European Banking in the 1990s

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# Contents

List of Contributors viii  
Introduction 1  
*Jean Dermine*

Overview: European Financial Markets — the Commission’s Proposals 7  
*Geoffrey Fitchew*

## Part I The Regulation of Financial Markets in Europe 15

1 European Banking: Prudential and Regulatory Issues 17  
*Ernst Baltensperger and Jean Dermine*  
Comment 37  
*Richard Herring*

2 The Regulation of Financial Services: Lessons from the United Kingdom for 1992 41  
*Colin Mayer*  
Comment 62  
*Pierre Hillion*

## Part II European Equity Markets and Investment Banking 65

3 European Equity Markets: Towards 1992 and Beyond 67  
*Gabriel Hawawini and Bertrand Jacquillat*  
Comment 102  
*Théo Vermaelen*

4 European Investment Banking: Structure, Transactions Flow and Regulation 105  
*Ingo Walter and Roy C. Smith*  
Comment 148  
*Nigel Carter*
Part III Banking in Six European Countries

5 Structural Adjustment in European Retail Banking: Some Views from Industrial Organization
   Damien J. Neven
   Comment
   Paul A. Geroski and Stefan A. Szymański

6 The French Banking Sector in the Light of European Financial Integration
   Christian de Boissieu
   Comment
   Patrick Artus

7 Banking and Financial Reregulation Towards 1992: The Italian Case
   Franco Bruni
   Comment
   Alfred Steinherr

8 Competition in Spanish Banking
   Ramon Caminal, Jordi Gual and Xavier Vives
   Comment
   Rafael Repullo

9 Portuguese Banking in the Single European Market
   Antonio M. Borges
   Comment
   Jorge Braga de Macedo

10 Swiss Banking After 1992
    Alexander K. Swoboda
    Comment
    Jean-Pierre Danthine

11 Capital Requirements of German Banks and the European Economic Community Proposals on Banking Supervision
    Bernd Rudolph
    Comment
    Ernst-Moritz Lipp
Contents vii

Part IV The Macro Perspective

12 The Euromarkets After 1992
   Richard M. Levich
   Comment
   Daniel Gros

13 Macro-economic Implications of 1992
   Charles Wyplosz
   Comment
   Wolfgang Rieke

Part V Lessons From the United States

14 European Banking Post-1992: Lessons From the United States
   Anthony M. Santomero
   Comment
   Greg Udell

Index
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The German banking industry has seconded the proposal for a single European banking market and the establishment of a 'fair level playing field'. In banking services, this implies the harmonization of rules on capital adequacy. Currently, the Cooke committee at the Bank for International Settlements and the European Commission are working on new capital guidelines. It is argued in this chapter that capital adequacy regulations significantly affect the competitive positioning of the German banking industry and that the German Banking Act should be revised.

The chapter is structured as follows. The German banking system, its supervisory controls and the deposit insurance mechanisms are described in section 11.1 and the effects of the new capital regulations are assessed in section 11.2.

11.1 The German Banking Industry and its Supervisory System

11.1.1 The Structure of the German Banking System

It is common practice to divide the German banking industry into three groups differing mainly with respect to the legal form of their member banks and to their connecting banking associations as well as their related regulations and deposit protection schemes. These three groups are the commercial banks, the savings banks and the credit cooperatives. Two of these groups, the savings banks and the credit cooperatives, operate within well defined areas (Regionalprinzip) and therefore do not compete with one another. In this case the competing units are the banking groups, acting in joint competition (Gruppenwettbewerb).

Commercial banks are organized as stock corporations or limited liability companies. For statistical purposes they are usually divided into four subgroups: the three big banks with their Berlin subsidiaries and a nationwide
network of more than 3,000 branches; the very heterogeneous group of so-called regional banks operating nationwide with only a limited number of branches, or only in a certain region, or as single banks like most of the subsidiaries of foreign banks belonging to this group; the branches of foreign banks; the private bankers, the oldest group within the banking industry but nowadays with only a few independent houses neither owned nor controlled by other banks.

The *savings bank sector* consists of nearly 600 local saving institutions and their 12 regional central institutions, the *Landesbanken/Girozentralen*, including a central institution, the Deutsche Girozentrale—Deutsches Kommunalbank, with similar functions. With a few exceptions savings banks are incorporated under public law and owned by their respective municipalities and districts. The *Landesbanken* are organized as public law corporations and owned by the state itself and/or the state savings banks association. At the moment the Hessian State is considering withdrawing from its *Landesbank* Helaba, leaving the Hessian savings banks association as the sole owner of this bank. Other *Landesbanken* are considering building larger groups through mergers with other giro institutions or larger savings banks.

The last of the three sectors, the *credit cooperatives* consists of more than 3,000 local credit cooperatives, eight regional institutions and a central institution. The local institutions are organized in the legal form of cooperatives, and the regional institutions are organized as stock corporations. At present the central institution of the credit cooperatives sector, the Deutsche Genossenschaftsbank, is planning to acquire the regional institutions with the aim of building the only two-tiered system in this sector. The final decisions have not been made. However, with the approach of 1992, merger activities will be stimulated in all sectors of the German banking system.

While the savings banks and cooperative banks show a certain 'unity and harmony, as a result of the regional organization which practically excludes competition within each group, commercial banks work together only on general economic and public relations matters' (Scheidl, 1988). Therefore, the central organization of the commercial banks (Bundesverband deutscher Banken) is a loose association representing its members' interests whereas the association of savings banks (Deutscher Sparkassen-und Giroverband) and the association of credit cooperatives (Bundesverband der Deutschen Volksbanken und Raiffeisenbanken) undertake more central functions for their members.

The banks of all three banking groups are called *universal banks* because in principle they carry out the full range of commercial and investment banking services. This common characteristic does not exclude some specialization with respect to certain customers or business activities on the basis of historical, regional or strategic differences. Therefore we cannot
Capital Requirements of German Banks

speak of a uniform type of universal banks. Only the three large branch banks, some other large regional banks and the central institutions of the savings and corporate banks operate as universal banks, i.e. as institutions offering the whole range of banking services and at the same time holding shares and supervisory board memberships in non-bank companies as well as exercising equity voting rights.\(^1\) The same institutions or most of them (with obvious and noteworthy differences) have built up a European or global network of subsidiaries and affiliates. The other institutions called universal banks offer a wide range of services in their regional district (partly in connection with their central institutions) but do not exhibit any other features of the large banks.

In addition to the three groups of universal banks mentioned above, there are a number of specialized banks with different legal forms and sometimes with their own associations and regulations. Some of the specialized banks are included in the statistics of the German Central Bank, the Bundesbank, namely the mortgage banks, the special functions banks and the postal giro and postal savings banks. The grouping, of these statistics gives a rough idea of the institutional structure of the German banking system (see table 11.1 for this grouping, together with data on the number of the banks in each sector and their respective business volumes).

### Table 11.1 The institutional structure of the German banking system

<table>
<thead>
<tr>
<th>Category</th>
<th>No. of reporting banks at end of 1987</th>
<th>Volume of business (billion DM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>314</td>
<td>875,782</td>
</tr>
<tr>
<td>Large banks</td>
<td>6</td>
<td>324,281</td>
</tr>
<tr>
<td>Regional and other commercial banks</td>
<td>157</td>
<td>425,541</td>
</tr>
<tr>
<td>Branches of foreign banks</td>
<td>59</td>
<td>69,846</td>
</tr>
<tr>
<td>Private bankers</td>
<td>92</td>
<td>56,114</td>
</tr>
<tr>
<td>Savings banks</td>
<td>598</td>
<td>1,400,595</td>
</tr>
<tr>
<td>Central and regional giro institutions</td>
<td>12</td>
<td>588,659</td>
</tr>
<tr>
<td>Savings banks</td>
<td>586</td>
<td>811,936</td>
</tr>
<tr>
<td>Credit cooperatives</td>
<td>3,487</td>
<td>641,410</td>
</tr>
<tr>
<td>Central and regional institutions</td>
<td>7</td>
<td>173,041</td>
</tr>
<tr>
<td>Credit cooperatives</td>
<td>3,480</td>
<td>468,369</td>
</tr>
<tr>
<td>Mortgage banks</td>
<td>38</td>
<td>523,491</td>
</tr>
<tr>
<td>Private mortgage banks</td>
<td>27</td>
<td>337,498</td>
</tr>
<tr>
<td>Public mortgage banks</td>
<td>11</td>
<td>185,993</td>
</tr>
<tr>
<td>Special functions banks</td>
<td>16</td>
<td>251,561</td>
</tr>
<tr>
<td>Postal giro and savings banks</td>
<td>15</td>
<td>55,957</td>
</tr>
<tr>
<td>All categories of banks</td>
<td>4,468</td>
<td>3,748,796</td>
</tr>
</tbody>
</table>
Other specialized banks, which are normally not included in the statistics of the Bundesbank, are the Bausparkassen (institutions similar to building and loans associations), investment companies, securities clearing houses and special guarantee banks. We shall not deal with these institutions here because, with one exception, they are not real competitors of the universal or specialized banks. The one exception is the building and loan associations which operate under a special law but are nevertheless central to the financial services industry. In the following we shall concentrate on the universal banks and only occasionally refer to related problems concerning the specialized banks.

11.1.2 The Development and Basic Structure of the Supervisory System

Development of the supervisory system

The fundamental law on the supervision of German banks is the Banking Act of 10 July 1961 (Gesetz über das Kreditwesen, KWG), which replaced the Banking Act of 1934. The introduction of general supervision of banks was a consequence of the banking crisis of 1931, which culminated in the illiquidity of the Danatbank in 1931. Prior to 1931 only partial legislation had existed with respect to banking supervision, for example the Mortgage Bank Act of 1899. In 1931 and 1932 a number of emergency orders set up for the first time a comprehensive system of governmental supervision of all banks. These orders were consolidated in the Banking Act of 1934 (Reichsgesetz über das Kreditwesen), which established the principle that banking had to be licensed and regulated following certain guidelines.

After the war bank supervision was carried out at state, as opposed to federal, level. A uniform regulatory framework did not exist until the passing of the Banking Act in 1961, which at the same time created the legal basis for the establishment of the Federal Banking Supervisory Office in Berlin. The Banking Act of 1961, which remained essentially unaltered for 15 years, adopted the central elements of the pre-war legislation. The first substantial changes were brought about by the amendment of the Banking Act in 1976. This amendment act incorporated various attempts to remedy certain weaknesses in the banking system which had become particularly apparent in connection with the collapse of Bankhaus I.D. Herstatt on 26 June 1974 (stricter rules on the extension of large-scale credits, on the information required of borrowers and on the Banking Supervisory Office’s rights of information and investigation). The 1976 amendments had been preceded and accompanied by other measures to improve the viability of the banking system. The developments following the Herstatt crisis support the thesis that the development of banking supervision is mainly a reaction to current
political pressures: the introduction of Principle Ia to limit risks from open currency positions relative to the bank's liable capital in August 1974; the foundation of the *Liquiditätskonsortialbank* in September 1974 with the objective of standing by in cases of liquidity shortages; the establishment of the study group *Grundsatzfragen der Kreditwirtschaft* in November 1974; the reform and further development of the deposit protection schemes by the savings banks in December 1975, by the commercial banks in May 1976 and by the credit cooperatives in April 1977.

