Effects of EU financial integration on banking configuration and coordination strategies - Propositions and evidence∗

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Abstract

EU financial integration is at an advanced, yet incomplete stage. This paper further links and contributes new insights to a) the financial integration, and b) the strategy literature strands. The research develops propositions on how the differing degrees of integration in EU financial markets affect banking configuration and coordination strategies, and it tests them empirically. It links integration in financial market segments with business foci of banks, and assesses the propositions’ validity directly at the level of a) the banking value chain, b) corporate spheres, and c) corporate policy areas. The empirical analysis is based on an original, representative survey of foreign banking units. The results demonstrate that a) the differing degrees of financial integration are visible in market participants’ strategies, b) the effects of financial integration differ with business focus, and c) internationally-operating banks seem to have exploited the benefits offered by financial integration if feasible. The results have policy implications. They encourage policymakers to take more care in differentiating a) configuration from coordination strategies, and b) between the business foci of banks in future policy initiatives and policy assessments.

JEL Classification: F23, G20

Keywords: EU financial integration, International banking strategies, foreign banking units, configuration and coordination strategies

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1 Introduction

1.1 Research motivation and propositions

A large body of research has documented that the degrees of integration in EU financial markets differ.\(^1\) There is still considerable fragmentation prevailing in EU retail financial markets whereas financial integration in EU wholesale financial markets is high, and in some cases even complete. Differing degrees of financial integration should differently affect the configuration and coordination (C&C) strategies of banking groups operating units in the EU.\(^2\) Configuration strategies basically address the task of where to concentrate value chain elements, and whether to standardize corporate spheres within an entire banking group. They ask 'Where does a bank do what, and in what manner?' Coordination strategies focus instead on the issue of 'Who does what with whom?' and deal with, for example, the intra-group allocation of decision-making power. In this setting, theoretic research questions such as 'What does EU financial integration imply for the C&C strategies of banks operating in the EU?' and empirical ones such as 'How have banking groups strategically reacted to differing degrees of EU financial integration?' arise.

The high confidentiality with which banks, and other market participants, treat information related to 'strategy' is arguably the most important reason why these questions have, until recently, been dealt with in a rather general form, and only sporadic insights were provided by the literature.\(^3\) For example, the ECB (1999) has looked at the possible effects of EMU on banking and argued broadly that "(...) EU banks seem to have increased significantly their awareness of the challenges that EMU will bring (...) [and] started reconsidering their strategic orientation."\(^4\) Still, this near research gap is surprising since numerous authors have implicitly stressed the importance of 'strategy' in the context of analyzing EMU's effects. For example, Gardener et al. (2003) highlight that "the arrival of Euroland represents a watershed in EU (...) banking",\(^5\) and Dermine (2003b) concludes that "a new banking world emerges, with very different sources of competitive advantages."\(^6\)

The EU Commission (2004a) has addressed these questions recently by analyzing the reorganization of value chains at the level of the EU. It finds a "refocusing and pan-European organization of certain upstream business functions (...). Functions in direct contact with financial markets are the first to be rationalized (...)"

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\(^3\)This hardly surprises as "competitive strategy is about being different." Porter (1996), p. 64.


\(^5\)Gardener, Molyneux, and Williams (2003), p. 144.

INTRODUCTION

and related functions (e.g. strategic planning, risk control, product development) also tend to be gradually organized at European level.\(^7\) The Expert Group on Banking (2004) adds that “even if, as far as retail banking is concerned, delivery is still essentially local, there are examples where steps in the business chain have been integrated on a pan-European basis.”\(^8\) Still, research that exclusively focuses on the effects of EU financial integration on banking C&C strategies is, to our knowledge, unavailable.

Six years after the euro’s introduction, this paper assesses how the differing degrees of financial integration are visible in market participants’ actions. It contributes to answering the above research questions, and to closing the outlined near research gap. To achieve its objective, the research develops propositions on the theoretic implications of EU financial integration on the C&C strategies of internationally-operating banks, and it tests them empirically. The research design conceptually follows the broad value chain (VC) approach suggested by the Expert Group on Banking (2004)\(^9\), which, among other things, was taken by the EU Commission (2004a). We contribute to these recent insights and other financial integration studies; a pure application of a VC approach, however, does not seem fruitful in our research context: In order to obtain a broader picture, we design into a wider context and investigate a number of VC elements, corporate policy areas, and corporate spheres.

The relevance of our research is underpinned by its additional contributions. First, in answering the outlined questions, we further link the financial integration literature with the strategy literature. In addition, uncovering and documenting some of the differences in how market participants have strategically reacted to EU financial integration is a valuable input for future policy initiatives. Thus, the research contributes to the ‘markets vs. policy-driven integration’ discussion in the literature.\(^10\) A better understanding of the effects of financial integration on banking C&C strategies provides guidance both for banks and supervisors: For banks in their development and assessment of their own strategies, and for regulators, since changes in market participants’ strategies potentially alter the risk profiles both of a national and of the emerging EU financial system.\(^11\)

The lessons learned from our research might also prevent the rise of generalized misconceptions about changes in banks’ strategies, or contribute to their uncovering.\(^12\) This is needed from a macro-perspective, since generalized misconceptions about C&C strategies of foreign banking groups could put serious clouds...
on the future of a single country, and also of the entire EU as a financial center. A 'debunking' of misconceptions, from a micro-perspective, is in the interest of internationally-operating banking groups as well: Transparency prevents national or EU regulatory action from being based on wrong assumptions.

Our empirical study is based on an original survey of high-ranking representatives of foreign banking units, members of the German Association of Foreign Banks (VAB). Internationally-operating banking groups offer a better case to study, compared to purely domestic-oriented institutions, since they enjoy a greater degree of flexibility in the way in which strategic adjustments can be made. Furthermore, taking foreign banking units as the unit of analysis, in combination with the sample’s representativeness, permits us to examine the research questions directly where strategic change takes place, and not at the remote head office level. An insider’s view is also needed, since external information about C&C strategies of banks is almost non-existent. A survey approach seems therefore warranted in our partly explorative research setting.

We build a bridge between the financial integration literature and the strategy literature by linking the degree of integration in financial market segments with banks’ business foci, as Figure 1 illustrates. The classification according to business foci allows for the development of a richer understanding of the extent to which financial integration affects banking C&C strategies than an aggregate view across all banking units. We assign all sample units into five business focus categories, yet our discussion focuses on Retail Banking, Investment Banking, and Trade Finance: First, from a market participant’s perspective, Investment Banking units operate in highly, sometimes perfectly integrated EU wholesale markets, Retail Banking units in rather fragmented EU retail markets. Thus, both form two ‘extreme ends’ of the financial integration spectrum. Second, Trade Finance units offer an interesting case since their key clientele is predominantly non-EU-based. They could be expected to be less affected by EU integration initiatives. Third, the limited similarities between these three business foci allow for a more polarized discussion.

Three words of caution seem warranted. First, although it is advantageous to consider only one country in our analysis, the validity of our results for other EU countries is difficult to assess. Second, somewhat related, we put on a German lens in this paper, which is why we sometimes refer to the debate about Germany’s future as a financial center. Third, we agree with, for example, Gardener (2003), the EU Commission (2004a), the Expert Group on Banking (2004), and Manna (2004) that the drivers, effects and repercussions of EU financial

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13 For example, it is relatively easy for them to shift parts of the VC from one foreign banking unit to other group units or to the parent co. level.


15 Canals (1999) points out that “retail banking has little in common with (...) investment banking,” (Canals (1999), p. 569) and both are also in our view rather unrelated to Trade Finance.
integration, those of other global trends affecting the banking industry, e.g. IT advances, disintermediation, securitization, Basel II, and the strategic requirements of business models can hardly be disentangled. Yet, by carefully taking these limitations into account, we are confident that our results are fruitful for answering our research questions, and for assessing the following propositions:

### A) Configuration: Centralization & Standardization

**Prop. 1:** 'An increase in financial integration should translate into a centralization of value chain elements, except those related to the local client-bank interface.'

**Prop. 2:** 'Financial integration should go hand in hand with a standardization of corporate spheres, except those related to the local client-bank interface.'

### B) Coordination: Decision-making power allocation

**Prop. 3:** 'Financial integration should go hand in hand with a centralization of decision-making power re a) general strategy, b) product, and c) risk management policy; d) distribution policy should be with local banking units.'

**Prop. 4:** 'With financial integration, decision-making power should be centralized, except re those policies that affect the local client-bank relationship.'

Source: Own illustration.

