

The Implications of European Retail Banking Integration on Small and Medium-Sized Enterprises Financing. An Overview

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Abstract

Considering the last few years, the European Union (EU) has become one of the most competitive and integrated economic regions of the world, following a rapid pace of change as a result of an inspired series of initiatives. The harmonization of the banking and other financial services legislation as component of the EU' Single Market, the creation of the European Economic and Monetary Union (EMU), alongside the ongoing implementation of the Financial Services Action Plan (FSAP) represent the central drivers of financial integration and the set of elements that have helped reducing the barriers to cross-border trade in banking services. The process of deregulation is another element that facilitated the environment in which technology and other bank strategic determinants have become increasingly important. The scope of the present paper is to analyze the implications of a higher degree of banking integration on firms financing options and choices. This paper is composed of two main parts. The first part focuses to the determinants of European banking integration, analyzing this process since the banking system represents the main financial channel for both the small and medium-sized enterprises and households. The second part concentrates on the effects of banking integration on considered entities' financial constraints. The concluding remarks outline that retail bank integration has an ambiguous implication on SMEs' access to credit.

Keywords: retail banking integration, SMEs, firms' financing, financial constraints, deregulation.

JEL Classifications: G21, G32.

1. Introduction

The banking industry has to play a vital role in any economy, above all as a facilitator of activity in other sectors. Its health and efficiency provide a foundation for economic growth and social welfare. Over the past decade, the European Union has made a step towards integrating its financial and banking markets, helping them to better serve the enlarged economic area, and improving their competitiveness at home and abroad. This process has been shaped by the European Single Market legislation, and, also, by a gradual restructuring and strategic re-positioning by the industry and by the powerful stimulus of globalization. However, progress was abruptly halted in mid-2007, when the financial industry found itself in the midst of a profound global crisis.

The paper is structured as follows: section 2 provides a literature review on the theory and empirical evidence of European retail banking integration, alongside an overview regarding the European Monetary Union impact on this process; section 3 investigates the relationship between the banking integration and the financing of small and medium-sized enterprises, in terms of financial constraints, opportunities, and choices. Section 4 concludes.

2. Overview of European banking integration: evolution and perspectives

2.1. Literature review

European financial convergence is one of the main goals of European supranational organizations. Rightly so, both economic theory and empirical findings suggest that the integration of financial markets contributes to the smooth functioning of the single monetary policy and to financial stability and economic growth (e.g., Gaspar et al. 2003, Guiso et al. 2004, ECB 2007)

The European Central Bank defines financial integration as "*The market for a given set of financial instruments or services to be fully integrated when all potential market participants in such a market (i) are subject to a single set of rules when they decide to deal with those financial instruments or services, (ii) have equal access to this set of financial instruments or services, and (iii) are treated equally when they operate in the market*" (Baele et al., 2004, p.6). European financial and banking integration can then be viewed as a process converging into a single market for financial-banking products and services, where all buyers and sellers within the Union have opportunities to transact in the most favorable terms. This process stimulated a huge amount of literature monitoring the convergence of European financial markets.

Despite a sustained legislative drive at EU level towards the integration and harmonization of financial markets, and despite evidence that money, bond and equity markets are highly integrated (Emiris, 2002; Hartmann et al. 2003, Baele et al. 2004, Manna, 2004, Guiso et al. 2004, Capiello et al. 2006), most analysts would accept that significant barriers to the integration of banking markets still exist. Barriers may arise from domestic economic conditions, culture, languages, and differences in fiscal and legal systems (Berger et al. 2001; Buch and Heinrich, 2002; Berger et al. 2004). According to Freixas (2003) and ECB (2004), European Union banking systems are inherently heterogeneous due to the historical differences in market structures, bank supervision and regulation and legal traditions, while anecdotal evidence suggests that there are considerable difficulties in reducing heterogeneity or integrating markets via financial deregulation.

