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The transformation of the financial services industry

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Foreword

It is a pleasure for me to introduce the second occasional paper published by the Financial Stability Institute. Apart from creating an awareness of, and providing information on, topics of interest to financial sector supervisors, these papers are also intended to provide food for thought on issues currently driving change in the financial sector. In many cases supervisors will be required to respond to these changes, often in ways that have far-reaching implications for financial markets.

The Financial Stability Institute believes that Dr H Onno Ruding, currently Vice-Chairman of the Citibank Group and formerly the Minister of Finance of The Netherlands, is ideally placed to provide a balanced view on the topic of the transformation of the financial services industry. He has been exposed to the workings and vagaries of financial markets from both the public and private sectors. This paper is based on a speech given by Dr Ruding at a conference on deposit insurance held at the Bank for International Settlements in November 2001.

The paper explores consolidation in the financial services industry and provides valuable insights on the forces driving consolidation and the implications for both financial institutions and supervisors. The paper also sets out minimum requirements for an effective safety net and provides thoughts on how the resulting moral hazard can be mitigated. Finally, the author examines the issue of regulatory and supervisory policies and the effect they can have on the competitiveness of participants in financial markets.

The issues raised in this paper are, we believe, both topical and relevant to financial supervisors, not only in developed countries but also in emerging markets.

Josef Tošovský
Chairman
Financial Stability Institute
March 2002

H Onno Ruding was born in The Netherlands in 1939. He holds a PhD cum laude in Economics from Erasmus University in Rotterdam (1969).

After a career at The Netherlands Ministry of Finance, as an Executive Director of the International Monetary Fund in Washington, DC and a member of the Board of Managing Directors of AMRO Bank in Amsterdam, he served as Minister of Finance of The Netherlands from November 1982 to November 1989. In that capacity he was Chairman of the Interim Committee of the IMF.

From 1990-92 Dr Ruding was Chairman of the Netherlands Christian Federation of Employers (NCW). In that capacity, he served as a member of the Council of Presidents of UNICE, Brussels. During this time, he chaired the Committee of Independent Experts on Company Taxation, whose 1992 report was prepared at the request of the European Commission.

Dr Ruding became a non-executive Director of Citicorp/Citibank in 1990 and has been a full-time executive since 1992. Since the merger of Citicorp and Travelers into Citigroup in 1998, he has devoted a large part of his time to promoting the growth of Citigroup (Citibank and Schroder Salomon Smith Barney) in Europe. He relocated his main office from New York to Brussels in 2000.

Dr Ruding is a non-executive Director of Corning, Pechiney, Unilever and RTL Group. He serves as the Chairman of CEPS (Center for European Policy Studies), of UNIAPAC and of the Advisory Council of AIF (Amsterdam Institute of Finance). He is also a member of the Trilateral Commission, the International Advisory Committee of the Federal Reserve Bank of New York, the European Advisory Board of AECA, the Board of The Netherlands-American Chamber of Commerce and the International Advisory Boards of Robeco and the Federation of Korean Industries.

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Introduction

The 1990s and the beginning of the new millennium have seen enormous changes in the financial services industry. The impact of, amongst other things, information technology, deregulation and liberalisation has changed and reshaped the financial landscape forever. Going forward, it is probable that this pace of change will continue. This paper discusses some of the more important aspects currently driving change in the financial services industry and considers several of the implications of these changes.

Firstly, the current trend towards consolidation in the financial services industry is discussed. In particular, the shift towards cross-category and cross-border consolidation is emphasised.

Secondly, the recent financial crises in several regions have highlighted the need for effective financial safety nets. The required components of an effective financial safety net are considered, together with the related potential for moral hazard and how it can, to some extent, be mitigated.

Thirdly, the paper examines the issue of differing national supervisory and regulatory policies and how this can impact on the structure and competitiveness of the financial services industries in different countries.

