% requiring to be Tier I. Tier I incorporates mainly ordinary share capital, disclosed reserves and retained profits. Tier II includes other reserves (undisclosed and those arising from asset revaluation), general loan loss provisions and various forms of hybrid capital instruments and subordinated debt (see Llewellyn, 1989a, Table 1). Assets are risk weighted and there are five classes – 0%, 10%, 20%, 50% and 100%. The rules state that banks have to hold a minimum of 8% of their risk-weighted assets in the form of capital by the end of 1992.

The main aim of the Basle agreement is to increase the stability of the banking system (Kapstein, 1991). Thus it might be thought that the introduction of capital adequacy ratios by EC countries at the same time as the introduction of the Second Banking Directive will ensure that the potential for instability is minimised. However there have been a number of criticisms of Basle which suggest that not only will stability not be encouraged but also that it might be undermined.[29]

There are several arguments that suggest that Basle will do little to promote stability. Firstly, no allowance has been made for funding risk (*i.e.* the degree to which bank assets and liabilities have different maturities). As we argued in the previous section, competitive pressures can lead to an increase in funding risk thus undermining the stability of the banking system.[30] Secondly, the risk weighting system has been criticised as being too crude. A large proportion of bank assets are classed as 100% weighted, suggesting that loans to developing countries, for example, are of equal risk with loans to multinationals. Finally, a more profound criticism of the risk-weighting system is that it views the riskiness of a bank's portfolio as

[29] See Llewellyn (1989a, 1989b) and Hall (1989).

[30] A recent announcement from the BIS in April 1993 suggests that if the Basle Agreement is amended at a later date, provision for funding risk might be made.

the weighted sum of the riskiness of its parts. Yet the message of portfolio theory is that as diversification proceeds, the riskiness of the banks portfolio could either increase or decrease since portfolio risk depends not only on the risk of each asset but also on the degree to which the returns from each asset move together (*i.e.* on covariances).

Moreover, not only may Basle fail to control risk, it may also work to undermine stability at least in the short run. Llewellyn (1991) has argued that banks now face a strategic dilemma. On the one hand, the BIS capital adequacy requirements have increased banks' demand for capital. On the other hand, increased competition in banking markets has tended to reduce the supply of capital (because of reduced profits) and increased the cost of capital (bank customers have become more sophisticated and demand higher returns on their accounts, for example, interest on their current accounts).[31] The result is capital imbalance – a shortage of capital. Llewellyn has suggested that a solution to this problem lies in structural changes in banking markets – mergers, takeovers and perhaps even some failures.[32] Whilst Llewellyn's point was applied to international banking generally, it is clear that developments in Europe are unlikely to help this dilemma. In particular, the increased competition associated with 1992 along side domestic financial liberalisation in southern European economies will reduce the supply of capital and increase its cost. Structural change is therefore likely for this reason alone.

Our argument in this paper suggests that bank supervision is more than simply a problem of capital adequacy.[33] If banks, as we

[31] We can note that Feldstein (1991) argues that US banks also no longer have access to low cost funds. The introduction of interest-bearing checking accounts and savings accounts in money market mutual funds enabled even small savers to get high interest rates during the 1970s and 1980s. This forced US banks to raise the interest rates they offered to small customers, thus depriving them of their main source of low-cost funds. Similar developments were seen in UK banking in the 1980s as banks were forced to compete with building societies for customers.

[32] Feldstein (1991) suggests that this strategic dilemma will probably lead to bank failure in the US, since there are few banks with extra capital that would enable them to acquire banks with too little capital. The problem is further compounded by the fact that those banks with low capital adequacy are often the largest and hence more difficult, if not impossible, for small banks to take over (see also Friedman, 1991). For a discussion of the strategic dilemma as applied to British banking, see Llewellyn (1992).

[33] That bank supervision should go beyond capital adequacy is all the more important in the light of moral hazard. The need for a lender of last resort in the event of bank failure may mean that banks undertake excessive risks, since they know they will be rescued if these risks do not pay off. Given that the withdrawal of a lender of last resort is neither credible nor indeed desirable, the existence of moral hazard generates a strong case for bank supervision during non-crisis periods. This supervision is intended to limit risk-taking.

argued in the previous section, become increasingly fragile as a result of increased competition in a world of imperfect information, then supervision of the Basle capital adequacy type does little to foster stability since it does nothing to mitigate the impact of competition or actually to control competition itself. In particular, we want to emphasise three areas which banking supervision should encompass. Firstly, there is intervention to limit and control the amount of risk which a bank undertakes. This includes intervention to control the degree of maturity transformation, exposure to foreign exchange risk, asset concentration and so on. Secondly, central banks may have an important role to play in ensuring that banks gather enough information. In highly competitive markets, there is an incentive to cut back on commercial/sovereign risk assessment through free riding.[34] This tends to lead to herd behaviour and banks as a whole gather a sub-optimal amount of information. There is therefore a case for central bank intervention to force banks to undertake risk assessment and to invest in improving it. The case for such intervention does not rely on the government being cleverer than the banks, merely that they can take a more detached and rational view. Finally, evidence from recent financial crises indicates that they have been fuelled by excessive competition. This suggests the need for central bank intervention to limit competition. Whilst this may have costs in terms of efficiency, the benefits take the form of increased financial market stability. In view of the public good nature of financial stability, the cost in terms of reduced efficiency may be well worth paying.

[34] For example, it is widely known that small US regional banks who participated in syndicated sovereign loans to developing countries undertook very little risk analysis of their own. Instead they interpreted the willingness of larger US banks to lend to a particular country as a signal that that country was creditworthy (Gibson, 1989).

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