Several analysts remark that the process of integration has advanced further in wholesale than in retail banking (Cabral et al., 2002; Heinemann and Jopp, 2002; Eppendorfer et al. 2002; Schuler and Heinemann, 2002). Factors that contribute to the segmentation of the

European retail banking market have been alternatively called borders (or barriers) and include issues of consumer trust and confidence, causing depositors to prefer local or national banks to foreign banks; a local bank's access to private information about a borrower's creditworthiness, which creates a rent that is unavailable to competing foreign banks and bundling of financial services, enabling banks to charge different prices for each component of the bundle in different markets (Barros et al., 2005). A distinction is often drawn between barriers due to asymmetric information (linguistic differences, lending relationship) and those due to legal and regulatory provisions. However, the concept of barriers remains a comprehensive one, and the jury is still out on which factors are prominent in hampering retail banking market integration in Europe. Financial services providers and consumers continue to be primarily focused on national domestic markets which show significant differences in terms of prices, range of products, and distribution channels.

Others (ECB 1999, De Bandt and Davis 2000, Artis et al. 2000, Buch and Heinrich 2002) found no signs of an increase in the presence of foreign banks in individual EU retail banking markets. Gual (2004) points out that some integration of banking markets has taken place, albeit at different paces depending on the market segment, and that integration was far from complete in retail markets. Cross-border M&As were relatively scarce (e.g., Boot 1999, De Bandt and Davis 2000, Belaisch et al. 2001, Walkner and Raes 2005). More recently, Dermine (2006) signaled that European banking integration is gaining momentum, in terms of cross-border flows, market share of foreign banks in several domestic markets, and cross-border M&As of significant size. Likewise, using cluster analysis to assess the extent of banking sector integration within the euro-zone between 1998 and 2004, Sørensen and Gutierrez (2006) conclude that the introduction of the Euro has increased the degree of homogeneity across countries.

European banking integration is of particular importance as it could positively contribute to economic growth by removing frictions and barriers to exchange, and by allocating capital more efficiently (Baele et al. 2004, p.12), while, on the other hand, it could mitigate negative effects derived from systemic risk (Goddard et al. 2007, p.5). European integration has also implication regarding the competition in banking markets, the nature of long-term borrower-lender relationships, and the links between ownership structure, technological change and bank efficiency.

Existing literature suggests that the increase in bank integration through cross-border acquisitions is associated with enhanced bank efficiency (Jayaratne and Strahan, 1998, p.240), improved inter-state income insurance (Demyanyk, Ostergaard and Sorensen, 2007, p.2765) and less state-level business cycle volatility (Morgan, Rime and Strahan, 2004, p.1557). However, these studies do not consider the impact of banking integration on individual firms. In theory, a more efficient and integrated retail banking could improve the allocation of financial resources to innovative and growing SMEs.

The literature has also addressed the negative consequences of European banking integration. The main concern is that bank consolidation through acquisitions may terminate established banking relationships between borrowers and lenders. Berger and Udell (1996)

show that an increase in average bank size in a specific market due to consolidation has the effect of decreasing bank lending to small business. Peek and Rosengren (1998) expand on this idea and find that after a merger, acquired banks adopt the leading patterns of the acquirer.

If the acquiring bank has a bias for large-firm lending, the target will adopt the same strategy. The international evidence shows a similar pattern of negative outcomes after banking consolidation. Karcesky, Ongena and Smith (2005) use a sample of Norwegian publicly-traded firms to study the effect of bank mergers and acquisitions (M&A) on their borrowers' stock prices. The authors find that small borrowers are the most affected after mergers and are also the least likely to switch to other banks for their credit requirements. In a detailed study of Italian firms, Bonaccorsi, Di Patti and Gobbi (2007) show a decrease in the amount that firms borrow from banks involved in a merge as a bidder or a target.

Overall, the evidence so far reports a fragmented retail market for consumer credit and some convergence in the corporate lending sector. Limited institutional convergence in European banking and the importance of national characteristics still play a major role.

2.2. Measuring European retail banking integration

The wholesale banking sector has been studied extensively but the retail market to a much lesser extent. The difficulty in analyzing the integration process in the banking market is linked to the heterogeneity that exists across the European countries with regards to factors such as risk attitudes, cultural differences, and the home-bias criteria.

The European Central Bank' definition has direct implications for how retail banking integration should be measured. So, previous research assesses the degree of integration using a set of three types of indicators: quantity-based, price-based and news-based measures of integration.

