Effects of increased foreign ownership in the bank sector

The European banking landscape is changing. A number of major European banks have expanded by acquiring banks abroad. Sooner or later, some sizeable Swedish bank may be targeted for a foreign takeover. The question is what the consequences would be for the Swedish banking system and how Swedish authorities should relate to such a development.The conclusion in this article is that there is no reason to fear any dramatic consequences of a sizeable foreign presence in the Swedish bank market. If anything, the effects should be beneficial for both the efficiency and the stability of the bank sector. On the other hand, supervision and crisis management with a cross-border bank can be complicated. The best way of addressing such challenges is with increased cooperation between national authorities. Additional restrictions on and less openness to foreign ownership would be the wrong approach.

Swedish banks' ventures abroad

Expansion abroad began early for the four largest Swedish banks: Handelsbanken, Nordea, SEB and Swedbank. As a result of their acquisitions abroad since the mid 1990s, more than half of the combined assets is now located abroad, mainly in other Nordic countries but also in Germany, Poland and the Baltic states. The share of their combined operating profit that is generated abroad is almost as large. In the case of the Nordea Group, which has large segments of its operations in Denmark, Finland and Norway as well as Sweden, the share amounts to no less than three-quarters. All the major Swedish banks now define their home market as Northern Europe.

In earlier phases of the banks' expansion abroad the emphasis tended to be on financial centres such as New York, London, Luxembourg and Singapore, while the supply of services was often aimed at foreign investors and large Swedish companies. The latest wave of ventures abroad is focused closer to home and the customers are local companies and households to a greater extent than before. In other words, the emphasis is on retail rather than wholesale banking.

Cross-border acquisitions of this type started relatively early in the Nordic and Benelux countries compared with the rest of Europe. The rather tough restructuring that occurred in the aftermath of Sweden's bank crisis was certainly one factor behind the Swedish banks' drive abroad. When the home ground had been consolidated, for the remaining banks the only way ahead lay in expansion elsewhere. Consolidation also gave these banks the size that is needed to accept the challenge that an international effort normally represents.

In recent years, similar enterprises abroad also seem to have got under way among banks in other parts of Europe. This development will hardly die out. The Swedish government is explicitly intent on disposing of the state-owned holdings in Nordea and the considerably smaller bank SBAB, for instance. Such a sale would probably attract foreign as well as Swedish interests. An increased foreign influence in the Swedish bank market therefore seems to be not entirely unlikely. That raises questions about the consequences for the Swedish banking system and how Swedish authorities should relate to such a conceivable development.

Some of the changes in the European banking landscape and their driving forces are described in the next section, followed by a section on some of the foreign entries to date in the Swedish market. The effects of foreign ownership – general experiences and specific consequences for the Swedish bank market – are then discussed. After that, some complications for supervision and crisis management that can arise from increased cross-border banking are considered. Finally, the Riksbank's conclusions are presented.

A changing European banking landscape

The number of banks in the EU has steadily fallen in recent years.[88] There has been substantial consolidation inside national borders, particularly in Italy and Germany. In the period 1993–2003 around 80 per cent of all acquisitions and mergers were in home markets. In the last couple of years, cross-border integration has picked up. To a greater extent than before, moreover, it has involved banks that offer retail services rather than, as before, those that mainly provide for professional players and large companies. The amounts involved in the acquisitions have grown with the mergers of some truly large banks. Examples are the Spanish Banco Santander's takeover of British Abbey National in 2004 and Italian Unicredit's acquisition of German HypoVereinsbank, not least its subsidiaries in Austria and Poland in 2005. Dutch ABN Amro acquired Italian Banca Antonveneta in the latter year and in 2006 French BNP Paribas took over Italian BNL. In March 2007 discussions were under way on a takeover of ABN Amro by British Barclays.

In many respects the series of acquisitions and mergers is already leaving its mark on the European banking landscape. This is evident not least in the growing share of bank assets outside the home country. However, the impact of this development on the structure of bank markets differs greatly from country to country. To clarify the picture of changes in the banking landscape it may be a good idea to distinguish between inward and outward internationalisation.

BANKS' PRESENCE OUTSIDE THE HOME COUNTRY

Outward internationalisation from a country refers here to the extent to which one country's banks have established branches and subsidiaries in other countries.

88 From end 2001 the number of credit institutions in the EU25 area declined by 11.5 per cent to 8622 at end 2005 (EU banking structure, European Central Bank, September 2006).

As mentioned above, Swedish banks display a relatively high degree of outward internationalisation. Elsewhere there are considerably larger banks that are at least as internationalised as those in Sweden. Some large bank groups in the EU that have at least half of their consolidated assets outside the home country are French Crédit Agricole and Société Générale, British HSBC, Dutch ING Bank, Italian Unicredit, Spanish Banco Santander and Belgian Dexia.

