Mr Wellink speaks about trends in the European banking industry and in banking supervision

Speech held by Dr A H E M Wellink, President of De Nederlandsche Bank, at the launch of the Netherlands Society of Investment Professionals on 6 October 1999.

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I. Introduction

Ladies and gentlemen,

It was with great pleasure that I accepted the invitation to deliver a speech on banking supervision at this official launch of the Netherlands Society of Investment Professionals. On this occasion, I would like to give you a broad picture of the major trends in the European banking industry. After having discussed the key driving forces for change, I shall present the strategic responses of banks to these forces. I will then describe the reactions of banking supervisors to these changes. At the end of my speech, I shall share my views on the future of banking with you. You will understand that it is impossible for me to tackle all relevant issues due to time constraints.

II. Forces for change in European banking

The European banking landscape is generally expected to undergo drastic changes over the next few years. Perhaps the most fundamental force for change in the financial sector has been the evolution of technology, particularly computing and telecommunications. Technological innovations affect banking capacity by changing production costs. They also spur disintermediation, increase competition by lowering entry and exit barriers, help the internationalisation process, and so on. Technological developments have shaped banking business both internally and externally. Internally by means of the reconstruction of banks' internal organisation and production processes and externally by spurring product innovation and establishing new distribution channels. The fruits of developments in information technology are, of course, available to non-banks as well as banks.

Another driving force behind structural changes in the European banking sector is undoubtedly the introduction of the euro. It is assumed that the euro capital markets will be deeper, more transparent and more liquid than the previously existing national capital markets. This could make it cheaper for large corporations to raise money directly in these markets than to borrow from banks. The privatisation of banks is another force for change. It is also argued that the deregulation of the financial sector will further erode the obstacles that deny new providers of financial products access to the market. Demographic factors are also shaping the European banking industry.

The widely held view thus appears to be that European banks are heading for turbulent times. The driving forces just mentioned will lead to intensified competition not only among banks but also between banks and other, new financial intermediaries. This is generally expected to increase the need for a restructuring of the banking sector. The general tenor seems to be that banks are specialised in an economic activity that can, to a growing extent, be performed by non-specialist players. If so, the demand for bank loans will decline and the structure of the balance sheets of banks will alter.

This envisaged disintermediation and securitisation is expected to pose a threat to relationship banking, which still occupies a prominent position in the banking industry. It even raises the question of the continued viability of banks. It should, however, be realised that any shrinkage of the banking industry as a result of market forces is not by definition cause for concern. That would be different if the decline of the banking industry were due to excessive regulation. Excessive regulation would prevent banks from operating more efficiently and from offering new products. This in turn would allow other or new providers of financial services, which are subject to less stringent regulation, to push banks out of the market. Such a situation would, of course, be highly undesirable.

III. Strategic responses of banks

As you may have guessed by now, I myself do not believe in the gloomy scenarios. The structural trends I have just identified have obviously prompted banks to reconsider their activities and their distribution channels. In the following, I will emphasise that the driving forces have not only posed threats but have also offered banks new opportunities.

Consolidation in the European banking industry

The driving factors mentioned before have changed the perceptions with respect to the efficiencies to be achieved through consolidation in the banking industry. Indeed, the number of mergers and acquisitions has increased considerably since the mid-1980s. Mergers and acquisitions are, in turn, partly responsible for the reduction in capacity and the slight increase in concentration in the EU banking industry over the past decade. So far, the recent wave of consolidation has developed mainly within national industries. Cross-border mergers or acquisitions still seem to be the exception, although things have started to change.

Looking at simple capacity indicators like the number of banks or branches per inhabitant, it can be expected that consolidation will continue in the French, German, and Italian banking sectors in particular. It is questionable, though, whether this process will follow the same pattern as, for example, in the Netherlands or Sweden, because the share of publicly owned banks has always been much larger in France, Germany and Italy. It is also unlikely that the expected consolidation process will ultimately lead to concentrated banking sectors such as that in the Netherlands. Indeed, the domestic markets in France, Germany and Italy are bigger and, consequently, offer room for a greater number of viable banks. It will also become increasingly difficult to interpret national concentration ratios in the euro area.