The second larger revision of the Banking Act was brought about by the Third Act to Amend the Banking Act which came into effect on 1 January 1985. Legislative actions which led to the 1985 amendments were expedited by the financial difficulties of the private bankers Schroeder, Münchmeyer, Hengst & Co. (SMH-Bank) in the autumn of 1983, although this case resulted in a remarkable rescue operation by the private banking community in concert with the authorities.

The 1985 amendments produced extensive changes in the regulatory system. Most importantly, they prescribed consolidation of banking groups, including foreign subsidiaries, for the purpose of both capital adequacy ratios and large-scale credit ratios. Until then the banks could build up so-called credit pyramids through their subsidiaries without a corresponding increase in the capital base of the parent bank, thereby bypassing the restrictions on business based on the bank's liable capital. In addition to these consolidation requirements the 1985 amendments reduced the ceiling for large-scale credits from 75 to 50 per cent of the equity, supplemented the provisions on equity by establishing stricter requirements for silent capital participation and by recognizing special participation rights, the so-called *Genußscheine*, as equity capital. Such capital must not, however, exceed 25 per cent of the other liable capital.

*Aims and regulating instruments of banking supervision*

Section 6 of the Banking Act quotes three functions of the supervisory authority which has the task of supervising banking institutions in accordance with the provisions of the Banking Act: the Federal Banking Supervisory Office shall counteract undesirable developments in banking which may endanger the safety of the assets entrusted to banks, adversely affect the orderly conduct of banking business or result in serious disadvantages for the domestic economy.

There is some debate as to whether the three functions are of equal importance or whether there are one or two main functions. In the past some authors seemed to give equal prominence to the protection of deposits and therefore to a special protection of the deposit owners on the one hand and the safeguarding of the orderly functioning of the banking system on the other hand. However, there has recently been a tendency to define the protection
of the functioning of the banking system as the main task of banking supervision. The 1985 amendments to the Banking Act underline this position in explicitly stating in section 6 (3) that the supervisory authority shall exercise its functions exclusively in the public interest. In addition to this debate, some hold the opinion that the instruments of the supervisory authority which serves the objective of deposit or lender protection also serve the objective of protecting the functioning of the banking system. This view can be legitimately held if one remembers that a bank collapse can be infectious.

The instruments of the supervisory authority can be classified in several ways. One possibility is to distinguish the instruments regulating entry to and exit from the banking market (licensing, start-up capital, powers to intervene) and instruments governing banking operations. We shall only deal with the second class of instruments concerning ongoing banking activities. These instruments can be classified as the so-called structural norms and the informational rights and obligations.

Structural norms are as follows:

1. provisions regarding equity and liquidity;
2. limitations of investments;
3. rules governing the extension and diversification of large-scale loans;
4. rules governing loans to borrowers closely associated with the lending bank (Organkredite).

Informational norms are as follows:

1. reporting obligations;
2. annual financial statements;
3. credit information exchange concerning loans of a million DM or more;
4. bank audits;
5. rights of information and investigation.

Basic features of the structural norms

The structural norms on banking operations, which are set forth in sections 10–20 of the Banking Act, relate to the definition of bank equity, the maintenance of adequate capital and liquidity, consolidation for supervisory purposes, and finally to the limitations of investments and credits in relation to equity capital.

Section 10 of the Banking Act defines what is to be regarded as liable capital (paid-up share capital plus reserves plus certain elements according to the legal form of the bank). Section 10 also requires banks to maintain adequate liable capital in order to fulfill their obligations to their creditors and particularly in order to safeguard the assets entrusted to them. The Federal Banking Supervisory Office draws up Principles according to which it assesses as a rule whether the requirement of adequate liable capital is satisfied.
Principle I stipulates that a bank's loans and investments should not exceed eighteen times its liable capital. For calculating the Principle I ratio the loans are weighted in accordance with various risk groups. The parent banks of banking groups must ensure that Principle I is also complied with on a consolidated basis.

Principle Ia limits the open positions in foreign exchange and precious metal trading as a proportion of the bank's liable capital (on a daily basis, on the basis of any calendar month and of any half of calendar year).

Section 11 of the Banking Act stipulates that banks invest their funds in such a way as to ensure adequate liquidity all the time. Liquidity is assessed according to principles II and III.

Principle II restricts the sum of the long-term assets to certain financial resources which are deemed to be long term.

According to Principle III the sum of various short- and medium-term assets should not exceed short- and medium-term financial resources.

In essence Principles II and III establish limitations on the banks' ability of maturity intermediation and transformation. Table 11.2 shows the average

<table>
<thead>
<tr>
<th>Year</th>
<th>Principle I</th>
<th>Principle II</th>
<th>Principle III</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(limit 18)</td>
<td>(limit 100%)</td>
<td>(limit 100%)</td>
</tr>
<tr>
<td>1977</td>
<td>12.7</td>
<td>86.1</td>
<td>73.5</td>
</tr>
<tr>
<td>1978</td>
<td>13.0</td>
<td>87.4</td>
<td>73.4</td>
</tr>
<tr>
<td>1979</td>
<td>13.6</td>
<td>89.3</td>
<td>77.9</td>
</tr>
<tr>
<td>1980</td>
<td>14.0</td>
<td>91.7</td>
<td>82.9</td>
</tr>
<tr>
<td>1981</td>
<td>14.3</td>
<td>92.1</td>
<td>85.1</td>
</tr>
<tr>
<td>1982</td>
<td>14.1</td>
<td>91.0</td>
<td>83.4</td>
</tr>
<tr>
<td>1983</td>
<td>13.7</td>
<td>90.1</td>
<td>80.9</td>
</tr>
<tr>
<td>1984</td>
<td>13.6</td>
<td>89.9</td>
<td>80.4</td>
</tr>
<tr>
<td>1985</td>
<td>13.4</td>
<td>90.2</td>
<td>78.2</td>
</tr>
<tr>
<td>1986</td>
<td>12.7</td>
<td>87.9</td>
<td>71.3</td>
</tr>
<tr>
<td>1987</td>
<td>12.3</td>
<td>86.7</td>
<td>65.2</td>
</tr>
</tbody>
</table>

Banking groups (averages on the basis of 1987)

<table>
<thead>
<tr>
<th>Category</th>
<th>Principle I</th>
<th>Principle II</th>
<th>Principle III</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks</td>
<td>12.7</td>
<td>84.1</td>
<td>83.2</td>
</tr>
<tr>
<td>Central and regional giro institutions</td>
<td>14.6</td>
<td>91.7</td>
<td>55.2</td>
</tr>
<tr>
<td>Regional institutions of the cooperative sector</td>
<td>6.7</td>
<td>83.2</td>
<td>47.6</td>
</tr>
<tr>
<td>Savings banks</td>
<td>12.0</td>
<td>87.7</td>
<td>52.1</td>
</tr>
<tr>
<td>Credit cooperatives</td>
<td>11.2</td>
<td>81.6</td>
<td>61.1</td>
</tr>
<tr>
<td>All banks</td>
<td>12.3</td>
<td>86.7</td>
<td>65.2</td>
</tr>
</tbody>
</table>
ratios of Principles I, II and III in the last ten years and makes clear that on average, banks can follow the requirements on capital and liquidity better today than in the past. However, there are marked differences between the banking groups, and we know that there are also large differences between the individual banks which cannot be obtained from the statistics.

Section 12 of the Banking Act stipulates that a bank’s fixed assets and shareholdings in other enterprises must not exceed its liable capital.

In section 13 of the Banking Act the loans to a single borrower exceeding 15 per cent of the bank’s liable capital (large loans) are restricted in two ways to enforce diversification: no single loan may exceed 50 per cent of the liable capital, and all large loans taken together must not exceed eight times the liable capital. These limits also apply to banking groups as a whole. Finally, loans to borrowers closely linked to the lending bank (insider loans) must be granted on the basis of unanimous decisions by all managers of the bank and only with the explicit approval of the supervisory board (section 15 of the Banking Act).

11.1.3 Deposit Protection Schemes

All banks belong to one of the deposit guarantee funds set up on a voluntary basis by the banking associations. The fund established for the commercial banks aims primarily at protecting depositors, while the schemes operated by the savings banks and credit cooperatives are designed to avert insolvency of member banks.

The Deposit Guarantee Fund of the commercial bank sector safeguards non-securitized liabilities to non-bank creditors in cases of insolvency. The protected deposits per creditor amount to up to 30 per cent of the last published annual liable capital number. Larger liabilities are protected up to this guarantee limit. Protection covers both deposits in the Federal Republic of Germany and those at branches abroad, irrespective of the currency in which they are denominated and no matter whether the creditors are residents or non-residents. The banks have to pay a contribution of 0.3 per thousand of the balance-sheet item ‘liabilities to other creditors arising from banking business’.

Although in the case of public savings banks responsibility for indemnifying depositors ultimately rests with the local authorities which set up the bank, the savings banks and giro associations have nevertheless set up guarantee funds. The by-laws of the credit cooperatives provide for a limited obligation of members to pay up further capital if called. However, the guarantee scheme operated by the credit cooperatives has ensured that not a single insolvency with full loss of value for one of the members has yet arisen in the credit cooperative sector.
11.2 The Development of the German Bank Supervisory System under the Second Banking Directive

German regulations concerning the soundness of individual banks as well as the stability of the banking system are currently being reviewed. Principles I and Ia on capital adequacy will have to be adjusted to account for new financial instruments, such as financial futures, options and swaps, and to incorporate the new EEC proposals. In what follows, we give a short overview of these new rules and their effects on German law. More specifically, we focus on capital adequacy regulation.

As discussed in chapter 1, the driving force of the European Economic Community (EEC) proposals is not the complete harmonization of national regulations, but rather the opening of financial markets guided by three principles: mutual recognition, home country control and minimal harmonization of the definition of own funds and capital rules.

11.2.1 The Regulation of Capital

The Commission intends to follow closely the recommendations of the Cooke committee *International Convergence of Capital Measurement and Capital Standards*, with one major difference. The Cooke regulations concern international banks exclusively, while the EEC proposals concern all credit institutions. In what follows, we consider the proposals of the Cooke committee and those of the Commission together.

The Cooke report deals with four topics: the definition of bank capital, the risk-weighting systems for assets, the solvency ratio and the timetable for implementation. The definition of capital is the most controversial issue.

Bank own funds are divided in two tiers, core capital and supplementary capital. Core capital includes equity (issued and fully paid ordinary shares as well as perpetual non-cumulative preference shares) and disclosed retained earnings. It is wholly visible in the published accounts and is the basis on which market judgements are made. The committee requires at least 50 per cent of capital to consist of core elements. Supplementary capital consists of the following elements which may be included by national authorities at their discretion. Elements not mentioned in the proposals cannot be included in the second tier.