On a countrywide basis, the degree of outward internationalisation is notably high in, for instance, Sweden, Belgium, the Netherlands, Italy and Spain. In the case of each of the bank groups Dexia and Fortis (Belgium), ING Bank and ABN Amro (Netherlands) and Nordea (Sweden) the value of the external assets is equivalent to between 50 and 75 per cent their home country's GDP.

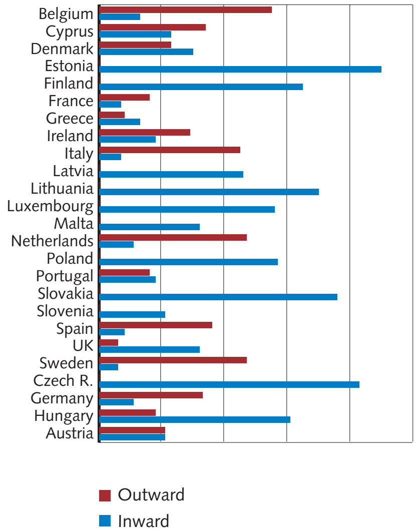
FOREIGN PRESENCE IN BANKS' HOME COUNTRIES

Internationalisation can also be considered as an inward process. In terms of a country's market share for branches and subsidiaries of foreign banks, inward integration is highest in EU's new member states. On average, almost 70 per cent of their bank markets is under foreign management, with a large presence of banks from other EU countries. In Estonia, where Swedish-owned banks predominate, the share is as high as 90 per cent. For comparison, in the countries in the euro area the average proportion of bank assets that are under foreign management is around 16 per cent.

In absolute terms, the United Kingdom stands out among the EU countries as a location for foreign banks. London's position as a financial centre has prompted many banks to establish wholesale operations there. The assets of foreign branches and subsidiaries in the United Kingdom total over 6,000 billion euro, twice the country's GDP. Luxembourg, one of the smaller EU countries, aims to attract financial companies and there the assets of foreign banks total around 750 billion euro or almost twenty times the country's GDP (the figure for Sweden is about 10 per cent of GDP).

Chart 1 shows the degree of outward and inward integration in the European banking sector. Outward integration is represented by the proportion of the assets of bank groups based in a country that is located in other EU25 countries and thus does not include assets outside EU25. Inward integration does include the presence of banks from non-EU countries, so the two indicators are not entirely comparable. The chart shows that integration as a whole is most advanced in the new as well as the small earlier member states. High outward integration is only natural in small countries because banks there are obliged to expand elsewhere in order to match the economies of scale that are available to banks with a large home market.

Chart 1. Outward and inward integration in the EU25 bank sector at end 2005



Note. Outward integration is represented by the share of the country's bank groups' assets that is located in other EU countries, inward integration by the share of a country's domestic bank market that is held by foreign banks (including banks from non-EU countries). The countries are listed in their Swedish alphabetical order.

Sources: ECB and the Riksbank

MANY DRIVING FORCES FOR CONTINUED INTEGRATION

A variety of motives no doubt lie behind the recent years' takeovers in the European bank market. Many forces are clearly working for increased cross-border consolidation.

- Potential access to new and hopefully more profitable markets, particularly if the home market is mature, is one important reason why banks expand abroad. The combination of strong economic growth and a financial sector that is usually less well developed gives a strong potential for expansion in the new member states, above all in Eastern and Central Europe.

- Technology has increased the potential for utilising economies of scale and synergies. When IT expenditures account for a growing share of a bank's fixed costs, economies of scale are particularly relevant. That was one of the explicit reasons for the merger of Banco Santander and Abbey National, for example.

- The new capital adequacy standards enable a bank to calculate capital requirements with increasingly advanced risk models.[89] At the same time, the cost of the new risk models can result in economies of scale that strengthen the case for consolidation.

- Banks' risk profiles can be improved by increasing the geographical diversification of the risks in loan portfolios.

- The massive efforts to create a proper internal market in the EU have also been important. One such effort is the EMU project, which has led not least to a number of significant deregulations and the removal of numerous barriers to the free movement of capital. The existence of the euro has been instrumental in reducing exchange risk and in facilitating cross-border marketing and price comparisons of financial services in different countries.

- Another aspect of these efforts is the work that has been done on harmonising financial regulations in the EU. The Financial Services Action Plan, launched in 1999, has resulted in some forty harmonisation measures, mostly in the form of new legislation, the aim being to facilitate a cross-border supply of financial services.

- Harmonisation in turn has been speeded up by a new, less drawn-out legislative process, the Lamfalussy process. In this way, the average interval between a proposal and a joint

89 Directive 2006/48/EG from the European Parliament and Council on the right to start and conduct operations in credit institutions (amended).

decision on new EU directives has been shortened to less than two years. Moreover, the process enables legislation to be more flexible and adaptable, which probably also benefits integration.

- Harmonisation has also been accompanied by increased cooperation in financial supervision and an endeavour to make supervisory methods more uniform. This hopefully stimulates integration by reducing the burden of regulations on cross-border banks.

