The Spanish banking sector and the European single banking market

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How to avoid further retreat in EU banking integration.

Advances in European banking integration have suffered a significant retreat in the past years as a consequence of financial instability, uncertainty and the economic crisis. To avoid further deterioration of this situation some key issues need to be addressed urgently. Without a supranational authority with banking regulation and supervisory powers, a unified deposit protection and banking crisis resolution mechanism and harmonization of certain key areas, creating a single banking market in Europe will not be possible. Part of the loss of confidence in Spain is attributable to problems in the design of the EMU and specifically the lack of a single banking market. This situation may continue unless specific measures and actions are taken to recover the lost ground and accelerate the creation of a genuine single European banking market.

The international financial crisis that began in the United States in mid-2007 and rapidly spread to the rest of the world has brought to light one of the weaknesses inherent in the process of financial market globalisation. Financial internationalisation and globalisation bring huge advantages in terms of growth, as the increased competition accompanying financial market integration gives economic agents access to more sources of finance at a lower cost. Also, from investors' points of view, access to new markets allows for portfolio diversification by widening the range of products meeting their preferences in terms of risk and return. However, the crisis has shown that more integrated financial markets increase the likelihood and rate of transmission of shocks, thus heightening international financial instability. Moreover, the liberalisation that has gone hand in hand with globalisation has not been accompanied by enhanced financial regulation and supervision. This has made a radical overhaul of the international financial architecture necessary.

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In the specific case of European financial market integration, the various reports published regularly by institutions such as the European Central Bank and the European Commission (the most recent being from April 2012) show that the crisis has clearly caused a reversal in the level of integration. In short, what these reports highlight is that since 2008, cross-border transactions have

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lost importance relative to domestic ones, and that the differences in prices (interest rates) between countries have widened. In the early stages of the crisis, it was initially those markets that were most integrated and closest to monetary policy (such as the interbank market) that suffered the biggest reversal in their level of integration. However, these markets are also those that rebounded fastest (in large part thanks to the measures taken). On the other hand, in retail markets, which are much less integrated (like the majority of banking markets), the pace of integration is recovering much more slowly.

Against this backdrop, this article aims to examine the position of the Spanish banking sector in the process of financial integration in Europe, by analysing the various segments of the banking market. For this purpose, indicators based on quantities and prices will be used. In the case of quantitative indicators, the most important reference variable with which to judge progress towards the single market is the composition of banking business, making a distinction between domestic and cross-border business, and, in the case of the latter, delimiting business with other European countries. Nevertheless, other indicators such as the share of the domestic market accounted for by banks from other European countries can also be used. In the case of prices, the analysis is based on the degree of compliance with the so-called "law of one price," according to which, in an integrated market two products with identical risk and liquidity characteristics should have the same price regardless of the geographical location of the supplier of the good or service.

Domestic *vs*. cross-border business of the European Monetary Financial Institutions

The European Central Bank (ECB) has published quarterly information on Monetary Financial Institutions' (MFI) cross-border positions in each of the euro area countries since 1999. This time series data can be used to analyse how the degree of integration has evolved since the advent of the euro and the accompanying single monetary policy, together with the adoption that same year of the Financial Services Action Plan, the aim of which was precisely to bring about a single pan-European financial market. The information on cross-border business distinguishes between transactions with other euro area countries and business with EU Member States that have not adopted the euro. This allows a more rigorous analysis of the effect of the euro on financial integration between the countries of the European Monetary Union. In addition, the ECB's data gives a breakdown by different banking products. This makes it possible to analyse the progress of integration in both wholesale and retail markets. In particular, the data cover the following banking markets: On the asset side, loans, distinguishing between MFI and non-MFI loans, thus enabling separate analysis of the progress of integration in the interbank loan market; securities other than shares (again distinguishing between MFI and non-MFI); and shares and other equity. And on the liabilities side, the ECB's information enables the interbank deposit market and other deposits to be analysed.

