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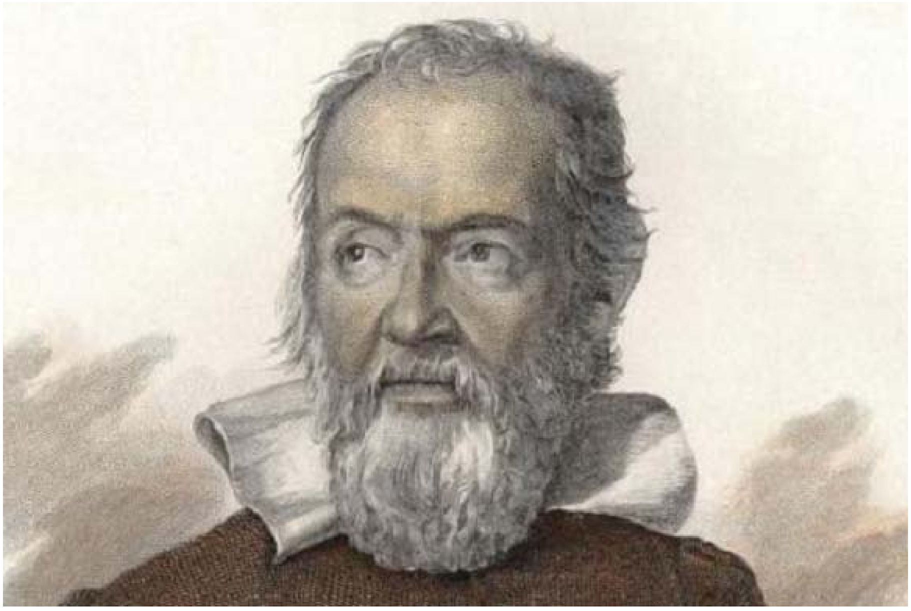
EU retail banking: Measuring integration

Integration of the EU retail banking markets is still in its infancy. Banks and consumers remain focused on their national domestic markets when offering or seeking retail banking products. Moves by the European Commission to alter this and gradually to create a European retail banking market are to be welcomed.

Any purposeful integration policy must begin by taking precise stock of the present degree of integration. Progress on integration must also be recorded exactly; otherwise it is not possible to administer the right regulatory instruments in the right dose.

So far, however, no one has come up with a satisfactory way of measuring the status of, or the progress made on, integration of the EU retail banking market. The selection, calculation and interpretation of potential integration indicators is regularly confronted with a string of complications. Rash judgements based on indicator readings considered in isolation are unacceptable.

Measurement of the integration of EU retail banking markets must therefore be placed on a broad basis. Only by considering a wide variety of indicators in combination can sufficiently valid conclusions be drawn to serve as a starting point for regulatory action.



"Measure what is measurable, and make measurable what is not so." (Galileo Galilei)

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Retail banking integration as a political goal

EU retail banking markets not yet integrated

Creating a single market for goods and services has for decades been one of Europe's major policy objectives. The way towards this goal – carrying the individual markets in the 27 EU member states further forward into just such a single domestic market – is termed the integration process. The extent to which the goal of integration has already been reached varies considerably across the markets for goods and services. One of the least integrated markets is retail banking, i.e. the market for services to banks' retail customers and small business clients. Both banks and consumers still focus largely on their national domestic markets when offering or seeking retail banking products.

Full integration, that is to say the creation of a truly single internal market for retail banking products, would imply consumer demand for bank services EU-wide and provision of these services EU-wide by the banks. In other words, suppliers and customers would operate across an integrated market as a whole without regard for national borders. Or to put it another way, they would perceive the single internal market in total as their domestic market.

Economic benefits of retail banking integration

Integration of the retail banking markets would increase economic welfare through two impact channels. Firstly, competition on what were previously national markets would intensify with the degree of integration. The discretionary scope that market segmentation allows the banks in pricing their services would be narrowed. Consumers would be given a broader selection of better products and better service at lower prices. These impact mechanisms do not necessarily require foreign providers to enter the marketplace. Far more important is that the markets are open to competition, i.e. that foreign providers are able to launch operations there at any time. Secondly, market integration would enable providers to realise economies of scale if they could offer their products across the EU and not only on their home market. This would reduce the costs of creating their products, and the break-even point for innovations could be lowered. All else being equal, on highly competitive markets this would drive down the prices of innovative products. Instead of being confined to product management, distribution and refinancing, economies of scale could also be achieved in risk management, because the banks could diversify their risks better in an integrated market.

European political activity

In order to reap the economic benefits of retail banking market integration (see box), European policy makers have launched a number of initiatives, ranging from a survey of competition through the Consumer Credit Directive to the White Paper on Mortgage Credit Markets, to name but a few. The common thread running through all these initiatives is that the European Commission begins by subjecting individual markets (such as those for mortgage credit) to closer scrutiny; as a rule this produces a diagnosis of inadequate integration leading to the prescription of a therapy usually consisting of several regulatory measures designed to help remove barriers that have so far stood in the way of the integration of national markets.

The Commission's aim to integrate retail banking markets is not a matter of dispute. However, there exists widespread uncertainty on (1) which criteria should be applied to assess the degree of market integration, (2) how far integration gaps stem from "natural" causes such as language barriers that cannot be redressed by means of regulation, and (3) which regulatory instruments appear suitable in the light of this to take integration of the retail banking markets forward.

Unresolved issues

This gives rise to three questions that neither regulatory discussion nor academic debate have so far managed to resolve satisfactorily:

— How to measure the degree of integration of the retail banking market?

— What are the causes of any integration shortcomings identified?

— How can integration be brought to the desired level?

How to measure integration?

To address the first of the three questions, we begin by considering in Section 2 how integration is, or can be, defined. One possibility is a broad definition of the term according to which integration, as described above, is achieved when banks and consumers perceive the entire EU as their domestic market and the positive economic effects of integration start to kick in. Then again, we can examine how far certain interim targets have been met on the road to full integration, for example altered behaviour by suppliers and customers or the removal of regulatory barriers to integration. Section 2 is therefore concerned first with identifying *what* exactly we are measuring when we measure integration, before examining in Section 3 *how* integration can be measured. Here, we must first check whether sufficient data is available to calculate measures. If this is the case, each measure must be sounded out as to whether specific values really do flag a high degree of integration and whether integration might not be achieved even if the values shown on the measure do not indicate target achievement. In other words, in each case we must investigate whether the measure is a suitable indicator or not. Section 4 summarises the consequences these considerations may have for the EU's integration policy.

When is integration achieved?

