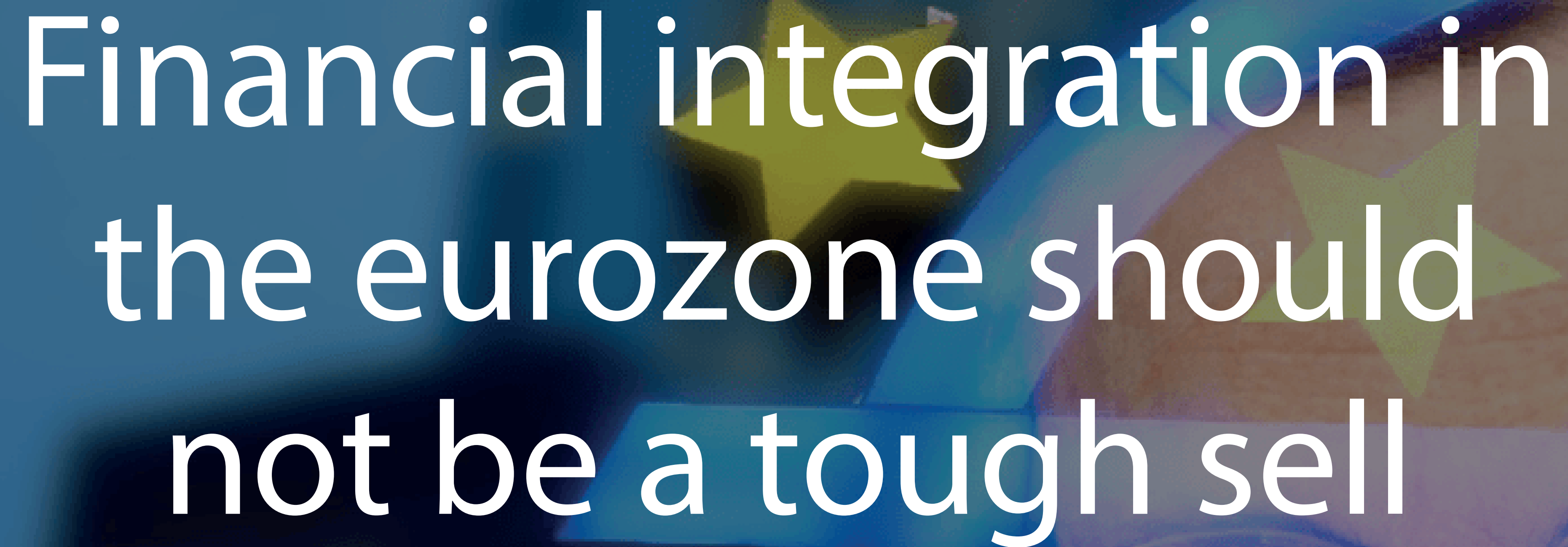
Financial integration in the eurozone should not be a tough sell



With Brexit on the horizon Teunis Brosens argues that the remaining member states need to accelerate the realisation of a true capital markets union

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Much progress has been made in recent years to improve the financial integration of the eurozone. This column argues that while banking union promotes stability, markets remain fragmented and consumers aren't yet fully enjoying the fruits of integration. With Brexit on the horizon, it is up to the remaining EU member states to foster competition and efficiency in financial services by completing the banking union, harmonising national regulation, and accelerating the realisation of a true capital markets union.

Much progress has been made in recent years to improve the financial integration of the eurozone. Banking union is the most important example. Increasing stability is an important objective. But let us not forget that an integrated financial market also helps European consumers and companies in a more direct way. A fully equipped banking union and a well-functioning capital markets union enable financial service providers and consumers to easily trade across borders. This fosters competition and innovation, and in the end, ensures better services at lower prices.