Few foreign entries in the Swedish bank market

The first establishments in Sweden by foreign banks occurred in 1986, when foreign banks were permitted to set up subsidiaries here. In 1990 foreign banks were also permitted to open branches in Sweden. Since then the number of foreign banks with a presence in Sweden has risen to 25 (end 2006).

Most of the foreign banks in Sweden focus on the corporate and securities markets. A notable exception in the retail sphere is Denmark's largest bank, Danske Bank; through the acquisition of Östgöta Enskilda Bank in 1997 and the establishment of a number of provincial banks, this is now the largest foreign bank in Sweden. With some fifty branches here and market shares of over four per cent of lending to and around six per cent of deposits from the Swedish general public, Danske Bank is now the fifth largest bank in Sweden.

Another example of entries to the Swedish market for financial services concerns Old Mutual, originally a South African group which now has its head office in London. In 2006 Old Mutual acquired a Swedish financial group, Skandia, with Sweden's second largest life assurance and mutual fund operations (over 20 per cent of the total stock of these assets). The group also includes SkandiaBanken, which has just over one per cent of the loan market and three per cent of the deposit market, making it the seventh largest bank in Sweden (after the four major banks, Danske Bank and SBAB).

Notwithstanding these foreign entries, the degree of inward integration is still relatively low in Sweden, as shown in Chart 1. Emerging markets normally provide a larger potential for the growth of foreign banks than mature markets such as Sweden. It would therefore seem to be more profitable to expand in other parts of the world. Even so, certain factors suggest that an increased foreign interest in Swedish banks cannot be ruled out. The profitability and customer networks of the Swedish banks may be attractive, as may the large stock of investment assets that results from the banks managing sizeable segments of people's mutual fund and pension savings. Another inducement may be the presence of Swedish bank groups in emerging markets. If the government's intentions of disposing of the state-owned holdings in Nordea and SBAB are realised, this may well attract investors abroad as well as in Sweden. Many of the major international banks have adequate resources, not least large cash reserves, for the acquisition of a major Swedish bank. This naturally raises a number of questions about the possible consequences of such a development for the Swedish bank market.

Foreign bank-ownership can affect competition as well as stability

The primary socioeconomic dimension of increased foreign ownership is, for most sectors, how the competition is affected in the domestic market. Competition is important because it promotes efficiency and that in turn promotes growth and prosperity. The bank sector, however, differs from other sectors, such as the automobile industry, because of its special role in the financial system. Structural changes in the bank sector are therefore a little more complex to assess than changes in other markets.

The main point to consider is the banks' key role in the payment system. On account of this role, there are times when the banks' mutual exposures are very large and a problem in one bank is then very liable to spread to other banks and to other parts of the financial system. As the social costs of a crisis in the financial system are potentially very great, financial system stability is a major public interest. That is one reason why banking operations are regulated separately and supervised by Finansinspektionen, Sweden's financial watchdog. It also means that monitoring and analysing developments in the bank market is a natural part of the Riksbank's function of promoting a safe and efficient payment system. Consequently, the effects of a possible increase in foreign influence must be assessed in the context of stability as well as competition.

For a long time economists have debated whether the public interest in competition is at odds with the interest in bank sector stability. Some economists argue that unduly strong competition may be bad for financial system stability.[90] The underlying mechanism is that weaker competition leads to higher bank profits and thus to a buffer against shocks, so that bank owners have less reason to take excessive risks. Moreover, competition that is too heavy, so that profits are too small, renders the banking system more vulnerable to financial and macroeconomic disruptions. From this point of view, a balance should be struck between the degrees of competition and financial stability to arrive at the situation that is best for society. Other economists argue that, on the contrary, competition results in a more stable banking system.[91] One of the arguments behind this view is that weak competition leads to higher interest rates on lending and that in turn destabilises the bank sector because it leads to a higher risk of default among borrowers.

90 Allen & Gale (2000).
91 Boyd & Nicoló (2005).

Both views are based on rather stylised theoretical models of reality and it is difficult to gauge the reliability of their predictions. There are also some extensive empirical studies but their results are not always easy to interpret, partly because competition and system stability are difficult to measure. A large study by Beck et al. (2005) found that high concentration in the bank sector does not appear to lead to a less stable banking system. On the other hand, the same study shows that banking system vulnerability is increased by regulations that obstruct the entry of new banks and restrict the range of banking operations; this was confirmed by Claessens and Laeven (2004). Schaeck et al. (2006) show that a banking system that is more exposed to competition is less likely to be hit by crises in the financial system. The hypothesis of a conflict between competition and stability is also rejected by Boyd et al. (2006).

Regardless of how one judges the need to balance competition and stability, the consequences of increased foreign influence on the Swedish bank market should be considered in relation to both these public interests. As a first step, let us look at experience in general of foreign entry.