Three definitions of integration conceivable

Europeans will feel the benefits of a uniform internal market once the banks offer their products Europe-wide and consumers can access them across the Union. Working on this basis, we can essentially construe three definitions of "integration". These start out from the outcomes of the integration process, market participants' behaviour and the regulatory framework conditions. In terms of its content, this division into three definitions conforms to the market performance / market conduct / market structure paradigm of competition policy.

Integration is achieved once the hoped-for economic effects materialise

Integration is not an end in itself. Its purpose is to provide new European business opportunities for the banks through more intense competition and the possibility of increasing returns to scale, and to give customers throughout the EU access to a similarly broad and reasonably priced range of products. In its broadest definition, we can therefore speak of integration when these objectives associated with the integration process have been achieved.

Too narrow definition inappropriate

In political practice, restriction to such a definition is unhelpful for two reasons. For one, strictly speaking it would not allow progress on integration to be measured. Integration would then simply either be achieved or not. Of course, in reality we can certainly construct integration indicators based on this definition in such a way that it is at least possible to make trend estimates of differing degrees of integration, and therefore of progress on integration. However, this approach leaves too many issues unresolved, for example with regard to the speed of the integration process, possible barriers to integration and the influence of regulatory initiatives. Another argument against a narrow definition of the term integration is that its interpretation of EU retail banking market integration might in fact be impossible. This is the case when "natural" barriers resulting from long-term structural differences between the member states (such as language, business customs, trust in domestic suppliers that has been built up over many years) make providers and customers unable or unwilling to consider the whole of the EU as their domestic market. Integration interpreted as full achievement of all the goals of the integration process would then never be realised. With appropriate construction of the indicators used, the best that might be achieved would be identification and analysis of the degree of progress on the way to the hoped-for goals.

Interim targets necessary

For these reasons suitable interim targets must be defined to enable more nuanced analysis. An opening platform is provided by the two major steps that precede final market integration: orientation towards Europe by banks and consumers and the removal of all regulatory obstacles that might impede or prevent market participants adopting such a Europe-wide focus.

Integration is achieved once banks and customers see the whole of the EU as their domestic market

Connect to market participants' behaviour

The objectives associated with the integration process can be achieved only if banks and consumers are able and willing to identify the whole of the EU as their domestic retail banking market. It would therefore stand to reason to define integration with reference to market players' behaviour. Integration would then constitute the situation in which banks and customers act as providers and consumers across national borders even without the positive effects (broad product range at low prices, innovative economic area) necessarily already having materialised. This can be explained at least partly by path dependencies (gradual adjustment in the behaviour of banks and consumers) and by the differences that remain between the member states despite all attempts at integration. It is, for instance, conceivable that while consumers in smaller member states have access to the same products as all other EU citizens, the banks are only able to create these products at relatively high expense – because, say, of the need to translate all the information and wording of the contracts into languages spoken by comparatively few consumers.

Integration is achieved once all regulatory impediments to integration have been removed

Enable Europe-wide activity

Finally, integration may simply be the situation in which banks and consumers are able to act across Europe. This is the case when no (regulatory) barriers stand in the way of Europe-wide activity. Whether market participants then actually engage in cross-border activities is equally as irrelevant to this understanding of integration as the question of the extent to which the integration process triggers the positive welfare effects ascribed to it. The definition by the European Central Bank[1] also points in this direction when it states that the market for a given financial product is fully integrated when all market participants (a) are bound by a single set of rules, (b) have equal access to the financial product and (c) are treated equally when they are active in that market.

"Natural" barriers remain

"Natural" barriers can thus continue to exist. They result from long-term structural differences between the member states (such as language, business customs, trust in domestic suppliers that has been built up over many years) which cannot be reduced or indeed removed in the short to medium term by regulatory measures. The ECB's definition refers only to "artificial" barriers. They are mostly legal in nature and must be removed by regulation, and as such they are the only launch pad for European policy to swing into action.

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[1] Baele, L. et al. (2004). Measuring financial integration in the Euro area. ECB Occasional Paper, Vol. 14, 2004. p. 6.

Measuring integration

Classifying integration indicators[2]

Different types of indicators

The classification of integration indicators can be geared to the type of data collected or to the information revealed. With this approach, indicators are calculated either on the basis of statistical data on actual business activities (e.g. interest rate statistics) or by means of surveys of banks' and consumers' behaviour and intentions. Surveys can be used, for example, to learn about the banks' international strategies or about consumer attitudes towards foreign providers. With regard to the type of information mined, the indicators can be either qualitative or quantitative. The latter category, in turn, can be volume-based or price-based.

Contribution to the measurement of integration as a criterion

On the other hand, indicators can also be classified by their contribution to the measurement of integration as specified in the three definitions of the term given above. Accordingly there are:

— indicators depicting the extent to which the economic objectives associated with the integration process have been met, in other words what progress has actually been made on achieving integration;

— indicators depicting whether banks and consumers perceive the uniform internal market as a whole as their domestic market;

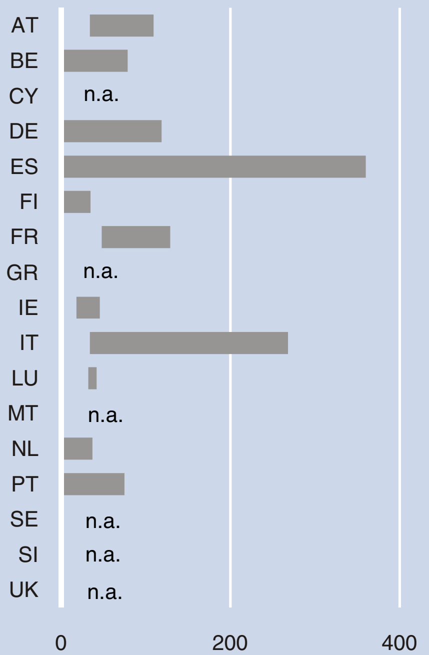
— indicators depicting the extent to which the legal prerequisites are in place for banks and consumers to take a pan-European view, i.e. how far the artificial hurdles discussed have been removed.

Two problems to solve

Two problems may arise with each of the three groups of indicators. Firstly, it may be difficult to measure correctly the variables entered into the respective indicator owing to limited data availability, for example. If this is not an issue, it will then be necessary to check whether the indicator calculated permits constructive statements on the status of retail banking market integration.

Prices of account packages vary considerably

Spread between highest and lowest price p.a. in EUR



Source: European Commission 1

Is the integration process having the welfare effects forecast?

Are prices converging towards a low level?

