Andrew Crockett: Managing change in the European financial system - lessons from experience

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Profound, at times painful, unquestionably beneficial, and above all fundamentally uncertain: these are the essential characteristics of the transformation that the financial services industry has been undergoing and is set to go through in the foreseeable future. "Profound" because it has affected production and delivery processes, the boundaries between institutions and markets, the relevance of geographic, functional and institutional distinctions, and the very way we think about the nature of the services and products supplied. "At times painful" because, to borrow Schumpeter's term, any process of "creative destruction" has its winners and losers and cannot be smooth. "Unquestionably beneficial" because it has resulted in a broader range of services, at lower prices, and more accessible terms than ever before.

And above all, "fundamentally uncertain" because those who have to work out the implications for strategic business or public policy decisions find it practically impossible to predict how the system will evolve. Who, for example, forecast in mid-1980 that the UK "Big Bang" would so sharply reduce the influence of traditional British financial firms. Who forecast in the early 1990s that centres of financial influence in the United States would arise in Madison, Wisconsin and Charlotte, North Carolina? And who is prepared today to forecast how electronic commerce will eventually change the face of the financial industry worldwide?

The European banking industry has been experiencing the effects of this transformation with increasing intensity. In this paper, I will address the challenges, risks and opportunities facing the European industry against the background of those faced by the financial industry more globally. I shall first outline the basic forces of change, then identify the key challenges and move on to sketch a preliminary assessment of how these challenges are currently being met. Finally, I will draw a few lessons for market participants and public authorities based on both European experience and that of others.

In doing so, I will emphasise the risks, rather than the obvious opportunities provided by these ongoing changes. This focus is not just the professional deformation of a central banker. It reflects the lessons drawn from observing how frequently, in many countries and over many decades, rapid change in the financial sector has been a source of significant economic disruption. It is only by being fully cognisant of such risks that they can be managed successfully and the full benefits of financial liberalisation realised.

While maintaining a focus on financial stability, I should note that I will tend to put more emphasis than usual on industrial organisation issues. The reason is that the link between industry structure and adaptability, on the one hand, and financial stability, on the other, has not received as much attention as it deserves. This is particularly so in continental Europe.

I. Forces of change

Many of the forces of change behind the transformation under way are common to the financial industry globally. Because the financial industry in Europe has, in some respects, been less affected by these forces to date, Europe should be in a good position to learn from the experience of others. Of the global forces, three can be highlighted, viz. technology, the declining role of the state, and the emergence of more demanding consumers of financial services and shareholders. In addition, two distinctively European events have been the creation of a single market and the birth of a single currency. This combination of lagging adaptation to global forces and idiosyncratic shocks implies a particularly challenging time for the European financial industry over the next few years.

Technology is probably the most far-reaching and fundamental force. Technological advances in the capture, elaboration and dissemination of information are paramount in an industry whose raison d´être lies in informational frictions between ultimate suppliers and users of funds.

The first wave of technological advances affected primarily the *range and nature of the products* provided, through the *elaboration* of information. Of particular importance was the conjunction of conceptual break-throughs (such as option pricing) and enhanced computer power that spawned the creation and rapid growth of new financial instruments which allow the effective trading of risks.

The second, more recent, wave has affected primarily *delivery channels* in the widest sense, through the *communication* of information. Consider the opportunities provided by the Internet for the dissemination of information about products and for trade execution, both at the retail level and, incipiently too, at the wholesale level. Once mainly a concern of commercial bankers, anxious about retaining their deposit base, these electronic channels have become a key preoccupation of investment bankers too, who until recently tended to dismiss this challenge as fanciful in the extreme.

The ultimate threat posed by technology is the "death of the middle man", the very essence of financial intermediation and, indeed, of the particular form of relationship banking which has characterised Europe to date. In the process, technological advances have been reshaping the contours of economies of scale and scope in the industry in ways that are not easy to fathom, further heightening business uncertainty.