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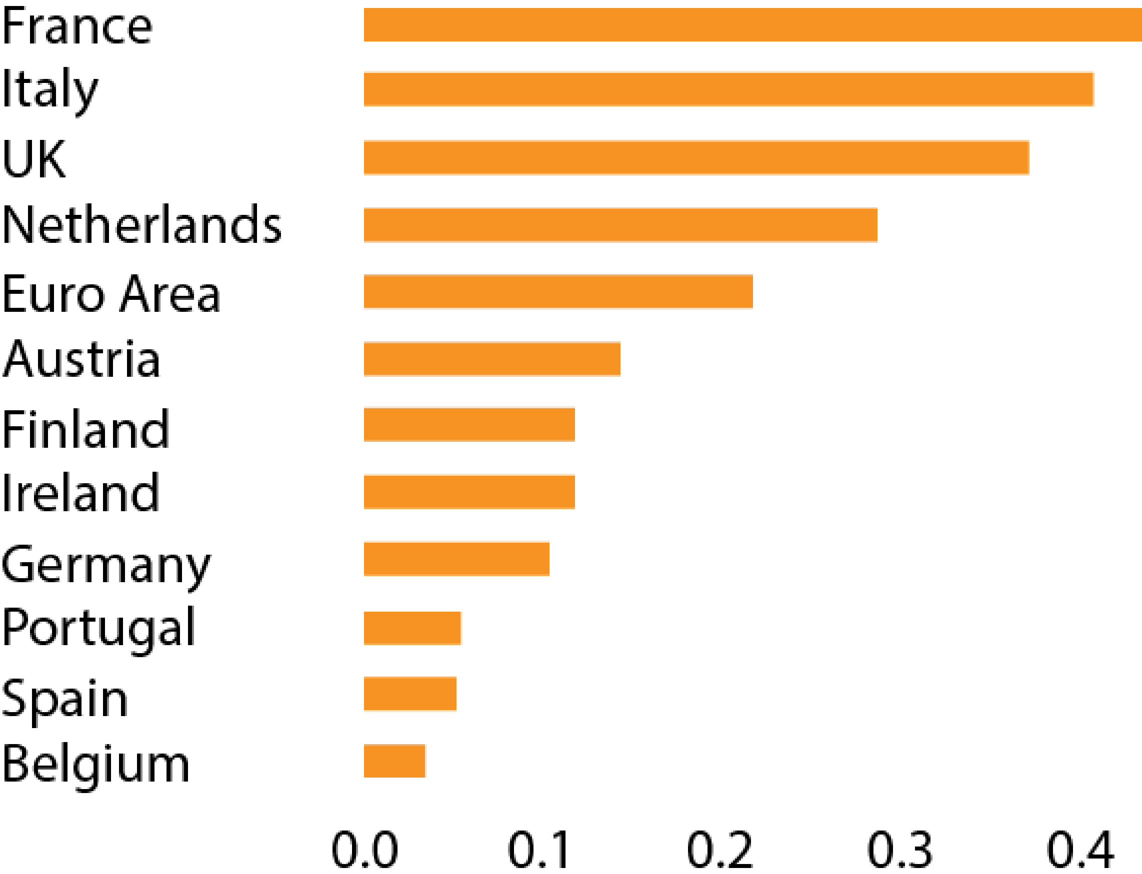
Low deposit rates everywhere, but real differences exist

A snapshot of eurozone financial services markets reveals that they are far from integrated. Deposit rates are the clearest indicator of fragmentation along national borders. Banks throughout the eurozone are reluctant to cut retail deposit rates below zero, wary of possible client reactions (Cliffe 2016). Yet differences within the currency zone are surprising. For example, the average rate on Belgian deposits has dropped to 0.03%. If Belgians took their money across the border, they could get almost ten times that in the Netherlands (0.28%). In France even, rates average 0.43%. Differences between other eurozone countries are also substantial, despite the low level of rates in general (Figure 1).

Why don't Europeans put their savings in a bank in another country? For starters, despite European regulation, opening a deposit abroad is cumbersome and sometimes even impossible. Savings accounts are often linked to payment accounts. Payment systems tend to be organised nationally (eg. 'iDEAL' in the Netherlands) and not every

Figure 1. Average bank deposit rates (%)



Source: ING calculations based on ECB and BoE data.