As a rule, debate on the degree of integration in economic areas begins with consideration of William Stanley Jevons' "law of one price". This postulates that there can only be one and the same price for a good if the objectively same kind of good is available to everyone everywhere in the market at a given point in time, and a state of perfect information exists. It is the task of integration policy to ensure that these conditions are met. If that is the case, all providers can operate across the entire economic area; market power is minimised and prices converge at a low level. How far this applies to retail banking markets in Europe is consequently demonstrated by comparing the prices of the products offered on these markets.

[2] For a comprehensive overview of the possibilities and limitations of market integration measurement see Speyer, Bernhard (2006). Evaluation of the FSAP's economic impact – A note on methodology. Deutsche Bank Research. EU Monitor 41. Frankfurt am Main.

Measuring the validity of the "law of one price"

Available data does not tell the whole story

Comparing the prices of retail banking products is, however, very difficult. There are two reasons for this. First, it is extremely difficult to find products that are really the same, because each individual product exhibits many different features, making it harder to define classifications of like products. A further complication in the case of loan products is that customer characteristics, as expressed in their credit rating, also influence the nature of the product and its pricing. Second, bank charges play an important part in retail banking products – also in loans. Comparing interest rates alone is therefore not sufficient for a full price comparison. But the availability of data on bank charges is even poorer than on interest rates, particularly in the current account and payments segment, where practically no international comparisons are possible.

Methodological difficulties

In a survey the European Commission attempts to plug this gap, but comes up against a host of methodological difficulties.[3] Chart 1 illustrates the price range for "account packages" (current accounts and various payment products). The first striking feature is that no data could be obtained for quite a few countries. Prices in the remaining countries vary considerably both nationwide and from country to country. The same surveys were conducted on prices for current accounts, credit transfers, direct debits, debit and credit cards, ATM cash withdrawals and internet banking.

Interpretation

Identifying really comparable products

Even if the methodological problems were resolved, we would still have to allow for the comparable product's potentially differing degrees of popularity in the member states. In extreme cases it will be the standard product requested by the overwhelming majority of customers in one country, whereas in another country consumers will make virtually no use of it even though it is available in principle. This will affect the banks' pricing behaviour and restrict the informative value of the price comparison accordingly. In a similar way, driven this time by provider motivation, cross-selling considerations mean that price comparisons referring to a specific product and point in time make little sense because many banks' pricing policies are geared to their earnings potential across the customer's life cycle.

There will always be price differences

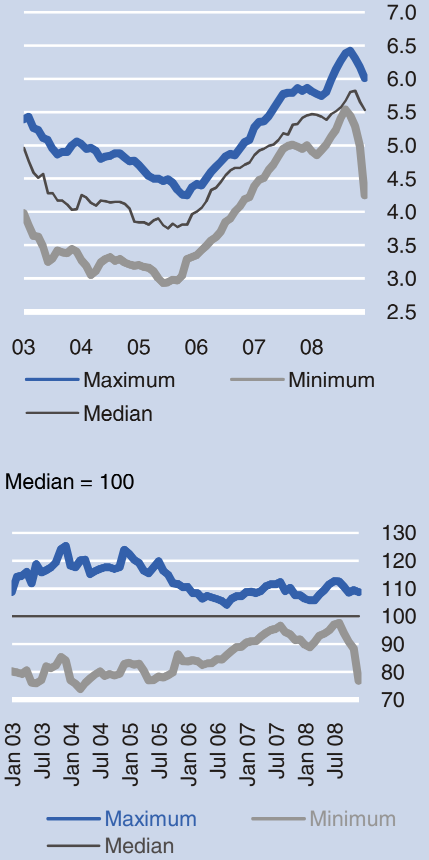
Added to this is the fundamental issue of how far full application of the law of one price can be taken as the benchmark for political integration attempts. Price uniformity is conditional on there being no more barriers at all, neither artificial nor natural, hampering EU-wide activity by banks and their customers. But regulatory measures can at best remove "artificial" barriers. Even if this objective were achieved, natural barriers can still give rise to price differences within the European Union. This insight can have two consequences:

— One could try to establish what share of the price differences is attributable to the "artificial" barriers that can be removed by regulation. Once the price differences have narrowed accordingly, integration is achieved. But this approach is presumably doomed to failure by the considerable difficulty of quantifying the significance of artificial barriers.

[3] See European Commission (2008). Preparing the Monitoring of the Impact of the Single Euro Payment Area (SEPA) on Consumers. Pp. 65-77. Brussels.

Mortgage rates diverging more strongly again

Effective interest rates in %



Sources: European Central Bank, DB Research **2**

Comparison of mortgage rates by Oliver Wyman

	Price 2003	Price 2006	Diff.
FR	0.89	0.36	0.53
UK	1.15	0.68	0.47
GR	0.70	0.35	0.35
IT	1.34	0.99	0.35
NL	0.97	0.64	0.33
ES	1.03	0.87	0.16
PT	0.95	0.88	0.07
DK	0.70	0.63	0.07

Source: Oliver Wyman **3**

— Instead of taking the differences in the prices of retail banking products in the individual countries as the absolute yardstick, an alternative would be to switch to a relative assessment. In this case the extent and speed of price convergence rather than international price differences would be of interest. But again, interpretation of the outcome is not clear. Even if price convergence is apparent, this alone is still not sufficient evidence of the effectiveness of the relevant regulatory measures. In the course of time the natural obstacles could also gradually have been eroded. Conversely, it does not necessarily follow from price divergence that regulatory measures have a negative impact on market integration. Instead, higher natural impediments could more than wipe out the effects of lowering artificial barriers.

So market integration may well have been achieved even if prices differ and, equally, it may not have been achieved if prices are the same.

Example: international price comparisons of mortgage loans

An attempt to draw conclusions on the status of mortgage market integration by comparing the prices of mortgage loans clearly illustrates how difficult it can be in practice to test the law of one price and to evaluate the outcomes of testing. There are three reasons for this. First, mortgage rates must reflect a complex bundle of risks (credit risks, house price risks and mortgage prepayment risks), institutional arrangements for covering which may differ considerably and which may exhibit very strong local variation, as is quite clear with property prices. Second, for many banks mortgage loans are an anchor product that serves to build up a long-term business relationship with clients and to tap into cross-selling potential. Third, consumer preferences differ enormously from one EU member state to another, for example with regard to interest rate lock-in periods.

In the recent past there have been two different moves to at least defuse these problems. One is the introduction of the ECB interest rate statistics, which since 2003 have reported the national average of the interest rate for a number of representative lending and deposit products in the countries of the euro area; however this leaves various issues open. Not only do the ECB interest rate statistics leave out all EU member states that have not yet introduced the euro, they do not indicate either what effect collateral has on the respective interest rate. What is more, the data is not normalised across the economic cycle. The more national credit cycles in the EU diverge, the less comparable the data becomes because profit margins and risk premiums differ systemically. Treatment of the mortgage prepayment risk, which finds its expression in contractual arrangements or statutory regulations on early cancellation, early repayment fees and unscheduled repayment options, is also too varied to be taken satisfactorily into account.