The evolution of European banking integration: The impact of the crisis

The retreat in the degree of integration occurring in the wake of the outbreak of the crisis in 2007 is clearly visible in the decline in cross-border business with other EU countries as a share of the total (domestic + cross border). As Table 1 shows, in terms of the average for banks in the euro area, the upward trend prior to 2007 was broken that year and followed by a decline, although the intensity varied from one product to another. The increase in the relative importance of cross-border business with EU countries was bigger than that with euro-area countries. This

Table 1

Cross-border activity of MFI. Percentage over total business (within country + cross-border)

SPAIN	% cross-border business with euro area countries					% cross-border business with EU countries				
	1999	2007	Q1 2012	Variation 2007-1999 (%)	Variation Q1 2012-2007 (%)	1999	2007	Q1 2012	Variation 2007-1999 (%)	Variation Q1 2012-2007 (%)
Interbank loans	16.6	25.8	16.0	55.0	-38.0	22.3	39.9	33.5	78.7	-16.0
Non-interbank loans	0.8	1.2	1.5	41.5	32.2	1.0	2.3	2.3	115.6	2.8
Securities other than shares issued by MFI	29.3	36.8	15.4	25.4	-58.1	32.9	50.3	25.2	52.9	-49.9
Securities other than shares issued by non-MFI	9.5	12.6	5.6	32.4	-55.3	10.6	17.5	6.6	65.9	-62.4
Shares and equity	10.5	18.5	9.1	75.2	-50.8	10.7	26.2	17.0	144.0	-35.1
Interbank deposits	18.9	31.9	19.1	68.8	-40.3	28.2	49.9	33.6	77.2	-32.7
Non-interbank deposits	2.1	2.1	3.9	0.1	82.2	2.6	2.9	6.0	7.7	111.9

EURO AREA	% cross-border business with euro area countries					% cross-border business with EU countries				
	1999	2007	Q1 2012	Variation 2007-1999 (%)	Variation Q1 2012-2007 (%)	1999	2007	Q1 2012	Variation 2007-1999 (%)	Variation Q1 2012-2007 (%)
Interbank loans	17.6	23.5	18.1	33.6	-23.1	27.5	42.0	31.4	53.1	-25.3
Non-interbank loans	3.0	4.5	4.8	51.7	6.1	4.4	7.3	7.5	65.3	3.7
Securities other than shares issued by MFI	42.6	68.4	44.3	60.6	-35.2	48.9	86.3	59.7	76.6	-30.8
Securities other than shares issued by non-MFI	24.2	37.4	21.5	54.4	-42.4	27.7	44.2	25.7	59.5	-41.9
Shares and equity	12.0	17.3	16.1	44.2	-7.1	13.9	23.4	21.9	68.4	-6.3
Interbank deposits	16.0	21.1	16.5	31.6	-21.7	27.5	37.6	31.2	36.5	-17.1
Non-interbank deposits	5.3	5.3	5.1	-0.1	-3.4	6.9	8.1	8.3	17.9	1.8

Source: ECB.

implies that the positive effects of creating EMU spilled over the borders of the euro area to neighbouring countries.[2]

If we take cross-border activity with all EU countries as our reference, the breakdown by banking products suggests that the progress towards integration up until 2007 was greater in the case of asset products than liabilities. The non-interbank deposits market showed most progress. By contrast, integration grew most in the case of debt issued by MFIs, with cross-border activities increasing rising to 76.6% of the total.

After the 2007 crisis, integration of some products evolved very differently from that of others, to the extent that whereas cross-border business in some markets declined (such as non-interbank loans and deposits), it increased slightly in others.

Looking at levels of integration, rather than focusing on the changes over time, the current situation varies widely from one banking product to another, with the degree of integration being only slight in the case of loans and non-interbank deposits. Specifically, in the case of the former, cross-border business with other EU countries accounts for just 7.5% of the total, whereas in the case of deposits, the percentage is 8.3%. As a result, although these two retail product markets (loans and deposits with domestic companies and households) have become more integrated since 1999, the level of integration remains low. These small percentages are in sharp contrast with interbank loan and deposit markets, where values in 2012 were 31.4% and 31.2%, respectively.

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Cross-border activity of the Spanish Monetary Financial Institutions

As Exhibit 1 and the data in Table 1 show, for loans and deposits, Spanish banks' business with other EU countries is on a much smaller scale than is the case for euro area banks as a whole. Using data for March 2012, the biggest differences between Spanish and euro area banks lie in debt investments and non-interbank loans, with percentages in the euro area that, in some cases, almost quadruple those of Spain. The most significant item in banks' assets, namely non-in terbank loans by Spanish banks to residents in other EU countries, represents just 2.3% of the total, compared with a value of 7.5% for euro-area banks. The difference is much smaller in the case of the main liability product, as the non-interbank deposits the Spanish banking sector attracts from other European residents

Spanish banks' cross-border business with other European countries has increased relative to the levels existing when EMU was created, except in the case of investments in securities other than shares issued by non-MFIs. Consequently, despite the crisis and its negative impact on financial integration, cross-border activity today remains much higher than it was at the birth of the euro.