OTHER COUNTRIES' EXPERIENCE MAINLY FAVOURABLE

As a rule, an increased presence of foreign banks and few restrictions on their operations have led to stronger competition in the bank market.[92] Foreign bank-ownership is, for instance associated with narrower profit margins for the domestic banks, particularly in emerging markets.[93] Competition from foreign banks has also helped to improve the quality and accessibility of financial services.[94] Moreover, an improved capital supply has often made it more possible to finance domestic investment.[95] The introduction of new business techniques by foreign banks has benefited the efficiency of the domestic bank market.

At the same time, foreign participants are sometimes criticised for concentrating on the bank market's most lucrative segments in ways that put the domestic banks at a disadvantage. Some studies note that in countries where the bank market is dominated by foreign players, small and medium-sized companies sometimes have poorer access to loans.[96] In some cases this has prompted attempts by the host country's authorities to control the types of operation that are open to foreign players.[97] Other studies have found that a foreign banking presence benefits all companies, though the effects are greatest for large corporations.[98]

92 Claessens & Laeven (2004).
93 Claessens et al. (2001).
94 Levine (1996).
95 Bhattacharaya (1993).
96 Detragiache et al. (2006).
97 Bonin & Ábel (2000).
98 Giannetti & Ongena (2005).

It is not least in Eastern and Central Europe that foreign ownership has played a crucial part in the development of modern banking sytems with institutions that are financially robust and independent. The importance of foreign participation in the privatisation of the bank sectors in Hungary and the Czech Republic, which in turn has been a significant step in the transition from a centrally planned to a market economy, is outlined in the box.

The effects on financial stability also seem to be favourable as a rule, while restrictions on foreign ownership appear to lead to less stability.[99] The impact on financial stability seems to be particularly positive in less developed economies. In such cases foreign banks can often contribute more up-to-date risk management techniques, better accounting routines and structures for corporate governance.[100] The fact that foreign banks often have a larger capacity to absorb risk also benefits financial stability. Moreover, they also tend to be more internationally diversified than domestic banks and therefore less vulnerable to macroeconomic shocks in the host country.[101]

The growing geographical diversification of individual banks does entail an increased linkage between their operations in different countries, with more numerous sources of risk and more channels for these risks to spread in the banking system. There is, not least, an increased dependence on developments in the parent bank's home country. Moreover, increased integration generally means a growing degree of real economic synchronisation between countries. The positive effects of diversification can therefore be smaller than expected.[102]

99 Rajan & Zingales (2003).
100 Cárdenas et al. (2003).
101 Montgomery (2003).
102 De Nicoló et al. (2004).

Foreign bank ownership in Hungary and the Czech Republic[103]

In the centrally planned economies the supply of capital was controlled by the government, often through the central bank. The first step in the reform of the bank sector was therefore to terminate the central bank's role as the supplier of capital and establish commercial banks. This left the central bank with the customary functions, such as conducting monetary policy and overseeing financial stability.

HUNGARY

Hungary was one of the first countries in Eastern and Central Europe to admit foreign investors. As part of its privatisation strategy, at an early stage Hungary sold majority holdings in state-owned banks to foreign investors. First, however, the banks' balance sheets had to be strengthened with additional capital in order to attract the right investors; moreover, as the impaired loans did not show up all at once, this had to be done several times. Still, in time it did prove possible to put the banks on a sound footing and find strategically suitable owners. In this way, Hungary was more successful than many other countries in the region in creating a functional banking structure early on.

CZECH REPUBLIC

The Czech Republic was more averse to foreign influence to start with and the initial privatisations were arranged mainly with domestic investors. The loan portfolios which the newly established commercial banks took over tended to be of poor quality, with a high concentration of risk. Moreover, the transition to a market economy began in a turbulent macroeconomic phase, which made the valuation of loan stocks difficult. New lending was particularly risky in the unstable economic situation and the old routines for granting new credit were allowed to continue as before.

In the absence of pressure for change from foreign owners, privatisation did not result in a stable bank sector. When the true state of loan portfolios eventually became clear it was evident that impaired loans made up a large part of the bank's assets; consolidating the bank sector cost the Czech government an estimated 30 per cent of GDP compared with around 10 per cent in Hungary. Foreign ownership did not become politically acceptable in the Czech Republic until the prospect of EU membership loomed. In the second round of bank privatisation, carried out between 1998 and 2000, majority holdings in the three largest Czech banks were sold to foreign investors. Today, the major part of the bank sector there is under foreign control.

103 For a fuller account of the development of the financial systems in a number of transitional economies, see e.g. Bonin & Wachtel (2003).

UNDRAMATIC CONSEQUENCES FOR THE SWEDISH BANK MARKET

A general assessment is that bank-market entry by foreign banks seems to be largely positive for the host country in terms of the bank sector's efficiency and stability, though it is in less developed economies that the effects are most pronounced. The consequences of an increased foreign presence in the Swedish bank market would probably not be as great. They can be divided into effects on competition and on banking system stability.