The impact of the ***declining role of the state*** has had two manifestations, both of which are furthest advanced (for better for worse) in the English-speaking countries. First, there has been a shift from controlling *activities* directly to retaining an indirect influence on the *risks* run by institutions, through minimum prudential standards. Examples of this process include the elimination of direct controls on prices and fees, on the dismantling of functional and geographical barriers, and on the sale of ownership interests.

Second, as public finances have come under increasing strain and demographic pressures have grown, the state has been *reducing its supply of pension services,* both in absolute terms and relative to demand. Hence the generalised shift from defined benefit to defined contribution schemes. These processes have translated into much greater operational freedom for institutions. They have also generated a hitherto unimagined demand for financial services, as witnessed by the rapid expansion of the asset management industry.

The ***emergence of a more demanding consumer of financial services and of an equally demanding shareholder*** is in many ways the result of the previous two forces. It represents a shift from the mere acceptance of the status quo to more aggressive return seeking in an environment where economic agents have become more alert to alternative opportunities and cannot rely as much as previously on state support. The result has been to heighten the need for innovative and quality services and to tighten corporate governance mechanisms. Hence, the rediscovery of "shareholder value" as a guide to business decisions.

In Europe, the ***single market*** programme has added impetus to these forces. To be sure, conduct-of-business restrictions still complicate the direct supply of cross-border services. Moreover, different legal, tax, regulatory and supervisory frameworks still hamper cross-border consolidation. Nor has the mortgage sector yet been exposed to the full rigours of international competition and progress has also been rather limited with respect to pension-related services. Nevertheless, the programme has set the ground for the establishment of a major integrated financial area in the global scene.

Finally, the establishment of a ***single currency*** for EMU countries has acted as a major catalyst for further restructuring. More effectively than previous deregulation, the creation of the euro has freed a large set of institutional players from foreign exchange constraints on their portfolio choices. It has boosted transparency across the spectrum of financial services, on both product and, equally importantly, cost-of-capital sides, and reduced the informational advantage of institutions vis-à-vis markets. The spectacular growth of the corporate bond market, as part of a broader fixed income market that rivals in size its US counterpart, is probably the most tangible illustration of the resulting transformation. Prospectively, it is also one that has the greater potential for altering at its roots the well-established relationships between banks and their clients.

In a nutshell, the forces underlying the transformation of the financial industry have vastly heightened competitive pressures, broadening the range of *potential* service providers well beyond traditional financial firms. Experience in the United States indicates that those that can use new communication networks to sell specialised products more effectively (like consumer credit and mortgages), or have regular contact with potential customers (like supermarkets) can make rapid and significant inroads. As economists would put it, the degree of "contestability" in the industry has taken a quantum jump.

Individual institutions have found themselves squeezed as a result. On the one hand, the tightening in corporate governance mechanisms has gone hand in hand with *more demanding profit targets*. On the other hand, the changes in the financial environment have made it *harder to achieve any given target.* For the industry as a whole, deregulation and technological advances have exposed *excess capacity* in a variety of segments, at both the retail and wholesale level.

A look at the performance of the banking industry globally illustrates the forces at work. Of course, in the second half of the 1990s, accounting profit measures have tended to be stable or to improve slightly against the backdrop of generally favourable cyclical conditions, with crisis-hit Japan being a major exception. From a longer run perspective, however, there has been a widespread narrowing of intermediation margins, a fairly common decline in "stand alone" credit ratings and a tendency for bank share prices to lag behind the overall index. Interestingly, the United States has been an exception to some of these longer-term trends and, according to some of the above measures, the United Kingdom has also outperformed continental Europe. I will come back to some of the lessons that might be learned from these different experiences.

II. The fundamental challenges

What are the challenges for European market participants and public authorities raised by the transformation under way? For individual institutions, the fundamental challenge is to raise profitability *on a sustainable basis.* For public authorities, it is to ensure that the adjustment process of the industry is a speedy and orderly one. It is worth elaborating briefly on these points and highlighting why these challenges are especially demanding in the European banking industry.

In banking, just as elsewhere, raising profitability on a sustainable basis requires that individual institutions choose the combination and scale of activities consistent with their comparative strengths, and that they secure cost-efficiency. What is perhaps less well appreciated is that, more than elsewhere, it also calls for *utmost attention to risk control.* For, unlike in other industries, a good credit standing is ultimately the basis of competitive advantage.