Quantitative measures of integration focus on the channels of integration and employ empirical proxies such as the number of cross-border M&A, number of foreign owned banks, number of foreign branches, market share of foreign banks in loan and deposits, or the share of foreign loans and deposits on bank's balance sheet. Most recently, however, some quantity-based indicators such as cross-border M&As reveal that banking market integration is gaining momentum - prompting some observers to conclude that the single European banking market is finally arriving. Very recently, however, cross-border M&As have been gaining momentum. The Dutch ING Bank bought German and Belgian banks, German HypoVereinsbank first acquired Austrian and CEE banks and has subsequently been bought by the Italian UniCredito, the Spanish Santander took over the British Abbey National, Dutch ABN-Amro succeeded in buying Italian Antonveneta, and most recently French BNP-Paribas bid for the Italian Banco Nazionale del Lavoro, and finally Nordea Bank AB's merger with four Scandinavian banks. What makes this last case so interesting from a market integration point of view is that Nordea established a single corporate structure using the status of a European Company, a.k.a *Societas Europaea*. While this clearly is a large step forward it also raises a number of regulatory issues with

respect to supervision and deposit insurance.

Likewise, cross-border banking has been increasing rapidly, albeit starting from a very low base. Inside the euro zone cross-border loans have more than doubled from € 152 billion in 1999 to € 361 in 2008 (Heuchemer, Kleimer and Sander, 2008, p.3). Some look at the extent of cross-border direct retail operations of banks (Gual, (2004), Perez et al. (2005), Kohler (2009)). The absence of such deals, say in comparison to the number of domestic bank mergers, has also been taken as evidence against retail banking integration. In sum, the evidence point to a still fragmented European banking system, but also indicates that the integration process is slowly gaining momentum.

In contrast, **price-based analyses**, which are motivated by the law-of-one-price (LOOP), paint a picture of advanced convergence. Price-based measures have been advocated for a variety of reason, but particularly because these data are readily and more easily available and are typically more accurate than quantity-based measures. They also allow for a more straightforward interpretation and may be better able to reveal long-term trends. LOOP is the benchmark for studies on European banking integration that focus on interest rate convergence after the euro (Quiros and Mendzibal (2001), Fernandez de Guevara et al. (2003), Baele et al. (2004)). For integrated European retail banking markets, the law of one price implies that the prices for retail banking products - such as interest rates on loans or deposits - should be equal across countries. Less interest rate dispersion among countries together with convergence towards the lowest prevailing interest rate in loans and the highest in deposits will confirms that the euro stimulates banking integration and increases social welfare.

In respect to this, assuming the Cournot type of competition, the equilibrium profit maximizing interest rate of deposits in market "i", will be equal to:

$$R_{di} = R * \frac{n_i \varepsilon_{di}}{n_i \varepsilon_{di} + 1} \quad (1), \text{ where:}$$

R_{di} represents the equilibrium interest rate in deposits in country i ;
 n_i reflects the number of banks in the market;

ε_{di} is the supply elasticity of deposits;

R is the inter-bank interest rate, the same in all euro countries after the introduction of the single currency (we assume 0 marginal operating costs).

The standard deviation of R_{di} can be used as a measure of interest rates dispersion. However, the applicability of the law-of-one-price in retail banking markets is questionable and the convergence results are largely driven by wholesale market integration.

Another method for detecting integration comes from Adam et al.'s (2002) study of retail interest rates. They analyzed the 5 year corporate loans and mortgage loans and found that lending rates barely converge after 1999. In a partial adjustment model the speed of convergence is only 2% per year for corporate rates and 7% for mortgage rates. Based on this slow rate on convergence, they conclude that retail banking markets are far from integrated and do not seem to be on a path towards integration.

The European Commission's annual Financial Integration Report (2009a) offers extensive descriptive information, such as the cross-country standard deviation of interest rates on various bank products to argue that retail bank markets are not integrated. Affinito and Farabullini (2009) show that interest rate dispersion is reduced after controlling for variables reflecting the characteristics of domestic borrowers, such as risk exposure, disposable income, firm size, etc. They also demonstrate that price dispersion is larger across the euro area than across regions in Italy.

For a more formal statistical test, two measures of convergence have been suggested: σ - and β -convergence. σ -convergence measures whether or not interest rates have become more similar over time when compared to each other or to a benchmark rate. In contrast, β -convergence measures the speed with which national interest rates converge. This latter measure has been borrowed from the economic growth literature. Better suited alternatives are analyses employing cointegration methodologies, convergence analyses of interest rate margins, and *news-based measures* of integration which investigate the degree of heterogeneity of the response of retail banking prices to common shocks.