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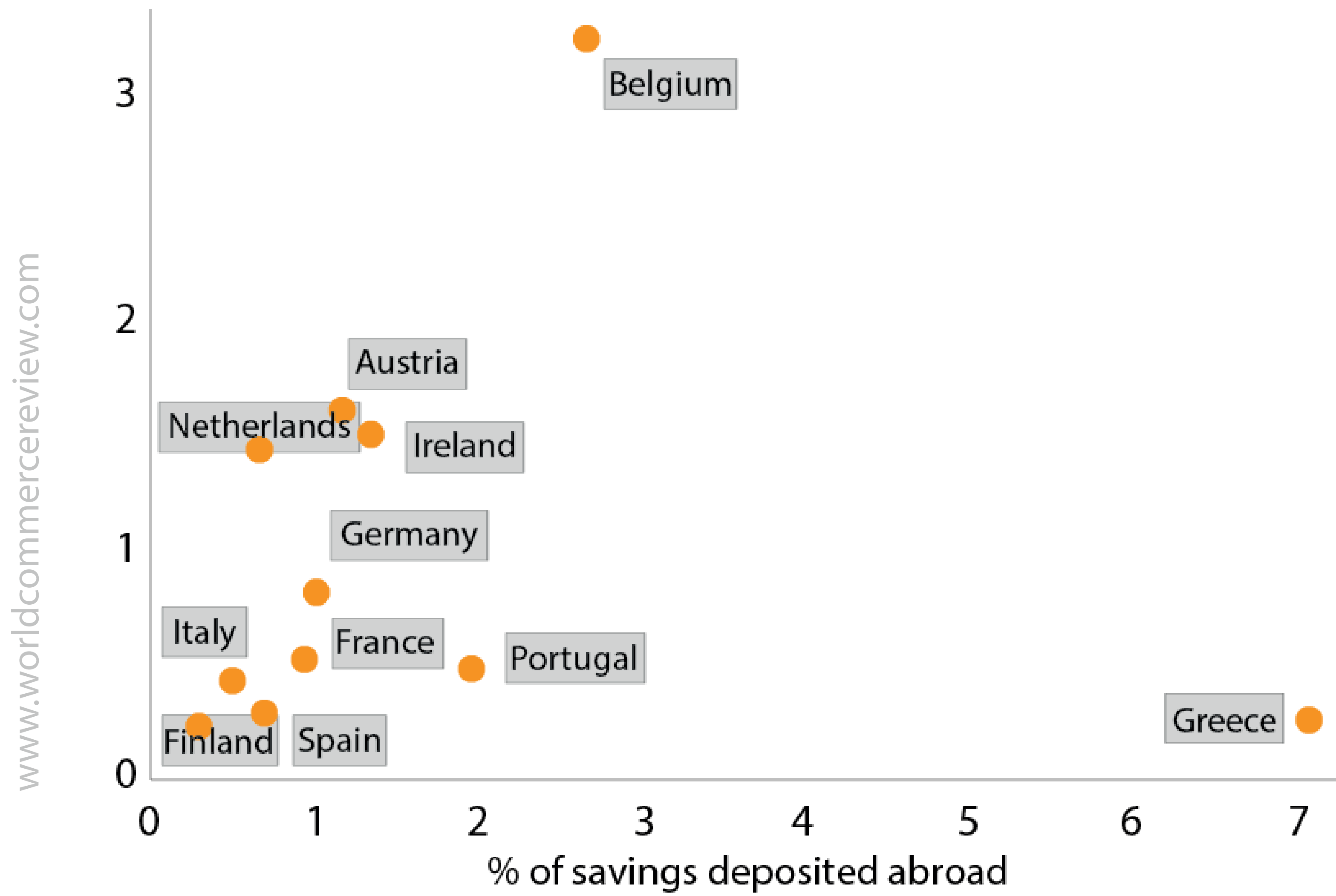
Figure 2. Percentage of households shopping across borders



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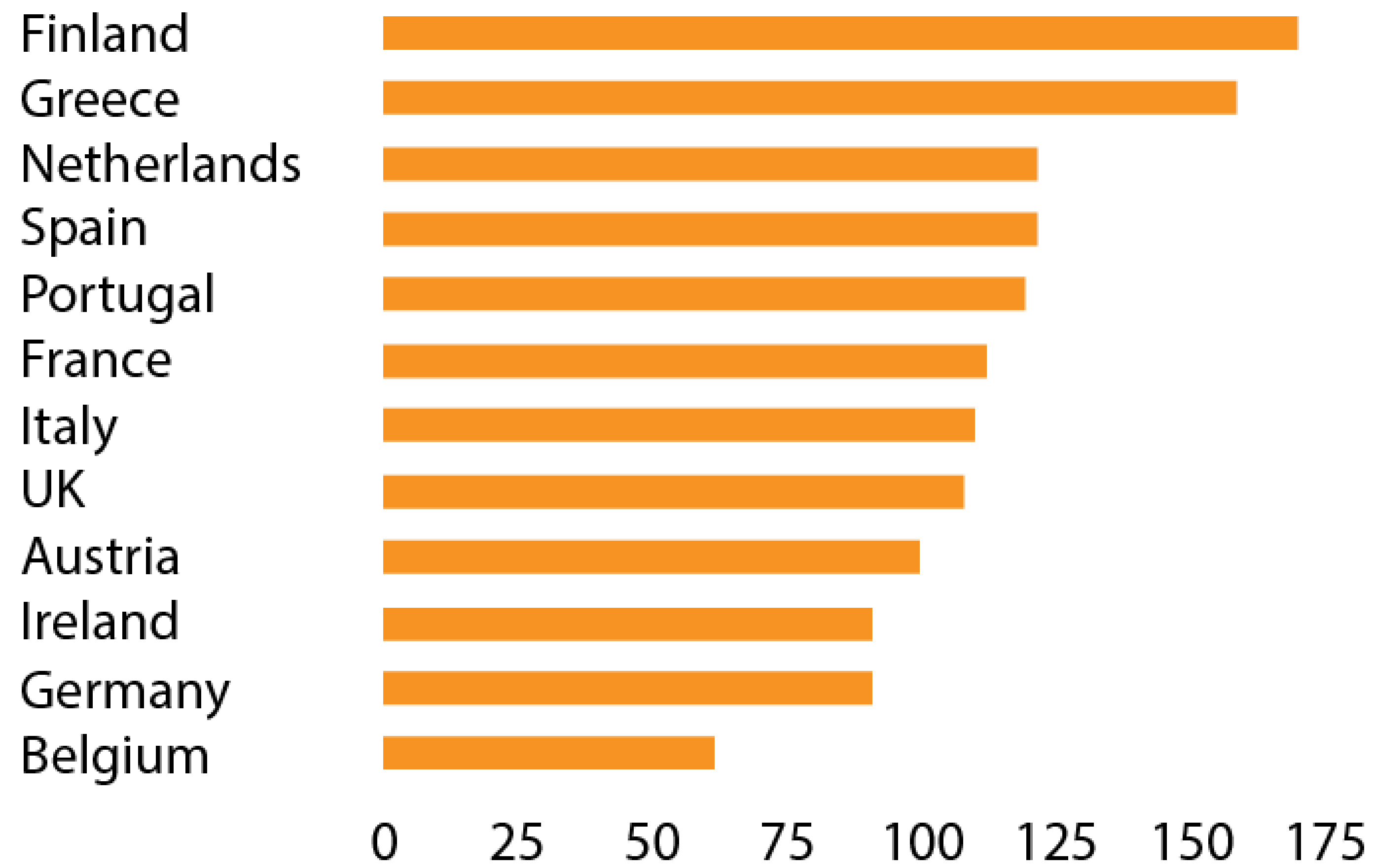
Source: ING calculations based on ECB data, March 2017