Undisclosed reserves are unpublished or hidden reserves which can be included if they have passed through the profit and loss account and if they are accepted by the authority. In the Federal Republic of Germany, this reserve is identified by the so-called 26a reserve. According to section 26a of the Banking Act, banking firms are allowed to show accounts receivables and securities held as current assets at a lower value than actual ones. These
reserves are a special vehicle to safeguard against the particular risks inherent in the business of banking institutions. According to the 1986 Council Directive on Annual Accounts, these reserves have to be limited to 4 per cent of assets. The reserves defined under section 26a will probably be included in supplementary capital.

Revaluation reserves may arise when a bank revalues certain assets to reflect current market values. The German associations are calling for the legal acceptance of revaluation, while the Bundesbank wants to exclude such reserves.\(^9\)

General loss reserves are created by banks to absorb anticipated but as yet unidentified future credit losses. The effective accounting law for German banks does not recognize general loan provisions, but Article 38 of the European Directive on Annual Accounts defines such an item. Therefore, we can anticipate that German law will recognize general reserves.\(^10\)

Hybrid debt capital instruments are instruments which combine some characteristics of debt and equity. In the Federal Republic of Germany Genußcheine do qualify for own funds (up to 25 per cent of the other components). Therefore, in this case, core capital as specified by Cooke is more narrowly defined.

11.2.2 Consequences of the New Capital Regulations for German Banks

Calculations by the Bundesbank have shown that the minimum solvency ratios of the Cook guidelines — 4 per cent for core capital and 8 per cent in total — are being met by German banks with 5 per cent and 9 per cent respectively. However, these calculations take all capital elements into account, even if they are not accepted by German regulation. This is understandable, since, in the opinion of the Bundesbank, the Cooke ratio is only voluntary at present.

This voluntary basis cannot be maintained for the solvency ratios of the EEC. Supplementary capital will only include those elements accepted by the German Banking Act. It is not yet clear what will be included, but it seems that the Bundesbank will follow a narrow definition of capital. This raises a question about the impact of the capital guidelines on the competitive positioning of the German banking industry.

In a pure Modigliani–Miller world, capital ratios will have no effect on profitability. Larger equity leading to higher solvency will be reflected in lower cost of deposits. However, this reasoning assumes full information, rationality of depositors and tax neutrality, three hypotheses which can be questioned. Our view is that capital is a costly resource.

So far, it is not clear whether the German regulatory authorities will adopt a narrow or a broad definition of capital. Probably there will be a
compromise. It should be based on the concept of two-tier equity and abandon the current single definition of capital. Unfortunately, neither the Cooke report nor the EEC directive offer a thorough explanation of the function of second-tier capital. A well-known study by the Committee on Financial Markets of the Organization for Economic Cooperation and Development (OECD) has come up with a useful definition: ‘Core capital should include all elements permanently available to absorb losses; they must not impose contractual charges against earnings; they must not be redeemable at the holders’ request’ (Pecchioli, 1987). Revaluation and undisclosed reserves clearly meet these standards and should be included in core capital. The current capital ratio of 18, which can be converted into a capital-to-asset ratio of 5.5 per cent, will pose no problem for German banks since the current 5.5 per cent can include subordinated debt up to 20 per cent. Therefore Principle I is in line with the 4 per cent core capital ratio. The main issue lies with supplementary capital and the inclusion or exclusion of hidden reserves or revaluation of assets.

In conclusion, the supervisory authorities in the Federal Republic of Germany should avoid penalizing the German banks. This implies a revision of the Banking Act, the introduction of the concept of two-tier capital and a broad definition of supplementary capital.

Notes

1 Cable (1985) states that the German banking system is virtually indispensable to companies seeking external finance. This finding is somewhat outdated as far as debt financing is concerned. Bank control, through board membership, shareholding and proxy rights, relates mainly to large stock companies. These companies succeed in avoiding controls by maintaining about ten core relationships with banks. Moreover, large companies have access to the Euromarkets. However, the hausbankprinzip seems to play a larger role for external equity financing.

2 For a more detailed analysis of the development of bank supervision in the Federal Republic of Germany, see Deutsche Bundesbank, Banking Act of the Federal Republic of Germany, Deutsche Bundesbank Special series no. 2, Schneider (1984), Schneider et al. (1986) and Fitzenreiter (1988).

3 James (1985) states that the collapse of 1931 was immediately attributable to monetary conditions. The best known study on this topic is that of Born (1967).

4 The Banking Act provides for cooperation with the Deutsche Bundesbank. While the Federal Banking Supervisory Office is the only institution responsible for granting or withdrawing banking licences, the Bundesbank is involved in permanent supervision by collecting and processing data.

5 The study group published its report Grundsatzfragen der Kreditwirtschaft in 1979. The work and results of this extensive study of universal banking in Germany are outlined by Krummel (1980).
6 For a short description of the main characteristics of *Genußscheinskапital* see Rudolph (1988).