EFFECTS ON BANK MARKET COMPETITION

The degree of concentration in the Swedish bank market today is clearly high. Between them, the four major banks have three-quarters of the Swedish deposit and lending markets. These banks are also very profitable. In 2006 their post-tax rates of return were all in the interval 19–22 per cent.[104]

The combination of high concentration and high profits is sometimes said to indicate a lack of competition. Matters are unfortunately not that simple. Measuring competition is difficult, partly because its existence is hard to catch.[105] For one thing, just the threat of new competitors can be sufficient to spur existing players to compete more without the market structure actually changing.[106] Moreover, profits are liable to vary for numerous reasons, such as the macroeconomic climate.[107] The Swedish economy is expanding strongly at present, so high profits are not necessarily evidence of weak competition here.[108]

There are many indications that, if anything, competition in the market for housing finance has grown in recent years; this is mirrored, for instance, in the narrower net interest margin (bank income from lending less expenditure on lending and deposits, all in relation to interest-bearing assets). One explanation, clearly, is that other players, for example SBAB, are competing more offensively with the four major banks for borrowers. The less onerous capital requirements for mortgage loans as a result of the new capital adequacy directive may also have induced many players to increase their presence in this market.[109] Margins on corporate loans have likewise been under pressure recently. There are also signs of increased competition in the deposit market, though it does not seem to have resulted in the same pressure on margins as in the lending market. A large share of

104 The figures are taken from the banks' financial statements.
105 For example, Beck et al. (2005) and Claessens & Laeven (2004) find no empirical support for a link between concentration and competition.
106 Besanko & Thakor (1992).
107 Industrial organisation theory has long stressed the need for other indicators of competition than concentration and profitability; see e.g. Baumol et al. (1982).
108 Interesting studies of efficiency in different bank markets are to be found in Carbó-Valverde et al. (2006) and Bikker & Bos (2006) .
109 Directive 2006/48/EG from the European Parliament and Council on the right to start and conduct operations in credit institutions (amended).

mutual fund and pension saving in Sweden is managed by the banks; with the locking-in effects of the current tax rules, competition in this market is probably not as strong as it could be.

Without an actual case to consider, it is hard to say in advance whether the effect of a sizeable foreign presence on competition in the Swedish bank market would be positive, negative or negligible. The outcome very much depends on the market structure that then ensues. The most probable scenario is an effect that is not particularly great.

For the Swedish authorities, however, an important lesson from the experience in other countries is not to create unnecessary obstacles for foreign competition or a foreign takeover of Swedish banks. Macroeconomic efficiency is a question of directing resources to their most productive use. Those who believe they can run a company more profitably than others are also prepared to pay most for a controlling holding. The threat of being bought up by someone with a better business model or a more efficient management acts as an incentive for existing managements to become more efficient. Such a "market for corporate control" is accordingly essential for economic efficiency.[110] Unwarranted obstacles to or restrictions on the possibility of corporate takeovers lead to a less functional market. That in turn can entail a less efficient use of the economy's resources. As a rule, therefore, limiting the possibility of foreign ownership for various protectionist reasons is not a sound socioeconomic proposition. A properly functioning market for corporate acquisitions is as important for efficiency in the bank sector as it is in other sectors.

EFFECTS ON FINANCIAL STABILITY

Neither do there seem to be any grounds for being apprehensive in advance about dramatic consequences for the stability of Sweden's financial system. A major international bank that takes over a Swedish bank would no doubt have plenty of resources for financial support as well as a portfolio of assets that is more diversified than that of the bank it acquires. The Swedish bank would then, if anything, be less vulnerable to disruptions than the remaining Swedish banks. The latter, moreover, would hardly be more exposed to the resultant subsidiary or branch than they were to the bank before it was taken over. So it is hard to see that increased foreign influence would lead a priori to any direct negative consequences for financial stability.

At the same time there would be the greater dependence on the parent bank and developments in its home country. There is always the possibility of problems arising in a bank. It will be increasingly difficult to prevent cross-border contagion if some component of a bank is in serious difficulties. The situation could be particularly troublesome if an international bank has operations that are critical for the host country but not the home country. For national authorities

110 See e.g. Jensen & Ruback (1983).

it may then be unsatisfactory to have less insight into and control over the bank compared with a domestic bank. This brings us to the division of responsibilities between home and host countries, a matter that in international fora is commonly referred to as the home/host problem.

More cooperation needed to manage crises in cross-border banks

The home country principle, which is the established norm in the EU, makes the home country responsible for the supervision of the parent bank, including its branches in other countries (in this context the home country is the country that issued the cross-border bank's licence). The branches abroad are included in the home country's deposit guarantee system. In the case of bank groups with subsidiaries abroad, the home country is responsible for supervising the group as a whole, while the subsidiaries and deposits in them are the responsibility of the respective host countries. There is also a home/host relationship between authorities in other matters than direct supervision, though without the formal structure that regulates this relationship in supervisory issues. One example is the acute management of a bank crisis that may require liquidity assistance from the central banks. Another is the allocation of costs in the aftermath of a crisis, when finance ministries may be involved.