<table>
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<th>Financial market segment</th>
<th>(sub-segment)</th>
<th>Corresponding business focus</th>
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<td>Deposits, checking</td>
<td>Investment support</td>
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Source: Own illustration.

Table 1: Overview of propositions

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1.2 Structure of the paper

The paper is structured as follows. Section 2 derives the rationale behind the four propositions, provides an overview of the employed methodology, and discusses key sample statistics. Section 3 assesses each proposition separately to ensure clarity of presentation. Due to conceptual linkages, cross-references are sometimes warranted. The discussion starts with an aggregate view across all units. Following these first insights, each subsection provides detailed evidence of the differences that exist between Retail Banking, Investment Banking, and Trade Finance units. Section 4 concludes and points to potential research extensions.

2 Derivation of propositions and methodology

2.1 Derivation of propositions

We define strategy as the direction and scope of an organization over the long term, which achieves sustained competitive advantage for the organization through its configuration and coordination of resources within a changing environment to fulfill stakeholder expectations.\textsuperscript{17} C&C strategies form important elements in this strategy definition. With increasing financial integration, organizations need to reconsider their C&C strategies for the "structures, processes, relationships and boundaries through which the organization operates."\textsuperscript{18} Individual elements need to be configured in such a way that existing complementarities will be exploited.\textsuperscript{19} Banking groups that operate a network of units in various countries have greater flexibility in how to achieve this 'fit', compared to domestic institutions, but they also tend to be confronted with more complex issues of structure and control.\textsuperscript{20}

This paper addresses, from two perspectives, the question of 'Where does a bank do what, and in what manner?', which underlies configuration strategies. First, internationally-operating banking groups have to decide whether to concentrate geographically, or centralize, elements of their banking units’ value chain (VC).\textsuperscript{21} We focus on four VC elements: 1) product development, 2) distribution, 3) risk management, and 4) back-office functions. (De-)centralization decisions are not static, but highly dynamic, and centralization does not need to occur at the headquarter. For this reason, and against the background of our research objective, we investigate for each VC element both whether a relocation occurred and, if a relocation took place, the degree to which the respective VC element has recently been centralized. Second, internationally-operating banks must decide from a holistic perspective whether to standardize or differentiate corporate spheres within the entire banking group. Strong standardization basically implies


that a corporate sphere does not differ much between group units. We investigate the status quo of the degree of standardization in five corporate spheres: 1) product range, 2) IT systems, 3) distribution channels, 4) target clients, and 5) marketing mix.\textsuperscript{22}

With respect to coordination strategies, this paper analyzes the effects of financial integration on the intra-group allocation of decision-making power from two perspectives.\textsuperscript{23} In a first step, it concentrates on the status quo and investigates whether strategic decision-making power is rather centralized or decentralized,\textsuperscript{24} i.e. if it is located rather at the level of the local foreign banking unit or centralized at the parent co. or at another group unit, in four policy areas: 1) unit’s general strategy, 2) product policy, 3) distribution policy, and 4) risk management policy. In a second step, it takes a dynamic perspective and investigates whether and how strategic decision-making power has shifted in these four policy areas.

The rationale behind the four propositions is based on those benefits of financial integration that are particularly relevant for banking C&C strategies.\textsuperscript{25} Although a precise quantification of these benefits is difficult, ECB (2003a) emphasizes that ”the purpose of promoting integration is the exploitation of these benefits (...) integration should particularly benefit the corporate sector.”\textsuperscript{26} We assume that banks act rationally and seek to exploit the benefits that financial integration offers them by correspondingly altering their C&C strategies. In light of the enormous cost and efficiency improvement potential and the many diversification opportunities offered by financial integration, which we will outline below, this assumption seems justified. Yet, we agree that ”a one-size-fits-all approach (...) does not seem advisable (...) and will probably not shape the emerging new banking scene in Europe.”\textsuperscript{27}

The ”effective interplay between market forces, collective action within the market community to overcome coordination problems, and action by public authorities,”\textsuperscript{28} the latter via harmonization, liberalization and deregulation initiatives,\textsuperscript{29} brought about, and continues to bring about, EU financial integration.\textsuperscript{30} The combined outcome of all initiatives significantly mitigates various risks. Among other things, the legal, regulatory and supervisory barriers that EU banking units of internationally-operating banks face in their day-to-day ac-

\textsuperscript{22}We assess the 'degree' of centralization and standardization since the extreme forms of pure centralization and standardization rarely exist. This argument also holds for the discussion of coordination strategies. See also Kutschker and Schmid (2004), p. 973, p. 981.


\textsuperscript{24}Johnson and Scholes (2002), p. 444ff., speak of 'devolution'.


\textsuperscript{26}ECB (2003a), p. 54.

\textsuperscript{27}Schmidt (2001), p. 436.

\textsuperscript{28}ECB (2003a), p. 53.


tivities have been reduced. The decrease in legal and regulatory risks was even particularly marked in the research period under investigation due to the progress made within the framework of the Financial Services Action Plan.\(^{31}\)

In addition, the creation of wider, deeper, more liquid, and often also rather standardized markets have led to lower liquidity risks.\(^{32}\) Currency risks have been eliminated within the eurozone, removing a major barrier to the cross-border provision of banking services, and interest rate risks have been reduced due to interest rate convergence, both yielding a reduction of market risk. ECB (1999) provides a good example of the numerous risk diversification opportunities offered by integrated markets by pointing out that "one major advantage of the euro area (...) is that it enables banks to unbundle and rebundle risks more easily than under the domestic banking perspective."\(^{33}\)

Integrated financial markets offer additional diversification opportunities as a result of "the emergence of rules, practices and standards common to all market players and service providers"\(^{34}\) and increasing similarities in client characteristics and product preferences. In combination with the creation of a wider market, this increasing homogeneity greatly reduces the research and development risk of financial products and embraces opportunities for significant economies of scale and economies of scope exploitation.\(^{35}\) Although Boot (2003) rightly argues that "the empirical evidence on scale and scope economies in banking is far from conclusive",\(^{36}\) we agree with ECB (2003a) that "financial service providers can also profit from the exploitation of the potential economies of scale and scope that a larger market offers",\(^{37}\) which allows, for example, one to recoup fixed costs more quickly. This view was recently reinforced by EU Commission (2004c) which highlighted that "one direct effect of the integration process is to create a wider market, which then results in improved efficiency. One key driver is of course economies of scale since fixed costs are distributed among a wider customer base."\(^{38}\)

With financial integration, although some customization is still clearly needed, basically the same products and services can be sold to the same client group in various EU countries. Information about specific target client groups can be reused and unnecessary duplication of bank processes can be avoided. Bank resources, such as human capital, reputational capital and product know-how, can be simultaneously pooled, employed more widely and allocated more efficiently to achieve competitive advantage and benefit from scale and scope economies.

Reaping these benefits and those arising from the previously outlined mitigation of risks has immediate consequences for C&C strategies.\(^{39}\) In integrated

\(^{32}\)See ECB (1999), p. 18.
\(^{34}\)Boot (2003), p. 2. See also ECB (1999), p. 20.
\(^{35}\)See Kutschker and Schmid (2004), p. 974ff., for a list of (dis-)advantages of each C&C strategy.
markets, the VC’s risk management element should clearly become centralized and standardized, and decision-making re risk management policy should become centralized. The same holds true for those areas that concern a banking group’s products: If the same products can be sold to an increasingly homogenous clientele in many countries, as is the case in integrated financial markets, and as has been made possible by IT advances, then it is cost-efficient to separate product development from distribution, to centralize the product development element of the VC, to standardize the product range across all units, and to centrally decide on product specifications. Similarly, financial integration provides a strong case for an efficiency-increasing centralization of back-office functions, which is, again, made possible by "technological changes that allow support services to be concentrated centrally,” new standardized market conventions, such as EURIBOR, EONIA and EUREPO, and new EU-wide standards, such as TARGET. Internal IT systems, being closely related to back-office functions since they provide the infrastructure for banking units’ operating and informational procedures, should then be standardized.

The picture is less clear for those areas that directly impact the local client-bank interface. This is particularly true for standardization decisions. It is essential to carefully distinguish between the three related corporate spheres a) distribution channels, b) targeted client group, and c) marketing mix. In integrated financial markets, and made possible by modern IT technology, a pure cross-border distribution of banking products and services, requiring no local physical presence, should theoretically be possible. Following the above line of argumentation, especially due to the scale and scope economies potential and the homogeneity of client preferences and client expectations, a high degree of financial integration should translate into a centralization of the distribution element of the VC, a standardization of distribution channels, targeted client groups and the marketing mix, and a centralization of decision-making power re distribution policy.