Chart 2 is based on the publication of a representative mortgage interest rate for each euro area country by the ECB. The upper section depicts the maximum, minimum and median interest rate trend in %. The lower section shows how the maximum and minimum rates have developed relative to the median, which is set at 100. It is striking that up to mid-2007 divergence from the median by both extremes steadily decreased, subsequently remaining roughly the same until the summer of 2008. Since then the minimum rate of interest has departed again significantly from the median. These fluctuations illustrate that no conclusions on the integration of mortgage markets in the EU can be drawn from this data, if only because of the short observation period.

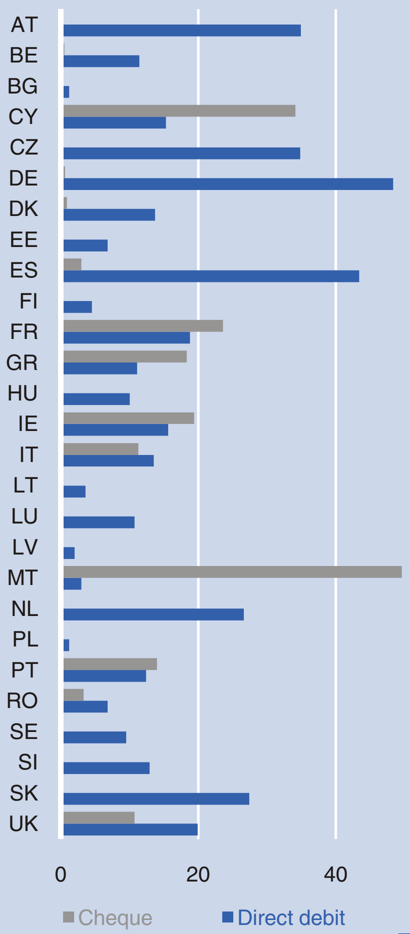
The second attempt at a comparison of European mortgage rates is made by Oliver Wyman (see Chart 3), a management consulting firm. In a study on the integration of European mortgage markets Oliver Wyman works with a reference rate adjusted for fees, the effects of the yield curve, credit risks and prepayment risks, which aims to be representative of the individual national mortgage markets. The adjusted price metric is intended to help address a number of the difficulties we have discussed with measurement and interpretation. But it also leaves many issues unresolved, for example with regard to the relative significance of the natural and artificial obstacles. More importantly, however, adjustment itself, while alleviating difficulties, also creates a major new problem. The resultant reference rate is an abstract construct based on very sweeping assumptions that is, moreover, very difficult to communicate in political debate.

Is the supply of retail banking products improving?

Market integration is intended to bring retail banking customers in the EU not only lower prices but also the best possible provision with varied products. The more options open to consumers, the better – all else being equal – the allocation of capital (deposits and credit products) will be, the more efficient the settlement of economic transactions (payment products) and the greater the likelihood of social objectives such as access to basic services (current account) and home ownership (mortgage loans) being achieved for ideally broad sections of the public.

Cheque and direct debit vary in popularity

Percentage of cheques and direct debits in total volume of payments



Source: European Central Bank 4

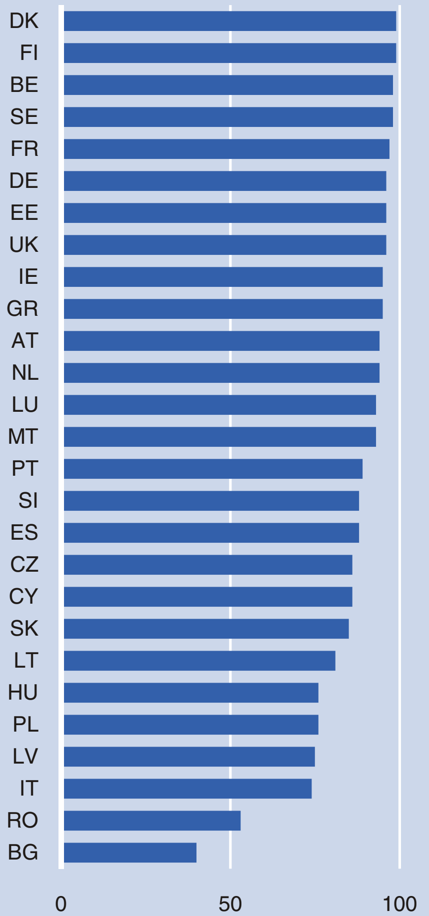
Measuring the level of provision

The provision of retail banking products can be defined in both quantitative and qualitative terms. As far as the quantitative provision of retail banking products is concerned, there is no equivalent to the law of one price. Even so, it stands to reason that provision with the same quantity of high-level products can be taken as indicative of advanced market integration. In the case of deposit and credit products the total amount is relevant, in the case of payment products the absolute number – relative to gross domestic product and the population size respectively.

Differentiation of the product range signifies the quality of the retail banking services on offer. The purpose of the integration process is that the same, ideally broad spectrum of retail banking products be available to customers across the entire economic area. No, or only minimal, differences between the range of products on the individual national markets point to a high level of market integration. By its nature, the quality of provision is not as easy to measure as the quantity. And since the qualitative view of the level of provision takes as its benchmark differentiation in the product range, attention will focus here on the breadth of supply within a single product category and across all retail banking products rather than on the provision of individual products. The breadth of supply can be established simply by enumerating the products on offer. But the lack of clarity in which this results may make it necessary to construct indices to address specific issues, which are then aggregated to form a single metric on, for example, the supply of different types of mortgage loans in the national markets.

Current accounts less widespread in Central and Eastern Europe

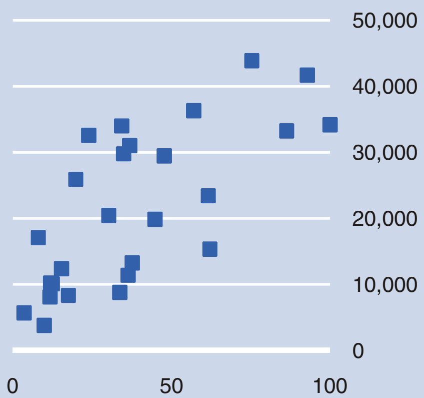
Percentage of households with current accounts



Source: European Commission 5

The higher per capita GDP, the higher the relative mortgage volume

x-axis: mortgage volume/GDP in %,
y-axis: per capita GDP in EUR
EU member states excl. LU



Source: European Mortgage Federation 6

The aim of calculating indices is to make the quality of provision in individual markets comparable. For this, information must be available on what the banks have on offer. Once this data has been obtained, each individual product variation must be assigned a value and a weighting factor to calculate the index. This calls for assumptions to be made on which product variations are to enter into the calculation (because they deserve to be considered as products in their own right) and which not (because they do not count as independent products).