As long as the cross-border operations of banks were relatively limited, the home country principle generally functioned satisfactorily. The arrangement will probably not suffice, however, as the cross-border element grows and banks' operations are liable to be critical for the financial system in more than one country. This is because of the inherent conflict between the home country being responsible for consolidated supervision and the host country having to shoulder the consequences that problems in a bank may have for financial system stability. What this amounts to in practice is that while the host country authorities are politically accountable for their country's financial stability, cases can arise where they have insufficient insight into and control over the bank in question. For the host country this can be a problem in particular when a bank uses branches for its operations abroad but it applies just as much to banks that use subsidiaries.

Some countries have chosen to adress this problem by simply being rather restrictive about the operations of foreign banks, at least in the form of branches. The models adopted by a couple of non-EU countries, Canada and New Zealand, are outlined in a box.

In EU cooperation, however, more restrictions on the cross-border supply of services are not an option. On the contrary, the removal of barriers is high up on the EU agenda. The chosen approach instead is an increased harmonisation of financial regulations. At the same time, EU cooperation creates conditions for other ways of tackling the challenges the authorities face from increased integration. In the field of supervision there is now a great deal of cooperation between the member states, for instance in the framework of the Committee of European Banking Supervision (CEBS). Supervisory authorities also have a number of informal networks for the supervision of some cross-border bank groups.

Furthermore, voluntary agreements have been concluded on cooperation for financial stability. A Memorandum of Understanding (MoU) was drawn up in 2005 between supervisors, central banks and finance ministries in what were then the 25 EU member states. It lays down basic structures for the exchange of information and cooperation on crisis management in cross-border banks, together with a foundation for extensive networks between the authorities. Agreements of this kind have become increasingly common and can take various forms: bilateral or multilateral, bank-specific or general, for one or several groups of authorities, and for supervision alone or together with crisis management. Besides the European MoU, the Riksbank has, for example, concluded MoUs with the other Nordic central banks, with the central banks in the Baltic states and with Sweden's financial supervisory authority (Finansinspektionen) and finance minstry.

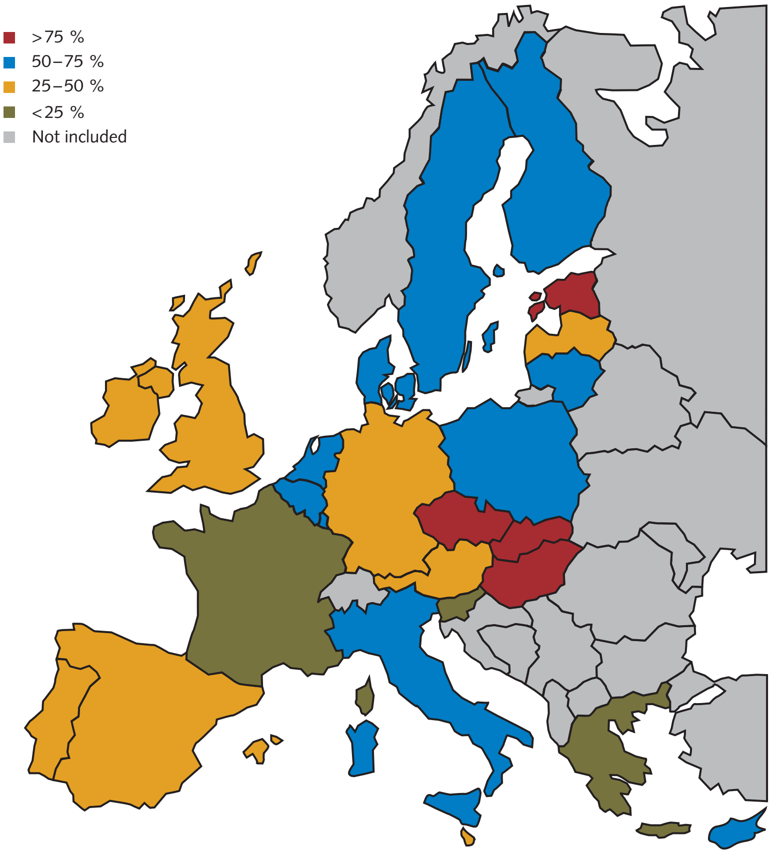
Along with these cooperation agreements, intensive efforts are being made to strengthen the cooperation on financial stability within the frameworks of the EU's Economic and Financial Committee (EFC) and the European Central Bank (ECB). One aspect of this work is to arrive at criteria for joint assessments of potential crises and mechanisms for managing the sharing of burdens arising from a crisis.

However, there are numerous complications to the management of a crisis in a sizeable cross-border bank and many issues and challenges still remain to be solved before authorities with responsibility for financial stability can rest assured.

The degree of integration in the bank sector is presented as the sum of inward and outward integration in Figure 1 (see also Chart 1). The two indicators are admittedly not fully comparable and there are methodological weakness in combining them. But a simple summation can provide a rough indication of the extent to which countries are likely to be affected by the home/host problem. The degree of integration is highest in the countries shown in red and lowest in those shown in green.[111]

111 See e.g. "The financial infrastructure – aspects of the framework for banks in the EU" in Financial Stability Report 2005:2, Sveriges Riksbank, pp. 51–68.