However, Dermine (2003b) points out that "the key issue is the speed of acceptance" of such cross-border strategies by clients. We doubt that such an acceptance will materialize any time soon both among wholesale and retail clients, although the former tend to be more internationally-oriented. The reasons for this hesitation are predominantly deeply-rooted natural factors, forming barriers that are to a high degree outside the scope of political actions. A 'home bias' prevails, in our view, which is likely a product both of an uncertainty avoidance attitude towards distance and of differences in culture with respect to client expectations re marketing. There is an inclination especially among retail clients "to

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42 See ECB (2003b), p. 16.
43 Full integration of financial markets implies that consumers chose among credit offers without paying interest to the domicile of a bank.” Heinemann and Schüler (2002), p. 7.
2 DERIVATION OF PROPOSITIONS AND METHODOLOGY

turn to their local and more familiar institutions.” More generally, “bricks-and-mortar establishments remain important as a means to attract new customers.”

Gardener et al. (2003) underscore that even in markets used by wholesale clients, where distance and national borders play a lesser role, such as in “government bond trading (...) distribution capabilities will also be more important.” As a result, even in integrated markets, there is a rationale for a clear decentralization of the distribution element of the VC, a decentralization of decision-making power re distribution policy and a differentiation of the marketing mix to build and strengthen local client relationships.

Distribution channels and target client groups should nevertheless be standardized to reap both financial integration and technology-led benefits.

2.2 Data source and methodology

The empirical assessment of the outlined propositions is based on original survey data. The survey was conducted in the fall of 2003 among 91 members of the Association of Foreign Banks (VAB) in Germany. A total of 40 questionnaires was completed which represents a return quota of 44%. The questionnaire was standardized since standardization allows for rapid answering and better applicability of quantitative models. All questions were asked in closed form, pre-defined options were provided in each question and a 6-point scale was provided to prevent participants from choosing middle values. The questionnaire was split into three question sets to provide participants with a thematic orientation. However, the research design did not intend to follow this chronology in the interpretation of the data. Various measures were taken to ensure reliability and validity of data, to reduce potential biases to a minimum and to ensure accuracy of data input.

The analysis was performed via SPSS. Missing data is of minor concern, since almost all respondents answered the questionnaire completely.

The validity of each proposition is separately assessed. For reasons of clarity, we only report mean values. The actual numerical values should not be interpreted as precise estimates, but rather as an indication of, for example, the pattern of relocation. Against this background, and for reasons of graphic pre-

45 Expert Group on Banking (2004), p. 10. We interpret 'local' not as a 'domestic', a physically present foreign banking unit is 'local' as well.
50 See VAB (2004b), §3 No. 1, No. 2 on the definition of a foreign banking unit. See Tolckmitt and Erb (2003), Coym (2004), VAB (2004a) on the role of foreign banking units in German banking.
51 The slight difference to the actual number of VAB members, 103 at the end of 2003, arises from the fact that various banking groups operate separate units in Germany. Only one local unit of each banking group was contacted. Representative offices were not considered.
52 See Schumann (2000).
53 All documents underwent numerous pre-tests and all questionnaires were coded twice.
54 In those rare cases in which a participant did not assess all pre-defined options that a particular question provided, the left-out options were excluded from the analysis variable by variable. This keeps the loss in data to an absolute minimum.
55 All other calculated statistics, cross-tables, one-way ANOVA tests are available upon request.
sentation, we transform all mean values into harvey balls and summarize each proposition under an intuitive heading. The exact mean values and the corresponding standard deviations are displayed in the appendix. These measures aim at equipping readers with an immediate graphic understanding of our results. Since pre-tests revealed that the questionnaire design required a consistent labeling of low values as $1 = \text{little relevance}$ or as $1 = \text{to / at parent co.}$, and of high values as $6 = \text{high relevance}$ or as $6 = \text{to / at foreign banking unit}$, the classification scheme differs among the propositions. However, as Figure 2 demonstrates, a fully black harvey ball indicates in all cases full, and a fully white one represents none regarding degree of validity in our intuitive labeling.

### 2.3 Representativeness of database

The sample is representative of the German foreign bank universe from an economist’s point of view. From a strict statistician’s point of view, various tests would be needed to speak of ‘statistical representativeness’. The data required for such tests, e.g. returns on equity, is unfortunately inaccessible. Still, as Figure ?? provided in the appendix demonstrates, there are strong arguments that our sample is representative of the actual foreign bank universe. First, as outlined above, our sample represents 44% of VAB members. Second, the split between branches and subsidiaries mirrors that of the actual foreign banking unit landscape. One hundred sixty-five foreign banking groups operated 85 (52%) branches and 80 (48%) subsidiaries at the end of 2003 in Germany. Among the participating institutions in our study are 55% branches and 45% subsidiaries. The geographic origin of parent co. is almost equally distributed. Forty-five percent of foreign banking units have EU-based, and fifty-five percent have non-EU-based parent co. Interestingly, units with EU-based headquarters tend to operate as branches. No clear pattern is observable among those with non-EU-based parent co., since only a slight majority operates as a subsidiary. These two results indicate that the advantages arising from the home country control feature of the EU Single Passport for branches are being exploited both by EU- and non-EU-based banking groups. Individual questionnaires reveal that various

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56See VAB (2004a). Not all foreign banking units are members of VAB.

57The Single Passport for branches, a major EU policy initiative to promote financial integration, allows,
non-EU-based banking groups have established a subsidiary in one EU member state (i.e. London) and use this subsidiary as a hub parent co. to operate branches in other EU countries, such as Germany. In addition, the partial exemption from German regulatory requirements for foreign banking units with non-EU-based parent co. provided by §53c KWG might explain why there is no clear pattern observable among those units that have non-EU-based parent co. Finally, the broad spread in size, measured as the number of employees per unit, further contributes to the representativeness of the database.

2.4 Assignment of business foci

The sample’s representativeness and the questionnaire’s design allow for a clear-cut grouping of foreign banking units according to their business foci via a modified version of the Client-Arena-Product (CAP-) model, introduced by Smith and Walter (1997). The resulting three-dimensional cube maps all possible combinations of target client groups, offered product types and arenas. Each segment and cell can be further broken down, and linkages exist between the three dimensions and between individual cells. The original Arena dimension cannot be directly applied to foreign banking units since they focus on providing services in one specific country. We investigated the geographic origin of their client base instead. In addition, we altered and added a few extensions to the original Product dimension to better capture the heterogeneity of product types that are offered by foreign banking units. This paper assigns all units one of the following business foci within the modified CAP-model:

- 1) Retail Banking (RB): Units operating in RB focus on the provision of consumer and corporate loans, deposit, checking and savings accounts and national and international payment services. Their target client group comprises a large number of local retail clients, small and mid-sized corporate clients and retail investors. Financial advisory services also play an important role whereas products from the securities business category are irrelevant.

- 2) Investment Banking (IB): These units place emphasis on all products from the securities business and money market categories. M&A advisory, corporate and market research, money, equity and debt capital markets products,
mixed products and derivatives dominate the product range. Corporate lending products and project finance services are offered as well, but to a lesser degree. Large corporate clients, public bodies, institutional investors, banks and other financial institutions are the main target client groups. Mid-sized corporate clients are targeted to a lesser extent and, in some cases, a unit is its own client in the case of proprietary trading.

- 3) Trade Finance (TF): The core activities of these units are the financing of trade transactions. The main product types are variants of corporate lending, structured finance, FX, deposit and checking, trade finance and national and international payment services. The number of transaction partners is rather limited as the target client group consists mainly of mid-sized and large corporate clients as well as banks and other financial institutions. The parent co.’s home clientele is very important and transactions are often allocated from parent co. to their foreign banking units. In addition, these units establish and manage local contacts both for their often geographically, culturally and regulatorily distant parent co. and their parent co.’s home clientele.

Five sample units operate in the RB category, 8 in IB, and 13 in TF. In addition, we have classified 5 units into the category Private and Institutional Investor Banking, 4 units into Corporate Banking, and five units do not fit into this classification scheme. For the reasons outlined above, our discussion exclusively focuses on RB, IB, and TF units. A break-down according to legal status further demonstrates that the advantages of the EU Single Passport for branches are being exploited by market participants. All eight units in the IB category exclusively operate as branches. Two branches in the IB category ultimately have non-EU-based parent co., which adds to our previous observation that various non-EU-based banking groups have established a subsidiary in one EU member state which itself acts as a hub parent co. to operate a branch in other EU member states, such as Germany. In addition, 4 out of 10 TF units with non-EU-based headquarters operate as a branch. This finding is not related to the EU Single Passport, but it reveals that the exemptions of §53c KWG can only be used if certain criteria are met.

