Banking Integration, Bank Stability, and Regulation

Introduction to a Special Issue of the International Journal of Central Banking

The link between banking integration and financial stability has taken center stage in the wake of the current financial crisis. To what extent is the banking system in Europe integrated? What role has the introduction of the common currency played in this context? Are integrated banking markets more vulnerable to contagion and financial instability? Does the fragmented regulatory framework in Europe pose special problems in resolving bank failures? What policy reforms may become necessary? These questions are of considerable policy interest as evidenced by the extensive discussions surrounding the design and implementation of a new regulatory regime and by the increasing attention coming from academia.

This special issue presents five papers that attempt to address these questions from different angles. The papers were presented at the 2nd ZEW Conference on Bank Regulation—Integration and Financial Stability that took place on October 29–30, 2007, at the Centre for European Economic Research (ZEW) in Mannheim, Germany. The conference was organized by Claudia Buch (University of Tübingen), Reint Gropp (European Business School), and Michael Schroeder (ZEW).

In the lead-off paper Massimiliano Affinito and Fabio Farabullini take another look at one possible measure of banking integration: the law of one price. The paper highlights that for tests of the law to be meaningful, one has to carefully control for the characteristics of the bank products under investigation. The paper finds that banking markets continue to be segmented within Europe. The authors attempt to disentangle supply factors in the lack of integration (such as lack of contestability across borders) from demand differences across countries. Only if supply factors were the main reason for the observed violations of the law of one price would there be room for further policy initiatives to foster integration. The results suggest that supply factors continue to be important, although Affinito and Farabullini also find that products with a higher elasticity of demand exhibit less variation in rates across countries.

Matthias Köhler emphasizes national political resistance as an explanation for the relatively low number of cross-border bank mergers in Europe. There is ample anecdotal evidence that political influence may constitute a barrier to the integration of European banking markets, as suggested by numerous recent cases in, for example, Italy and France. Köhler constructs, based on a survey of supervisors in the EU, an index of the transparency of the process governing the approval process for cross-border bank mergers. He finds that the probability that a credit institution will be taken over by a foreign bank is significantly lower if the regulatory process is less transparent, controlling for a host of bank and country characteristics. Interestingly, particularly large banks seem to be less likely to be taken over by foreign credit institutions if merger control lacks procedural transparency, which lends further credence to his results.

Wolf Wagner analyzes from a theoretical viewpoint the question of financial integration and stability, with particular reference to the overall efficiency of bank portfolios from a welfare perspective. The paper emphasizes the role of regulation in a financial system in which the costs of financial stress at institutions are interdependent. The paper shows that there may be externalities arising from banks' portfolio choices. The assets a bank holds on its balance sheet determine not only its own default probability but the default probability of all other banks as well. As banks fail to take this externality sufficiently into account, the equilibrium portfolio allocations in the economy are typically not efficient. Wagner concludes that regulation should explicitly take the correlation of one bank's portfolio with all other banks into account.

The likelihood of cross-border bank contagion within Europe is analyzed in the paper by Reint Gropp, Marco Lo Duca, and Jukka Vesala. The paper employs a new method to estimate the effect of a large decline in the distance to default of banks in one country on the probability of large declines in the distance to default in other countries. The paper finds evidence of significant cross-border contagion among large European banks and no contagion among smaller European banks. This is consistent with a tiered cross-border interbank structure. The results also suggest that contagion increased after the introduction of the euro, suggesting some banking system integration within Europe at least at the level of large listed banks.

The final paper of the issue focuses on the difficulties arising from the particular institutional structure of bank supervision in the EU in the context of the potential recapitalization of a large cross-border bank. Starting from the notion that a recapitalization is efficient if the social benefits exceed the costs, Charles Goodhart and Dirk Schoenmaker argue that in a cross-border setting ex post negotiations on burden sharing lead to an underprovision of recapitalizations. Cross-border externalities of failing banks are not incorporated in the decision-making process. The authors then turn to ex ante burden-sharing mechanisms to overcome the coordination failure. Based on a calibration with data on large cross-border banks in Europe, the paper argues that a scheme relating the burden to the location of the assets of the bank to be recapitalized (specific burden sharing) may be able to overcome the coordination failure.

As a whole, the papers in this volume offer a useful and timely perspective on the interplay between institutional arrangements and financial sector stability. Much remains to be done on this important theme, but the papers in this volume will be a timely source of reference in the continuing research.

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