The trend towards consolidation in banking[1]

Perhaps the single most important factor transforming the financial services industry at this time is consolidation. There are several valid motives for bank consolidation by way of

[1] See also Group of Ten, *Consolidation in the financial sector*, Report by a Working Party chaired by Roger W Ferguson Jr, January 2001.

mergers or acquisitions. One motive is the need for a large capital base. Capital is much more relevant to the business of banking than to growing potatoes. A large capital base serves as a buffer to absorb losses and, therefore, provides the institution with credibility and its customers with confidence in the institution. The benefit of a large capital base is clear in the case of Barings, which could not absorb a loss of £1 billion and was forced to terminate its life as an independent institution. It was acquired for a token amount by ING after the Bank of England, as its regulator, had, correctly, refused to bail it out. If a loss of the same magnitude had occurred to the largest bank in the same country, its operations would have continued virtually as normal because £1 billion was a relatively small percentage of its capital base.

A second motive for consolidation is customer growth. As customers undertake larger and larger deals, a bank frequently has to offer greater financial commitments in order to stay in the race for those customers. When legal lending limits are in place, they are often related to the size of the capital base. Even without legal lending limits, however, a large capital stock can assist in a bank's prudent behaviour. The idea behind diversification of the amounts of exposure to customers is that you must not put too many eggs in one basket - a couple of additional eggs means something different if there are hundreds of eggs in total as opposed to if there are only five.

A third motive for consolidation is a more recent development, which has occurred only during the last 20 years or so, namely the growing cost of technology, information and communication. These investments are necessary and, although they can be delayed, they must eventually be undertaken. In relative terms, this factor bears more heavily on mid-sized institutions; whereas frequently the total amount of the investment is not widely different, a large institution has a broader revenue base with which to absorb the extra cost.

A fourth motive is the flight to quality, especially in uncertain times. There have been many examples in a number of countries, both developed and developing, in recent times as well as in earlier periods. If the general public begins to question the solidity and creditworthiness of a particular financial institution - or worse, the entire financial system of a country - this may lead to substantial withdrawals of customer balances at the bank(s) in question. Frequently these suspicions about quality are fuelled by negative press reports. Even if such a process of adverse publicity, doubts about solidity and creditworthiness, and withdrawal of deposits is not so serious that it leads to the worst outcome, that is, insolvency and/or illiquidity resulting in default and closure of the bank in question, it is likely to lead to an acceleration of consolidation in the banking sector. This category of consolidation may be initiated by the troubled institution itself, by seeking a merger with a stronger institution, or brought about by the actions of the regulator. Practical experience indicates that a flight to quality tends to be related, in part, to size, in the sense that in the minds of many people a larger financial institution is perceived as being safer and of better quality. An interesting case of flight to quality presented itself in Japan during the so-called Asian crisis in 1998. Japan was not at the heart of this crisis and Japan did not - and does not - suffer from any weakness in its external position, unlike many developing countries. Nevertheless, there were long queues of Japanese customers wanting to transfer their deposits (both in yen and in foreign currency) from the top Japanese banks to the only large non-Japanese bank with a network of retail branches in Japan. The reason was clearly not related to the prospect of obtaining more attractive interest rates. It was a matter of general doubt among the domestic public about the quality of even the largest local banks in this, the second largest industrial economy in the world.

A fifth motive for consolidation is to overcome weaknesses in profitability. A large number of mergers and acquisitions are driven by defensive motives - institutions become aware that they can no longer function both profitably and independently. Even if the above-mentioned doubts among the public and clients about solidity do not exist, a persistently low return on capital or assets may lead to market forces inducing a bank to look for a partner.

The factors influencing consolidation apply to banks around the world. In most of the OECD countries, these factors work against medium-sized financial institutions, and have resulted in a growing number of them either merging with one another - in which case they are still in operation, but no longer medium-sized - or being acquired by larger banks. What remains, almost by definition, is a smaller number of very large institutions, and a number of small ones - boutiques that offer specialist services and to which the above arguments do not apply. Capital is irrelevant, because such institutions are frequently advisers; size is irrelevant, because their business is dependent on a few high-quality individuals. These specialist firms do well if they provide a good service. But for the group of banks in between, these factors favoring consolidation apply. One can observe this in many countries. Whether or not this is good or bad, it is probably unavoidable.