[2] The decline in relative importance of European banks' cross-border business with other EU countries seen since 2008 was also observed using BIS data on banks' exposures to other countries' debt. Thus, as was examined in the previous issue of SEFO, there has been a decline in the total foreign exposure of European banks to other EU countries.

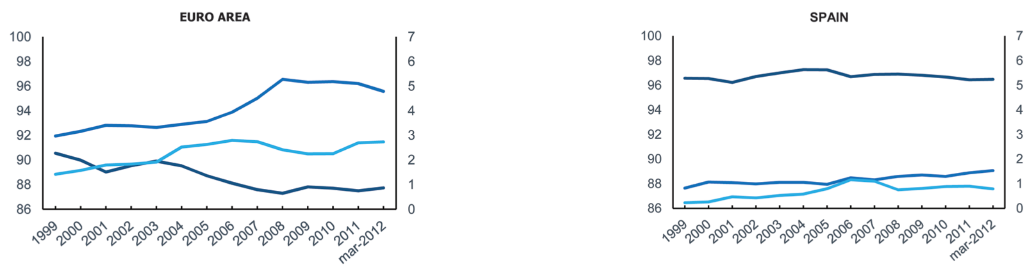
Exhibit 1

Cross-border activity of Monetary Financial Institutions in the loan and deposit markets (share of total business)

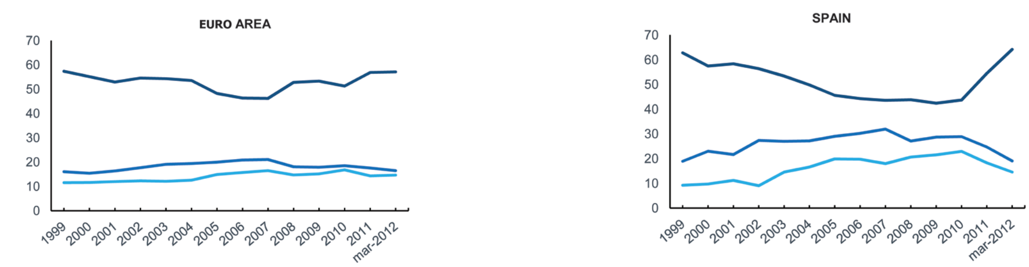
(percentages)

a) Interbank loans

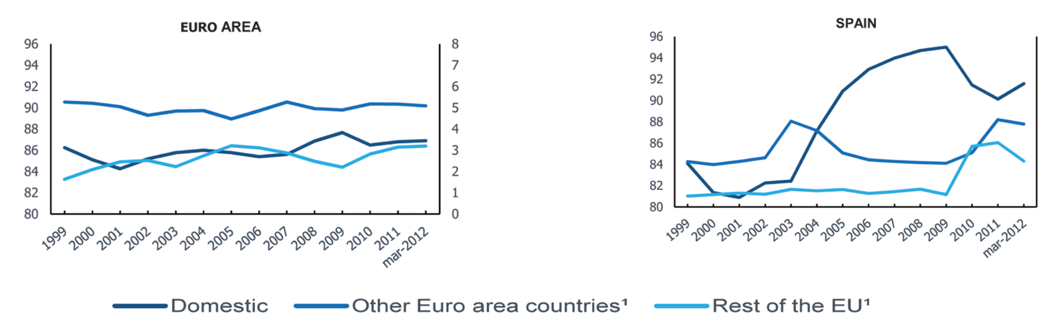
b) Non-interbank loans[1]



c) Interbank deposits



d) Non-interbank deposits[1]



[1] For Non-interbak loans and Non-interbank deposits, the Other Euro area countries and Rest of the EU: right -hand scale.
Source: ECB.

represented 6% of the total, two percentage points below the average for European banks.