The reason is that, at its core, banking is fundamentally about liquidity provision and credit intermediation. Liquidity provision can take many forms. Examples include absorbing the risks inevitably involved in the settlement process; holding relatively illiquid assets (such as loans) or contingent claims on such assets (such as back up credit lines or asset securitisation with some implicit or explicit recourse) against relatively short-term liabilities; and market-making. But all of these activities are grounded in banks' greater ability to raise the necessary funding than ultimate users.

In a tougher environment where the banks' franchise is under threat, this advantage is increasingly dependent on their own creditworthiness. Experience in the United States in the late 1980s and, to a lesser extent, Japan in the 1990s, confirms that the loss of this edge sooner or later results in a haemorrhage of business with clients of good credit standing leaving banks with a much riskier clientele than was traditionally the case.

For their part, the authorities should ensure that, on the one hand, their policy framework is conducive to a speedy adjustment to a more efficient financial system, and that, on the other, the risk of financial distress at system level is contained. The recent experiences of China, India and a number of Latin American countries shows this process can unfold too slowly; while those of Japan, Mexico and many countries in East Asia clearly indicate that it can also go too fast. In any industry undergoing profound transformation, the restructuring process and elimination of excess capacity that should ultimately lead to sustained risk-adjusted profitability entails certain dangers. This is an inevitable consequence of the competitive system, in which individual firms fight to be the winners in a given market. Not everyone can win, but those who do not dare, know they will be left behind, and potentially put out of business entirely. Such reasoning must have been part of the explanation why so many Telecom companies have been willing to bid so extravagantly for broad-band spectrum licences. However, in banking these common risks are further exacerbated by a unique *"exit problem"*.

By this I mean that the elimination of excess capacity in banking is harder than in other businesses. There are two reasons for this. First, excess capacity can be less *visible*. In contrast to other industries, excess supply does not necessarily put immediate downward pressure on prices and profits. In fact, it can contribute to lending booms which tend to sustain economic activity and boost asset prices, thereby improving for a while the financial condition of both borrowers and lenders. As a result, the extent of the underlying imbalance can be masked, until the process necessarily turns into reverse. Recent experience points to many such examples, with Japan perhaps being the most dramatic though that of the Nordic countries in the late 1980s being closer to home.

Second, excess capacity can be more *stubborn*. For those very forms of official protection that have historically buttressed the banks' competitive advantage in liquidity provision tend to delay exit. They do so by weakening market discipline on the institutions. Government ownership or other guarantees can play a similar role. We have seen this in many emerging market economies, but it is by no means uncommon in industrial countries as well. Finally, the introduction of cutting edge technology by large firms raises their fixed costs while lowering variable costs, thus increasing the likelihood of firms continuing to compete fiercely right up to the point of bankruptcy.

The bottom line is that forces specific to the banking industry tend to generate pressures towards excess capacity quite apart from other innovations. This complicates the required restructuring. Indeed, seen through this lens, financial crises can be viewed as a kind of "safety valve of last resort", a catalyst for needed structural adjustments. It would be better, of course, if market participants and policy makers rather acted to ensure that restructuring occurred in a speedy and orderly way without activating such extreme mechanisms.

III. Meeting the challenge: a preliminary assessment

How well has the restructuring been proceeding in the European financial industry? Assessing the progress is not straightforward. For the reasons mentioned above, it is hard to disentangle cyclical from structural factors. Balance sheets and profit and loss accounts are especially difficult to interpret in banking. And there is considerable uncertainty about what the correct business choices should be regarding scale, combinations of activities and technologies. To simplify the analysis, I will focus on the *direction and pace of change* rather than on a more ambitious comparison between current conditions and some ideal benchmark.