Interpretation

Interpretation of the figures obtained this way needs to tread carefully, because cultural differences and path dependencies pose natural stumbling blocks in the form of fundamental divergences in demand that frustrate complete harmonisation of national product range types and the use made of them. Cultural differences may exist, for example, in households' attitudes towards borrowing. Even if all regulatory obstacles are removed, there will still be different levels of consumer lending. The same is true of payment products such as card payments. What is more, path dependencies play an especially important part here, because high specific investment is needed to establish a payment system. Additionally, the use of payment products is governed by network externalities. The more users opt for a particular type of payment, the greater the benefit to everyone will be. If at all, changes in payment behaviour are therefore to be expected only in the long term, even with the removal of all regulatory barriers to integration (see Chart 4).

We can also expect to see positive correlation between the level of economic development and the supply of retail banking products in an economy. For example, the level of development across all the Central and Eastern European member states is lower than in the EU-15 (see Chart 5). Because of this, a high degree of market integration need not necessarily be reached only when all products are available everywhere and are taken up to the same extent everywhere.

An example: International comparisons of provision with mortgage products

Provision with mortgage products is a good illustration of these considerations. Quantitative supply, as measured by the total mortgage loans outstanding relative to gross domestic product or the population, is easy to measure because the ECB makes the necessary data available. A comparison of the amounts outstanding in proportion to the population or gross domestic product shows at a glance what considerable impact the level of prosperity has (see Chart 6). There is no other way of explaining the low values across all the Central and Eastern European member states.

Recently the International Monetary Fund[4] and the British management consultant firm Oliver Wyman[5] attempted to measure the quality of supply with the aid of an index. Both surveys diagnosed marked differences in the level of provision. Statements on developments over time are not possible because each of the two indices was calculated only once (see Chart 7).

[4] International Monetary Fund (2008). World economic outlook – housing and the business cycle. April 2008. pp. 103-132. Washington D.C.
[5] Mercer Oliver Wyman (2003). Study on the financial integration of European mortgage markets. October 2003.

The IMF approach

	MEW	Ref.	LTV	Term	MMI
AU	Yes	Ltd.	80	25	0.69
AT	No	No	60	25	0.31
BE	No	No	83	20	0.34
CA	Yes	No	75	25	0.57
DK	Yes	Yes	80	30	0.82
FI	Yes	No	75	17	0.49
FR	No	No	75	15	0.23
DE	No	No	70	25	0.28
GR	No	No	75	17	0.35
IE	Ltd.	No	70	20	0.39
IT	No	No	50	15	0.26
JP	No	No	80	25	0.39
NL	Yes	Yes	90	30	0.71
NO	Yes	No	70	17	0.59
ES	Ltd.	No	70	20	0.40
SE	Yes	Yes	80	25	0.66
UK	Yes	Ltd.	75	25	0.58
US	Yes	Yes	80	30	0.98

The Oliver Wyman approach

	Var.	Risk	Dist.	Inf.	Index
DK	85	62	71	80	75
FR	81	67	42	70	72
DE	62	48	54	100	58
IT	65	51	42	50	57
NL	81	73	88	80	79
PT	35	58	71	40	47
ES	58	67	88	90	66
UK	77	92	100	100	86

7

The methodology

An index such as this is constructed in four stages. First, the measure must be set, with low values indicating a low level of provision and high values a high level. The IMF and Oliver Wyman operate with values between 0 and 1 and 0 and 100 respectively. The next step is to determine the variables to be entered into calculation of the index. For the IMF index these are the existence of mortgage equity withdrawal (MEW), fee-free mortgage repayment (Ref.), the typical loan-to-value (LTV) ratio and the average term of the loan (Term). Oliver Wyman works with the available product variations (Var.), the risk profile of the customer groups served (Risk), the diversity of distribution channels (Dist.) and the quality of information and advice (Inf.). The individual indicators are scored for each country and variable. Finally, a relative weighting must be assigned to the scores for the individual variables to calculate the overall index reading.

Does the quality of service converge at a high level?

Assessments of the cost effectiveness of banking services usually pay too little attention to the quality of the service. However, it can be assumed that the removal of regulatory barriers to integration and the attendant increase in competitive intensity will not only push prices lower but cause the quality of service in the individual EU member states to rise to a broadly harmonised level.

Measuring objective and subjective service quality

Service quality has an objective and subjective component. A high (or low) subjective perception of service quality is reflected in customer satisfaction (or dissatisfaction). Accordingly, measurement of service quality can start out from its objective determinants; alternatively, we can attempt to deduce the quality of service from the degree of customer satisfaction.

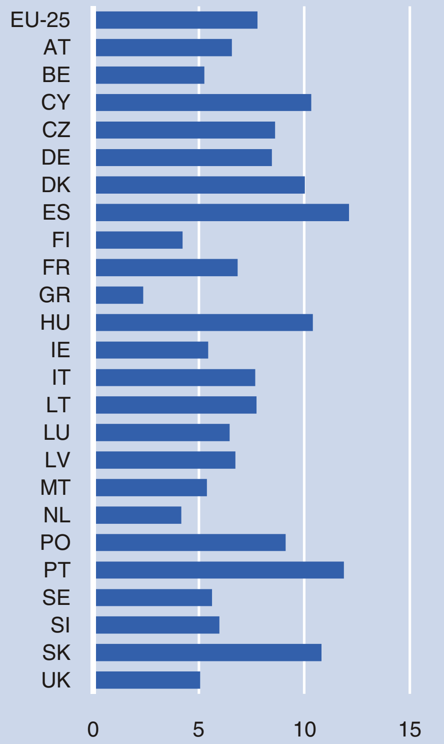
Objective service quality factors such as opening hours, branch density or the average waiting time on telephone hotlines can be measured and compared directly. However, they presumably encapsulate only a small part of all determinants of service quality. What is more, different customers make different demands of a bank's service features. Online customers with a strong bias towards technology will attach more importance to the navigability of a bank's website than to the opening hours of its branches, while the opposite will be the case with many others who value personal contact with "their" account manager. This contrast in preference is mirrored in the north-south divide apparent in internet usage in Europe. Indicators measuring the possibility of direct access to bank staff would fail to capture the preferences of bank customers in Scandinavia; the same is true of online banking-focussed approaches and the interests of southern Europeans. Measuring objective service quality factors therefore requires a broad methodological approach that makes allowance for differences of this kind. But even then it will hardly be possible to paint a complete picture of the quality of banking service in the individual EU member states using this method.