Spanish banks' cross-border business with other European countries has increased relative to the levels existing when the EMU was created, except in the case of investments in securities other than shares issued by non-MFIs. Consequently, despite the crisis and its negative impact on financial integration, cross-border activity today remains much higher than it was at the birth of the euro. On the other hand, in the debt market, the increase in cross-border business with Europe prior to 2007 has vanished entirely, such that today's levels are below those of 1999.

Weighing the effect of the advent of the euro on the Spanish banking sector in terms of progress towards financial integration, the information on cross-border business shows that there has been a bigger increase in the importance of business with other European countries although its relative importance, particularly in the case of loans, is less than the European average. In the interbank market, Spanish banks currently have a level of business with European banks that is higher even than the euro area banks' average in terms of its relative importance as a share of the total (domestic + cross border-business).

Foreign banks' business in domestic markets

Another indicator of the progress towards financial integration is how foreign banks' market share has evolved in other European countries' domestic markets (through both branches and subsidiaries). The bigger the presence and business of foreign banks from other European countries in a given national market, the greater the relative importance of cross-border activity and consequently the higher the degree of integration.

As Exhibit 2 shows, in average terms, euro-area banks' market share in national markets grew by 55% from 2000 to 2007, reaching 17.3% at the end of the period. This growth was cut short by the outbreak of the financial crisis, such that in 2008 market share had dropped to 16.1%. In the two subsequent years the share recovered slowly, although the 2010 level (the last year for which data is available) was below that of 2007.

In Spain's case, the market share of other European countries' banks is much smaller, reaching a maximum differential in the last year examined. Specifically, in 2010 the euro area average (16.8%) was twice the value for Spain (8.3%), which clearly shows the limited presence of foreign banks in the country, above all in terms of subsidiaries, whose market share in Spain is just 3%, compared to 12.8% in the euro area as a whole. As Exhibit 2 shows, Spain is the euro area country in which banks from other European countries have the smallest market share.

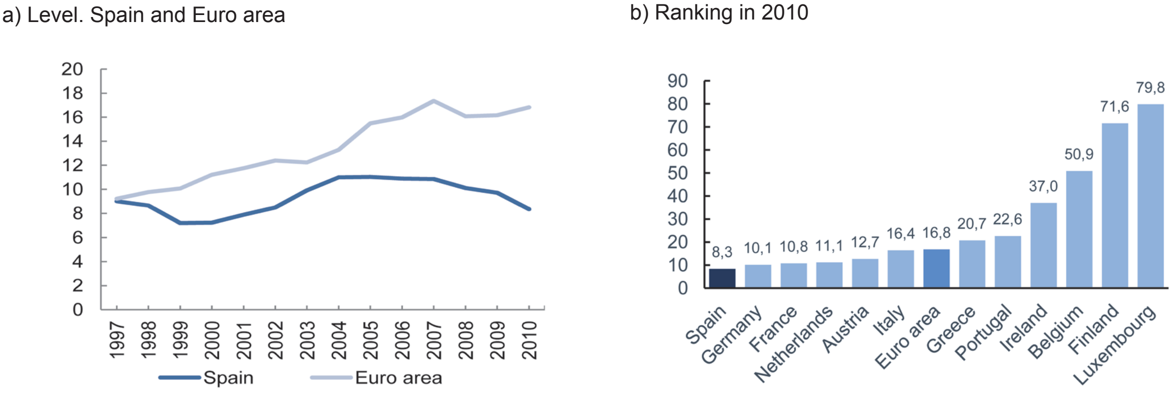
In the last few years there has also been a drop in European banks' market share, although this began before the onset of the crisis. Nevertheless, the biggest drop took place after 2007, with a cumulative reduction of 2.5 percentage points.

Price-based indicators of financial integration

The extent to which the law of one price holds can be examined by comparing the differences in the price at which a given financial service or product is available in different countries. Using standard deviation as a statistical measure of dispersion, Exhibit 3 shows that retail bank markets, being the most fragmented, have been least affected by the crisis. However, as the crisis has dragged on they have also suffered its effects. The differences in interest rates between countries of the euro area began to widen in 2008, although the impact of the crisis and degree of integration differed according to the product analysed. In the case of loans to businesses and time deposits, the dispersion of interest rates is highest at the end of the series (December 2011), and the difference in interest rates is smaller in the case of home