Figure 3. Loan to deposit ratio (%)



Domestic loans to households and companies
as % domestic deposits, March 2017

Source: ING calculations based on ECB data.

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seller accepts foreign EU bank accounts. So, a French bank account may not get you very far in Germany. On top of that, countries sometimes impose additional national restrictions, for example to counter money laundering. In some countries, you need to be tax resident, and in others the obligation of identification can only be satisfied by physically appearing in a bank branch. As a result, in most countries the share of savings deposited abroad does not exceed 2% (Figure 2).

Fragmented markets

So, are Belgians, Spaniards, and the Portuguese being exploited by their banks? And do French and Italian banks have to review their deposit pricing models? Not so fast. As I show in a recent paper, the differences in rates are primarily the result of fragmented markets and a lack of financial integration (Brosens 2016). Apart from the mentioned differences in national regulation, nationally oriented prudential regulation prevents banks from moving

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The UK, the main host of Europe's capital markets, is on its way out and will no longer try to advance the capital markets union

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assets and liabilities freely between eurozone countries (Schoenmaker and Verón 2016). Banks in Belgium have relatively few loans on their balance sheet compared to deposits (Figure 3). In the Netherlands, the situation is exactly the reverse. As a result, Dutch banks pay higher rates on deposits than Belgian ones.

Another reason for different pricing is the opportunity funding costs banks are facing. Figure 4 shows that between 2008 and 2014, bank wholesale funding costs (approximated here by CDS premiums) diverged across the eurozone, closely tracking the divergence in sovereign funding costs. This was the result of the intimate relationship between the two, often referred to as the 'sovereign-bank nexus' (eg. Angelini and Grande 2014, Gros 2016, Buti et al. 2016, Navaretti et al. 2016). Banks were holding government bonds and were thus regarded as being vulnerable to government default or debt restructuring. At the same time, the national sovereign was seen as the saviour of last resort for its domestic banks. The increasing dispersion in funding costs seen from late 2015 onwards is attributable to issues regarding non-performing portfolios and bank profitability in several countries.