That is why it is also necessary to measure the subjective perception of service quality, i.e. customer satisfaction. This can be identified in customer surveys and by observing customer behaviour. The latter can flag customers' satisfaction as well as their dissatisfaction. Customers' willingness to switch banks, as expressed, say, in the average duration of banking relationships, is an example: a low tendency to change banks is a measure of high satisfaction and vice versa. The same applies to complaint patterns. Dissatisfied customers are likely to make lots of complaints, while few complaints are to be expected from satisfied customers.

Charts 8 and 9 portray two key figures, "churn" (Chart 8) and the "average term of contract" (Chart 9), which give an insight into banking customer mobility in the EU member states. According to the source of the data, the Commission's Report on the Retail Banking Sector Inquiry, "churn" sets out to capture the share of customers who change providers in a given year, while the "average term of contract" is a measure of the average age of all existing banking relationships. For a variety of methodological reasons[6], current accounts can be expected to significantly outlast their arithmetical "longevity", and the actual proportion of customers

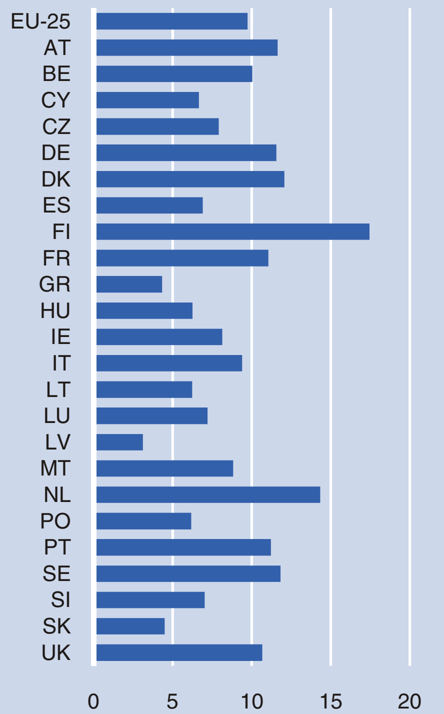
[6] European Commission (2007). Report on the Retail Banking Sector Inquiry. Commission Staff Working Document, pp. 71-72.

Customers seldom change their bank...
Churn in %



Source: European Commission 8

...their current account agreements are correspondingly long
Average term of contract in years



Source: European Commission 9

switching their bank is lower than the arithmetical "churn rate". This is illustrated by the average term of contract: When the Iron Curtain came down, the banking markets in the new EU member states were exposed to considerable upheaval. It is not therefore surprising that the average lifetime of the accounts that currently exist there (average 6.28 years) is lower than in the EU-15 (average 10.5 years).

Interpretation

By their nature, objective indicators of service quality are relatively easy to define and measure. In contrast, defining customer satisfaction (or dissatisfaction) with reference to surveys raises a host of methodological issues that make it advisable to use this tool only as a back-up:

— Who is to conduct the surveys and collect customer complaints? Possibilities here are the banks themselves, banking associations or ombuds offices, consumer protection organisations and government bodies.

— Are the number of complaints and customer dissatisfaction really positively correlated?
This need not necessarily be so. Rather, a high number of customer complaints can also result from strong acceptance of the complaint system.

— How can comparable EU-wide data be gathered?
The data is only suitable for examining the level of retail banking market integration if the survey results and the number of customer complaints are collected on a uniform methodological basis. This means that the data must either be collected by a central agency itself or that the agency must at least prescribe the methodology.

— Is data gathered by means of a uniform method really comparable?
Cultural differences may lead bank customers from different EU member states to give different answers to the same questions or to exhibit different complaint behaviour even with standardised recording.

Examples: International comparisons of retail banking service quality

With the aid of Eurostat surveys, the European Commission regularly monitors how satisfied consumers are with the quality of the service provided by their national suppliers. The polls cover a broad range of sectors besides retail banking. Added to these are many surveys on the topic by national banking associations and consumer protection organisations. However, the latter regularly suffer from dubious objectivity in terms of how the questions are phrased and evaluation of the outcomes – because in many cases market participants have commissioned the research – and from differing methodologies from one member country to another. Apart from this, allowing for national consumers' varying expectations of service quality is not easy. Even if the quality of service is objectively the same, customer satisfaction may vary due to the different demands that consumers make of service quality. Surveys must therefore satisfy exacting methodological requirements. When they do so, surveys are a reliable measure of integration.

With its "Consumer Markets Scoreboard" project launched at the beginning of 2008 the European Commission aims to record the

Objectives and methodology of the Consumer Markets Scoreboard

In January 2008 the European Commission published the first Consumer Markets Scoreboard under the auspices of Meglena Kuneva, the Commissioner for Consumer Affairs. The second edition followed in January 2009. Going forward, the Scoreboard is intended by the Commission as an information tool for permanent use as a gauge of end user satisfaction.

The Consumer Markets Scoreboard goes back to previous monitoring which, in the European Commission's view, revealed weaknesses in the internal market. It is designed to complement the Commission's general market screening by delivering additional in-depth information on market malfunctioning from the consumer perspective. The major objective is to identify sectors in which the internal market does not satisfy the needs of consumers.

In response to the outcome of the first Consumer Markets Scoreboard, in 2008 the Commission began gathering specific consumer-related information in collaboration with the competent national authorities. The core theme is improvement and harmonisation of the database and data quality.

The Scoreboard consists of three parts. It begins by screening the performance of various markets from the consumer's viewpoint with reference to five indicators. These are consumer complaints, price levels, consumer satisfaction, the ability to switch providers, and consumer confidence in product safety. In the second analysis phase, indicators are presented that can be used to measure progress on integration of the consumer markets. The purpose of the third part is to benchmark the consumer environment in order to ensure that comparable data is available at the national executive level to drive forward full integration of the EU internal market. The intention here is to use the Scoreboard to identify particularly successful member states, whose institutions can then be emulated by the less successful countries.

The Commission has prioritised various activities for 2009, including special studies on the retail trade and the retail electricity market. It also aims to develop a harmonised complaints classification system.

situation of consumers in the member states sector-specifically and systematically. The indicators fed into the Scoreboard include the number of customer complaints and consumer satisfaction. If constructed in such a way as to avoid the problems involved in the measurement of service quality discussed previously, the Consumer Markets Scoreboard may be a useful integration policy tool (see text box). But this is still a long way off.

Do banks and retail customers see the entire EU as their home market?