62 Turkish banking units are special cases since they operate branch networks for a large number of Turkish descendants in Germany. See Posselt (2003), p. 349ff.
63 The results re Corporate Banking and Private Banking units are available upon request.
64 Most TF units do not qualify for the exemptions and, thus, are obliged to operate as a subsidiary. See the above comments on §53c KWG.
3 Evidence on propositions’ empirical validity

3.1 Proposition 1: Centralization of value chain elements

Prop. 1: ‘An increase in financial integration should translate into a centralization of value chain elements, except those related to the local client-bank interface.’

The previous section provided the rationale for Prop. 1, which we label as *Value Chain Centralization*. In a first step, we investigate whether a change in the location of the four VC elements a) product development, b) distribution, c) risk management, and d) back-office functions took place over the past five years. In a second step, for those units where a relocation happened, we investigate whether a centralization or a decentralization occurred.

An exclusive analysis of the percentage of units that experienced a change, leaving aside the direction of change, reveals a striking dichotomy between units operating in IB and in TF, with RB units in between. Figure 3 displays above each harvey ball the exact number of foreign banking units that indicated either *no change* (= no relocation, number to the left) or *change* (= relocation, number to the right) has occurred, the percentage values indicate the proportion of units among which a relocation occurred.

At the one extreme, a relocation of VC elements occurred among all units operating in IB. One hundred percent of these units experienced a relocation with respect to distribution and back-office functions and almost all saw a shift re product development and risk management. In stark contrast, at the other extreme, a relocation of VC elements only took place at a minority of TF units: Only 2 out of 13 units, or 15%, in this business focus category indicated for all four VC elements that a change has happened. Among RB units, a relocation in all four investigated VC elements is observable for a majority of units.

This immediate finding of a dichotomy as well as the observation that a relocation has not happened re all VC elements nor among all foreign banking units can be linked to the differing degrees of financial market integration. Over the past years, the degree of integration in EU wholesale financial markets has increased rapidly. The strong relocation activity observed among IB units indicates that centralization strategies among these units were adjusted accordingly. On the contrary, progress in the financial integration of EU retail financial markets has been much slower. Fragmentation rather than integration prevails, which reflects the fact that not all, but only a slight majority of RB units experienced change.

The results suggest, as well, that EU financial integration only weakly affects the centralization decisions of TF units, as only a minority of these units expe-
rienced change. This puzzle may be resolved by the fact that the majority of units in the relatively stable TF category have a non-EU-based parent co. from geographically and culturally distant countries, or from developing or transition countries. Many transactions are routed from a parent co. to its EU-based banking unit, and TF units often aim at establishing local contacts for both their parent co. and their parent co.’s home clientele. It seems rather difficult for them to profit from the benefits offered by financial integration re C&C strategies.

A second dichotomy can be uncovered in the analysis of those units that experienced a relocation. The harvey balls displayed in Figure 3 represent those units in which a relocation of a VC element took place. A fully black harvey ball signals strong centralization, a fully white one strong decentralization. The proportion of units for which the harvey balls apply is provided by the percentage values. A first view across all sample units reveals a dichotomy that generally conforms with Prop. 1: On the one hand, on average across all units, both product development and back-office functions have been strongly centralized, and risk management has been moderately centralized. On the other hand, distribution has been relocated towards the local level of the individual banking unit.

The analysis according to business foci provides evidence that internationally-operating banks exploited the outlined financial integration benefits, underscores the validity of Prop. 1, and specifies previous results of the literature. The pattern in the relocation of product development, distribution, risk management and back-office functions is stable with respect to business foci, yet the degrees of (de-)centralization differ. Among all IB, RB and TF units that experienced change, a strong centralization of product development and back-office functions took place. The observable strong centralization of product development among all units is in line with, for example, the EU Commission (2004a) which emphasizes that the ”initial fixed costs implied by developments of new and more efficient infrastructures are more easily distributed among a larger number of participants.”

The strong centralization of back-office functions mirrors the findings of the EU Commission (2004c) that "efficiency gains can be quickly realized via a process of back-office integration." 68

Risk management was centralized as well, yet to a lesser degree than product development and back-office functions. Among RB units, the location of the risk management element of the banking VC remained fairly stable, whereas it was centralized among IB units. 69 These results mirror again that the degree of integration in EU wholesale markets, in which IB units operate, is higher than in EU retail financial markets. Still, Prop. 1 would have anticipated an even stronger relocation of risk management among IB units. Thus, one could claim that there is potential for these units to further exploit financial integration benefits with respect to this VC element. However, it cannot be ruled out that a strong centralization of risk management already occurred prior to our research period. The latter view is somewhat supported by the EU Commission (2004c), which argues that "financial institutions have (...) moved towards risk management at a European level." 70

The results with respect to the distribution element of the banking VC, which directly concerns the local client-bank interface, are unambiguous. Distribution has been relocated towards the level of the local foreign banking unit. Decentralization was also much more intense among IB units than among RB units. On the one hand, analyzing the number of units that experienced change, a relocation towards the local level took place among all IB units. This contrasts with RB units of which only 60% experienced a decentralization of distribution. On the other hand, comparing those units where a decentralization took place, the distribution element was more decentralized among IB than among RB units. Both results add to the above argument that not only retail clients tend to turn to locally-established, and thus more familiar institutions, but that the establishment and management of client relationships with wholesale clients requires a decentralization of distribution, as well, even in rather integrated financial markets. These results also reflect the finding of the EU Commission (2004c) that "the distribution of services and products remains mostly local." 71

These results shed further light on important, yet rather general observations made in the recent literature. The Expert Group on Banking (2004) argues that "delivery is still essentially local, there are examples where steps in the business chain have been integrated on a pan-European basis." 72 Our results not only support this observation, they provide concrete examples. In addition, they shed additional light on the general point made by the ECB (2003b) that "(...) management structures (...) have generally become leaner and more centralized." 73

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69 In this analysis, we do not further comment on TF units.
They also provide empirical underpinning for the view that the "centralization of (...) back-office activities (...) appears to be a widely applied strategy." Finally, our results add to the sometimes heated debate on the future of Germany as a financial center. This debate has given rise to the misconception that elements of banks’ value chains have recently been shifted away from the local level. Our results demonstrate that this near ‘myth’ is (only) partially valid.

3.2 Proposition 2: Standardization of corporate spheres

Prop. 2: ‘Financial integration should go hand in hand with a standardization of corporate spheres, except those related to the local client-bank interface.’

We label Prop. 2 as *Sphere Standardization* and assess its empirical validity by investigating the status quo of the degree of standardization in the five corporate spheres a) product range, b) distribution channels, c) target clients, d) marketing mix, and e) IT systems.\(^7^5\)

<table>
<thead>
<tr>
<th>Corporate sphere</th>
<th>Degree of ‘Sphere Standardization’ in each business focus</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>all</td>
</tr>
<tr>
<td>Product range</td>
<td>☐</td>
</tr>
<tr>
<td>Distribution channels</td>
<td>☐</td>
</tr>
<tr>
<td>Target clients</td>
<td>☐</td>
</tr>
<tr>
<td>Marketing mix</td>
<td>☐</td>
</tr>
<tr>
<td>IT systems</td>
<td>☐</td>
</tr>
</tbody>
</table>

Source: Own illustration.

Figure 4: Prop. 2: Evidence on degree of standardization

First hints at the empirical validity of the *Sphere Standardization* proposition stem from the aggregate view analysis. Fully black harvey balls in Figure 4 represent a very high degree of standardization, fully white ones stand for strong differentiation. As suggested by Prop. 2, the degree of standardization is very high with respect to the product range and IT systems, and, to a slightly lesser extent, target client groups and distribution channels. In addition, the marketing mix, which directly concerns the local client-bank interface, is much less standardized overall.

The analysis of individual business focus categories further underscores that Prop. 2 is reflected in market participants’ standardization decisions, and it further reveals that the differing degrees of financial integration are visible in their strategies. The product range is strongly standardized among IB units. This finding reflects that it is beneficial to offer the same products in various EU countries in integrated EU wholesale financial markets. In contrast to the markets in which

\(^7^4\)ECB (2003b), p. 16.
\(^7^5\)The following question was asked: ‘To what extent are the following elements standardized in the entire parent company group?’
EI units operate, where EU borders almost do not matter any more, the need to adapt the product range to local market conditions in fragmented markets is visible among RB units. Here, a much lower degree of standardization of the product range is observable.