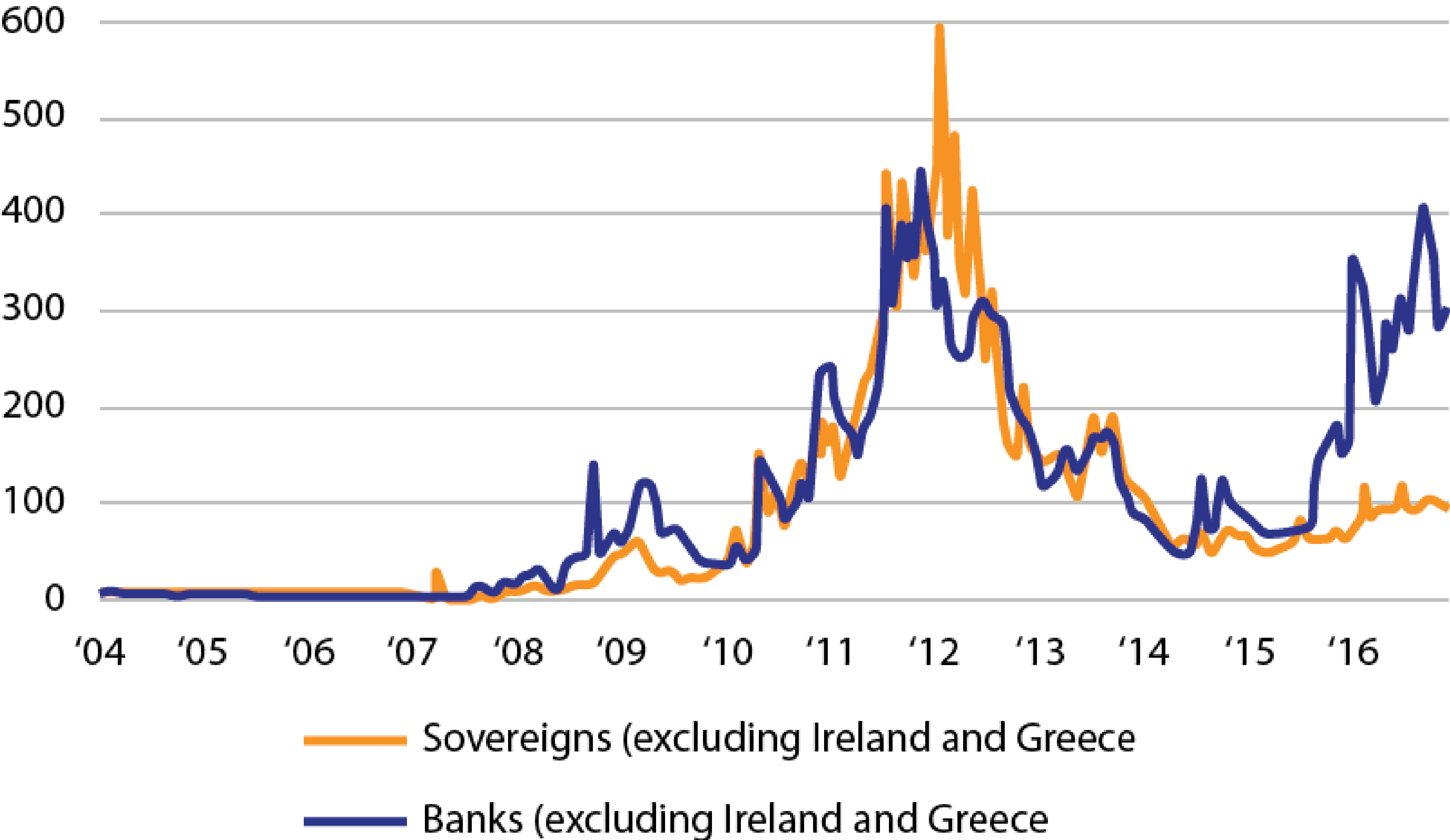
The banking union was conceived to break the 'deadly embrace' between banks and sovereigns. Unfortunately, progress has stalled and therefore the vicious circle between sovereigns and banks remains a potential source of pricing differences between countries.

A final source of fragmentation is that eurozone banking markets each have their own national characteristics. In France for example banks offer savings accounts that are regulated and remunerated by the state ('Livret A').

The Finns borrow against 1.8%, the Irish pay 3.6%

Like deposit rates, borrowing rates may diverge between countries due to market fragmentation. Yet comparing borrowing rates is more complicated than for deposit rates, as they may also differ for reasons that have little to do with fragmentation. For starters, borrowing rates also include a risk premium. The crisis made us all realise that

Figure 4. Dispersion in five-year CDS premiums across the eurozone



Source: ECB.