Conglomeration

A second manifestation of the forces for change is conglomeration in the financial sector. Largely due to the deregulation of previously segmented financial markets, different types of financial institutions have entered each other’s territory over the past decade. A familiar example of this is the provision of typically traditional banking products like mortgages by pension funds and insurance companies. In parallel with this development, banks, securities institutions, and insurance companies have merged into financial conglomerates. In the Netherlands, 10 out of the 15 largest banks are part of a financial conglomerate, which makes our country the undisputed leader in this field. The recent acquisition of the Nationale Investeringsbank by the PGGM and ABP pension funds is the first major partnership involving institutional investors and commercial banks.

New products, markets and distribution channels

The driving forces identified earlier also have major implications for the type of business conducted by banks, and the way that business is conducted. The information technology and the deregulation of the financial services sector have enabled banks to develop an entire range of new, complex financial products and new distribution channels. Technological innovations have recently been instrumental in the creation of various derivative products – including credit derivatives – and the application of credit scoring techniques to consumer finance, credit cards and mortgages. It has also become possible to unbundle the various risks implicit in any single financial instrument – for example market risk, credit risk and liquidity risk – and to trade these risks separately.

As for disintermediation and securitisation, it is true that securities markets have become increasingly important in providing funding to businesses. However, banks are closely involved in the issue of securities by large corporations and institutions. Investment banks possess the expertise necessary to manage issues successfully, to attract potential investors, to maintain a securities market, and to hedge or underwrite possible risks. As regards the trade in shares, bonds, and derivatives, banks increasingly focus their activities on executing customers’ orders, speculate on market developments, and engage in proprietary trading. Activities of this kind generate commission income for the banks.

So, how much truth is there in the pessimistic view that the position of banks in the financial intermediation process is being gradually eroded? Indeed, one could say that the banks' role in supplying credit has been steadily declining, as evidenced by their falling share in total financial debt. The decreasing reliance on bank loans seems to be most pronounced among large firms with credit ratings, which can resort to public capital markets to meet their funding needs. By accessing the public capital markets, these firms can bypass the usual screening by banks to some extent.

However, I think that this view on banks' disintermediation must be nuanced and put into perspective. Bank loans, savings accounts, and deposits continue to grow when expressed in terms of national income. Therefore, I am sure banks will continue to play an important role in solving asymmetric information problems in the financial markets. Some businesses can rely only on bank loans because they are unable or unwilling to reveal their financial position to the outside world. If insufficient information is disclosed, rating agencies are unable to form an accurate opinion of the financial position of a particular company and the attendant risks. Such companies are thus only able to obtain external funds in the form of bank loans after screening and monitoring by banks. Recent international experience has shown that, particularly during periods of economic stress, banks perform a critical function in providing large corporations, too, with liquidity. In other words, large firms also need to and want to maintain relationships with banks.

Besides, conclusions with respect to the position of banks in the financial system which are based solely on balance sheet activities are misleading. In recent years, banks have developed an extensive range of off-balance sheet operations. By offering instruments like financial derivatives, banks have been able to tap new sources of income. If one ignores these activities, one may wrongfully conclude that banks are a dying breed. For Dutch banks, the credit equivalents of off-balance activities already amount to between 15 and 20% of their on-balance sheet operations.

Even taking balance sheet and off-balance sheet operations together does not present an accurate picture of the true position of banks in the economic system. Banks are, for example, also closely involved in setting up, managing and marketing investment funds. In most EU countries, more than 80% of all investment funds are controlled by banks. In the Netherlands, half of all investment funds are associated with banks. Banks have thus been successful in internalising at least part of the supposed disintermediation on their liabilities side, which indicates their capacity to adapt to altered market conditions.

Developments in information technology also offer potentially important commercial uses in the retail distribution channels. In the development of, and participation in these new distribution channels, banks are leading the way. Through alliances with supermarket chains, banks in some EU countries are already marketing simple banking products in-store. Banks are closely involved in the development of e-commerce, too, and have established a sound position in remote banking.

IV. Developments in banking supervision

As indicated earlier, the driving forces have enabled banks to venture into many new areas. Many banks have seized the opportunity to diversify their activities, both geographically and in terms of their product mix. This obviously increases the burden on regulation and supervision. Bank supervision has always focused on the assessment of the quality of a bank's balance sheet at some point in time, and on whether it complied with capital requirements and restrictions on portfolio composition. This approach, however, has become less adequate in a world where banks are active players in international capital markets and can, because of potential trading losses, be driven into financial problems extremely rapidly. Thus, the emphasis in banking supervision has shifted toward risk control and market discipline. Take, for example, disclosure requirements to improve transparency as well as reliance on internal risk models that are more flexible than capital requirements.