7 Therefore no depositor has the right of recourse to the supervisory authorities in the case of a bank failure.


9 See note 8.

10 Loan loss general reserves are part of core capital in the latest version of the EEC proposal (Article 2).

References


Index

accounting standards, 10, 24
adaptive efficiencies, 386–7
adjustment costs, 406, 412, 425, 431
adjustments in regulatory framework, 212–19
administrative overheads, 380
Admissions Directive, 11, 56, 76, 99
adverse selection, 48, 50
advertising, 143
advisory services, corporate, 115–29
agencias, 300, 301
aggregate demand, 320, 321
aggregate effects, 405, 406
agriculture, 348, 409
aid policies, 413
Al Saud Bank, 193
Aliber, R. Z., 383
Allen, P., 168, 169
Allianz, 127
allocative efficiency, 155, 163, 164, 179, 180
American Banking Institute, 170
Amsterdam Securities Accounting System, 70
ancillary services, 213
Anglo-American tradition, 12
anti-trust policies, 118, 131, 146, 244, 255, 293, 348
arbitrage
international, 414
regulatory, 135–6
risk (markets), 118
structural, 374, 387–8
Armstrong, T., 164
asset strippers, 126
assets, 39, 269, 369
allocation strategies, 89–92
illiquid, 27, 31
liability, 380
risk-weighting, 363, 365, 370
‘assignment statement’, 383
Association Francaise des Banques, 188
Association of Futures Brokers and Dealers, 46
Association of International Bond Dealers, 142
asymmetric information, 48–9, 50, 51, 53, 58, 62, 80
asymmetric policy effort, 433
asymmetries
distribution of, 417–22
source, 426–7
auditing of accounts, 51
AUSKLANDKASSENVEREIN, 74
authorization, 44
home country, 56–8, 132–3, 135
host country, 132–3, 136
automated teller machines, 155, 165–6, 187, 285, 296, 442
automatic cash dispensers, 187
bail-out, 193
balance-sheet totals
France, 197, 202–5, 207–8
Switzerland, 336–7
balance of payments, 21, 24, 234
crises, 415–16
balance of trade, 157, 425
Balladur, Edouard, 200
Ballarin, E., 283, 289, 291, 296
Baltensperger, E., 25, 31, 162, 164, 249, 250
Banesto group, 276, 277, 291, 295, 296
bank
balance sheets, 228, 240
holding companies, 439, 442–3, 450, 452
loans see loans
loyalty, 170–1
profitability see profitability revenues
(new structure), 212–14
runs, 27–33, 37, 47, 50
Bank of America, 17, 175, 443
Bank of Bilbao, 17, 272, 276–7, 285, 291, 295
Bank of England, 42, 43, 376
Bank of France, 183–5, 188, 193, 198, 200
Bank of Hispano, 175, 276–7, 295–6
Bank Holding Company Act (1956), 439, 442
Bank for International Settlements, 218, 243, 378
capital adequacy standards, 118, 136, 146, 223, 357, 390
Cooke Committee, 139, 357, 365–7, 370
guidelines, 24, 38–9
Bank of Italy, 238, 249–51, 260
Bank Merger Act (1960), 442
Bank of Portugal, 315–16, 317, 333
Bank of Spain, 263, 266, 307
Bank of Vizcaya, 17, 272, 276–7, 285, 291, 295
bank strategies
deregulation and, 164–74
implications of liberalization programme, 219–24
Bankers Association, French, 197, 198, 201, 213, 214
banking, European
Commission’s proposals, 9–10
lessons from USA, 437–57
prudential/regulatory issues, 17–35
see also European investment banking
banking (six European countries), 2–4
France, 183–225, 227–9
Germany, 357–70
Italy, 231–60
Portugal, 309–34
Spain, 261–308
structural adjustment, 153–82
Switzerland (after 1992), 335–56
Banking Acts
Britain (1979), 42–3, 52; (1987), 43
France (1941), 184; (1984), 188–9, 192–3, 218; (1988), 192, 197
Germany (1899, 1934, 1961, 1976, 1985), 360–1
United States (1933), 438, 441
Banking Advisory Committee, 22
banking institutions, 260–73
competitive analysis, 294–8
banking products (prices), 161–74
banking regulation
economics of, 25–33
harmonization of, 21–2
banking secrecy, 394
Switzerland, 340–1, 344, 348, 350, 355–6
banking sector
integration/deregulation, 155–61
see also central banks; commercial banks;
savings banks; universal banks
banking services, 156–8, 237–8
banking system
Germany (structure), 357–60
Spain, 262–85
USA (evolution), 438–47
Bankinter Bank, 276, 277
bankruptcy, 31, 163, 176, 193
Banque Indosuez, 197, 227
Banque Nationale de Paris, 197, 198, 221, 223
Banque Paribas, 197, 227
Banque de Participations et de Placements, 193
Banques AFB, 210
Banques Populaires, 197
barriers to entry, 37–8, 49, 168, 176, 438
France, 191, 225
Italy, 238
Portugal, 324, 327
Spain, 294, 295, 296
barriers to exit, 176
barriers to trade, 155, 156
Barro, R., 418
base money, 250, 251, 253
Basle Agreement, 10, 38, 267
Basle Capital Convergence Accord, 343
Basle Committee, 146
Basle Concordat, 390, 391
BAT Industries, 127
Bean, C., 406, 413
Beatty, R., 446
Begg, D., 420
beggar-thy-neighbours policy, 425, 428, 438, 454
Benston, G., 162
Berger, A., 286, 288, 456
Berger, N., 456
Bernanke, B., 27
Bertrand-type models, 290
Bhattacharya, S., 27
Big Bang
(1986), 70, 77, 146
(1987), 192, 200
Big Crash (1987), 406
bilateral agreements, 347
Black, F., 32
Blunden, Sir George, 456
Boiteux Committee, 214, 216
bond rating services, 114
‘bootstrap’ financing, 455
border costs, 407
Boyd, J., 32
Brady Commission, 390
branch banking, 158
density, 155, 165
France, 184, 190–2, 225
Italy, 237–8
networks, 164–8, 175, 286, 290, 296, 298
Spain, 265, 268, 285–6, 296, 298
brand names, 117
Bretton Woods system, 421
Bridel, P., 336
Britain see United Kingdom
British Aluminium, 127
brokerage, 192
  secondary market, 129–30
brokers and dealers, 48–51, 55, 57, 70, 95
Bryan, L., 168, 169
Buchan, D., 138
budgetary constraint, 216, 224
Bundesbank, 333, 359–60, 366, 377, 433
  credibility, 417–20, 426, 434
caisses d’épargne, 188, 192, 198
Caisses des Dépots et Consignations, 188, 192–3, 214, 228
Cajamadrid, 277, 282, 296
call system, 72
Campoy, J., 269, 292
capital
  accumulation, 70
  asset pricing model, 87, 103
  core, 223, 365–6, 367
  equity, 297, 361, 362
  flight, 349, 388–9
  flow, 20–2, 24, 155–8
  movement, 155, 158–66, 341, 349
  movement (liberalization), 8, 67, 234–5, 332, 334, 414
  ownership, 227
  raising, 106–15
  ratios, 24, 223–4, 243, 255, 343, 367
  regulation, 365–7, 370
  restrictions, 432–3
  standards, 10–11
  supplementary, 365–7, 370
capital-to-assets ratios, 210, 239, 243, 339, 343, 346, 367
capital adequacy, 11, 12, 38, 348
  BIS standards, 118, 136, 146, 223, 357, 390
  European investment banking, 131, 136
  France, 222–4
  Germany, 363, 365
  UK, 46, 57
capital controls, 377
  abolition, 174, 375, 402, 414–16
  France, 211, 212, 228, 400
  Italy, 400
  Portugal, 332
capital gains, 77, 393–4
capital market, 145, 150
  efficient, 168, 174, 299–300, 326, 334
  financing, 106–12, 114
  requirements, 74
    Italy, 242
    Spain, 267, 301
    Switzerland, 339
    UK, 44–6, 50, 53–6, 58–9, 62
capitalization, 95, 136
  Italian banks, 243, 244, 255
  market, 69, 70, 81, 116
  state-owned banks, 224
cartels, 340, 344, 348, 350, 351, 352
  cash management, 198, 449, 450
  cash settlement, 72–3
  ‘Cassis de Dijon’, 25
  catch-up effect, 196
Cecchini Report, 153, 179–80, 405, 407, 409
Central de Anotaciones en Cuenta, 263
central banks, 30, 40, 401, 418–19, 426–7
  European proposals, 403, 424, 433
  France, 186, 213
  Group of Ten, 10, 390
  Italy, 232, 250–3
  Portugal, 312, 314, 316, 318, 331, 333
  Spain, 265, 268, 277, 285, 291, 295
  see also individual central banks
certificates of deposit, 233, 247–8, 381
change
  elements of, 197–200
  forces of, 447–50
  institutional effects, 450–1
chartering function, 37
  ‘Chinese walls’, 192
Chirac, Jacques, 200
Christensen, B. V., 339
circuit breaking, 73
Citibank, 388
Citicorp, 450
City of London, 43, 414
Clarotti, P., 20, 24
  ‘classical’ trade, 154, 155, 156–8
  ‘clawback clause’, 37, 39
  clearing systems, 71, 73–4, 97, 114
  clients’ money, 44, 46, 47, 53
  club principle, 57
  clubs (role), 45
  Cobb–Douglas approach, 287, 288
  Cohen, D., 423, 424, 425
  Cohen, N., 143
cold-calling, 44, 46
  collective investment of transferable
    securities see transferable securities
collusion, 154, 161, 198, 207, 292, 293
  ‘comfort letters’, 242
commercial banks, 19, 20
  France, 184, 196, 201–6, 208, 210
  Germany, 357–8, 359
  Italy, 233–4, 240, 250
Portugal, 323, 328–32, 334
Spain, 264, 270, 273, 294, 306, 316, 317
USA, 134, 438, 440–2, 447–9, 455–6
commercial paper, 51, 113, 268, 269, 326, 448
commercial paper market, 186, 385
Commerzbank, 175
commission, 190, 196, 197
structures, 77, 129
taxation and, 77–8
Commission des Operations de Bourse, 140
Committee for Banking Regulation, 189
Committee on Financial Markets, 367
Common Agricultural Policy, 409, 412
common passport, 133–5
common trade policy, 156
Communications, 389, 395
Compagnie du Midi, 192
company listings, 76, 99
comparative advantage
France, 214, 219
Hecksher–Ohlin trade, 408, 410
Italy, 239
Switzerland, 340–2, 355
compartmentalization, 13, 188
compensation, 44, 47–8, 52, 54, 56, 133, 214, 259, 263
competition
deregulation through, 93–4, 102
effect, 63
evolution (Portugal), 309–10, 322–4, 328–30
evolution (Spain), 268–82
extended (effect), 219–21
free (investment banks), 105–6
influence of, 112–13
international, 385–90
investment banking, 144–6, 150
monopolistic, 410, 411, 412
price, 154, 161–74, 179–81
regulators/contestable markets, 386–7
worldwide challenge (Switzerland), 350–1
competition (in Spanish banking)
comment, 306–8
competitive analysis, 294–8
concluding remarks, 298–300
efficiency, size and market power, 286–94
industrial organization perspective, 261, 289, 290, 306
run-up to integration, 262–85
stock market reform, 300–1
competitive advantage, 103, 160, 344, 369–70, 402
analysis, 294–8
deregulation, 160–1, 163, 174, 176, 212
disadvantage, 246, 248, 255, 259, 260
distortions, 390, 395
pricing, 290
shifts, 117
complaints procedures, 44, 136
comptes d'épargne-logement, 184
Comptroller of the Currency, 456
computers, 187
concentration
effect of extended competition, 219–21
Herfindahl index, 171–2, 272, 274–8, 291, 297, 306
Italy, 244, 245, 259
ratios, 40, 174, 179–80, 197–8, 450
Spain, 262, 272, 274–8, 283, 291, 297, 306
conditions of business, 131
conduct, trading, 143–4
conduct-of-business rules, 43–4, 46, 50, 52–3, 55–6, 58, 131, 135, 139–43, 144
confidentiality, 139
Conseil National du Credit, 190, 195, 204
consolidation process, 12, 93
consumer protection, 9, 12, 18, 22, 24–5, 391
information and, 26–7
c consumer surplus, 153, 181, 242
consumers, 449–50
bank loyalty, 170–1
price discrimination, 168–70, 180
contestable markets, 386–7
continuity (French banking), 197–200
continuous market system, 71, 72
contract law, 12
control
corporate, 115, 116, 118, 126, 163, 164, 179
home country, 9, 18, 21–5, 42, 67, 134–6, 391
host country, 18, 25, 56, 134
monetary see monetary control
procedures, 215–16
prudential, 192–3, 249
Cooke Committee, 139, 357, 365, 366–7, 370
Cooke ratio, 222–3
coordination, 425
directive, 21, 56, 266
international regulation, 388–90
legislation, 19, 21
core capital, 223, 365–6, 367
corporate
banking, 449
control, 115, 116, 118, 126, 163, 164, 179
financial advisory services, 115–29
Index

financing, 195–6
restructuring, 107, 115, 144–5, 148–50
correlation matrix, 81–4
Corrigan, E. G., 31
Corstjens, M., 168
cost
intermediation, 197, 202, 204, 206, 207, 213, 225
of non-Europe, 236–7, 244, 255
opportunity, 247, 248, 252
of reserve requirements, 247–8
structure (Spanish banks), 286–8
cost–benefit analysis, 224–5
costs
efficiency and, 343–4
information, 388, 389
marginal, 222, 290, 291, 351
net regulatory burden, 373–6, 387–8
operating, 206–7, 209–10, 220, 287–8, 296, 325, 344
switching, 170, 171, 180
transaction, 161, 375, 387, 388, 389, 396, 455
Council of Ministers, 8, 11, 17, 19, 24, 133
counter-party default, 48, 54
'coupon washing', 138
Cournot model, 290, 291
course aux guichets, 184
covered interest parity condition, 414, 415
Crabbe, M., 117
credibility argument, 417–20
credit, 27, 184
cards, 175, 176, 388
tools, 249, 312, 324
cooperatives, 270, 357–9, 361, 364
creditworthiness, 38–40
institutions, 21–3, 32, 132, 188–90, 192–3, 197, 199–201, 223
instruments, 449–50
Portugal, 312–16, 320–1, 324, 326, 329–33
ing rating, 51
rationing, 49, 377
review, 380
risks, 10, 244, 249
Spain, 264, 268, 270, 272
subsidies, 189–90
Crédit Agricole, 190, 197, 198
Crédit Commercial de France, 196
Crédit d’Equipement des Petites et Moyennes Entreprises, 198
Crédit Industriel et Commercial, 197, 221
Crédit Lyonnais, 197, 198, 223
Crédit National, 198
Criminal Justice Act (1987), 140
crisis
in Spanish banking, 267–8
systemic, 18, 27–33
cross-border trade, 9, 13, 456
services, 20, 22–5
transactions, 118–21, 123
'crowding-out' effect, 97
Cumming, C. M., 390
currency
conversion costs, 387
reform, 431
risk, 86–7, 88
current accounts, 168
custody procedures, 114
customs union, 156
d’Aspremont, C., 167, 181
Danatbank, 360
David, E., 287, 295
davis, K., 221
de Benedetti, Carlo, 128, 129
de Boissieu, M., 211
De Grauwe, P., 418
de Jonquières, G., 117, 138
de la Dehesa, G., 300
dealers, 48–51, 55, 57, 70, 95
dealing rules, 129
Debré, M., 184
debt-to-income ratio, 253, 256, 331
debt financing, 97, 107, 111
decentralization, 59, 451
decision-making, 222
default, 44, 47, 48, 54
defensive strategy, 212
Delgado, F. L., 288, 307
delivery costs, 387
delocalization (savings), 214, 215, 216
Delors, Jacques, 139, 185, 187
Delors Committee, 403
demand
aggregate, 320, 321
deposits, 164, 212–13, 217–18
democracy, 347
Demsetz, H., 289
depackaging, 219
deposit
Guarantee schemes, 10, 24–5, 268, 364
insurance, 18, 23–5, 27–8, 30, 33, 37, 39, 164, 192, 218
protection schemes, 43, 361, 364
-rate regulation, 29, 162, 185
rates (deregulation), 212–14
-takers, 42–3