Overall, it has thus been concluded that price-based studies looking at interest rates typically find some evidence for integration. This finding is, however, difficult to reconcile with the obtained quantity-based picture, which signals a lack of integration.

Pass-through studies, which employ *new-based measures* of integration, are increasingly regarded important for assessing the degree of financial integration in the euro zone retail banking market. The idea underlying this thought is as follows: Rather than cross-border arbitrage, a smooth pass-through of monetary policy rate changes onto lending rates in all EMU member-countries can eventually lead to *tying together* of interest rates and *produce* the statistical artefact of evidence for or against (co-)integration.

Wagenvoort et al. (2009) have introduced an additional convergence measure (other than σ convergence and β convergence) to reassess whether retail bank market integration is absent, ongoing, or complete. They point out the concept of **factor convergence** by applying factor analysis in order to decompose the loan rates in a number of latent factors where each factor is multiplied by country-specific factor sensitivities, so-called **factor loadings**. Factor convergence is considered complete when factor loadings are the same for all countries (strong factor convergence). Factor convergence is absent when some factor loadings (of a significant factor) display insignificant values or of different sign. In their approach, factor convergence captures the synchronization of interest rate movements but ignores time-invariant differences in the absolute levels.

Most researchers and practitioners agree that banking markets are still least integrated, regardless whether they base their assessment on quantity-based indicators such as cross-border loans and mergers and acquisitions, price-based indicators such as interest rate convergence or new-based indicators such as reaction of the banking market to common shocks.

2.3. The impact of European Monetary Union

In spite of the common currency' introduction and the liberalization and harmonization of the regulatory side of the financial services industry as a natural consequence of two banking directives and the FSAP, the overall pictures reveals that retail banking is however, a "national business".

The establishment of the European Monetary Union has led to some convergence in the levels of retail loan and deposit interest rates in the euro area, through significant differences still exist, suggesting that market segmentation remains strong thus impending banking integration (Cabral et al. 2002, Sorensen and Gutierrez, 2006). The value of cross-border retail lending represents less than one percent of the total lending (Gropp and Kashyap, 2009, p.12). This figure indicating strong national segmentation justifies the use of domestic lending rates to evaluate whether or not the cost of corporate debt financing converge across the euro area.

Figure 1 shows the cross-sectional standard deviation in interest rates to small business and households over 2002-2007, with the spreads showing relatively little convergence.

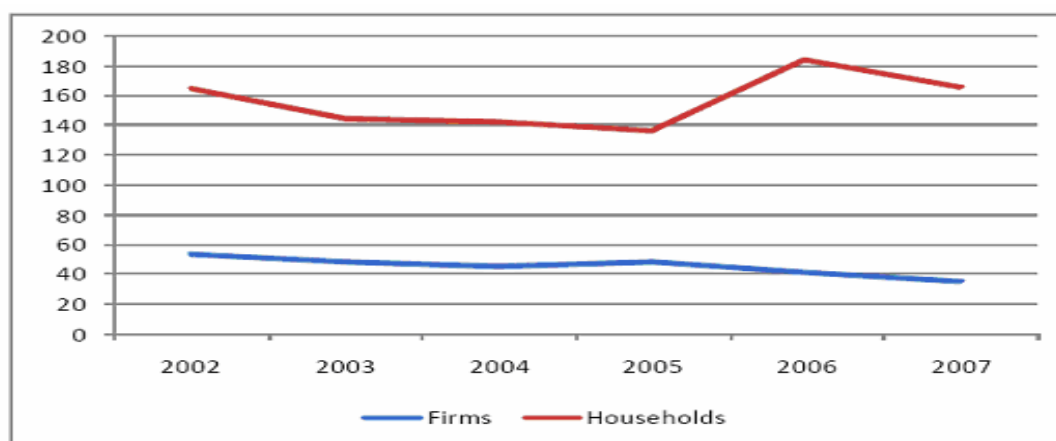


Figure 1: Cross-country dispersion in lending rates in the period 2003-2007

Source: Data from ECB Statistical DataWarehouse, 2008.