Among TF units, the results point to a standardization of the product range, but the degree of standardization is less pronounced than among IB units. Drawing on our previous argument that TF units remain largely unaffected by financial integration, there are two likely explanations for this finding. First, TF units’ predominantly home country clientele probably expects that the same range of products is offered locally as by the distant parent co. Second, the frequent rerouting of transactions between group units in TF implies a need for each local banking unit to offer a rather standardized range of products.

The high degree of financial integration in wholesale markets, coupled with the professionalism of clients, also goes hand in hand with a very strong standardization of the target client group among IB units, as Figure 4 illustrates. In contrast, and as implicitly suggested by Prop. 2, the target client group among RB units is not fully standardized. Although we assume that RB units aim at exploiting the integration benefits accruing from a standardization of the target client group, they are unable to do so since retail clients still do not form homogenous segments. The degree of standardization of this corporate sphere among TF units is comparable to RB. This is, again, less likely to be related to financial integration, but rather to the fact that those units’ clients originate predominantly from their parent co.’s home country, and that they only serve some local clients.

Two additional results illustrate the role of financial integration in standardization decisions. The degrees of standardization of IT systems and of distribution channels are very high among IB units, which indicates that these units fully exploit the integration benefits. Both corporate spheres are rather standardized among RB units as well, yet to a lower extent than among their peers in the IB category. The finding that IT systems and distribution channels still seem to require a certain adaptation to local market requirements in RB corresponds to the lower degree of integration in the financial market segments that these units operate in.76

The results reported in Figure 4 concerning the degree of marketing mix standardization confirm this view and the empirical validity of Prop. 2. Compared to units with other business foci, RB units more strongly adapt the ways in which they present themselves and in which they advertise their products to local market conditions. Strikingly, among IB units, the marketing mix is the only corporate sphere that is not strongly standardized, but to some degree locally adapted. Thus, among other things, although product and service expectations and requirements tend to be homogenous in integrated wholesale financial markets, this is evidently not the case for the way in which client relationships can be

76The degree of standardization in these corporate spheres is lower among TF units. We do not associate this finding to financial integration, but to the distance of parent co.
established and managed. Even among TF units, some marketing mix differentiation is observable. In sum, these results underscore that those activities that directly concern the local client-bank interface cannot be fully standardized.

Similarly to the previous section on Prop. 1, these results on Prop. 2 provide support for, and add to, various insights from the recent literature. They confirm and extend the general point made by ECB (2003b) that an "ongoing standardization can be observed." They provide additional empirical evidence that not only among units operating in IB, but also among those operating "in the retail segment, products have become increasingly standardized." In addition, these findings indicate the existence of interdependencies between configuration strategies. Standardization, at least partially, goes hand in hand with a VC centralization. For example, IT systems have been strongly standardized and the related back-office VC element has been strongly centralized among all units, regardless of business focus. This corroborates Schmidt (2001) for whom one example of "the most dramatic effects of IT (...) is the opportunity to reduce costs by (...) concentrating and relocating back-office functions."

Overall, our findings indicate a strong empirical validity of Prop. 1 and 2, they confirm and add to insights made by the recent literature, and they demonstrate that market participants have exploited the benefits that financial integration offers them with respect to configuration strategies. The next section addresses Prop. 3 and 4, and examines if and how banking institutions have adjusted their coordination strategies in light of progressing EU financial integration.

### 3.3 Proposition 3: 'Power Vacuum'

Prop. 3: ‘Financial integration should go hand in hand with a centralization of decision-making power re a) general strategy, b) product, and c) risk management policy; d) distribution policy should be with local banking units.’

As outlined in Section 2, our research on the effects of financial integration on coordination strategies focuses on the allocation of intra-group decision-making power. Following Prop. 1 and 2, we take both a static and a dynamic perspective. In a first step, Prop. 3, which we label *Power Vacuum*, looks at the status quo. We investigate whether strategic decision-making power is centralized or decentralized in the above outlined four corporate policy areas. Figure 5 provides an overview of the findings.

The aggregate view across all units provides a first indication that the empirical findings are in line with Prop. 3, but also demonstrates that it is important to take the analysis to the level of business foci. In Figure 5, a fully black harvey

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77 ECB (2003b) p. 17.
78 ECB (2003b) p. 17.
80 The following question was asked: ‘How independent is your banking unit in the following areas in its strategic decision-making?’
ball indicates strong centralization, a fully white one represents strong decentralization of decision-making power. At the one extreme, in line with Prop. 3, foreign banking units have considerable, almost exclusive, decision-making power re distribution policy which is located locally overall. At the other extreme, in line with Prop. 3 as well, decision-making power re general strategy is centralized. However, the picture is less clear with respect to decision-making power re product and risk management policy. In this highly aggregate view, decision-making power is almost equally spread between local units and other group units.

The break-down according to business foci sheds light on this blurred picture and confirms Prop. 3. In addition, a direct comparison of IB and RB units reveals remarkable differences in the way in which the differing degrees of financial integration translate into market participants’ coordination strategies. Decision-making power both re distribution policy and re product policy is almost exclusively located locally in retail banking. This finding of a strong decentralization in both of those policy areas adds to our previous observations: In fragmented retail financial markets, there is a strong need to adapt to local market conditions. Local units simply cannot execute distribution and product policy decisions made by distant group representatives who lack the relevant local market knowledge. Decisions on distribution policy and on product specifications have to be taken locally in fragmented EU retail financial markets, even if, as was shown above, the product development element of the VC is strongly centralized among RB units. Fragmentation and the need to adapt to local market conditions is reflected as well in the relatively high degree of independence that RB units have re decisions concerning their general strategy.

The results for these policy areas, compared to RB units, are almost the reverse among IB units. Against the background that IB units operate in financially integrated wholesale markets, it is not surprising, and it is in line with Prop. 3, that strategic decision-making re product policy and re general strategy are strongly centralized. The finding re product policy is particularly striking. The product development element of the VC is centralized, as we have previously shown, and product policy decisions are taken centrally among IB units. In contrast, among RB units, product development is centralized as well, but product policy decisions
are made locally. Furthermore, again in contrast to RB units which are strongly empowered in this area, the degree of decentralization of decision-making power re distribution policy is less pronounced in the IB category. The combination of these findings with the additional observation that decision-making re risk management policy is strongly centralized among units of both business foci indicates that the benefits of financially integrated wholesale markets are being exploited.

Whereas RB and IB units form opposing and also polarized cases, the results for TF units appear puzzling at first sight. With the exception of decision-making power re general strategy, which is strongly centralized as in the case of IB units, decision-making power re product, distribution and risk management policy tends to be weakly decentralized, and the degrees of decision-making power re these three policy areas are almost equal. These observations are in our view again unrelated to financial integration and further underscore that TF units remain largely unaffected by EU financial integration. They are instead explained by general joint decision-making by local managers and parent co. representatives which results from the fact that "as a rule, [these] foreign banks have one managing director, who is seconded from the parent bank, and one German managing director."\footnote{Posselt (2003), p. 351.} In particular, the relatively strong decentralization of decision-making power re risk management policy accentuates that TF units are by and large unaffected by EU financial integration. It reflects that the majority of those units have a non-EU-based parent co. that falls under sometimes completely different regulatory regimes. Local decision-making power re risk management is essential to satisfy local risk management regulations. TF units can hardly benefit from the harmonization of EU risk management requirements or the risk diversification opportunities offered by integrated EU financial markets.

### 3.4 Proposition 4: 'Power Depletion'

Prop. 4: 'With financial integration, decision-making power should be centralized, except re those policies that affect the local client-bank relationship.'

Prop. 4 addresses the same four policy areas as Prop. 3 in the previous section, yet it takes a dynamic perspective. Consequently, we label it *Power Depletion*. Figure 6 illustrates our findings.\footnote{The following question was asked: 'How has the strategic decision-making power in the following areas changed over the past 5 years?'} Following Figure 3 in the discussion of Prop. 1, Figure 6 displays above each harvey ball the exact number of foreign banking units that indicated either *no change* (= number to the left) or *change* (= number to the right) in strategic decision-making power has occurred. The displayed harvey balls represent those units that indicated that a relocation in strategic decision-making power took place. The percentage values state the proportion of units for which the harvey balls apply.