Bigger in banking or insurance, however, is not always better. There are a number of good arguments that big can be better than medium-sized. There are, however, some disadvantages to being big, such as problems with the span of management control. Evidence of such problems can be seen in a number of mergers and acquisitions that, if not outright failures, are at least not successful. It cannot always be proven that merged institutions are doing better as a result of the merger or acquisition and it should not be too easily believed that consolidation is always useful and necessary. Implementation is at least 50 percent of the consolidation process. Strategy - the decision itself - is important, but the transaction can fail later with suboptimal implementation and integration of the institutions.

There are enough examples in many countries that illustrate this point. In Japan, a substantial number of mergers have been announced among already large institutions in order to make them almost mega-sized. Such an announcement on its own may be good news, but if it is combined with a statement that it may take up to three years to implement the merger, the consolidation probably will not help the firm much. Such a long period means that the banks are effectively paralysed, creating risks and delaying cost savings. Was the idea to merge wrong? No, not necessarily. Rather, the implementation process was flawed. If consolidation occurs, it should be done quickly, including achieving the intended cost savings by, for example, closing overlapping branches. In this context it may be worth noting that problems related to quality (of assets, risk management, expense controls and profitability) cannot be resolved simply by merging banks, which all struggle with these same issues. Merging two big but weak banks leads to one bigger but still weak bank, unless (new) management really addresses the root of the problems.

There is another explanation for the ongoing consolidation. Until recently, financial institutions in some countries could continue their independent life by benefiting from various forms of direct or indirect state aid from central or regional public sector entities in their own country. Such aid could be in the form of, for example, guarantees, lower taxation or cheap funding (subsidised loans). I refer to cases in, for instance, France and Germany. The more active approach by the European Commission, particularly within the context of European competition policy, is likely - and rightly so! - to lead to the abolition of several of these distortive practices. The case against the Landesbanken in Germany is such an example. The likely consequence of this new approach is a fundamental change in the character of these institutions and in their relationship with the authorities, resulting in a curtailment of their subsidised activities.

Another trend that is becoming more visible is related to the weakening of the position of financial institutions that are active solely in one European country. Whereas they themselves do not benefit from the growing liberalisation in the European Union by expanding cross-border, they face growing competition from foreign-based institutions that penetrate their home turf. This development affects their profitability and accelerates further consolidation through either offensive or defensive actions.

A quite different factor in favour of further consolidation in the banking sector is related to “Basel”. The proposals by the Basel Committee on Banking Supervision to amend the capital adequacy rules (“Basel II”) contain a fundamental, positive change. Capital requirements will now become different for large and “sophisticated” banks that are able, and allowed, to follow an “internal ratings-based approach” (IRB) to calculate required capital, whereas other banks will follow a “standardised” approach. The former category will benefit from lower capital requirements, although the precise size of the differences is not yet clear. There is therefore a regulatory incentive for banks to develop more sophisticated (credit) risk methodologies. Large and well run banks can afford not only more efficient distribution and production, but also risk-taking which provides them with an important competitive advantage. As the new proposals give an impetus to more efficient credit risk methodologies, many smaller or less sophisticated banks will find it more difficult to maintain an appropriate risk-return profile, particularly if they are obliged to hold relatively larger amounts of (expensive) capital.

Finally, the recent general economic downturn and the terrorist events of 11 September could also contribute to an acceleration of mergers and acquisitions among banks, related to flight to quality and weakening of the earnings and capital position of a number of banks.

Cross-category consolidation

My second point deals with consolidation amongst different types of financial institutions, such as when a bank merges with an insurance company. When such a consolidation takes place, there could be two, three or even four pillars under one roof, for example commercial banking, insurance, investment banking and asset management, sometimes resulting in a financial conglomerate.

Apart from the general motives already mentioned, there are several specific arguments in favour of cross-category consolidations. First is the ability to sell a combination of financial products and services to one customer. Experience has shown that whilst successful cross-selling is not easy to achieve, it can be done. Cross-selling is never 100 percent successful and it takes time. However, if executed persistently with priority attention at all levels in the (combined) organisation, substantial amounts of extra revenue can be generated.