At one level, this fragmentation is not surprising, in view of the importance of local information in assessing small-business and consumer loans and differences in national legal systems in the enforcement of repayment and foreclosure procedures. In relation to retail payments, ongoing high charges for cross-border payments have limited the tangible benefits of a single currency for bank customers. However, the 2008 launch of the Single Euro Payments Area (SEPA) should help in providing a low-cost unified payments system that does not discriminate between intra-national and cross-national payments within the euro area. Today, retail payments are still small, although there is a bit of evidence of an increase in cross-border retail activity in the vicinity of some borders.

There is considerable evidence that following the introduction of the euro money markets have become integrated, which should have equalized the costs of funds across countries. Combined with the elimination of exchange rate volatility this should facilitate the comparability of rates of returns of banks in different countries. The under-or over-performance of a bank, therefore, can be easily compared and evaluated. In addition deeper equity and bond markets permit easier financing of large scale transactions (ECB, 2008, p.23). Hence, the euro has improved the corporate governance of listed banks in the euro area. Martynova and Renneboog (2006) find that non-financial cross-border corporate takeovers did increase in the euro area more strongly than domestic takeovers since 1998. Ekkayokkaya et al. (2007) present results that are consistent with increased cross-border competition among bidders for banks in the post euro-era.

Considering the impact of the euro on retail finance, much remains to be done in terms of promoting integration at the retail banking level. However, the launch of the Single Euro Payments Area (SEPA) in 2008 marks an important milestone in eliminating the distinction between domestic and cross-border electronic payments across the euro area. Further progress in the integration of securities settlements systems is also desirable and a major target for European policymakers. In large part, the barriers to integration in these areas are not technical but reflect political efforts by incumbents to preserve monopoly power in their home markets.

3. The Lack of Capital - a Barrier to Growth for SMEs

In the financial literature, the term "Small and medium-sized enterprise" (SME) is defined differently from one country to another and between financial institutions. The European Union defines SMEs as companies with less than 250 employees and with a turnover smaller than 50 million euro.

The importance of SMEs for the economy is well recognized in the literature. SMEs represent an important source of job creation, economic growth, entrepreneurship and innovation, competitiveness, dynamism and flexibility in advanced industrialized countries, as well as in emerging and developing economies.

SMEs represent the dominant form of business organization, accounting for over 95% and up to 99% of enterprises depending on the country (OECD, 2006, p. 1). In the European Union, nearly 99% of the companies are SMEs, while 90% of them are micro enterprises. At the same time, the SMEs account for approximately 67% of the overall employment in the European Union. In economic terms, SMEs generate around 60% of the value added to the European economy.

Usually, SMEs start out as an idea from one or two people, who invest their own money and other people's money (OPM) - friends and families - in the business. In order to set up and later expand their operations, develop new products, and invest in staff or production facilities, the SMEs need financing. Comparing with larger firms, SMEs obtain harder financing from banks, capital markets or other suppliers of credit. OECD suggests that the "financing gap" is all the more important in a fast-changing knowledge-based economy because of the speed of innovation (OECD, 2006, p. 2).

Many studies found that SMEs are more financially constrained than large firms and the lack of access to (external) finance represents a barrier to SMEs growth (see Vos et al., 2007 and Beck et al., 2008). Financing constraints can be define as „the inability of a company to obtain a sufficient amount of financing to fund its investment needs at current, or even higher, interest rates” (Antão P. et al, 2007, p.35). As a response to these financial constraints, many governments initiated programs to foster SME financing including government subsidized lines of credit, public guarantee funds, (public) venture capital funds and other public SME support schemes.

Financial constraints can be measured with the help of surveys and econometric analysis. At European level, Enterprise & Industry Directorate General of the European Commission conducted a survey on SME finance every second year. According to the latest Flash Eurobarometer on access to finance, about one-sixth of companies selected access to finance as their most pressing problem (European Commission, 2009, p.6), with important differences from one country to another. The financial constraint was more relevant for companies established between two and nine years ago (20%-21% vs. 12% in companies established less than two years ago and 14% in companies existing for 10 years or more) and for companies in the construction sector (20% vs. 14% in the services sector and 17% in trade and industry). However, most firms reported “finding customers” as the most pressing issue.