Exhibit 2

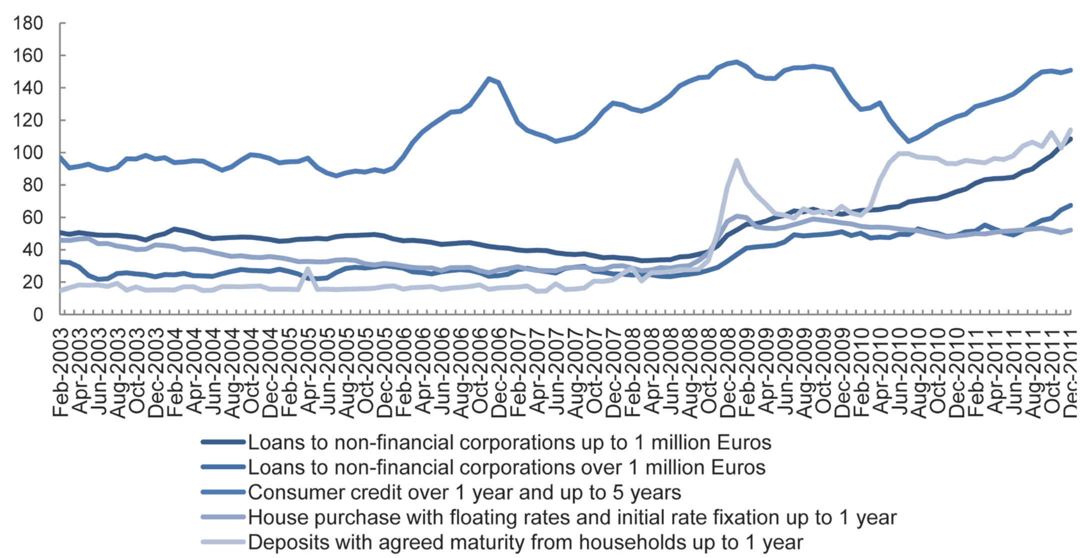
Market share of EU banks (foreign branches and subsidiaries) in the domestic markets
(percentage of total assets)



Source: ECB.

Exhibit 3

Standard deviation of Spanish Monetary Financial Institutions



Source: ECB.

purchase loans. There is more segmentation of national markets in the case of smaller loans to businesses (up to a million euros). The impact of the crisis on these smaller loans has also been more marked, with the dispersion of interest rates being twice that of loans of larger amounts. It is in the case of consumer loans that there is greatest deviation from the law of one price. The biggest concern is that in the case of some products the dispersion in interest rates at the end of 2011 is greater than that at the end of 1999, clearly revealing the impact of the crisis.

Against this backdrop of a retreat in the integration of European banking markets, Spanish banks have also been affected by the crisis, as the analysis of interest rate spreads compared to euro area banks' average shows. The higher or lower interest rates set by Spanish banks relative to their European peers reflects the different risk premiums affecting each country and the levels of competition. It also highlights the differences in the impact of the crisis on access to wholesale funding markets. As Exhibit 4 shows, with the exception of consumer credit, which has been 120 basis points above the euro area average since mid-2005 in Spain, it is since early 2009 that the interest rates set by Spanish banks have diverged from those set by their European counterparts, although the pattern of behaviour varies from one product to another. The information for December 2011 shows how interest rates in Spain are above the European average for loans to businesses and consumer loans in the domestic economy. Rates for house purchases are similar, however, and interest on time deposits somewhat lower. In the case of consumer loans and business loans for amounts less than a million euros Spanish banks set rates well above European averages, particularly in the case of the former, where the rate exceeds the euro-area average by 57%.