The first motive, then - the ability to sell more products from the merged institutions to a customer - is an offensive one, a desire to expand. The second motive, equally important, but different from the first, is defensive, namely the desire for the institution to diversify: diversify its businesses, activities and risks, because financial products are always based on risk. This is not diversification to eliminate risk (this cannot be done because then one is not in business), but for the overall institution - as opposed to its individual units - to become less vulnerable to volatility, shocks, risks and mistakes. The volatility and risks of individual products are in most cases not fully correlated and, therefore, the combination makes the overall institution more diversified and more stable in its earnings. Diversification also reduces the dependence on one or a few lines of business, for example equity trading or advisory fees from merger and acquisition activities, and can also help mitigate the effects of events such as the Asian crisis.

There are, however, several warning lights flashing for this kind of consolidation. When apples and oranges are combined, they may be financial apples and financial oranges, but they are still different from one another. A euro’s worth of risk in banking is not a euro’s worth of risk in insurance. It sounds simple, but it is not in practice. There is, then, the risk of disregarding differences in risk. Managements make wrong decisions and mistakes because they do not always fully understand what they are deciding when it is related to a business that is new to them.

Another aspect is related to perceptions of those who do not like conglomerates in general, even when they are limited to financial activities. This may result in the risk that this kind of consolidation will lead to a lower, rather than a higher, share price or p/e ratio due to negative reactions by investors.

Also related to conglomerates is the issue of overall size. Whilst a large, diversified financial conglomerate may do business in several different areas (commercial banking, investment banking and insurance), and may be the market leader in revenues, earnings (profits), capital and market capitalisation, it should not necessarily strive to be the largest in terms of total assets. Activities should only be undertaken if they are profitable. The goal is not simply to be large in terms of assets, particularly if these are low-yielding assets.

It is too early to say whether the positive arguments for this kind of cross-category merger have worked, although they appear to have done so in the case of Citigroup. It took time to get the elephants to dance together in a narrow cage, because elephants are not very elegant dancers and it requires special skills to train them. Both arguments - the offensive motive of cross-selling and the defensive motive of diversification - were vital in bringing this success about. The main motive, however, was not simply to enlarge the asset base, although the substantially increased amount of capital of the combined institutions is considered to be very helpful. Another feature of such "All-Finanz" (ie, covering all categories of financial services) is that the cross-selling activities are uniquely wide - corporate banking with investment banking products, as well as retail banking with insurance products and securities brokers who also sell banking and insurance products.

Successful cross-selling is based on the ability to *distribute* additional, different financial products through existing sales outlets to existing customers of a financial institution. The ability to *manufacture* all these products in-house is, however, less essential. For example, underwriting insurance policies can be unattractive if losses happen to be high and substantial amounts of capital are required. Recent experience indicates that cross-selling is more likely to succeed when distributing life and annuity insurance products to bank customers than when distributing non-life (property and casualty) policies through these same bank branches. Separation of the manufacturing and distribution of insurance products also enables a bank to more easily widen its choice of products by selling, through its branch network or credit card organisation, not only its own insurance products, but also the policies underwritten and branded by several other insurance companies, thereby increasing its revenues from sales commissions. This approach of separating manufacturing and distribution requires long-term contracts with regard to product offering and use of brand names between bancassurance company X and "pure" insurance company Y. Here, Y underwrites the policies formerly underwritten by X while X continues to distribute the insurance products it used to manufacture itself.

All-Finanz institutions have been made possible by the relaxation of national restrictions preventing such mergers and acquisitions. In the United States, such consolidation was prohibited by the - historically mistaken - Glass-Steagall Act of the 1930s, and the Bank Holding Company Act of 1956, which was not a mistake but imposed a number of limitations.

Cross-border consolidation[2]

The other focus is on cross-border mergers, that is, between institutions in two or more countries. Again, there are both general and ad hoc motives for such consolidation.

Cross-border consolidation may be beneficial to institutions that are large in their home country. If they wish to expand, they may no longer be able to do so at home, either because

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[2] See also H Onno Ruding, *The consolidation of financial institutions: on a global or national basis?*, papers of the Tenth Annual Hyman P Minsky Conference on Financial Structure by The Jerome Levy Economics Institute, Blithewood, Annandale-on-Hudson, New York, 27 April 2000, pages 9-13.

the antitrust rules do not allow it, or because they do not want to put all their eggs into one basket.