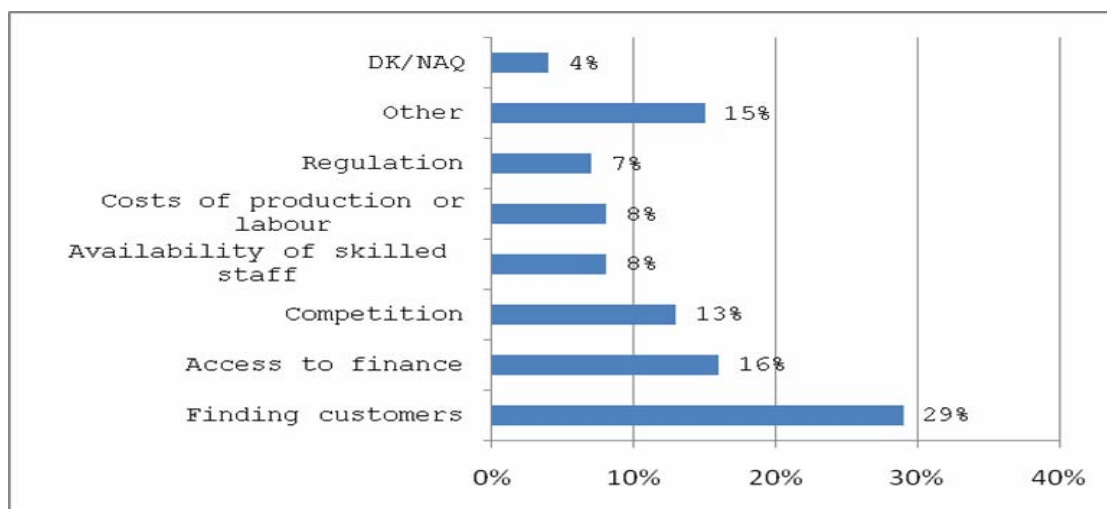


Figure 2: Companies' most pressing problem in 2009

Source: European Commission, 2009b, p.27

According to the latest Flash Eurobarometer on entrepreneurial mindset, 75% of the Europeans consider it difficult to start their own business due to a *lack of available financial support*. In this respect the situation in the new Member States has considerably improved reaching 77% in 2007 compared to 84% in 2004. The access to finance and complex administrative procedures still constitute major obstacles to establish a firm (European Commission, 2007). The main factors that limit SME financing are: an incomplete range of financial products and services, gaps in the legal framework, lack of collateral, information asymmetries, and bias against small firms.

SMEs pass different business development stages and in each of these stages they need other types of financing with different terms and conditions. All the SMEs face the same issue in their early stage development - how to find the money that enable them to start and build up the business. How a SME raises capital depends on a great deal on the size of the firm, its lifecycle stage, and its growth prospects (Ross S. et al., 2007, p. 448).

Internal financing, considered the most common source of SME financing, includes owner investment, funding through retained profits and/or the sale of assets.

External financing sources include bank loans, leasing and hire purchase, private equity or risk capital (venture capital, equity financing and mezzanine instruments), factoring and trade credit. In most countries, bank lending and hire and leasing are the largest source of external SME finance, with important differences within the European Union. An illustration of the financing structure of euro area SMEs in 2009 is shown in Figure 3. In these circumstances **the growth of the SMEs sector depends on large extent on the access to bank credit.**