Figure 1. The degree of cross-border integration in the EU25 bank sector at end 2005



Note. The degree of integration is represented by the sum of outward and inward integration, where outward integration is the share of the country's bank groups' assets that is located in other EU countries and inward integration is the share of a country's domestic bank market that is held by foreign banks (including banks from non-EU countries)

Sources: ECB and the Riksbank

Country approaches to foreign-owned banks

A good many non-EU countries with a bank sector that has a high level of foreign ownership have rules that make it easier to handle foreign-owned institutions.

New Zealand

New Zealand, where the bank sector is mainly under foreign ownership, has tackled the problem by prohibiting foreign bank branches in principle. The requirement that every systemically important bank has to be registered as a New Zealand company is intended to result in legal entities that are more manageable than a foreign branch would be. Insisting on a subsidiary structure means that in the event of a crisis, a bank's assets and liabilities can be controlled more quickly and with greater legal certainty. Moreover, given that the subsidiary has a local board, the company is more likely to be run in line with the national interest. It would also be easier to wind-up the operations in New Zealand. At present, all but one of the systemically important banks are registered as New Zealand companies. New Zealand also considers it important that certain banking functions are undertaken inside the country so that they come under the national supervision. To this end, certain restrictions have been imposed on outsourcing.

Canada

Canada used to have a similar ban on branches. In 1999, however, the law was amended to admit foreign bank branches, albeit with substantial restrictions. Above all, branches of foreign banks are not allowed to accept deposits from the general public and may do so from other financial institutions only for a minimum amount of CAD 150,000.

A basic condition for operating a deposit branch is that the bank's global assets total at least CAD 5 billion. This does not apply to branches that do not accept deposits. In any event, a foreign bank has to be under the consolidated supervision of its home country, in accordance with international practice, in a way that is approved by the supervisory authority.

For branches, as for subsidiaries, there is a capital requirement in the form of a deposit. A branch that accepts deposits from financial institutions is required to maintain the equivalent of at least five per cent of its commitments (minimum CAD 10 million) as a deposit in an institution approved by the supervisor. For branches whose operations are confined to lending, the required deposit is CAD 100,000. The supervisor may stipulate that the assets stay in Canada as cover for the branch's commitments.

Conclusions

Experience shows that foreign entries to bank markets are mainly positive for the host country. For the Swedish bank market, the effects of an increased foreign presence would probably not be dramatic. All else equal, the stability of the Swedish financial system would most likely be strengthened. Competition also benefits from an open attitude to foreign entry.

Increased cross-border banking does, however, raise questions to do with the organisation of supervision and crisis management. Above all, the home/host problem has to be handled. But creating barriers to and restrictions on foreign branches, as has been done in some countries, should not be an alternative for Sweden or Europe.

A more integrated market for financial services can substantially enhance efficiency and thereby contribute to higher economic growth in Europe. That has been the main driving force behind the intensive efforts in recent years to harmonise financial regulations in the EU. It is also an important argument for refraining from protectionist solutions to the problems that arise. If many countries were to adopt solutions that entail obstacles to continued integration, economic development in Europe would be endangered. At the same time, problems created by the increased integration must not be ignored. In order to promote financial stability in Europe, cooperation between national authorities must therefore be further developed and intensified.

For Sweden it would, moreover, be natural to promote a symmetric approach to Swedish and foreign banks. In other words, foreign banks in Sweden should be treated in the same way as we wish Swedish banks to be treated abroad.

References

Allen, F. & D. Gale (2000). *Comparing Financial Systems.* MIT Press, Cambridge and London.

Allen, F. & D. Gale (2004). “Competition and Financial Stability”. *Journal of Money, Credit and Banking,* Vol. 36, No. 3, June 2004.

Baumol, W.J., J.C. Panzar & R.D. Willig (1982). *Contestable Markets and the Theory of Industry Structure.* Harcourt Brace Javanovich, San Diego, CA, USA, 1982.

Beck, T., A. Demirgüç-Kunt & R. Levine (2005): “Bank Concentration and Fragility: Impact and Mechanics”, *NBER Working Paper No. 11500*, July 2005

Bhattacharaya, J. (1993). “The Role of Foreign Banks in Developing Countries: a Survey of Evidence.” Cornell University, mimeo.

Bikker, J.A. & J.W.B. Bos (2006). “Recent developments in efficiency and performance of European banks”. In Heikkinen & Korhonen (Eds.): *Technology-Driven Efficiencies in Financial Markets.* Bank of Finland Expository studies, A:110-2006.

Besanko, D.A. & A.V. Thakor (1992). “Banking Deregulation: Allocational Consequences of Relaxing Entry Barriers”. *Journal of Banking and Finance* 16, 909-932.