Another different - but equally valid - motive is that institutions may have large customers that they wish to serve internationally. In order not to lose such customers, they must either grow abroad organically, which is not easy, or make acquisitions, which can facilitate growth more rapidly. Sometimes institutions want to expand outside their own country for reasons of profitability. The market in the foreign country may be less over-banked than at home, the margins may be better, and competition may be less fierce. This might have been a motive for French, German, Dutch or Swiss banks, as it is not easy to bank in those countries because there are so many competitors, particularly when these belong to the public sector (Germany and France).

But despite these valid arguments, in practice there are still handicaps. Even though we constantly talk about globalisation, cross-border mergers for banks, insurance companies and other financial firms are more difficult to achieve than domestic ones. Apart from the language and the culture, there are tax and legal complications (such as worker codetermination in the case of firms with employees in Germany). There may also be strict bank regulations and currency complications. These factors are still national. They lead to extra barriers, complications and risks that make cross-border transactions more difficult to achieve than, say, a merger of two identical banks that happen to be headquartered in the same country.

An even more serious complication that varies by nation is the case of countries in which national authorities are more strict in approving acquisitions of domestic financial institutions by foreign than by other domestic ones. There are - sometimes understandable - national and sovereignty arguments raised. In the 1980s the British and Dutch governments were able in Brussels to abort the dangerous idea of a “fortress Europe” - of creating a kind of protectionist barrier around the EU against cross-border acquisitions and mergers, particularly in banking.

Sometimes there are other obstacles as well. It is more difficult to finance large, cross-border mergers. When cash is paid, the matter is “easy” if the acquiring bank can afford the negative impact on its capital ratios. However, when payment is by an exchange of shares, the selling shareholders are reluctant when the foreign acquiring bank is less well known in their country or its shares are not liquid enough (because they are not listed in New York, for example).

The best legal approach to cross-border mergers is a general principle that does not limit itself only to banking: the so-called national treatment rule. This is fundamentally different from the reciprocity rule previously used in the financial sector, which does not work sufficiently well in practice. The national treatment rule is fine, provided the rule applies both ways, between, say, the USA and Europe. That is, country B treats a bank from country A that wants to become active in country B in the same way that it treats a bank from within country B. Such treatment is fair. The bank from country A cannot expect more, but if country B provided less than national treatment, it would be discriminating against cross-border transactions. The national treatment rule is being applied now in most cases by the USA and Europe.

Cross-border consolidations between banks or financial conglomerates have been, and still are, limited in number, although they are expected to increase. There already are important examples. In the Nordic countries there have been quite a number of cross-border mergers where the initial results appear to be positive. The same applies to institutions in The Netherlands and Belgium. Admittedly, in all these cases, consolidation has been easier because of the lack of language barriers.

There are also many cases of important acquisitions of banks in emerging markets by banks in the OECD countries. Some - but by no means all - of these involve struggling domestic banks in countries that have been weakened by crisis. A domestic bank, which has been bailed out by the government to avoid it going under, is sold. The host country wishes to give the bank a strong new basis for survival and so may require that it be taken over by a larger and stronger bank that promises to inject capital and bring in good management. Such an acquiring institution is frequently based in either the USA or Europe. In practice, however, authorities in several countries where problem cases reside hamper efforts by foreign banks to acquire ailing domestic banks. This is probably motivated by a combination of national pride, misconceptions about asset values and fear of dismissal of large numbers of bank employees.

The creation of the euro has - not surprisingly - provided a major impetus to, and acceleration of, integration of the European economic and financial sector. We see this every day with new cross-border activities. Although for many years several American banks had been active in Europe, their appetite for expanding their business in the region was substantially stimulated by the emergence of a genuinely integrated financial market in Euroland, much larger and with much higher liquidity, quality and choice of financial instruments than before. This development was realised with the coming of the euro in 1999. In the current situation, it is striking to observe the major role being played in Europe by non-European banks (banks active in Europe but headquartered elsewhere, particularly in the USA). This applies to US commercial banks and even more to US investment banks. One example: already many years ago an American institution became the first pan-European bank with offices in all countries of (western) Europe. (This pan-European characteristic refers to corporate banking activities only; no bank has achieved a pan-European presence in retail banking). It is striking to observe that an American rather than a European institution has achieved this status. In the arena of investment banking (mergers and acquisitions, advisory work, equity and bond issues, underwriting and distribution) a similar development has taken place. Several US institutions are now among the top players in Europe in this area. Only a few truly European banks come close.