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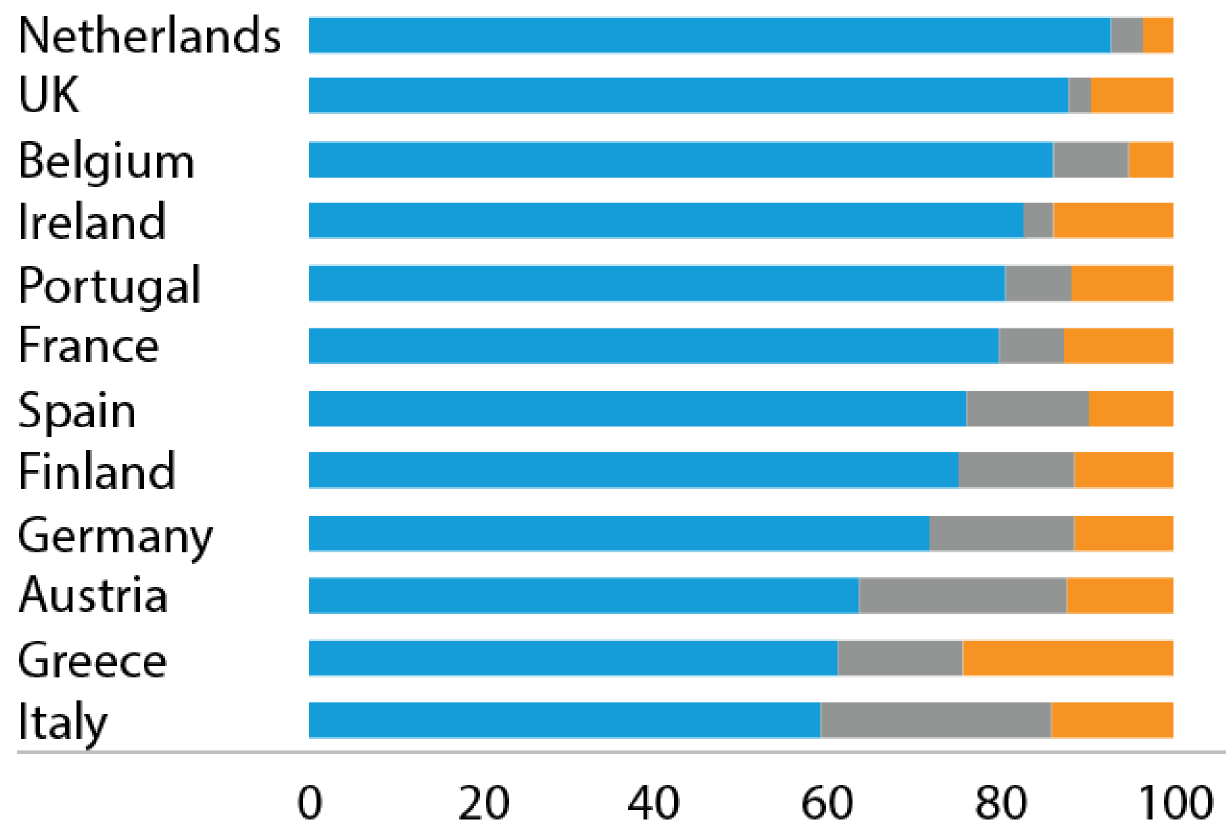
Figure 5. Bank credit to households, by type (% of total)



Source: ING calculations based on ECB data.

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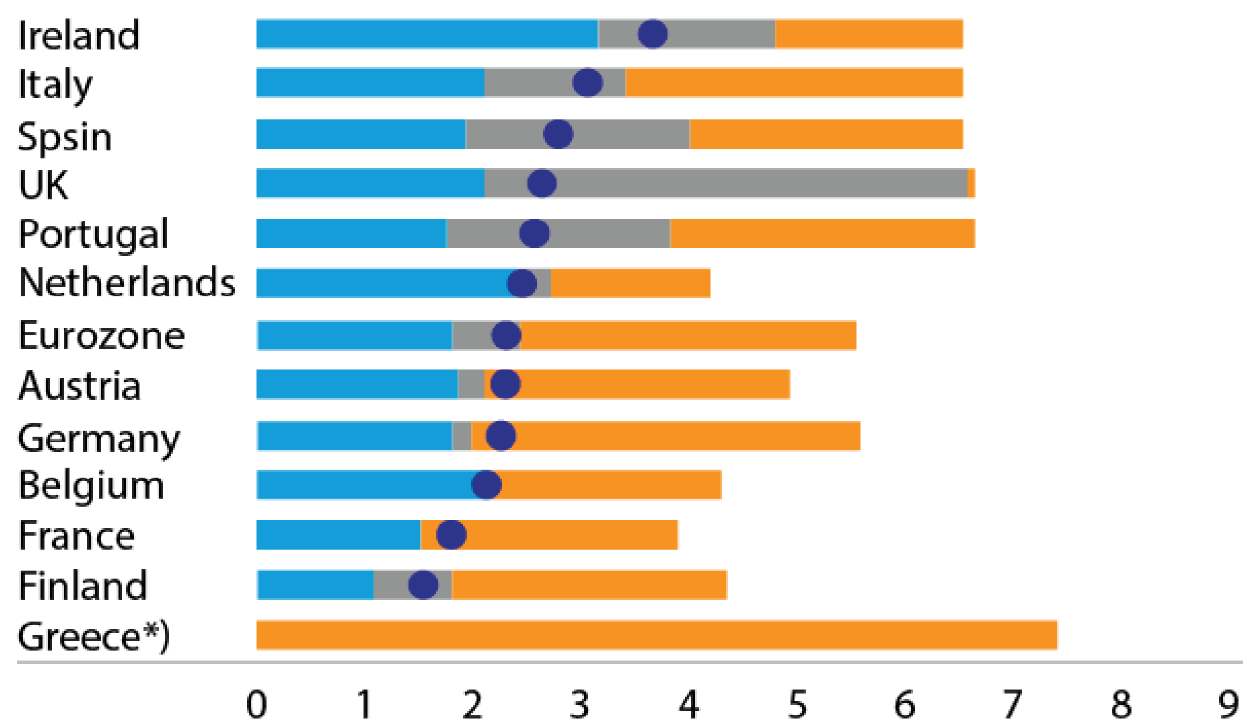
Figure 6. Borrowing rates on new household loans