Again, two striking dichotomies can be uncovered if the analysis is restricted
to the percentage of units that experienced a change, leaving aside the direction of change. First, the aggregate view immediately reveals that a relocation of decision-making power has not happened re all policy areas nor among all foreign banking units. Approximately 40% of all units indicated in all policy areas that no change in the location of strategic decision-making power occurred over the past five years! Second, the break-down according to business foci reveals that units operating in IB and in RB, on the one hand, and those operating in TF, on the other hand, form opposing cases. There has been much less change in decision-making power in the TF category than in the other two business focus categories. More than 60%, and in some policy areas even almost 70%, of TF units experienced no change at all whereas most, and in various policy areas even all, foreign banking units operating in IB and in RB indicated that a shift in decision-making power took place. In addition, a comparison of the results of Prop. 1 and 4 reveals that a higher percentage of RB and TF units experienced a change in decision-making power than a relocation of VC elements. This suggests, on the one hand, that financial integration has a stronger impact on RB units’ coordination strategies than on configuration decisions. On the other hand, the overall remarkable stability among the majority of TF units provides further support to our argument that these units’ C&C strategies remain largely unaffected by EU financial integration.

The analysis of those units that experienced a shift in strategic decision-making power confirms Prop. 4, and it sheds more light on recent findings. First evidence on the empirical validity of Prop. 4 stems from the aggregate view across all units. Figure 6 reveals that there has been a centralization of strategic decision-making power re general strategy, product, and risk management policy and some decentralization re distribution policy overall. The analysis according to business foci underscores the differing impacts of financial integration on business.

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83 These observations disagree with the assessment that "an overall pattern has emerged in the past decade or so which suggests that organizations (…) are attempting to drive responsibility for strategic decisions nearer and nearer to markets." Johnson and Scholes (2002), p. 292.
foci. A very strong centralization of decision-making power re product policy, general strategy and risk management policy took place among IB units, which operate in integrated wholesale markets. Decision-making power re distribution policy was slightly decentralized among all IB units.

The findings re IB units underscore the exploitation of financial integration benefits by market participants, yet the observations re RB units indicate that the financial integration process has not reached all decision-making power areas. Among RB units, stressing again that they operate in fragmented markets, a strong centralization of decision-making power re general strategy and risk management policy took place, as would be expected in increasingly financially integrated markets. Yet, in contrast to IB units, only a relatively weak centralization of decision-making power re product policy has occurred over the past years. This further corroborates our previous argument that product policy decisions need to be taken locally in fragmented markets. However, the slow centralization of decision-making power in this policy area shows that retail financial market integration is progressing and has already started, albeit weakly, to have an impact on coordination decisions of RB units. The finding that decision-making power re distribution policy has become further decentralized confirms Prop. 4 as well: Decisions that directly affect the local client-bank relationship are increasingly left to the local banking unit.

A combination of all findings encourages policy-makers to put more attention to the effect of financial integration on coordination strategies. The EU Commission (2004a) argues that “functions (e.g. strategic planning, risk control, product development) also tend to be gradually more organized at European level.” This emerging trend is confirmed by our findings with respect to Prop. 1. The discussion there has shown that a strong centralization of the product development, risk management and back-office VC elements has taken place both among IB and RB units, suggesting that market participants, although operating in markets characterized by differing degrees of financial integration, were able to exploit the benefits that financial integration offers them with respect to this specific configuration strategy. However, a full exploitation of financial integration benefits seems, at least so far, not possible with respect to coordination strategies. The analysis of the intra-group allocation of decision-making power has revealed that not all of those policy areas, which are related to the investigated VC elements, have been equally affected. One finding with respect to RB units illustrates this view: Among most of these units, the product development element of the VC has been centralized, but decisions re product policy, i.e. product specifications, are taken locally, and the latter situation has not much changed over the past years. Further financial integration clearly yields enormous opportunities for RB units, whereas IB units have made use of the benefits that financially integrated markets offer them.

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84 We do not further comment on TF units here.
Our combined results also reveal that various foreign banking units have a greater degree of independence than seems generally presumed. In the context of the discussions on the future of Germany as a financial center, there appears an, often heated, debate among academics, politicians and market participants about whether and how strategic decision-making power has shifted. The assertion that foreign banking units experienced a depletion in strategic decision-making power seems widespread. Yet, our results document that this general assertion is, if at all, only partially justified. The next section will conclude.

4 Conclusion and outlook

This paper has developed various propositions on the effects of financial integration on the C&C strategies of internationally-operating banking groups. We have shown that, in financially integrated markets, internationally-operating banks should generally perform a centralization of VC elements and of decision-making power as well as a standardization of corporate spheres, with the exception of those related to the local client-bank interface, in order to exploit the benefits that financial integration yields with respect to C&C strategies. The empirical validity of our propositions was confirmed via original evidence from a representative sample of foreign banking units, members of the Association of Foreign Banks in Germany. The results of this research have drawn, further linked and contributed new insights to the financial integration and strategy literature strands.

The research has repeatedly demonstrated how the differing degrees of financial integration are visible in market participants’ C&C strategies, and how the effects of financial integration vary with business foci. Units operating in rather integrated EU wholesale financial markets have been intensely affected by the recent, strong progress in financial integration. Our research was able to document how change took place with respect to their C&C strategies, and it clearly points to a significant exploitation of financial integration benefits by market participants. Our findings indicate that units operating in rather fragmented retail financial markets, where recent progress in financial integration was weaker and slower, were less affected by financial integration. In addition, in stark contrast to IB units, they were only partially able to exploit the benefits offered by financial integration. Since there remain ample opportunities for those units to benefit from further EU retail financial market integration, our research calls upon policy-makers to continue promoting financial integration in this area.86

Whereas C&C strategies of IB and RB units seem clearly, and differently, affected by the differing degrees of EU financial integration, the research has shown that units with a TF focus have largely remained unaffected by EU financial integration. These findings re TF units implicitly indicate that geographic origin plays a role. The majority of units in the relatively stable TF category have a

86Yet, Padoa-Schioppa (2000), p. 1, argues that “in the case of retail activities (...), cross-border operations are largely lacking, but we should not expect the signs thereof to materialize very soon.”
CONCLUSION AND OUTLOOK

geographically and culturally distant non-EU-based parent co., and the exploitation of benefits that EU financial integration yields re C&C strategies is hardly possible for them.

Our results have additional policy implications. They underscore that the VC approach suggested by the Expert Group on Banking (2004) is indeed "a valuable reference for targeting EU action." However, they encourage policy-makers, for example the EU Commission, to more carefully distinguish configuration from coordination strategies in future policy initiatives and policy impact assessments. The VC approach should be supplemented with a detailed assessment of the impact of financial integration on centralization and standardization strategies, and on strategies that concern the allocation of decision-making power. This is needed since there is both large diversity and simultaneity in the ways in which internationally-operating banking groups utilize C&C strategies to respond to EU financial integration. It is also needed since our research has shown that, and indicated how, C&C strategies are interrelated. In particular, it is not always the case that a centralization of a VC element and a centralization of decision-making power in the corresponding corporate policy area go hand in hand. Rather the opposite can be true, and beneficial. Finally, our findings provide evidence that various generalized misconceptions about C&C decisions of internationally-operating banking groups, as they are sometimes heard among politicians and the media, are unwarranted.

This paper reflects from various angles that the economic reality of differing degrees of EU financial integration is incorporated in the C&C strategies of internationally-operating banking groups. In light of various recent and upcoming EU initiatives to promote financial integration, it seems safe to conclude that further changes in their C&C strategies will take place, dynamically altering the character of banking in the EU. Various extensions of this study are possible to keep pace with this change. The explorative research could be extended to include additional old and new EU member states, and the results of such a comparative cross-country analysis could be linked to the broad financial systems literature. In addition, the survey could be undertaken at the parent co. level, gathering additional views from parent co. representatives. Future research building on the findings of this study could also closely investigate the interactions between the analyzed elements, e.g. between a centralization of one specific VC element, a standardization of its related corporate sphere, and a centralization of decision-making power in its corresponding policy area. In all cases, research on the effects of financial integration on C&C strategies contributes to uncovering those areas in which the exploitation of financial integration benefits by market participants is hampered by remaining obstacles.

88Reminder: The product development element of the VC was centralized, yet decision-making power re product policy is decentralized among RB units.
8910 countries joined the EU on 01 May, 2004, resulting in a union of 25 member states.
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——— (2004): “Drivers of European financial integration - Markets or policy?,” *Introductory remarks at the symposium concluding two years of the ECB-CFS research network on "Capital markets and Financial Integration in Europe*.