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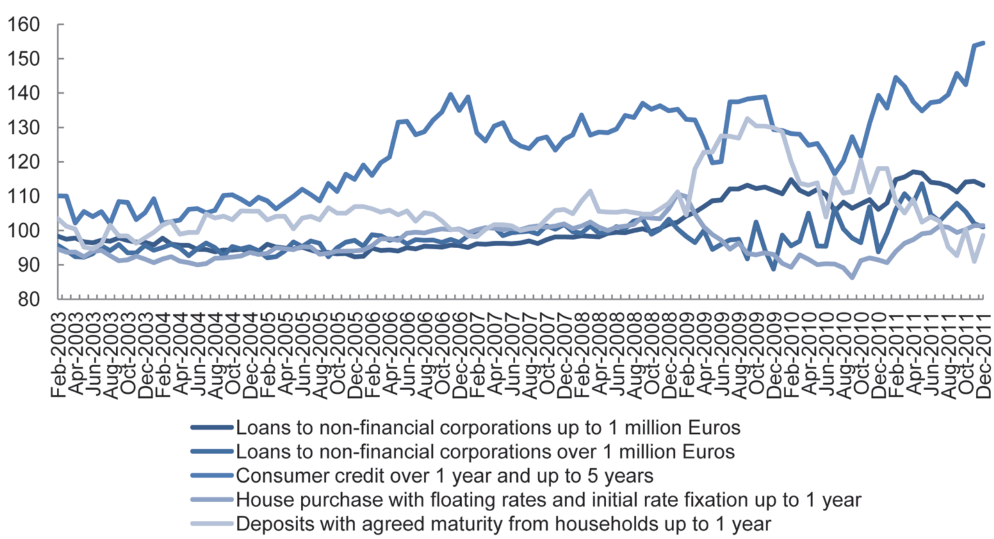
Exhibit 4

Spanish monetary institutions interest rates. Euro area=100 in each period



Source: ECB.

The progress of interest rates on time deposits is worth highlighting, as a gap opened up between Spain and the rest of the euro area at the start of 2009, which has been gradually closing in 2010 and 2011.

Conclusions

The creation of the EMU made progress towards European banking integration, in the context of growth, possible. But in the wake of the crisis and the ensuing spread of a climate of financial instability and uncertainty, there has been a retreat in the degree of banking integration. This is confirmed by the price-based indicators, which reveal an increase in dispersion between countries since 2008, and hence a deviation from the law of one price. The decrease in the level of cross-border investment and holding of bank debt also confirms the increased fragmentation of funding markets. Thus, euro area banks have reduced their holdings of securities other than shares issued by banks in other countries of the euro area, compared to their holdings of debt issued by domestic issuers, resulting in a geographical segmentation of the banking market.

The retreat of integration has revealed that it is not possible to create a single market without putting banking regulation and supervision in the hands of a supranational authority, and designing unified deposit protection and banking crisis resolution mechanisms. This means national sovereignty over banking matters has to be yielded, and the huge differences currently existing in many areas, such as characteristics of deposit guarantee schemes (in terms of the level and scope of coverage, funding mechanisms, the payout delay, etc.) or the different rules used for bank recovery and resolution (there is as yet no EU framework for managing crises in the banking sector, although last June 2012 the European Commission presented a proposal, have to be harmonised).

In the specific case of the Spanish banking sector, joining the euro enabled rapid progress towards integration with Europe, although the level of openness of Spain's banking sector to Europe, and the importance of Spanish banks' business with European partners, remain below average. Thus, European banks' market share in Spain is very small, as is the relative importance of cross-border transactions with European countries.

The market uncertainty surrounding the Spanish banking sector has had a severe impact on the level of integration of Spanish banks in Europe. The most visible sign of this is the closure of wholesale funding markets and the drop in cross-border business. Part of this loss of confidence is due to macroeconomic imbalances in the Spanish economy as a whole and the delay in resolving the problems affecting a small and well contained part of the banking sector. But as the IMF has recently pointed out, another part of the loss of confidence (the main indicator for which is the sovereign risk premium) is attributable to problems in the design of EMU, one of the most serious of which is the lack of a single banking market. Consequently, it will be hard to restore this confidence unless specific measures are taken soon to build this integrated market, as the Spanish government asked in writing last July in the letter sent to the presidents of the European Commission and the European Council. Moreover, given that the evidence shows that financial integration fosters economic growth, the measures needed in order to recover the lost ground in terms of integration and create a genuine single European banking market need to be taken as soon as possible. Fortunately, the recent proposals of the European Commission for EU-wide rules for a single European recovery and resolution framework (June 2012), a single supervisory mechanism for banks in the euro area with the European Central Bank at the core and involving national supervisors (September 2012), and the proposal of July 2010 for a harmonized deposit protection schemes, are important steps forward building a genuine banking union. For the Spanish economy, accelerating the achievement of a single supervisory mechanism is crucial, considering that it is a precondition for the direct recapitalisation of banks by the European Stability Mechanism.