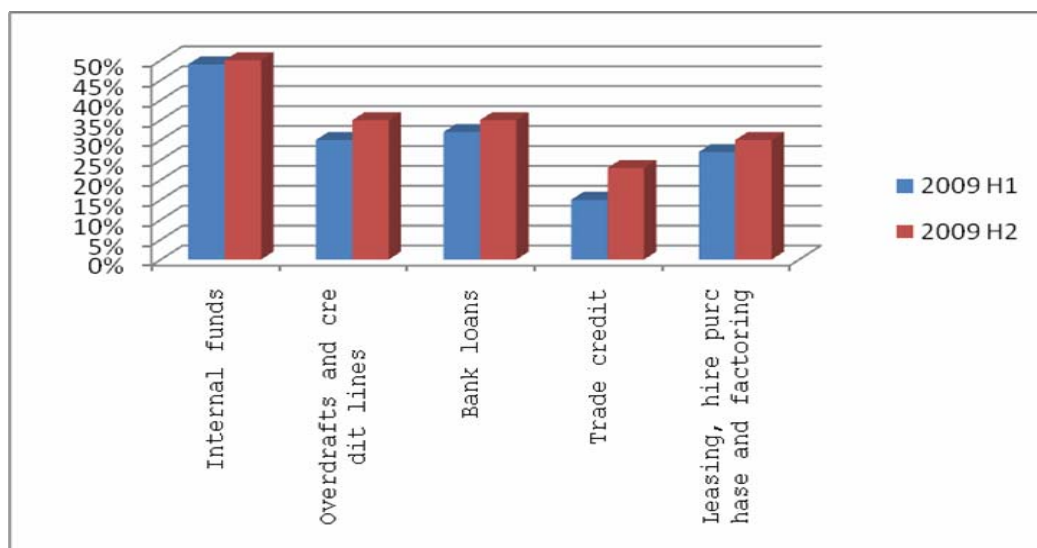


Figure 3: Financing structure of euro area SMEs in 2009 (over the preceding six months, percentage of respondents)

Source: ECB, 2010.

In the OECD countries, which have competitive financial markets, SMEs are more likely to obtain bank loans because the banks consider SME finance as an attractive line of business. However, in many countries there is a financing problem in the case of a subset of SME, namely innovative SMEs. These SMEs implies a higher risk to banks and the risk assesment is different from traditional SME or large companies because innovative SMEs are usually newcomers to the market, seek financing for a new type of product or service, and have negative cash flows or untried business.

OECD research suggests that the overall SME financing gap is important in non-OECD countries. Even though SMEs are important for these economies, their access to bank loans is still limited. The commercial

banks do not provide finance to a viable SME because of:

- lack of sufficient collateral and track record in the case of start-ups, very young firms, micro and small enterprises;
- poor business performance and insufficient information for medium-sized firms.

No matter of size classes, SMEs show a far more volatile pattern of growth and earnings, with greater fluctuations, than larger companies. At the same time, their survival rate is lower than for larger companies. For these reasons, banks are reluctant to finance SMEs relative to larger and more established firms. The banks are generally not interested in making loans to start-up companies with no assets (other than an idea) run by entrepreneurs with no track record.

In the same time, banks and other traditional sources of credit may consider that SMEs are risky than larger companies, and respond by asking for higher interest rates. In these conditions it is difficult for SMEs to borrow from banks than for bigger companies.

The conventional view in academic and policymakers circles states that large and foreign banks are generally not interested in serving SMEs, while small and niche banks have a comparative advantage because they can mitigate SME opaqueness through relationship lending.

In many European countries, banks are considering SMEs as a core and strategic business segment. News studies found that most banks (including large and foreign banks, not only small and niche banks) are interested in serving SMEs and consider this business segment profitable (de la Torre et al, 2010, p. 2). Moreover, because most of the SMEs rely on one single bank for all their transactions, banks have develop a wide-range of fee-based, non-lending products and financial services for SMEs.

As empirical and theoretical studies reported, the European retail banking integration is still very low. Across the euro area, there are important differences (almost 200 basis points even after adjusting rates for macroeconomic conditions such as systematic risk and inflation) in the average cost of bank loans, mostly for small loans with short rate fixation periods.

4. Conclusions

The European financial integration and its implications have attracted much attention in the last years, becoming an important topic for economists. However, there are relatively few papers that discuss the impact of European retail banking integration on the SMEs financing.

The financing of SMEs represents a topic of great relevance for firm growth and economic policy. The innovative SMEs are increasingly vital to economic development and job creation as the knowledge-based economy develops. Access to finance represents a necessary (but not a sufficient) condition for SMEs growth. For this reason, addressing the SMEs' financial gap represent a top priority for both industrialized and developing countries.

The current financial crisis has made the access to finance for SMEs even more critical. The related literature suggests that bank loans to

small firms can be severely affected during a downturn, such as the present global crisis. Empirical evidence suggests that banks consider the SME lending riskier due to the macroeconomic instability.

Because banks are by far the first source of finance of SMEs, the integration of retail banking could facilitate the access to finance for SMEs. According to the several surveys conducted by the European Commission and to the national surveys, some euro area SMEs may face financing constraints (i.e. have no access to finance despite having borrowing requirements), as perceived by firms, although not in all countries. However, the cost of external finance is higher for smaller than larger firms as a result of higher monitoring costs and problems in assessing firms' risk. European SMEs have not yet enjoy a level playing field in their debt financing costs and there are few sign of improvement in the next years. These financial constraints and the higher cost of debt may affect the SMEs investment and innovation activities, hence hampering their R&D and capital investments and their growth prospects.

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