Criminal Justice Act (1987), 140
crisis
in Spanish banking, 267–8
systemic, 18, 27–33
cross-border trade, 9, 13, 456
services, 20, 22–5
transactions, 118–21, 123
'crowding-out' effect, 97
Cumming, C. M., 390
currency
conversion costs, 387
reform, 431
risk, 86–7, 88
current accounts, 168
custody procedures, 114
customs union, 156
d’Aspremont, C., 167, 181
Danatbank, 360
David, E., 287, 295
davis, K., 221
de Benedetti, Carlo, 128, 129
de Boissieu, M., 211
De Grauwe, P., 418
de Jonquières, G., 117, 138
de la Dehesa, G., 300
dealers, 48–51, 55, 57, 70, 95
dealing rules, 129
Debré, M., 184
debt-to-income ratio, 253, 256, 331
debt financing, 97, 107, 111
decentralization, 59, 451
decision-making, 222
default, 44, 47, 48, 54
defensive strategy, 212
Delgado, F. L., 288, 307
delivery costs, 387
delocalization (savings), 214, 215, 216
Delors, Jacques, 139, 185, 187
Delors Committee, 403
demand
aggregate, 320, 321
deposits, 164, 212–13, 217–18
democracy, 347
Demsetz, H., 289
depackaging, 219
deposit
Guarantee schemes, 10, 24–5, 268, 364
insurance, 18, 23–5, 27–8, 30, 33, 37, 39, 164, 192, 218
protection schemes, 43, 361, 364
-rate regulation, 29, 162, 185
rates (deregulation), 212–14
-takers, 42–3
deposits
- concentration, 272, 274–6
- demand, 164, 212–13, 217–18
- Eurocurrency, 380–1
- margins on, 162–3

deregulation, 18, 32, 77
- bank strategies, 164–74
- banking sector, 155–61, 175, 176, 179, 181
- through competition, 93–4, 102
- competitive, 160–1, 163, 174, 176, 212
- of deposit rates, 212–14
- of entry (1957–73), 19–21
- France, 211, 212
- incentives for efficiency, 163–4
- investment banking, 105, 114
- Italy, 231–3, 254–5, 258–9
- - deregulation dialectic, 189–93
- Spain, 262, 266, 294
- Switzerland, 335, 342, 349
- of UCITS, 218–19
- USA, 401, 454, 455–7
- see also financial reregulation

derivative markets, 78–9, 94
- derivative products, 94
- Dermine, J., 25, 31, 249, 250
- destablizing orders, 73
- Deutsche Bank, 17, 175
- devaluation, 414, 416, 424, 428
- Diamond, D., 26, 27
- Dickson, T., 138
- Dietrich, M., 220, 221
- direct finance, 183, 188, 193, 195–6, 218
- see also disintermediation

directives
- European securities, 99–100
- and proposals for, 33–4
- see also individual directives

discipline effect, 235

direct house, 198

discount rate, 265

diseconomies of scale, 170, 198, 221
- disequilibrium, 232, 330
- disinflation, 204, 206, 208, 418–19
- disintermediation, 201, 213, 238, 249
- direct finance, 183, 188, 193, 195–6, 218
- Portugal, 314, 317, 325
- Spain, 268–70, 294, 295, 298

dispersion, 408–9

distribution effects, 213, 214, 229

diversification, 62–3, 189, 221–2
- divestitures, 118, 120–1, 122–3, 144–5
- Dixit, A., 166, 168
- dollars
  - Eurodollars, 332, 375, 377–8, 396, 401
  - USA, 376–7, 378, 380–5 passim

domestic
- activities, 355
- constraints/responses, 351–2
- interbank, 400
- issues, 113
- stocks, 69, 70

domiciliary approach, 389–90

Dooley, M. P., 389

Dornbusch, R., 87, 423

Douglas Amendment, 442, 443

Drazen, A., 423

Drexel Burnham Lambert, 455

dual banking, 456

Dybvig, P., 27

Eagle Star Insurance, 127

Eaton, B., 167

econometric approach, 222, 228, 292

economic dimensions (of EEC), 282–3

economic growth, 313, 320

economic rent, 172–3

economics of banking regulation, 25–33

economies of scale, 117, 162, 175, 179–80, 410
- France, 207, 220–1, 229
- Portugal, 323, 324
- Spain, 286–8, 295, 307
- USA, 449, 459

economies of scope, 117, 169, 221–2, 288, 295, 410

Edge Act offices, 442

EEC, 292, 293

Commission’s proposals, 7–13

and European banking see European banking

banking (prudential/regulatory issues)
- financial market, 345–7
- financial services, 390–4
- harmonization of regulation, 56–7

securities industry, 131–44

Switzerland and, 345–8

effective competition rule, 348

efficiency, 131
- allocative, 155, 163, 164, 179–80
- cost and, 343–4
- hypothesis, 286–7, 289, 293
- incentives for, 154, 163–4
- informational, 79–80
- productive, 154–5, 163, 164, 179
- size and, 286–94

see also economies of scale; economies of scope

efficient frontier, ex post, 89–91

efficient market hypothesis, 68, 79

Einzig, Paul, 377

Eisenbeis, R. A., 25
Index

Elders IXL, 128–9
Electric Storage Battery, 126
employment, 337, 419, 451, 452–3
endowment effect, 204–6
‘endowment profits’, 206
entry
  barriers see barriers to entry
costs, 387
  into Spanish banking, 266, 294, 297, 299
threat of, 181–2, 207
equity-to-asset ratio, 32
equity-linked debt, 113
equity-linked derivative products, 94
equity capital, 297, 361, 362
equity financing, 94, 107, 111, 113
equity funding, 93–4
  equity markets, European, 2
    future, 93–7
portfolio diversification, 80–92
equity options, 79
equity values, 117
Erhard, Ludwig, 431
establishment rights, 158–60
Euro-equity market, 106, 112, 113
Euro-interbank, 400
Euro-sclerosis, 7
Eurobonds, 106, 107, 113, 114, 129, 141, 142, 339, 340, 374
Eurocommercial paper, 113, 374
Eurocurrency deposits/loans, 380–1
Eurocurrency market
  growth, 377–9
  historical overview, 374, 376–7
  pricing of deposits/loans, 380–1
Eurodollars, 332, 375, 377–8, 396, 401
Euromarkets, 111, 114–15, 141
  comments, 400–3
  conclusions, 394–6
Eurocurrency market
  growth, 376–85
  financial services, 390–4
  innovation and market linkage, 383, 385
  international competition, 385–90
  net regulatory burden, 373–6
syndication, 448
Euronote programmes, 113
Europe
  lessons from USA, 437–57
  see also EEC
European banking (prudential/regulatory issues)
  comment, 37–40
  conclusions, 33
data, 19, 20, 21
directives and recommendations, 33–4
economics of regulation, 25–33
issues, 17–18
‘European Banking After 1992’ conference, 1
European Commission, 17–18, 33–4
banking data, 19–25
  Court of Justice, 25
  Directorate General, 131, 133
  key directives, 67–80, 99–100
  objectives and issues, 1–5
European Currency Units, 20, 23, 81, 111, 242
European equity markets
  comment, 102–4
  current structure/operations, 68–80
    future, 93–7
  key directives, 67–80, 99–100
  portfolio diversification, 80–92
European financial centres, 394–6
European financial markets
  Commission’s proposals, 7–13
  regulation see regulation
European Free Trade Association, 347
European Institute of Business Administration, 1
European integration, 9
  banking sector, 17–18, 22, 37–8, 153, 155–61, 174–5
directives/recommendations, 33–4
  equity markets, 93, 97
  financial market, 414–23
  flows of banking services, 156–8
  goods market, 405, 406, 407–13
  impact, 62–3
  Italy, 242–3
  key issues, 1–5
  movement of factors and, 158–61
  Spanish banking in run-up, 262–85
European investment banking, 105
  comment, 148–50
  policy implications, 144–6
  securities industry regulation, 131–44
  services, 106–30
European Monetary System, 24, 86
development, 211
discipline of, 231, 254
monetary policy and, 333–4, 394, 415–17
European Monetary Union, 422, 424–5, 427
European Option Exchange, 78–9
Eurosecurities, 113, 138, 142
excess reserves, 184, 318
exchange controls, 67, 114, 211, 235, 240, 332
Switzerland, 341, 342
Index

exchange rate, 81, 92, 211

currency risk, 86–7, 88

fixed, 414, 415, 421, 432
floating, 415, 432

Italy, 234, 253, 254, 256

macro-economic implications, 412, 414–17, 419, 421–2, 424–8, 431, 433

Portugal, 320, 332–3

Switzerland, 341

exclusion clauses, 12

execution errors, 54

exit barriers, 176, 387

explicit taxation, 251

export/output services, 156–7

export restraints, 407–8

external financial liberalization, 232, 233, 234

external trade policy, 156

externalities, 18, 27, 47

factor mobility, 154–5, 158–66, 409

fair level playing field, 357, 395

Fama, E., 26, 248, 250

family groups, 328, 329

Fanjul, O., 276, 287–8

Faulhaber, G., 204

Federal Banking Supervisory Office, 360–4, 370

Federal Deposit Insurance Corporation, 27, 380, 454, 456

Federal Reserve Board, 380, 424, 439, 441, 454–5, 456

Federal Savings and Loan Insurance Corporation, 456

federalism, 347, 413

fees, 190, 196, 197

fiduciary operations, 336, 337, 339

financial advisory services, 115–29

Financial Center Development Act (1981), 439

financial groups, 328, 329

financial innovation, 185–7, 455

financial institutions
history of regulation, 42–4
principles of regulation, 47–53
Spain, 270–2, 273
taxation of, 215

financial instruments, 215–16, 219

financial intensity, 234–5

Financial Intermediaries, Managers and Brokers Regulatory Association, 46, 53

financial liberalization see liberalization

financial market
EEC and Third Countries, 345–7
integration, 414–23
USA (forces of change), 447–50
financial regulation (coordination), 388–90