In-depth analysis of cross-border transactions and cross-border demand may help to cast light on how far banks and consumers behave as they might in an integrated market, namely by acting as though the entire EU were their home market. However, as we shall discover in the following, cross-border retail banking transactions are just one aspect of Europeanisation. In another sense, the term also covers the emergence of multinational European banks organised with a view to realising returns to scale and exploiting the benefits of different locations within the Union.

Measuring cross-border retail banking

Before cross-border transactions can be measured, we must first define what is meant by the term. In its narrowest definition, it refers to consumers' use of distribution channels in a foreign bank's home country to purchase its products. This entails retail customers either crossing the border to visit a branch, contacting a call centre abroad or accessing a foreign bank's product range online. Under the slightly broader definition of the term "cross-border banking", consumers acquire foreign retail banking products through domestic (from the consumers' perspective) distribution channels. These can either be the foreign bank's own distribution channels – an internet presence and call centre, for example, or even its own branch network – or a local partner with which it works together, such as other banks, brokers, and cooperating partners in the retail trade. According to both these definitions, retail banking is cross-border if the product concerned is not "made" in the consumer's home country. That the foreign bank can also deal with these consumers through local distribution channels is not therefore at odds with this interpretation of "cross-border".

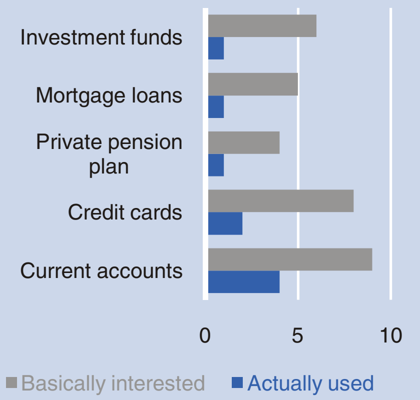
Cross-border transactions by this definition come about when banks wish to offer their products beyond the borders of their national markets and there is customer demand for these products. The volume of cross-border transactions can thus be recorded either at the banks or with the customers. Whereas direct statistical recording is possible at banks, transactions by customers can be identified only through surveys.

What stands in the way of cross-border banking?

Interpretation

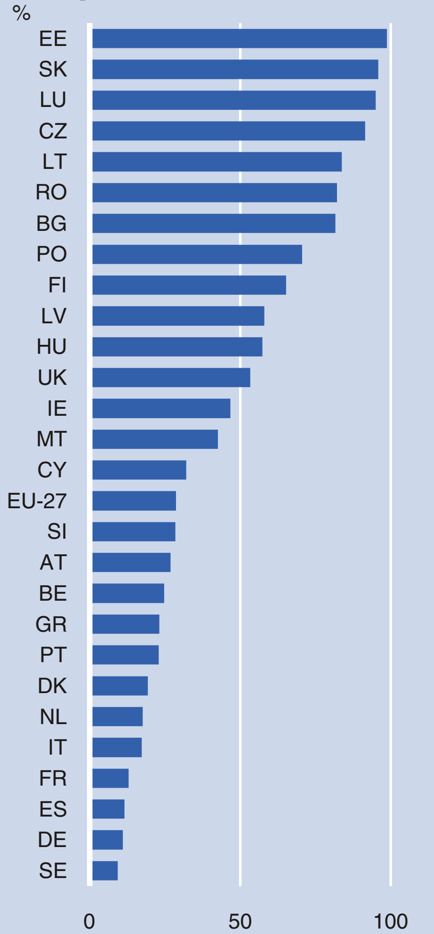
In extreme cases the absence of cross-border transactions stems from a lack of interest on the part of both banks and consumers. Alternatively, there may be bank customers who would like to make use of banking products beyond their national borders but are unable to do so because no suitable offers exist; equally, banks may certainly be willing and able to sell their products abroad but do not do so because demand for these products is non-existent or too small. In both cases no cross-border transactions in the narrower sense materialise even though banks and customers are acting as is to be expected of them in an integrated market. It is necessary to

Potential for cross-border banking services?
% of respondents



Source: Eurobarometer 10

Foreign banks' market share: Central Eastern Europe ahead
%



Sources: ECB, DB Research 11

examine these cases and the underlying reasons for them in greater detail to reveal the obstacles that have so far frustrated cross-border transactions.

Beginning with the demand side, it seems logical to contrast the volume of actual cross-border transactions with the level of potential business identified in consumer surveys. The fact that the latter generally far outweighs the former suggests that Europeans would like to take up banking products from abroad but are prevented from doing so by regulatory barriers (see Chart 10).

But this initially raises the question of how far survey outcomes reflect consumers' actual willingness to take advantage of services by foreign providers. Yet again, exacting requirements must be made of the methodology. A survey needs to be constructed very skilfully indeed to expose consumers' cost-benefit considerations – taking into account their risk preferences – when they weigh up the pros and cons of really taking their banking business cross-border.

Above and beyond this caveat, the purely demand-oriented argument disregards the supply side for one, and for another it makes very far-reaching deductions from simple survey data. To draw the correct conclusions from low-volume or non-existent cross-border transactions, a more sophisticated approach is necessary, particularly when it comes to identifying the stumbling blocks to cross-border supply and cross-border demand. The key issue here is whether the barriers to this are natural or artificial, because European policies can only influence the latter. The next step is to investigate which barriers are causing departure from the theoretically desirable state and what regulatory means are needed to remove them. For this, the survey must determine the specific arguments for and against cross-border operations from the viewpoint of banks and consumers alike.

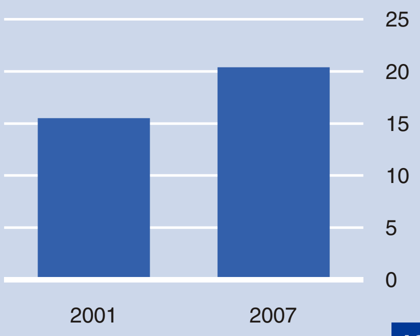
What is more, the term "cross-border transaction" must not be defined too narrowly. A high volume of cross-border operations would be possible even if there were only purely national banks in the European Union, in other words banks whose product management and operational units were located entirely in the home country. Theoretically, cross-border transactions by such national banks alone could broaden the product range for all EU citizens and cause prices to converge at a low level and the quality of service at a high level. But there are, of course, also banks that have developed beyond the confines of their domestic markets by setting up subsidiaries or acquiring banks in other EU member states. The Europeanisation of their operations then helps them diversify their earnings and risk. One of the expectations of the European integration procress discussed at the beginning of this study is therefore that such internationally operative banks will put their risk and capital management on an EU-wide basis.

Indicators of this development are, among others, the number and scale of cross-border mergers and acquisitions in the banking sector, the market share of foreign-owned banks (see Charts 11 and 12) and the geographic composition of a European banking group's loan book or deposit portfolio.