Appendix

A  Sample representativeness

<table>
<thead>
<tr>
<th>Criteria</th>
<th>No. of units</th>
<th>% of units</th>
</tr>
</thead>
<tbody>
<tr>
<td>a) Scope of study</td>
<td></td>
<td></td>
</tr>
<tr>
<td>VAB members</td>
<td>103</td>
<td>100.0%*</td>
</tr>
<tr>
<td>Sample size</td>
<td>91</td>
<td>100.0%*</td>
</tr>
<tr>
<td>Return</td>
<td>40</td>
<td>44.0%</td>
</tr>
<tr>
<td>b) Legal status of unit</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Branch</td>
<td>85</td>
<td>51.5%</td>
</tr>
<tr>
<td>Sample</td>
<td>22</td>
<td>55.0%</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>80</td>
<td>48.5%</td>
</tr>
<tr>
<td>Sample</td>
<td>18</td>
<td>45.0%</td>
</tr>
<tr>
<td>c) Origin of sample parent companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU-based</td>
<td>18</td>
<td>45.0%</td>
</tr>
<tr>
<td>Branch</td>
<td>13</td>
<td>72.7%</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>5</td>
<td>27.8%</td>
</tr>
<tr>
<td>non-EU-based</td>
<td>22</td>
<td>55.0%</td>
</tr>
<tr>
<td>Branch</td>
<td>9</td>
<td>40.9%</td>
</tr>
<tr>
<td>Subsidiary</td>
<td>13</td>
<td>59.1%</td>
</tr>
<tr>
<td>d) Size of sample units (No. of employees)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large</td>
<td>4</td>
<td>10.0%</td>
</tr>
<tr>
<td>&gt;1000</td>
<td>1</td>
<td>2.5%</td>
</tr>
<tr>
<td>500-1000</td>
<td>3</td>
<td>7.5%</td>
</tr>
<tr>
<td>Mid-sized</td>
<td>19</td>
<td>47.5%</td>
</tr>
<tr>
<td>100-499</td>
<td>11</td>
<td>27.5%</td>
</tr>
<tr>
<td>50-99</td>
<td>8</td>
<td>20.0%</td>
</tr>
<tr>
<td>Small</td>
<td>17</td>
<td>42.5%</td>
</tr>
<tr>
<td>2049</td>
<td>10</td>
<td>25.0%</td>
</tr>
<tr>
<td>&lt;20</td>
<td>10</td>
<td>17.5%</td>
</tr>
</tbody>
</table>

Source: Own illustration. Source re FB & VAB universe: VAB (2004a). S.D. = Standard deviation, FB = Foreign banking unit universe. * = Various banking groups operate separate units in Germany. Only one local unit of each banking group was contacted. Representative offices were not considered.

Table 2: Sample representativeness
### B Descriptive sample statistics

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Business focus:</th>
<th>No. of units:</th>
<th>Statistics: Mean (S.D. of the mean)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>all units</td>
<td>RB n=5</td>
<td>IB n=8</td>
</tr>
<tr>
<td></td>
<td></td>
<td>TF n=13</td>
<td></td>
</tr>
<tr>
<td>Prop. 1:</td>
<td>'Value chain centralization'*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product development</td>
<td>2.27 (1.32)(22)</td>
<td>2.33 (0.58)(3)</td>
<td>2.43 (1.81)(7)</td>
</tr>
<tr>
<td>Distribution</td>
<td>4.20</td>
<td>4.00</td>
<td>4.63</td>
</tr>
<tr>
<td>Risk management</td>
<td>2.80 (1.58)(20)</td>
<td>3.67 (2.00)(3)</td>
<td>2.80 (1.60)(8)</td>
</tr>
<tr>
<td>Back-office functions</td>
<td>2.08 (1.11)(20)</td>
<td>2.33 (1.15)(3)</td>
<td>1.63 (0.84)(5)</td>
</tr>
<tr>
<td>Prop. 2:</td>
<td>'Corporate sphere standardization'</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Product range</td>
<td>4.53 (1.50)(40)</td>
<td>3.60 (1.52)(5)</td>
<td>5.38 (0.92)(8)</td>
</tr>
<tr>
<td>Distribution channels</td>
<td>4.10</td>
<td>4.20</td>
<td>5.38</td>
</tr>
<tr>
<td>Target clients</td>
<td>4.25 (1.57)(40)</td>
<td>3.80 (1.92)(5)</td>
<td>5.25 (0.52)(8)</td>
</tr>
<tr>
<td>Marketing mix</td>
<td>3.70 (1.32)(40)</td>
<td>3.20 (1.30)(5)</td>
<td>4.13 (0.71)(8)</td>
</tr>
<tr>
<td>IT systems</td>
<td>4.38</td>
<td>4.20</td>
<td>4.88</td>
</tr>
<tr>
<td>Prop. 3:</td>
<td>'Corporate policies: Power vacuum'</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unit’s general strategy</td>
<td>2.35 (1.46)(40)</td>
<td>2.20 (1.30)(5)</td>
<td>2.25 (1.28)(8)</td>
</tr>
<tr>
<td>Product policy</td>
<td>3.55</td>
<td>5.60</td>
<td>2.25</td>
</tr>
<tr>
<td>Distribution policy</td>
<td>4.58 (1.60)(40)</td>
<td>5.80 (0.55)(5)</td>
<td>4.00 (0.71)(8)</td>
</tr>
<tr>
<td>Risk management policy</td>
<td>3.13</td>
<td>2.80</td>
<td>3.00</td>
</tr>
<tr>
<td>Prop. 4:</td>
<td>'Corporate policies: Power depletion'**</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unit’s general strategy</td>
<td>2.67 (1.17)(24)</td>
<td>2.67 (0.58)(3)</td>
<td>2.43 (1.27)(7)</td>
</tr>
<tr>
<td>Product policy</td>
<td>2.91</td>
<td>3.75</td>
<td>1.67</td>
</tr>
<tr>
<td>Distribution policy</td>
<td>4.00 (1.35)(23)</td>
<td>4.00 (0.96)(4)</td>
<td>3.63 (0.52)(6)</td>
</tr>
<tr>
<td>Risk management policy</td>
<td>2.57</td>
<td>3.00</td>
<td>1.80</td>
</tr>
</tbody>
</table>

Source: Own illustration. Mean value of 1 = low relevance, mean value of 6 = high relevance of criteria. * (**) = The mean values and S.D. only represent those units in which a relocation of a VC element (of decision-making power) took place. Note: The in most cases low values of the S.D. underscore the results' validity. It must be taken into account in the interpretation of these values that they only represent few units in each business focus categories.

Table 3: Detailed data: Mean values and standard deviations
C Assignment of business foci via modified CAP-model

Figure 7: Modified CAP-model


Figure 8: Arena: Break-down of client base

Comment: German clients form the largest client base for most foreign banking units, as Figure 8 demonstrates both at an aggregate level and in a more broken-down analysis. However, some units do not have German clients at all (0%-24%) or only to a limited extent (25%-49%). Instead, their clients either come from
the parent co. country, hinting at a follow-your-client strategy, or from other EU and non-EU nations.

Geographical origin of parent co. plays an important role in the composition of foreign banking units' client base. On the one hand, the majority of units with EU-based parent co. rely a great deal on German clients (14 out of 18). In fact, in this case, there is no unit that has no German clients. In addition, a few units appear to pursue a follow-your-client strategy since parent co. clients are highly relevant for 3 out of 18 units. EU clients other than those from the parent co. country have some relevance for only a few foreign banking units (3 out of 18) whereas international, non-EU clients are irrelevant (18 out of 18). All Retail Banking and Investment Banking units fall into this category.

The picture becomes much more nuanced for foreign banking units with non-EU-based parent co., on the other hand. In this case, German clients form the most important client base for only approximately 45% of units (10 out of 22). The remaining units also deliver services to German clients, yet for them, clients from the parent co. country and other non-EU clients are much more important. Clients from other EU countries are almost irrelevant. These findings show that a follow-your-client strategy is more frequently pursued by foreign banking units with non-EU-based parent co. than by their peers with EU-based ones. Most Trade Finance units fall into this category.