financial reregulation, 189–93, 211, 374, 385, 386, 401

financial reregulation (Italy), 231

comment, 258–60

conclusions, 254–6

financial liberalization and, 232–5

reserve requirements, 246–53

structural problems, 236–45

financial restrukturings, 107, 115

financial sector (importance), 153

financial services, 153, 219

Commission’s proposals, 8–13
in 1992, 390–4

financial services, UK (regulation), 41

comment, 62–3

conclusions, 57–9

harmonization proposal, 56–7

history, 42–4

investment managers, 53–6

principles of regulatory financial institutions, 47–53

regulation of services, 44–7

Financial Services Act (1986), 41–8, 55, 132, 135, 140

financial stability, 29–32, 39

financial systems

France (developments), 183–201

Spain, 262–4

‘financing flexibility’, 97

financing structure (France), 193–7

firm-specific risks, 51

firms, nature of, 52, 58, 62

First Fidelity Bank, 447

fiscal adjustment, 332–4

‘fiscal asymmetry’, 251

fiscal federalism, 413

fiscal policy, 186, 320, 331–2, 394–5, 405, 406

effects on, 422–3

‘fit and proper’ tests, 9, 43–4, 46, 50, 52–3, 55–6, 58

Fitchew, 1

fixed commission, 77

Fleuriet, M., 116

Flood, R., 415

floor trading, 70–1

flow-of-funds perspective, 184, 195

‘focused diversification’, 92

‘fonds communs de créances’, 197

Fontainebleau conference, 1

foreign

banks (in France), 199

banks (in Spain), 263, 265–6, 272, 282, 294, 296, 297

bonds/equities, 113

branches (accounting for), 24
direct investment, 158–9, 410, 411
exchange (Italy), 233, 234
exchange monopoly, 234
stocks, 69, 70
Foreign Credit Restraint Programme, 377
‘Fortress Europe’, 13, 346, 431
forward contract, 383, 385
France (banking sector)
comment, 227–9
concluding remarks, 224–5
developments, 183–201
profitability, 201–11
see also liberalization (consequences)
Frankel, J., 415
Franks, J. R., 41, 44, 47
fraud, 43–4, 45, 48, 51, 52, 58
free-market policies, 80, 105
free services, 290
free trade, 347
Freeman, S., 27
French, M., 117
French Bankers Association, 197–8, 201, 213, 214
Frenkel, J. A., 383
functional control, 222
funds committed to non-financial entities, 220
futures contracts, 94, 129
futures exchanges, 132
Garber, P., 415
Garn–St Germain Act (1982), 442
GATT, 13, 135, 349, 408, 410
GDP per capita (EEC), 408–9
GEC, 127
general loss reserves, 366
global environment, 342–5
global neutrality, 213
global securitization ratio, 196
GLOBALCLEAR, 74
globalization, 19, 244, 342, 349
Golembe, Carter, 448
Goodfriend, M., 30
Goodhart, C. A., 28, 44, 250–1
goods market integration, 405–13 passim
Gordon, D., 418
government budgetary constraint, 216, 224
government securities, 129
Gower Report (1984), 41, 43
Grabbe, J. O., 377
Graham, S., 32
Great Depression, 437
Greenhouse, S., 138
Gresham’s law, 130
Gros, D., 252
gross margins, 202–6, 207, 209
group pensions, 10, 11
Group of Ten, 10, 390
Groupe des Assurances Nationales, 221
groups of banks (Spain), 275, 276, 278, 280–1
growth, inflation and, 419–20
Gual, J., 292–3
Guarantee Funds, 9
Guipuzcoana Bank, 276, 277
Gutiérrez, F., 269, 292
Hamada, K., 425
Hanover Summit (1988), 8
harmonization, 21–2, 228–9, 258
proposals, 9, 11–12, 56–7, 97, 334, 349–50
taxation, 138–9, 392–3, 394
harmonized solvency ratio, 10
‘Hausbank’ relationships, 113, 145
Hawawini, G., 79, 80
Hecksher–Ohlin trade, 408–10, 411, 412
hedging techniques, 113
Hennessy, J. M., 141
Herfindahl index, 171–2
Spanish banks, 272, 274–8, 291, 297, 306
Herrhausen, Alfred, 126
Herstatt crisis (1974), 360
Hicks, J., 183
high yield bonds, 118
Hispano group, 175, 276, 277, 295, 296
Hodrick, J., 415
home country
authorization, 56–8, 132–3, 135
control, 9, 18, 21–5, 42, 67, 134–6, 391
principle, 18, 132, 402
Hong Kong and Shanghai Corporation, 175
Horrigan, R., 251
host country
authorization, 132–3, 136
control, 18, 25, 56, 134
hostile transactions, 117, 126–9
Hotelling, H., 181
households, 193–4, 219, 239, 449
‘hub’ centre (London), 95–6
human capital, 173, 295, 307
Humphrey, D., 286, 287, 456
hybrid debt capital instruments, 366
illiquid assets, 27, 31
implicit taxation, 251–3, 256, 260, 330–2, 333, 334
import substitution, 328
imports (banking services), 156–7
incentives, 375, 395
for efficiency, 154, 163–4
income variability, 26
incompetence, 48, 51, 54
indexation differential, 205
indirect finance, 183–4
‘industrial’ banks, 264, 270
industrial groups, 328
industrial organization, 261, 289, 290, 306
inertia effects, 213, 228
inflation, 29, 198, 412, 418, 421–3, 426–7
disinflation, 204, 206, 208, 418–19
growth and, 419–20
Italy, 251–4
monetary policy, 415, 416, 434
Portugal, 310, 318, 320, 330, 331, 334
profitability, 172, 174
Spain, 263
Switzerland, 341
taxation, 251, 252, 253, 341
information
asymmetric, 48–51, 53, 58, 62, 80
consumer protection and, 26–7
costs, 388, 389
disclosure, 9, 10, 11, 44, 51, 80, 141–3, 263, 394–5
insider, 102–3
-related services, 26
informational efficiency, 79–80
informational norms, 362
infra-marginal firms, 29 bis
innovation
activities (Spain), 294
Euromarkets, 383, 385
financial (France), 185–7, 455
Switzerland, 342, 344, 351, 352
input–output tables, 239, 240
INSEAD, 1
insider information, 102–3
insider trading, 11, 80, 102–3, 119
rules, 140–1
Spain, 263, 300
Insider Trading Directive, 77, 100
insolvency, 32, 37, 50
institutional control, 222
institutional investors, 95
Institutional Net Settlement, 74
institutional portfolios, 117
insurance, 51, 54, 56, 221–2, 234, 249, 260
sector, 10, 11–12, 25, 26
integration see European integration
interbank fund (Italy), 234
interbank operations, 199, 202
sizeable (permanence), 198
interbank rate, 164, 172, 400–1
Interbourse Data Information System, 74
interest arbitrage, 385
interest margins, 29–31, 162–3, 202–6
interest rate, 433, 434
demand deposits, 212–13
deposit rate regulation, 162
deregulation, 154, 155, 189–90
EMU option, 424–5
France, 198–9, 201–7, 209
gross margins, 202–7, 209
insurance, 26
Interest Equalization Tax, 377
Italy, 250–1, 253, 254, 256
linkages, 406
offshore, 380–1, 383
parity relationship, 383, 385, 414–16
Portugal, 312, 318, 320–1, 325, 330–3
‘prime’, 381, 400
Spain, 263, 265, 283–4, 293
spreads, 164–5
taxation on, 393, 394, 423
Interim Reports Directive, 76, 99
interlinkages, 47–8, 97
intermediaries, 95, 190
protection of, 74–7
intermediation
approach, 220
cost, 197, 202, 204, 206, 207, 213, 215
margin, 312, 314, 324–5, 329, 331
ratio, 195–6
internal financial liberalization, 232, 233, 234
internal market, 13, 117
completion, 7–8, 22–5, 153, 155, 156
international activity, market size and, 68–70
international asset allocation, 89–92
International Banking Facilities, 379
international comparisons, 282–5
international diversification, 103
international financial centre, Switzerland as, 340–2, 350, 355–6
international financial regulation (coordination), 388–90
International Financial Services Research Programme, 1
International Financial Statistics, 81
international financial system (changes), 342–5
Index

International Monetary Fund, 81, 240
International SEAQ, 130
International Stock Exchange of London, 68, 70, 136
internationalization
  equity markets, 70
  security markets, 59
interstate banking, 443–7, 454, 455–6
intra-European market, 113–15, 129–30
intra-industry trade, 410–12
investment
  management, 46, 53, 142–3
  managers, 41, 48–50, 53–7
  overinvestment, 50, 155, 165
  portfolio flexibility, 97
  Portugal, 314, 320, 326
  ratio, 195
  regulation of (UK), 53–6
  requirements, 267, 307
  services, 11, 12, 24, 75, 100, 131–2
  taxation, 137–9
Investment Advisers Act (1940), 55
investment banking Services, 26, 184
fraud, 43–4, 45, 48, 51, 52, 58
Gower Report, 41, 43
  in Spain, 296
  USA, 440, 441, 447, 448, 455
see also European investment banking
Investment Management Regulatory Organization, 46, 53
Investment Services Directive, 11, 12, 24, 75, 100, 131–2
investors
  behaviour, 228
  institutional, 95
  protection, 43–4, 46, 49–53, 55–9, 74–7, 133, 160
Italy see financial reregulation (Italy)

J. P. Morgan and Company, 450
Jacklin, C. J., 27
Jacquillat, B., 80
Jaffee, D. M., 49
Johnson Matthey Bankers, 43, 52
junk bonds, 114, 115, 448, 455
Kane, E., 185, 212, 386–7, 391
key standards, 9
King, R., 30
Kirkland, R., 117
Klemperer, P., 170
Krugman, P., 415
La Caixa, 277, 282, 296
labour
  costs, 409
  human capital, 173, 295, 307
market (Switzerland), 341, 348, 351, 352
migration, 412–13
mobility, 409–10
mobility (Italy), 244, 255
movement of, 155, 158–66
productivity, 282–3
Lafuente, A., 289
‘large risks’, 10, 23, 24
Large Shareholding Directive, 76–7, 99
Lascelles, D., 142
‘league tables’ of securities, 106
‘least-regulated country’, 212
Lebegue Committee, 214, 215, 216
lender of the last resort, 18, 28, 30, 32, 33, 39–40, 390
‘level playing field’, 357, 395
leverage effect, 223
leveraged buyouts, 115, 118, 120–1, 145, 455
Levich, R. M., 383
Levy, H., 80
Levy-Garboua, V., 220
Lewis, M., 221
liabilities, 269, 270, 317
liberalization
  of capital flows, 156
  capital movement, 8, 231, 234–5, 254, 349
  cost, 228–9
  fiscal adjustment and, 332–4
  Portuguese banks, 309
  reregulation and, 232–5
  Spanish banking, 264–5
  Swiss banking, 345–6
liberalization (consequences)
  adjustments in regulatory framework, 212–19
  implications for bank strategy, 219–24
  programme, 211–12
licences, 9, 11, 13, 22, 24, 38, 134, 160, 266, 346, 347, 360
Life Assurance and Unit Trust Regulatory Organization, 46
life insurance, 10, 44, 46, 216
Lindenberg, E., 291
Lipsey, R., 167
liquidation, 22, 23
liquidity
  insurance, 26
  of market, 47
  Portuguese, 319
  Spain, 263, 264
  ratio, 22, 218
  transformation, 29
Listings Directive, 76, 99
Litan, R., 32
loan loss reserves, 207, 210, 366