Rates charged on new loans. Average weighted according to volumes outstanding, March 2017.
*) Greece: no current data available except for consumer credit.

Consumer credit Other Mortgage Average

Source: ING calculations based on ECB and BoE data.

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despite sharing a currency, eurozone economies still very much move nationally. Moreover, different debt levels, loan-to-value ratios, duration preferences, and creditor protection all contribute to different risks per country, which translate into different borrowing rates.

That said, contrasts in the eurozone are marked. Not just because rates differ, but also because households tend to finance themselves very differently (Figure 5). In the Netherlands, 93% of bank loans to households are in the form of a mortgage. In Italy, this is only 59%. Consumer credit, being without collateral, is riskier for the lender. It therefore typically carries higher rates than a mortgage secured by a property. So, it is hardly surprising that Italians pay higher rates on their debt than the Dutch (Figure 6). National habits and preferences also play a role. On average, Finns pay relatively low rates, as they tend to opt for – currently very low – variable rates on their mortgages (EMF Hypostat 2016). The Dutch on the other hand tend to prefer security, choosing long fixed rate periods (at higher rates).

As with deposits, only a small percentage of households shops across borders for their loans, typically 1.5% or less (Figure 2). This clearly suggests room for more competition.

Businesses would benefit from more financial integration too

The picture is slightly different for businesses. Especially for bigger companies it is easier to attract diverse funding, from banks in other countries or by issuing debt on capital markets. Yet despite that, the share of foreign bank finance in total business bank finance remains limited (well under 10% in the major eurozone economies). Moreover, data show a striking difference in the degree of capital market funding for businesses (Figure 7).

Within the eurozone, French businesses tap capital markets the most, with bonds representing 23% of business funding. That is almost double the 12% eurozone average. In Spain, bonds only represent 3% of business funding.

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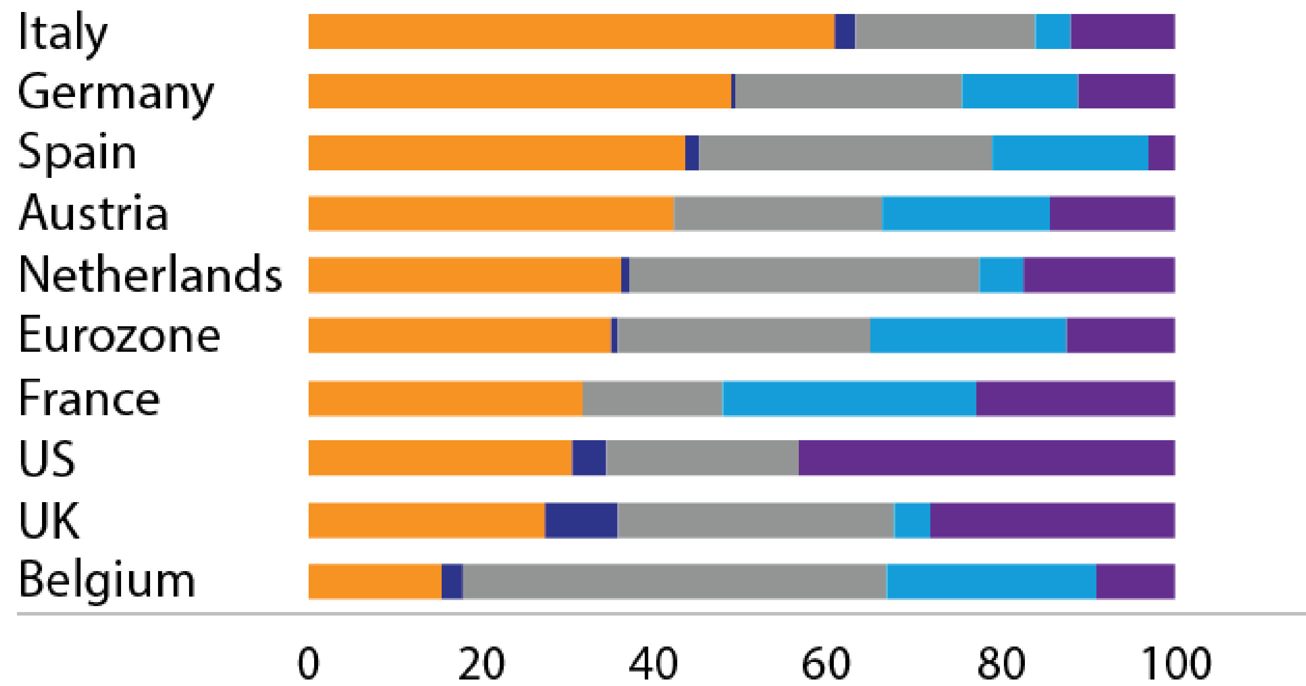
Figure 7. Types of business borrowing