<table>
<thead>
<tr>
<th>Target client group</th>
<th>Min</th>
<th>Max</th>
<th>Mean</th>
<th>Median</th>
<th>Std D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail clients (RC)</td>
<td>1</td>
<td>6</td>
<td>2.00</td>
<td>2.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Private clients (PC)</td>
<td>1</td>
<td>6</td>
<td>2.07</td>
<td>2.07</td>
<td>1.00</td>
</tr>
<tr>
<td>Small corp. clients (SC)</td>
<td>1</td>
<td>6</td>
<td>2.08</td>
<td>2.08</td>
<td>1.01</td>
</tr>
<tr>
<td>Mid-sized corp. clients (MC)</td>
<td>1</td>
<td>6</td>
<td>3.40</td>
<td>3.40</td>
<td>1.82</td>
</tr>
<tr>
<td>Large corp. clients (LC)</td>
<td>1</td>
<td>6</td>
<td>4.13</td>
<td>4.13</td>
<td>2.10</td>
</tr>
<tr>
<td>Banks &amp; Financials (BF)</td>
<td>1</td>
<td>6</td>
<td>4.31</td>
<td>4.31</td>
<td>1.94</td>
</tr>
<tr>
<td>Public bodies (GOV)</td>
<td>1</td>
<td>6</td>
<td>3.23</td>
<td>3.23</td>
<td>1.91</td>
</tr>
<tr>
<td>Retail investors (RI)</td>
<td>1</td>
<td>6</td>
<td>1.70</td>
<td>1.70</td>
<td>1.62</td>
</tr>
<tr>
<td>Institutional investors (II)</td>
<td>1</td>
<td>6</td>
<td>3.30</td>
<td>3.30</td>
<td>2.22</td>
</tr>
<tr>
<td>Own Bank (OB)</td>
<td>1</td>
<td>6</td>
<td>1.82</td>
<td>1.82</td>
<td>1.62</td>
</tr>
</tbody>
</table>

Source: Own illustration.

Figure 9: Clients: Break-down of target client groups

Comment: An analysis of target client groups further underscores the heterogeneity among foreign banking units and the need to perform a business focus classification. They target all client groups, yet to a differing degree as Figure 9 demonstrates. In an aggregate view, foreign banking units particularly focus
on mid-sized and large corporate clients, financial institutions, public bodies and institutional investors. Retail clients and investors, private clients and small corporate clients are less targeted overall.

There are a few differences in this pattern that arise from geographic origin and legal status. Units with EU-based parent co. tend to focus on average more intensely on retail clients and investors, institutional investors, large corporate clients and public bodies than those with non-EU-based ones. In addition, branches aim considerably more strongly at gaining access to large corporate clients, financial institutions, public bodies and institutional investors than subsidiaries. The last observation seems puzzling, yet, it is easily explained if by the analysis of business foci. All Investment Banking units services, as we outlined before, implying a strong focus on these four client groups, are exclusively provided in our sample by units that operate as branches.

Individual questionnaires and descriptive statistics reveal that foreign banking units strongly focus on specific client groups. The standard deviation of mean values fluctuates in the range of 1.5 - 2.2 and the minimum and maximum values for each target client group encompass both the least (= 1, little focus) and the highest (= 6, high focus) possible values. In addition, the median values for the degree of focus on retail, private and small-sized corporate clients and retail investors are 1, the lowest possible value. In fact, more than 50% percent of units do not focus at all on these three target client groups, a finding that is disguised by the mean values. These statistics again indicate that an aggregate analysis only provides an indication of the extent to which foreign banking units target each client group.\textsuperscript{90}

<table>
<thead>
<tr>
<th>Offered product type</th>
<th>Min.</th>
<th>Max.</th>
<th>Mean</th>
<th>Median</th>
<th>Std. Dev.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advocacy, personal</td>
<td>1</td>
<td>6</td>
<td>2.06</td>
<td>1.0</td>
<td>1.77</td>
</tr>
<tr>
<td>M&amp;A Advisory</td>
<td>1</td>
<td>6</td>
<td>1.08</td>
<td>1.0</td>
<td>1.49</td>
</tr>
<tr>
<td>Research</td>
<td>1</td>
<td>6</td>
<td>1.04</td>
<td>1.0</td>
<td>1.03</td>
</tr>
<tr>
<td>ECM Underwriting</td>
<td>1</td>
<td>6</td>
<td>1.01</td>
<td>1.0</td>
<td>1.30</td>
</tr>
<tr>
<td>ECM Sales</td>
<td>1</td>
<td>6</td>
<td>1.08</td>
<td>1.0</td>
<td>1.82</td>
</tr>
<tr>
<td>DCM Underwriting</td>
<td>1</td>
<td>6</td>
<td>2.14</td>
<td>1.0</td>
<td>2.00</td>
</tr>
<tr>
<td>DCM Sales</td>
<td>1</td>
<td>6</td>
<td>2.14</td>
<td>1.0</td>
<td>2.00</td>
</tr>
<tr>
<td>M&amp;A Products</td>
<td>1</td>
<td>6</td>
<td>2.22</td>
<td>1.0</td>
<td>1.04</td>
</tr>
<tr>
<td>Asset Management</td>
<td>1</td>
<td>6</td>
<td>2.45</td>
<td>1.0</td>
<td>1.99</td>
</tr>
<tr>
<td>Derivatives</td>
<td>1</td>
<td>6</td>
<td>2.46</td>
<td>1.0</td>
<td>2.19</td>
</tr>
<tr>
<td>Consumer loans</td>
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<td>6</td>
<td>2.28</td>
<td>1.0</td>
<td>1.97</td>
</tr>
<tr>
<td>Lines of credit</td>
<td>1</td>
<td>6</td>
<td>2.35</td>
<td>1.0</td>
<td>1.82</td>
</tr>
<tr>
<td>Corporate loans</td>
<td>1</td>
<td>6</td>
<td>3.07</td>
<td>5.0</td>
<td>2.19</td>
</tr>
<tr>
<td>Mortgage loans</td>
<td>1</td>
<td>6</td>
<td>1.05</td>
<td>1.0</td>
<td>1.35</td>
</tr>
<tr>
<td>Project finance</td>
<td>1</td>
<td>6</td>
<td>1.05</td>
<td>1.0</td>
<td>1.35</td>
</tr>
<tr>
<td>Foreign Exchange</td>
<td>1</td>
<td>6</td>
<td>3.25</td>
<td>3.0</td>
<td>2.13</td>
</tr>
<tr>
<td>Repo market/transactions</td>
<td>1</td>
<td>6</td>
<td>2.30</td>
<td>1.0</td>
<td>1.77</td>
</tr>
<tr>
<td>Money market/transactions</td>
<td>1</td>
<td>6</td>
<td>2.84</td>
<td>2.0</td>
<td>1.99</td>
</tr>
<tr>
<td>Deposits/ checkings</td>
<td>1</td>
<td>6</td>
<td>2.26</td>
<td>1.0</td>
<td>1.93</td>
</tr>
<tr>
<td>Savings accounts/certificates</td>
<td>1</td>
<td>6</td>
<td>1.70</td>
<td>1.0</td>
<td>1.04</td>
</tr>
<tr>
<td>Domestic payments</td>
<td>1</td>
<td>6</td>
<td>3.00</td>
<td>4.0</td>
<td>1.99</td>
</tr>
<tr>
<td>Internal payments</td>
<td>1</td>
<td>6</td>
<td>3.04</td>
<td>4.0</td>
<td>2.19</td>
</tr>
<tr>
<td>Internal trade finance</td>
<td>1</td>
<td>6</td>
<td>3.15</td>
<td>1.0</td>
<td>2.81</td>
</tr>
<tr>
<td>(IF) Export documentary</td>
<td>1</td>
<td>6</td>
<td>3.13</td>
<td>1.0</td>
<td>2.25</td>
</tr>
</tbody>
</table>

Source: Own illustration.

Figure 10: Break-down of offered product types and of business foci

\textsuperscript{90}The results of the analysis of each individual client group are available upon request.
Comment: The large diversity among foreign banking units is mirrored in an analysis of the offered product types. Starting again with an aggregate view, foreign banking units not only cover all client groups to a differing degree, but also all product groups. Figure 10 shows that they on average focus strongly on the provision of corporate loans, project finance, foreign exchange and the entire range of payment instruments.91

Individual questionnaires and descriptive statistics again demonstrate that the mean values only provide hints at the heterogeneity in the types of products that are offered by foreign banking units. The standard deviation of the mean values fluctuates in the band of 1.30 to 2.35 and many units indicated that they do not offer a particular product at all (= 1, little focus) or focus strongly on it (= 6, high focus). The misleading picture provided by the taking mean over all units is further underscored by the high frequency of the median value 1 (= little degree of focus on product type): Fifty percent of units do not offer most product types at all.92 In sum, an aggregate view alone would be insufficient as foreign banking units obviously focus on specific target client groups, product types and arenas. Our business focus classification scheme reduces greatly all of the discussed distortions and allows for an adequate assessment of the outlined propositions. For example, in contrast to the aggregate analysis, where most median values were 1 (see above), spikes in the median values now occur exactly at those product types and target client groups in each business focus category as our business focus classification scheme predicts.93

91The numbers 1-6 represent the six product type categories identified in Figure 7.
92The results of the analysis of each individual product type are available upon request.
93The results of this analysis are available upon request.