468
loans
  Eurocurrency, 380–1
  Italy, 233
Spain, 272, 274–6, 278–9, 281–2
local preference buying, 407
location theory, 167–8, 180–1
Lomax, D., 44
London Interbank Bid Rate, 381, 400
London Interbank Offered Rate, 381, 400
London International Financial Futures
  Exchange, 78
London Stock Exchange, 68, 70, 130, 140
London Traded Option Market, 78–9
longer-term debt, 113
Lucas, R., 87
McDougall report (1977), 407, 413
McFadden Act (1927), 441, 442, 443
  McKinsey Quarterly, 169
macro-changes (Italy), 254, 255
macro-domino externality, 27
macro-economic framework, 193–5
macro-economic implications (of 1992), 405–6
comment, 431–4
financial market integration, 414–23
goods market integration, 407–13
transition options, 424–8
macro perspective, 4–5
comment, 431–4
Euromarkets after 1992, 373–403
implications of 1992, 405–28
malpractice, 52
Maravall, F., 276, 287–8
March group, 276
Marché des Options Negociables de Paris,
  78–9
Marché à Terme International de France,
  78–9
  189
marginal costs, 222, 290, 291, 351
marginal reserve requirements, 402
mark-ups, 290–1
market
  access, 135, 158, 159
capitalization, 69, 70, 81, 116
centration, 159, 171–2, 174
correlation, 81–4, 92
discipline, 39, 40
efficiency, 136, 418
forces, 214, 454
linkages, 383, 385
  -making activities, 72, 95
size, 68–70
support services, 114
value, 38, 292
market failures
  potential (sources), 25–33
responses to, 49–53, 58
see also asymmetric information; systemic
  risks
market power, 175–6, 179, 180, 181
  Italy, 239, 248
Spain, 90–3, 306, 307
market share, 19, 20, 171–2, 180
absorbed by foreign institutions, 158–9
Euromarkets, 381–3, 384
Italy, 241–2
Spain, 277, 279–82, 289, 295
Switzerland, 336, 338
market structure
deregulation and, 164–74
France, 197–8
organization and, 70–2
two-tiered, 95–6
markets
  offshore, 375–7, 380–5, 395
on-shore, 380, 381, 385–6, 396
Markowitz optimization framework, 89
Martinez-Girault, X., 167
mass risk insurance, 10, 11–12
Mathieu, C., 424
Matropasqua, C., 427
maturity transformation, 198–9
Mayer, C., 41, 44, 47
medium-term debt, 113
Meltiz, J., 420
merchant banks, 233, 297
mergers and acquisitions, 93
hostile transactions, 126–9
investment banking, 107, 115–26, 138,
  144–5, 148–9, 150
Italy, 244, 245, 255
retail banking, 154, 175–6
Spain, 295–6, 297, 452
USA, 443, 446
Merusi, F., 249
Mester, L., 286
‘mezzanine’ debt issues, 118
micro-developments, 254–5
micro-economic policy, 405
‘middle-market’ companies, 96
minimalist framework, 391
Mitterrand, François, 102–3, 126, 224
modernization, 93, 232–3
Modigliani–Miller model, 366
monetary control, 263, 265, 402–3
monetary policy
  EEC, 392, 394
  EMS and, 415–17
France, 185, 186, 199, 200
indirect, 223
Italy, 232, 249, 250, 251, 254
macro-economic implications (after 1992),
  405–6, 414, 417, 419, 421, 432, 433
N-1 problem, 201, 424
Spain, 266
Switzerland, 341
tight (impact), 310, 319–21, 332–3
monetary union option, 406
monetization, 310, 312, 318
money
base, 250, 251, 253
clients’, 44, 46, 47, 53
money market modernization, 232–3
money market mutual funds, 219, 388, 455
money multiplier model, 250
monitoring services, 26, 50, 51–2, 58
monopolistic competition, 410, 411, 412
monopoly rents, 181
Monetary Act (1978), 185–6
Monti, M., 233, 249
moral hazard, 48, 50, 425
moral suasion, 200–1, 213, 218
Morgan Guaranty Trust, 393–4
Morgan Stanley Capital International
Perspective, 81
Morgan Stanley and Company, 126
mortgages, 22, 26, 114, 359
most-favoured-nation status, 135
multi-annual fiscal adjustment strategy, 333–4
multi-options facilities, 113
multibank holding companies, 439
multinational corporations, 410
multiplier model, 250
multiproduct activities, 220, 261, 270, 290, 294
Murphy, P., 140
mutual banks, 19, 20
mutual funds, 10, 25, 55, 75, 95, 156, 185, 194, 218, 388
investment management and, 142–3
mutual investment funds, 233, 234
mutual recognition, 9, 22, 38, 67, 76, 97, 159–60, 345, 347, 391
National Association of Securities Dealers, 70
National Council of Credit, 190, 195, (France), 204
national equity markets, 93–4
national sovereignty, 394, 395
National Stock Exchange Commission, 300
'national treatment', 18, 135, 346–7
nationalization, 310, 313–14, 318
France, 200–1, 220, 224
Portugal, 310, 313–14, 318, 324–6, 328–31 passim
nature of firms, 52, 58, 62
negligence, 48, 51, 54
Neher, J., 140
Nestlé, 127
net banking income, 204, 209, 213, 215
net regulatory burden, 373–6, 387–8, 391, 394–6, 401, 402, 403
networks, 164–8, 175, 286, 290, 296, 298
Neven, D. J., 168, 285, 290
new issues practices, 142
New York CD, 400
New York prime rate, 381, 400
Newcastle Breweries, 128–9
non-bank investment businesses, 11, 41–2
non-compliance, 133
non-deposit taking institutions, 43
non-discriminatory access, 135
non-domestic European capital market
issues, 111–12
non-European securities, 129
non-financial corporations, 107, 108, 110–11, 112
non-financial entities, 32, 220
non-investment grade securities, 114
non-monetary financial institutions, 313, 315, 328–9
non-price competition, 171
Northeast Bancorp case, 443
note issuance facilities, 113
Nurkse, R., 421
Nyborg Summit (1987), 427
Obstfeld, M., 415
'occasional' branches, 190–1
OECD, see Organization for Economic
Cooperation and Development
off-balance-sheet operations, 196–7, 223, 336, 342, 388
off-floor trading, 70–1
offensive strategy, 212
offering securities products and services, 75
offshore markets, 375–7, 380–5, 395
oligopoly, 198, 207, 208, 298
onshore market, 380, 381, 385–6, 396
open-ended unit trusts, 10, 24, 25, 184, 185, 194, 218
open-market operations, 233, 253, 265
openness of banking, 240–1, 255
operational efficiency, 92
opportunity cost, 247, 248, 252
optimal international asset allocation, 89–92
options contracts, 94, 129
options exchanges, 132
Organization for Economic Cooperation and
Development
area, 38, 138, 185–6, 200, 204, 283
Committee on Financial Markets, 367
publications, 97, 349
survey data, 162, 190, 202, 207, 238, 336, 343
out-of-state activity, 439–40, 442, 443
overdetermination, 201, 421
overdraft economy, 183, 184
overinvestment, 50, 155, 165
overshoot scenario, 221, 222
‘own-book’ positioning, 95
own funds, 24
ownership (French banks), 200–1, 227
‘packaged trades’, 96
Padoa-Schioppa, T., 391, 407, 413, 416
passport, common, 133–5
payment mechanisms, 25, 456
payment services, 213
payment technologies, 187
payor-payee behaviour, 456
Pebereau, Georges, 128
Pecchioli, R., 367
Pechiney-Triangle scandal, 140
pension funds, 95
Pensions Savings Plan (Belgium), 95
PepsiCo, 138
periodic call system, 72
Personal Equity Plans, 95
physical capital mobility, 410
physical delivery (securities), 71, 73
Plan de’Epargne Retraite, 95
plans d’epargne-logement, 184
Plesner, J., 127
PNC Financial, 450
point-of-sales system, 187
policy coordination see coordination
policy implications (investment banking initiatives), 144–6
political constraint, 216
political unification, 424
Porta, A., 252
portfolio
diversification, 80–92, 103, 212, 228
investment, 8
management, 25, 145, 336, 339, 341, 344
replicating, 383, 385
volatility, 84–6
Portugal (banking), 309
banking structure, 322–4
comment, 328–34
outlook, 324–7
taxation, 310–19
tight monetary policy, 319–21
Post Office, 345, 352
postal financial services, 188, 219
postal giro/savings banks, 359
Postlewaite, A., 27
power distribution, 417–22
Prevention of Fraud (Investments) Act
(1958), 43–4
price competition, 154, 161–74, 179–81
price discrimination, 168–70
price setting mechanisms, 72
price stabilization techniques, 72–3, 102
price stickiness, 416
Price Waterhouse study, 153, 158, 161, 168, 172
pricing, 381–3, 384
prime rate, 381, 400
private banks, 227, 269–71, 276–7
Portugal, 309–10, 313–15, 324–6, 330, 334
private financial innovation, 185–6
privatization, 94, 200, 224, 244, 255, 259, 330
sales, 107, 111–12, 130, 220, 318–19
probability of ruin theory, 32
product differentiation, 170–1
product market, 163, 164
expansion, 438–41, 455
USA, 447–8
production approach, 220
production of services abroad, 355
productive efficiency, 154–5, 163, 164, 179
productivity, 184, 285
wages and, 173, 174
profitability
bank (France), 201–11
bank (Italy), 238–9, 258–9
foreign penetration and, 159, 172
Portugal, 312, 322–6, 331
size and (Spain), 262, 288–9, 306–7
Progress Report, 8
Prospectus Directive, 76, 99, 141
protectionism, 120, 133, 140, 231–3, 240, 255, 346, 348, 349
Protzman, 395
provisioning, 218, 223
proximity services, 191, 219, 225, 268, 271, 290
prudential control, 192–3, 249
prudential regulation, 395
prudential supervision, 160, 348, 349
public companies (Portugal), 313
public debt
Portugal, 310–15, 318–19, 330–3
Spain, 263
public expenditure, 413
public financial innovation, 185–6
public good, 57, 391
information-gathering as, 26–7
public interest, 12, 25
public intervention, market failure and, 25–33
public offer prospectus, 11
Index