Here again, these figures need to be interpreted with caution. Full integration of the retail banking market is certainly not conditional on the banks in Europe ceasing to concentrate their business activities on any specific geographic region. It is more likely that while the banking sector will tend to Europeanise in the course of market integration, the trend may come up against its limits. These limits

EU banking markets increasingly intermeshed

Market share of banks from other EU countries in national banking markets, in %



Sources: ECB, DB Research 12

are not set by natural barriers to integration alone; additionally, the very Europeanisation of banking operations may create scope for providers with a purely national slant who seek to set themselves apart from their multinationally operative rivals with specialised market knowledge and cultural proximity to clients in their domestic market. Conversely, even banks with a strong international orientation may not necessarily find all markets in the EU equally attractive; indeed, some markets may even be unattractive, for example because they are simply too small.

Should the statistics fall short of the expectations pinned on the integration process, surveys can cast light on the banks' motives for not committing to Europe. Once again, it is a matter of identifying whether the banks' European alignment is frustrated by natural or artificial barriers and – in the latter case – of finding how to remove the artificial barriers.

Looking beyond cross-border transactions and multinational risk and capital management, the extent to which the banks structure their organisation and processes to Europe is particularly important. There are two toe-holds for this: exploiting returns to scale and utilising comparative cost advantages of different locations within the EU. These strategic options are combined when individual functions to realise scale economies are centralised where advantage can be taken of comparative benefits. Since only a very limited amount of information on banks' strategic alignment can be mined from official statistics, surveys must be used for the purpose – always with regard for the caveats already variously mentioned.

Have the integration barriers been removed?

Integration of the EU retail banking market is predicated on dismantling all of the obstacles that prevent financial services providers and customers from viewing the whole of the EU as their domestic market. Again assuming that the natural barriers will continue to exist at least in the short and medium term, removal of the regulatory obstacles therefore comes before integration of the market.

Review of potential regulatory barriers to integration

What "artificial barriers" are there?

Before progress on the removal of obstacles can be assessed, the various barriers that stand in the way of market integration must first be identified. Basically, these may be hurdles that prevent either the banks or consumers from considering the entire EU as their home market. Precisely which barriers are involved must be established separately both for banks and consumers and also for each product segment.

Banks must be able to realise returns to scale

For the banks, realising scale economies by conducting business Europe-wide is the decisive factor. This can be frustrated by the need for a bank to design its products with reference to up to 27 different legal systems. Problems can occur with consumer protection legislation (e.g. on advertising, pre-contractual information requirements, rights of withdrawal) as well as with general and particular civil law (e.g. cross-border assignment of receivables, treatment of delinquent debtors), among others. An example from the field of data protection illustrates this. Consumer credit providers whose business model is based on largely computerised lending reliant on credit scoring of the borrowers can only export their business model to other EU markets without the need for major amendments if they have access to broadly the same customer data. If this is not the case – owing, for instance, to different data protection regulations on the collection, storage and processing of so-called positive data – market entry is no longer worthwhile for the banks because in a worst-case scenario they would have to adapt their scoring model to each EU member country in which they operate.

Consumers must have confidence

On the consumer side, confidence in providers outside the familiar home market is extremely important, especially with regard to information on the products offered and their comparability, the possibility of withdrawing from a contract, cancellation possibilities and protection against quality defects. What is more, conclusion of the contract, utilisation of the service during the term of the contract and termination of the contractual relationship must not entail prohibitively high monetary and non-monetary expense for the consumer. The question arises here, for example, as to how far consumers are deterred by uncertainty over their legal position from buying products from non-national providers in the single internal market that they basically consider good value for money.

Interpretation

Regulation can both frustrate and foster integration

Regulation can therefore stand in the way of integration on the one hand and smooth its path on the other. This juxtaposition of effects of regulatory measures that both foster and frustrate integration often determines the debate on integration of the EU retail banking market. There is a danger that well-intentioned suggestions to heighten consumer confidence may reduce the incentive to banks to offer their products elsewhere. Integration cannot therefore be said to exist until all regulatory barriers that conflict with the desired behavioural patterns have been removed for both customers and banks. That is the case when the regulatory framework is designed in such a way that banks are able to offer their products in other member states without incurring unreasonably high additional expense and consumers feel confident about taking up these products.

It is therefore necessary to tread carefully

We must be correspondingly careful in our assessment of whether all regulatory obstacles to integration have been removed, for removing a barrier that prevents banks from acting abroad may deter customers from taking up the foreign banks' offers. Equally, measures to promote cross-border demand can give rise to new or higher costs for multinationally operative banks. It is therefore particularly difficult to measure integration defined as the absence of all artificial barriers.

Conclusion

Policies cannot hit the spot without measurement

Any targeted integration policy in the EU must start out from a precise review of the status quo encapsulating the degree of integration in the market under consideration. Otherwise it is not possible to apply the right instruments in the correct dose. However, we do not yet have a definitive answer to the question of how to measure the degree of market integration. This applies not least to the EU retail banking market.

What is integration?

The first issue to be clarified is what we mean by "integration" in the first place. Possibilities are, firstly, the removal of all regulatory impediments to the Europeanisation of banks' and consumers' behaviour; secondly the attitude of the market participants them-selves, in other words the extent to which banks and consumers consider the entire EU as their domestic markets; and thirdly, materialisation of the positive economic effects (the convergence of prices at a low level and of product line-ups and service quality at a high level) that are theoretically associated with market integration.

Calculation and interpretation of indicators

Irrespective of how integration is defined, there are two fundamental difficulties in establishing the degree of integration: it must be possible to calculate the indicators chosen and to interpret the indicator readings meaningfully. While the issue of calculability, i.e. measurement of the degree of integration with reference to the respective indicator, is primarily a matter of data availability, the situation with regard to interpretation of the indicator values is more complicated. Here, it is important to check whether the indicator really enables us to conclude in every case that the EU retail banking market (or parts of it) is perfectly, partially or not at all integrated. In many instances we find that integration may have been achieved even if an indicator does not flag this. It is equally conceivable that the indicator points to integration which in reality has at best been achieved in rudimentary form.

Wide-ranging review necessary

That integration can be defined and measured quite differently and that the outcomes of measurement need interpreting shows that there is no single definitive way of assessing the status of retail banking market integration in the EU. What is necessary is a wide-ranging review of the status quo, which will ideally be highly nuanced both in terms of the underlying definition of integration and with regard to the measurement of its depth and breadth. That way, by considering several indicators in parallel it is possible to recognise the weaknesses of individual measures and also to take very targeted steps on the further road to a single EU retail banking market.

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