Enterprises need to cut costs and branch networks while at the same time converting them to higher value-added services. In the process, at least in the medium term, employment would have to fall and skills be upgraded. There is widespread agreement on the desirable features of the restructuring. There should be fewer and on average, larger financial institutions in Europe. Concentration, therefore, is set to increase as it is in most other geographical areas. Consolidation can help to withdraw capital, to alleviate destructive competition, and to reach the minimum critical size needed to support the required expenditures on infrastructure. It can thus contribute to achieving efficient production and distribution, notably in wholesale segments such as investment banking and the processing business (eg global custodians).

While generalisations are hazardous, it seems fair to say that in addressing these challenges, by comparison with the United States and even the United Kingdom, the banking industry in continental Europe has faced particularly testing conditions which may explain its relatively slow pace of adjustment.

First, ***the degree of excess capacity*** appears to be greater, especially when assessed in relation to the goal of an area-wide single market. This does not emerge so much from comparisons of the number of institutions or size-concentration measures. It is, however, more apparent from indicators of profitability such as returns on assets and costs, especially labour costs, and (on some measures) branch density, which tend to be less favourable in much of Continental Europe. This may be the legacy of the more sheltered environment provided by governments.

Second, ***corporate governance structures*** have been less sensitive to market forces. In particular, government ownership and other forms of support have been more pervasive. In addition, for historical reasons, savings, cooperative and mutual banks have accounted for a relatively large share of the overall market. In a sheltered environment, the coexistence of different types of ownership structure was of little consequence. But with growing competition, it has become a significant factor influencing the means and incentives of the various players to adjust, and hence the speed and pattern of the restructuring. The degree of discretion enjoyed by management, the determination of acceptable profit targets, the ability and willingness to take on risks, and the vulnerability to takeover, are just some of the areas where corporate governance structures can play a key role in hindering or encouraging necessary adjustments.

Finally, and I would stress this point, ***the European labour market*** has been relatively inflexible to date, even if important structural reforms are now underway in many countries. Obstacles to the adjustment of labour are just as important as obstacles to the adjustment of financial capital. They can result in dangerous inertia in cost structures. And they may prevent the productivity gains otherwise attainable through the reorganisation of business processes and products, particularly through the adoption of new technologies.

The pattern of the restructuring process under way in Europe tends in many respects to confirm these propositions. Available evidence indicates that the tendency for the number of institutions to decline and concentration to rise is a generalised one. At the same time, it also indicates that in terms of cutting branches and, above all, employment, continental Europe is lagging well behind English-speaking and Nordic countries. This broadly underscores the picture that emerges from the behaviour of indicators of profitability, costs and creditworthiness reviewed above. Tellingly, the evidence also indicates that the restructuring has proceeded fastest, and in some respects has gone furthest, in those Nordic countries that experienced a banking crisis in the late 1980s and early 1990s. And it suggests that, while in terms of numbers of institutions consolidation has been most substantial among savings, cooperatives and mutual banks, employment appears to have been comparatively less responsive, except where financial difficulties have emerged.

Against this background of limited progress at the level of the firm, what can be said about the current wave of mergers and acquisitions (M&A)? M&As are an important means through which restructuring can take place. Indeed, the available statistics indicate that the share of financial sector deals in the total has tended to increase in recent years. Also, the average size of transactions has gone up substantially. Mega-deals of unprecedented proportions have been making headlines. At the same time, the experience with previous merger waves has, on balance, been somewhat disappointing. In addition, it stands to reason that the performance of merged entities is likely to be as sensitive as that of individual firms to a number of environmental elements, ranging from sub-optimal corporate governance structures to inflexibility in factor markets. A look at the current wave shows some brighter spots but is not free of clouds.

On the positive side, cost-cutting and down-sizing in overcrowded market segments has received higher priority in announced objectives. This has been particularly evident in the case of in-market mergers, where the scope to slim down overlapping branch networks is greater. The same can be said of consolidation in wholesale processing segments, such as among global custodians, where the existence of economies of scale would seem obvious in light of recent experience in the United States.