Share of credit outstanding, March 2017. Intercompany loans include domestic loans only.

Bank loans · Other · Bonds · Securitised loans · Intercompany loans

Source: ING calculations based on ECB, Eurostat and BoE data.

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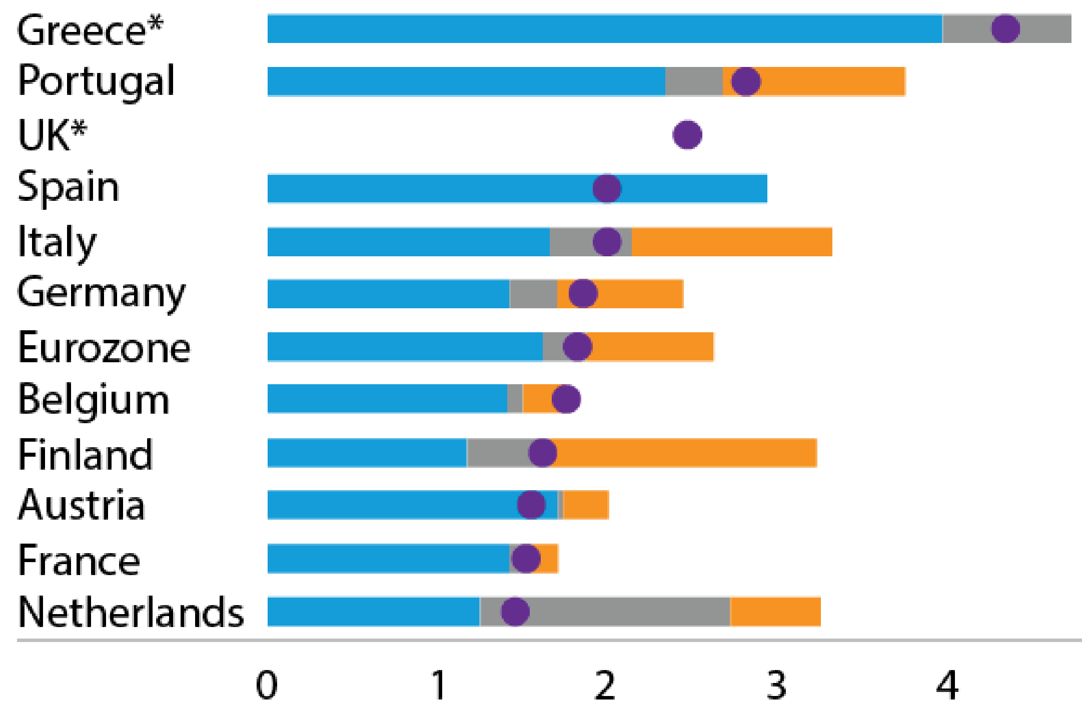
Figure 8. Bank lending rates for businesses (%)



Rates charged on new loans. Average weighted according to volumes outstanding, March 2017.

* Greece: no current data available for loans < €250k. UK: no breakdown available.

<€250k >€250k <€1m >€1m Average

Source: ING calculations based on ECB and BoE data.

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Bank dependency is highest in Italy (61%). On average, banks supply 35% of funding to businesses. For SMEs, banks often are the only available supplier.

Banks charge different rates across eurozone countries (Figure 8). Of course, the differences are not only explained by a lack of financial integration, but also by diverging risks and institutional differences.

Conclusion

Eurozone financial markets for consumers and businesses remain highly fragmented. Further integration can increase competition and deliver lower prices. It could also provide SMEs with access to a wider supply of funding. To bring this about, a further deepening of banking and capital markets union is needed. Banking union has become stuck on the European deposit guarantee scheme. The UK, the main host of Europe's capital markets, is on its way out and will no longer try to advance the capital markets union. It is up to the remaining EU member states to foster competition and efficiency in financial services by completing the banking union, harmonising national regulation, and accelerating the realisation of a true capital markets union. ■

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