The process of mergers and acquisitions in banking mentioned earlier raises supervisory questions with respect to concentration and market power. It is difficult, however, to draw conclusions about the competitive nature of banking markets on the basis of concentration ratios. The reason is that the figures for the banking industry as a whole can mask sharply different degrees of concentration in specific segments of the market. In wholesale markets, competition may be fiercer and a critical mass may be required which exceeds that appropriate for national markets. In the retail markets, on the other hand, banks still operate in fairly fragmented national markets.

It is also true that for a proper evaluation of the relationship between concentration and competition, the volume of intermediation activities by non-banks in specific segments of the retail markets should be taken into consideration. The high concentration index for the banking industry must be interpreted differently if other financial institutions also have a significant market share. As you know, non-banks also perform an important function in the intermediation process in the Netherlands.

Another supervisory issue related to mergers and acquisitions, internationalisation and conglomeration in the financial sector is systemic stability. Here, a distinction should be made between the national and international dimension. Nationally, the issue of systemic stability is particularly relevant for small countries where very large banks or financial conglomerates have emerged. In the Netherlands, systemic supervision, aimed at safeguarding overall financial stability, is the domain of the Nederlandsche Bank, especially where banks and payment systems are concerned. Internationally, the trends just sketched stress the increasing importance of coordination and cooperation between national supervisory authorities and further harmonisation of regulatory rules. These elements are effected by various sector-specific international groupings of regulators and supervisors, such as the Basel Committee on Banking Supervision, the Joint Forum on Financial Conglomerates, the Financial Stability Forum, and the Banking Supervision Committee of the European Central Bank. Given the responsibility of national central banks for fostering financial stability in the eurosystem, this Banking Supervision Committee could, in principle, develop as a forum for strengthening the multilateral mode of supervisory cooperation within EMU.

Yet another supervisory issue is raised by the increasingly blurred distinction between different types of financial institutions and the growing importance of financial conglomerates. These developments have recently led to the establishment of a Council of Financial Supervisors in the Netherlands. This Council consists of Board members of the Securities Board, the Insurance Board and the Nederlandsche Bank. I consider the establishment of the Council as an accurate and logical reaction to the structural developments in the financial services industry. It seals the long-standing close and harmonious relationships between the Dutch financial supervisors.

The Council of Financial Supervisors will not execute supervisory functions itself, but leaves that to its constituents. It deals with regulatory issues that go across boundaries of specific financial sectors. The first issue concerns the supervision of financial sector integrity. The second field of operation deals with the supervision of financial conglomerates. The third subject is related to customer protection, focusing on adequate product information. In this respect, the Nederlandsche Bank has recently established a Consumer Protection unit. This unit deals with the supply of information to consumers on the supervisory role of the Nederlandsche Bank. The unit will also stimulate the supply of information by institutions under supervision regarding their products, and will inform consumers on the possible procedures and competent authorities to settle disputes.

V. Concluding remarks

Let me now briefly summarise the key insights emerging from my speech. Banks now conduct a much wider range of business than simply taking in deposits and making loans, which is their traditional financial intermediation business, and have become financial services firms. In many countries off-balance sheet income of banks now exceeds income earned from their traditional activities. Moreover, profound changes in the distribution channels for banking products and in bank-customer relationships can be observed.

The driving forces identified in this speech may have put the industry under pressure but, more importantly, they have also created new opportunities. One is left with the undeniable impression that the regulation of banks has not prevented them from developing new activities and entering into new markets. In this respect, it may be noted that banking supervision and regulation are naturally frequently re-assessed in light of new developments. The recent suggestions for adaptations in the regulatory framework for banks by the Basel Committee on Banking Supervision mirror the genuine intention and proactive attitude of supervisors to ensure sound market conditions in the financial services industry, and to safeguard the stability of the global financial system.

Having said all this, I cannot but finish with an optimistic observation. The banking industry has shown ingenuity in coping with many challenges. This is mirrored in the diversification of its activities. By continuously aiming at a high level of ethics and professionalism within the Dutch investment community, the Netherlands Society of Investment Professionals will certainly contribute to the health and integrity of the financial sector in general, and the banking industry in particular.