Moreover, on balance, both rating agencies and financial markets have been more positive in their assessment of recent M&A transactions in Europe. It has not been uncommon, for instance, for the prices of the shares of both the target and acquirer firm to rise around the time of new deals. In previous waves, by contrast, the price of the acquirer would often tend to decline. Another positive element is that "bancassurance" deals are more common in Europe than elsewhere, largely reflecting a less restrictive regulatory framework. The basic logic is to exploit more effectively the existing distribution networks of banks for the delivery of insurance products. Of course, it remains to be seen whether this strategy will eventually succeed or rather fall victim to organisational diseconomies and, in some cases, to difficulties in embracing less expensive delivery channels.

What about the clouds? While it is too early to assess the effects of the more recent deals, studies looking at actual post-merger performance continue to cast doubt on the effectiveness of such transactions. This seems to be the case both in Europe and in other jurisdictions. A majority of M&As appear in retrospect to have failed to create value in contrast to original expectations. Organisational diseconomies are commonly underestimated while acquirers tend to overpay for their targets ("winner's curse"). The fact that the current M&A wave, as previous ones, has been taking place on the back of a strong equity market also counsels caution. The same overly sanguine expectations that could be behind aggregate share performance may taint the perception of individual transactions as well.

Likewise, it may also be too early to tell whether share repayments, which are increasingly common, are truly a reflection of prudent management faced with declining profit opportunities as opposed to representing, at least in part, an attempt to raise rates of return on equity by increasing leverage. And finally, the assessment of credit rating agencies, while more positive on average, has not been uniform. It has tended to be more uncertain about cross-functional operations, where very different lines of activity and business cultures are brought together. In addition, assessments have varied across countries, taking into account the specific environmental factors likely to impede necessary adjustments.

The fact that, at least until recently, cross-border mergers in Europe have been comparatively rare, especially in the retail segment, is difficult to assess. On the one hand, it can be judged positively in that it reflects a prevailing view of differences in business cultures and of limited prospects for increasing profits in the retail sector. Cross-border mergers seen to date have tended to take place in regions where certain cultural affinities have been in place. On the other hand, the paucity of cross-border mergers may also stem less positively from obstacles that would prevent the restructuring required to reap higher profits. It is probably not a coincidence that rating agencies have tended to be less optimistic about M&A deals in those cases where the environmental impediments to cost cutting and to the adoption of potentially higher-productivity technologies have been greater.

IV. Lessons

If the foregoing analysis is correct, a number of lessons follow, both for the official sector and for market participants. As noted, the key challenge for the public authorities is to ensure that their policies are supportive of a speedy and orderly restructuring. Besides monitoring developments closely, they can make a positive contribution through policy initiative in four broad areas.

First, the authorities can ***lessen the obstacles to the adjustment of labour and capital***. Some significant progress has indeed been made in reforming labour markets in Europe, but this has not been uniform across countries, nor have all the steps taken necessarily been in the right direction.

As regards the adjustment of capital, the issues are considerably more complex. In particular, taken at face value the empirical evidence on the benefits of M&As might suggest that an even more restrictive attitude might be justified. If M&As involving financial firms do not add value, and if at the same time the systemic risks inherent in ever larger and more complex firms are increased, then facilitating M&As through changes in take-over or, more indirectly, tax codes might not seem warranted. However, it would be rash to draw such a conclusion in view of the solace it would give to national, rather than European, interests and to the supporters of the status quo. It is particularly important to ensure that it is economic rather than political considerations that guide policy decisions; and in this context, a number of non-transparent impediments to cross-border mergers deserve special attention. More generally, the policy focus should primarily be on promoting conditions that favour business decisions directed at value generation and the long-term performance of firms.

Second, and consistently with the previous point, the authorities can ***encourage more market-sensitive structures of ownership.*** This should result in business decisions more consistent with the required adjustments. Privatisation plays a key role here. Much has been achieved in this area, but more could still be done. [Prospective rulings by the European Commission in response to concerns raised by private banking sector organisations about state supported financial institutions could prove a watershed in this regard.]

Third, as a complement to ownership structures, public policies can aim at ***improving market discipline***. Several strategies fall into this category. One is to *enhance disclosure standards*, so that outsiders are in a better position to assess the underlying profitability and risk profile of financial institutions. The traditional opaqueness and lack of comparability in profit-and-loss and balance-sheet statements in the financial sector can hinder a proper evaluation. By the same token, it can also lead to overly aggressive profit targets, which in turn can induce excessive risk taking. The opaqueness of financial information is an area that has been attracting increasing attention recently, not least by accounting authorities and supervisors. It is one where the potential for improvements is substantial.