Bonin, J.P. & I. Abel (2000). ”Retail Banking in Hungary: A Foreign Affair?”. *William Davidson Institute Working Paper No. 356,* December 2000.

Bonin, J.P. & P. Wachtel, (2003). “Financial Sector Development in Transition Economies: Lessons from the First Decade”. In *Financial Markets, Institutions and Instruments 12(1),* NY University Salomon Center, Blackwell Publishing Inc.

Boot, A. W. & S. Geenbaum (1993) “Bank regulation, reputation and rents: Theory and policy implications”, in Mayer & Vives (Eds.): *Capital Markets and Financial Intermediation.* Cambridge University Press, Cambridge, U.K.

Boyd, J.H. & G. De Nicoló (2005). “The Theory of Bank Risk-Taking and Competition Revisited”. *Journal of Finance,* Vol. LX, No. 3, June 2005.

Boyd, J.H., G. De Nicoló, & A.M. Jalal (2006). "Bank Risk-Taking and Competition Revisited: New Theory and New Evidence". *IMF Working Paper 06/297.* IMF, December 2006.

Carbó-Valverde, S., D. Humphrey, J. Maudos & P. Molyneux (2006). "Cross-Country Comparisons of Competition and Pricing Power in European Banking". *Proceedings from The 42nd Annual Conference on Bank Structure and Competition,* Federal Reserve Bank of Chicago, May 2006.

Cárdenas, J., J.P. Graf, & P. O'Dogherty, 2003. "Foreign Banks' Entry in Emerging Market Economies: A Host Country Perspective". *Working paper prepared for CGFS Working Group on Foreign Direct Investment.* BIS, 2003.

Claessens S. & L. Laeven (2004). "What Drives Bank Competition? Some International Evidence". *Journal of Money, Credit and Banking,* 36, 563-584.

Claessens, S. & L. Laeven (2005). "Financial Dependence, Banking Sector Competition, and Economic Growth". *World Bank Policy Research Working Paper 3481,* World Bank, January 2005

Claessens, S., A. Demirgüç-Kunt & H. Huizinga, 2001. "How Does Foreign Entry Affect Domestic Banking Markets?" *Journal of Banking and Finance,* 25(5), 891–911.

De Nicoló, G., P. Bartolomew, J. Zaman & M. Zephirin (2004). "Bank Consolidation, Internationalization, and Conglomeration: Trends and Implications for Financial Risk". *Financial Markets, Institutions & Instruments,* V 13, No 4. New York University Salomon Center, Blackwell Publishing Inc., November 2004.

De Nicoló, G. & A. Tieman (2006). "Economic Integration and Financial Stability: A European Perspective".*IMF Working Paper 06/296.* IMF, December 2006.

Detragiache, E., T. Tressel, & P. Gupta (2006). "Foreign Banks in Poor Countries: Theory and Evidence". *IMF Working Paper 06/18.* IMF, January 2006.

EU Banking Structures (year 2005). Banking Supervision Committee, European Central Bank, 28 September 2006.

Financial Globalisation, BIS Papers No 32, BIS, December 2006.

Foreign Direct Investment in the Financial Sector – Experiences in Asia, Central and Eastern Europe and Latin America, CGFS Papers No 25, BIS, June 2006

Giannetti, M. & S. Ongena (2005). "Financial Integration and Entrepreneurial Activity: Evidence from Foreign Bank Entry in Emerging Markets". *CEPR Discussion Paper No. 5151.*

Jensen, M. & R. Ruback (1983). "The Market for Corporate Control: The Scientific Evidence". *Journal of Financial Economics 11,* 5-50, April 1983.

Levine, R. (1996). "Foreign Banks, Financial Development and Economic Growth" in Claude, E.B. (Ed.): *International Financial Markets,* AEI Press, Washington DC.

Levine, R. (1997). "Financial Development and Economic Growth: Views and Agenda". *Journal of Economic Literature,* 33, 688-726.

Levine, R. (2001). "International Financial Liberalization and Economic Growth". *Review of International Economics,* 9(4), 688-726.

Levine, R. (2003). "Denying Foreign Bank Entry: Implications for Bank Interest Margins". *Central Bank of Chile, Working Paper No. 222.*

Montgomery, (2003). "Future Role of Foreign Banks in Asia". *Research Policy Brief,* 6, 10 pp.

Rajan, R. G. & L. Zingales. (1998) "Financial Dependence and Growth". *American Economic Review,* 88, 537-558.

Rajan, R. G. & L. Zingales (2003). "The Great Reversals: The Politics of Financial Development in the 20th Century". *Journal of Financial Economics 69,* 5-50.

Schaeck, K., M. Cihák, & S. Wolfe (2006). "Are More Competitive Banking Systems More Stable?". *IMF Working Paper 06/143.* IMF, June 2006.

Uiboupin, J. (2005). "Short-Term Effects of Foreign Bank Entry on Bank Performance in Selected CEE Countries". *Working Papers of Eesti Pank, No 4, 2005.*