public sector (Portugal), 313-15
  frozen, 328-30
public sector borrowing requirement, 310-11, 318, 328
purchasing power parity, 416, 427-8
q-ratios, 291-2
quality competition, 167-8
quasi-equity, 118, 223, 224
quasi-taxes, 216-19
quotas, 407-8
‘raiders’, 126
rate of return, profitability and, 159, 172
Reagan administration, 406, 432
real estate assets, 114
realignments, 425-6
recession, 208, 330, 425
reciprocity, 13, 133-5, 181, 211, 346-7, 348, 349
redistribution system, 95
Reform Bill (Spain, 1988), 300
regional banking, 443-7, 451
regional banks (Germany), 358, 359
regional policies, 409, 412-13, 425, 427
regulation, 1-2
  banking (economics of), 25-33
  European banking, 17-35, 37-40
  financial institutions (principles), 47-53
  financial institutions (UK), 42-4
  financial services (UK), 41-60
  harmonization in EEC, 56-7
  international competition, 385-90
  investment managers, 53-6
  securities industry (EEC), 131-44
  Spanish banking system, 264-7
regulators, competition among, 386-7
regulatory
  arbitrage, 135-6
  burden, net, 387-8
  dialectic, 185, 386
regulatory framework (France)
  adjustments, 212-19
  recent evolution, 188-93
Renard, F., 220
rent sharing, 172-3, 174, 175
replicating portfolio, 383, 385
reporting requirements, 76-7, 99
repricing gap, 205
Repullo, R., 294
repurchase agreements, 114
reregulation see financial reregulation;
  financial reregulation (Italy)
reserve requirements
  EEC, 392
  France, 217-18
  Italy, 234, 246-53, 260
reducing (consequences), 252-3, 256
Spain, 265-7, 307
restrictive practices, 43
restructuring
  corporate, 107, 115, 144-5, 148-50
  economic, 126, 129, 330
  financial, 107, 115
  industrial, 116
retail banking, 19, 270, 298
  structural adjustment, 153-82
retail market, 212, 298, 299
returns, risk-adjusted, 87-9, 103-4
Reusin, P., 140
revaluation reserves, 366, 367
Revell, J., 202, 244, 343
revolving underwriting facilities, 113
Reynolds Metals, 127
Rhodes Summit (1988), 8
Ricart, J. E., 292-3
right of establishment, 158-61
risk
  -adjusted returns, 87-9, 103-4
  arbitrage markets, 118
  -based capital adequacy, 118, 223
  classification, 38, 267-8
  currency, 86-7
  diversification, 81-6
  -free deposits, 26-7, 28, 33, 39
  insurance, mass, 10, 11-12
  Portugal, 318, 321, 332-3
  premium, 318, 332-3, 415
  provisions for, 207
  -reduction opportunities, 68, 87
  -return trade-off, 85-6, 87-91
  -sharing, 26, 54, 455
  Spain, 267, 268
  systemic, 41, 47-52, 55-8, 62-3, 198
  UK, 41, 47-52, 54-8
  -variance, 32
  weighting system, 267, 363, 365, 370
Rogoff, K., 418
Roll, Richard, 102
roll-over financing, 449
Rome Convention, 12
Romer, D., 294
Romiti, Caesare, 113
Ross, S., 291
Rowntree Mackintosh, 127
Rudolph, B., 370
Russell, T., 49
safety nets, 30-1, 32, 38
Sala, V., 289
Salomon Brothers, 94, 95, 446
Sampson, G., 155
Santander group, 276, 277, 296
Sarnat, M., 80
‘satellite’ exchanges, 95–6
Saunders, A., 32
savings, 164, 170
delocalization, 214, 215, 216
France, 184, 194–5, 214, 219
Italy, 260
Portugal, 314
Switzerland, 341
taxation, 8–9
savings banks, 19, 20
Germany, 357, 358, 359
Spain, 265, 268–73, 276–82, 294, 296–9, 306
Schaefer, S., 32
Scheidl, K., 358
Schmamlensee, R., 159, 168, 289
Schmidt, Helmut, 431
Schuster, L., 289
secondary banks, 19, 20
secondary market trading, 129–30, 136
securities
intra-European market, 113–15
inventories, 114
underwriting new issues, 106–12
Securities Association, 46
Securities draft directive, 134, 135
Securities and Exchange Act (1933), 142
Securities and Exchange Commission, 140, 142
securities industry
key directives, 67–80, 99–100
regulation (EEC), 131–44
see also European equity markets
Securities and Investments Board, 45, 46, 140, 143–4
securities sector, 10–11, 12, 24
UCITS, 24, 75, 99, 142–3, 185, 189, 194–5, 211, 215–16, 218–19
securitization process, 193, 196–7, 342
security markets, 57
seigniorage, 251, 252–3, 256, 423
Portugal, 331, 332, 334
self-financing ratio, 195
self-regulation, 45–6, 49, 53, 57–8, 136, 144
sellers, European, 122, 123–4, 148
selling practices, 143
semi-strong form efficient market, 79
Serious Fraud Unit, 140
services
corporate advisory, 115–29
investment banking, 106–30
production of abroad, 355
Servicio de Compensación Liquidación de Valores, 300
settlement delays, 54
settlement systems, 71, 73–4, 97, 129
Shaffer, S., 287, 295
Shaked, A., 49
Shapiro, C., 50
share registration, 141–2
‘short side’, 212, 216
SICAV, 10, 24, 25, 184, 185, 194, 218
SICOVAM, 73, 74, 99
Siemens, 127
Silber, W., 186
Silva, Cavaco, 331
size
effects, 221
efficiency and, 286–94
Italian banks, 244, 245, 259
profitability and, 288–9, 307
Spanish banks, 285–96, 307
see also economies of scale
small and medium enterprises, 187
SMH-Bank, 361
Smirlock, M., 169, 286, 289
Snape, R., 155
Soares, Mario, 329
social democrats, 330, 331
socialism, 105, 333
Socialist Party (Portugal), 329, 330
sociedades, 300, 301
Société Générale de Belgique, 128–9
Société Générale de France, 128, 197, 227
Société Interprofessionnelle de Compensation des Valeurs Mobilières, 73
sociétés de bourse, 192
Solnik, B., 80, 92
solvency, 23, 47, 262, 267, 268
solvency ratio, 10, 22, 23, 366
sovereign debt, 218
sovereign risk, 207, 210
sovereignty, 394, 395
Spain
banking competition, 261–303
foreign direct investment, 410, 411
spatial competition, 167–8, 181
Spearman correlation, 220
specialization, 188–9, 219, 270–2, 409
specialized banks, 359–60
spreads, 118
stability, 432, 433, 434
financial, 29–32, 39
of financial markets, 33
investment banking, 131
stabilization, 142, 319–20, 321, 331, 333
stabilizing speculation, 73
stakes, purchases of, 118, 120, 121, 122–3
stamp duties, 335, 339–40, 344, 348, 355

Index

standard metropolitan statistical areas, 442
state-owned banks, 224
Steinherr, A., 168, 197, 199, 220, 254, 259, 283
Sterdyniak, H., 424
sterling, 376
Stigler, G. J., 49
Stiglitz, J. E., 49
stock exchange
admissions, 11, 56, 76, 99
Italy, 234
membership, 11, 56, 74–7, 132
organization, 70–2
Paris, 184
Switzerland, 342–3, 351–2
Stock Exchange Automated Quotation system, 130
Stock Exchange Compensation Fund, 54
stock index future, 78, 79
stock index options, 78–9, 94
stock index returns, 81
stock market
Big Bang, 70, 77, 146, 192, 200
Crash, 112, 119, 406
Portugal, 321, 325, 331
reform (Spain), 263–4, 269, 291–2, 300–1
stocks and bonds, 129
stop-go policies, 330, 331
strong form efficient market, 79
structural adjustment (Portugal), 328
structural adjustment (retail banking)
comment, 179–82
conclusion, 174–6
integration and deregulation, 155–61
price competition, 161–74
structural adjustments, 2–4
structural arbitrage, 374, 387–8
structural norms (supervision), 362–4
structural problems, 231, 236–45
structural vulnerability, 37
structure–conduct–performance paradigm, 289, 290
structure of German banking, 357–60
submarkets, 292–3, 298
subsidiary, 155, 158
subsidized credits, 189–90, 204
subsidized refinancing (Italy), 260
subsidized services, 168, 179, 204, 209
sunk costs, 219
supervision
home country, 9
prudential, 38
supervisory system (German banks), 357
aims and instruments, 361–2
development, 360–1, 365–7
supplementary capital, 365–7, 370
supply side, 405, 406
supranational authorities, 33, 391
Sutton, J., 49
swaps, 113
Sweet, L. M., 390
Swiss Federal Banking Commission, 339
Swiss National Bank, 377
Swiss Options and Financial Futures Exchange, 342–3
switching costs, 170, 171, 180
Switzer, L., 169
Switzerland (banking after 1992), 335
banks, 349–52
comment, 354–6
EEC and, 345–8
international financial system (changes), 342–5
system before 1992, 336–42
symmetry (sources), 426–7
'synthetic' funds, 143
synthetic securities, 113, 114
systemic
asymmetry, 421–2
bias, 421–2
crisis, 18, 27–33
risks, 41, 47–52, 55–8, 62–3, 198
Szymczak, P., 201, 202, 204, 205, 222
Tait, N., 117
take-over, 118, 131, 146, 155, 164, 180, 331
defence, 115, 149
hostile, 126–9, 163, 222
Take-over Panel, 116, 127
taxation, 8–9, 114, 131, 380, 440
commission and, 77–8
financial (adjustments), 214–17
of financial institutions, 215
on financial institutions, 215–16
harmonization, 228, 348, 392–3
implicit, 251–3, 256, 260, 330–4
inflation, 251–3, 341
innovation, 185–6
on interest, 395
investment, 137–9
Portugal, 310–19, 320, 331–2, 334
regulation as, 388, 389
Switzerland, 340, 346, 348, 349–50
system adjustment (France), 212–19
Tax Act (1988), 334
technology, 118, 387, 395, 447–8, 449, 455
tender offers, 118, 120
Termes, R., 267
termination function, 38–9
terms of trade, 285
Thatcher government, 432
third countries, 13, 345–7
Tirole, J., 181
Tobin, J., 30
trade
balance, 157, 425
barriers, 155, 156
‘classical’, 154, 155, 156–8
creation, 156
cross-border see cross-border trade
diversion, 156, 157–8, 140
flows, 156–8
intra-industry, 410–12
negotiations, 135
restrictions, 407–8
Trade and Industry, Department of, 140
trade unions (Portugal), 333
trading, secondary market, 129–30
trading conduct, 143–4
trading halts, 73
training, 50
transactions, 54
costs, 161, 375, 387–9, 396, 455
hostile, 126–9
mergers and acquisitions, 115–26
volumes, 69, 70
Transfer and Automated Registration of
Uncertificated Stock system, 73–4
transfer payments, 412
transferable securities (UCITS), 10, 24, 75, 99, 142–3, 185, 189, 194–5, 211, 215–16, 218–19
translog cost function, 220, 307
transparency, 131, 143, 343
transport costs, 407
TRAX, 142
Treasury (Portugal), 330, 331, 333
Treasury Bills, 232
Portugal, 311, 314, 316–18, 325
Spain, 263
Treasury bonds, 263, 299
Treasury Department (France), 185, 188
Treasury notes, 263, 268–70, 307
Treaty of Rome, 7, 9, 17, 19, 20, 221, 409
Triangle scandal, 140
Trujillo, J., 264, 270
turnover ratio, 69, 70
two-speed finance, 214
two-tier equity, 367
UCITS, see transferable securities
unbundling, 374, 376
uncertainty, 228, 229, 389, 396
uncovered interest parity, 414–15
under-regulation, 57, 63
underwriting new securities issues, 106–12
undisclosed reserves, 365–6, 367
unemployment, 27, 341, 409
benefit, 413
Uniao de Bancos Portugueses, 328
uniformity, 22, 56, 62
Union des Assurances de Paris, 221
unit trusts, 10, 24, 25, 75, 99, 184–5, 194, 218
United Kingdom, 102, 128
financial services regulation, 41–60
United States
hostile transactions, 126–7
mergers/acquisitions, 118–20, 121–2
United States (lessons from), 5, 437
comment, 454–7
evolution of banking, 438–47
experience (distillation), 447–51
future issues, 451–3
universal banks, 12, 23, 134, 150
France, 188, 221
Germany, 358–9, 360, 370
Spain, 264
Switzerland, 339–40, 341, 349
Urquijo-Union, 276
Uruguay Round, 135, 349
usury, 12
value-added tax, 215
value added, 420
Switzerland, 336, 337
Veljanovski, C., 44
venture capital pools, 448
Verfaille, G., 418
Vermelen, T., 80
Vives, X., 27
volume-of-business requirements, 46, 54
volumes, deregulation of, 190
voluntary export restraints, 407–8
von Weizsacker, C., 170
vulnerable gross margins, 204–6
wages, 419, 425
disindexation, 194, 195
productivity and, 173, 174
Wagstyl, S., 134
Walter, I., 135, 138, 140
Warburg, S. G., 127
weak-form efficient market, 79
wealth transfer (uncompensated), 48, 51, 52
Weiss, A., 49
welfare, 213–14, 406, 422
costs, 412
effects, 229, 300, 412
neutrality, 213
White Paper (1985), 7, 8, 9, 11, 22, 24, 43, 154, 155, 390
White Policy Paper (1983), 17, 22
wholesale market, 212, 270, 298–9, 325, 326
wide interest margins, 202–3
winding up, 22, 23
Wolman, C., 140
working capital, 113
worldwide financial competition, 350–1

Wyplosz, Charles, 414, 416, 418, 420, 421, 423, 425
X-inefficiency, 179, 207
Yarrow, G., 164
yen, 378, 385

Index by Jackie McDermott