A second strategy is to limit those forms of intervention that provide official protection without commensurate oversight, thereby reducing the incentives to act prudently (in economists' jargon, to *limit moral hazard*). Various forms of implicit or explicit public sector guarantees are obvious cases in point. Besides their impact on risk taking by the beneficiaries, they also distort competition, thereby having knock-on effects on the risk taking of competitors.

A third strategy is to *manage financial distress,* if and when it arises, *consistently with the above principles*. Above all, this means taking swift action and proceeding vigorously with the restructuring of the failing institutions, in a way that promotes the elimination of excess capacity and that pays due regard to fair competition. Above all, shareholders and management must pay, and be seen to pay, the price when things go wrong. It is not entirely clear whether, to date, policies in all of continental Europe have been fully consistent with this approach.

Finally, alongside market discipline, the authorities can ***strengthen official discipline***, in the form of improved regulation and supervision of institutions. One question hotly debated in Europe at the moment is the appropriate institutional framework for regulation. In particular, are current arrangements defined along national lines consistent with a single currency area? This issue is currently being addressed by the group of "wise men", headed by Alexandre Lamfalussy. Another important issue is the degree to which previously separate supervisory agencies should be merged. Since the United States and the United Kingdom provide contrasting precedents for continental Europe, here too there might be a lively debate.

Regardless of *who* is in charge of supervision, *how* this is done is of vital importance. From this perspective, the new minimum capital adequacy standards being developed by the Basel Committee are of key importance. These are designed to improve the risk sensitivity of minimum capital requirements. This is true of the new standardised approach as well as of the internal-ratings based approach, for which initial proposals are under elaboration and which may include both a "foundation" approach and more advanced approaches for banks able to meet tighter standards. But it is particularly true of the two additional "pillars" of the new Capital Accord. These define the roles of ***supervisory oversight*** and ***market discipline*** as ways to buttress and sensitise minimum capital standards.

Importantly, these new proposals are also being developed with a view to building in incentives for banks to improve their own risk management practices. This is of particularly great importance since history provides us with so many examples of lenders acting imprudently, commonly when the economy is expanding strongly. What needs to be learned is that credit risk ***rises***, rather than ***fall***s, in the cyclical upswing, even if these risks only materialise when the inevitable downturn in activity occurs.

This takes me to the main challenge for market participants, namely to raise their risk-adjusted profitability on a sustainable basis. Rather than trying to add to the debate on the "profit" side of the equation and the corresponding business decisions, I will elaborate briefly on the "risk-adjusted" component.

In recent years, a succession of crises has raised everyone's awareness of the risks involved in financial activities. In the wake of these crises, major strides have been made in the measurement and management of risk. These improvements have been evident with respect to the various forms of risk, such as market and, more recently, credit risk, and in the way risk is receiving more attention in internal capital allocation decisions. But, recognising the fact that financial crises are happening more rather than less frequently around the world, the scope for further improvements remains enormous. It is vital that this process gains momentum and extends its reach across institutions and countries. And it is equally important that the steps taken are not just a passing fashion but become a permanent element of a new business culture.

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The upshot of this analysis is straightforward. The momentous transformation under way in the European financial industry holds the promise of unprecedented gains in efficiency and in the value of services provided to society. At the same time, it raises a number of serious challenges for authorities and market participants. To the extent that these challenges are especially severe in Europe, by the same token, the opportunities and potential rewards are that much greater.

There is much that the authorities can and should do to facilitate a speedy and orderly restructuring process in the European financial industry. Ultimately, however, the key to lasting success for the banking industry is in the hands of market participants themselves. It lies in successfully marrying an innovative spirit with a rigorous risk management culture. In turn, this should be buttressed by heightened awareness of the pivotal role played by credit standing in the banking business, as a precondition for the lasting prosperity of the industry in the future.