One may ask whether this is a good or a bad development. From a subjective European viewpoint, one may be tempted to dislike this American dominance. From an objective point of view, however, one should give more weight to the factual conclusion that the activities of these New York-headquartered banks make a major contribution to the creation of large, highly developed, efficient and liquid financial markets in Europe, to the benefit of both suppliers and users of financial capital.

A recent and important development relates to the strict attitude adopted by the European Commission in the implementation of its competition policy. In a growing number of cases, further consolidation among companies in the same country is being blocked because of the (perceived) disadvantages of a dominant position in a (national) market. For the banking sector, and probably the insurance sector as well, this development implies de facto the end of the trend towards consolidation among large domestic institutions (the creation of “national champions”), particularly in smaller countries (see the recent case of SEB and Swedbank), but also in large countries (see recent cases in the UK, such as the intended merger between Lloyds TSB and Abbey National, where the competition authority was the national British one, rather than the European Commission). This important limitation on seeking growth through domestic mergers and acquisitions may induce several banks and insurance companies to consider cross-border expansion more seriously, either through organic growth or through acquisitions.

The creation of the euro in 1999 has eliminated - in Euroland - one major obstacle to cross-border investments, namely exchange risk. The shield of the national currency no longer protects a domestic institution and competition from foreign-based firms will grow. This in turn will stimulate cross-border mergers. It is, however, not yet clear whether this factor alone will trigger many cross-border mergers in Euroland, since other obstacles still remain.

Financial safety nets

Moving now from the private financial sector to the area of public policy, it is worth emphasising that there exists a link between the above-mentioned structural developments in banking (including consolidation) and the issues currently being addressed by the Financial Stability Forum (FSF) in Basel. For many reasons it is vital to establish a financial safety net in each country. It is equally vital to ensure, firstly, appropriate international cooperation and coordination among countries and among the national mechanisms and, secondly, the appropriate composition of any (national) safety net.

The Report by the Working Group on Deposit Insurance[3] of the FSF correctly addresses this second point by stating "...a financial safety net usually includes prudential regulation and supervision, a lender of last resort and deposit insurance". It is worth emphasising the relevance of having effective mechanisms in place in all three of these areas, in other words, a combined approach. A country that has established a well developed mechanism in only one (or two) of these three areas is likely to face insurmountable obstacles in finding effective solutions for preventing, or resolving, serious difficulties in its banking system. The report correctly states that a deposit insurance system "...needs to be supported by strong prudential regulation and supervision, sound accounting and disclosure regimes, and the enforcement of effective laws".

In any country where there is an absence of a well devised financial safety net, the risks of a destabilisation of the banking system will grow. This, in turn, will lead to international repercussions such as reluctance on the part of foreign institutions to hold claims on the domestic banks in that

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[3] *Guidance for developing effective deposit insurance systems*, Basel, September 2001, pages 7-8.

country and the emergence of a “country premium” for international interbank deposits, for example the “Japan premium”. Domestic banks have to pay above the normal interbank rates in order to attract these routine funding resources from abroad. Ultimately, such developments may lead to defaults of domestic banks or - to avoid such defaults - a process of forced consolidation in which the weaker banks are acquired by stronger - domestic or foreign - banks at a pace that is faster than would have been the case with a solid financial safety net. This structural change to the domestic banking system in a weak environment is frequently accelerated by the flight to quality mentioned above. To avoid losses, balances (deposits, savings accounts) are withdrawn from the weaker banks and transferred to other (foreign or domestic) banks that are perceived to be financially stronger and safer. A well devised deposit insurance system would be able to prevent this development to a certain extent.

Another aspect that has rightly received great attention in the above-mentioned report is the danger of moral hazard[4]. The risk of any financial safety net, especially any deposit insurance system - besides that of being ineffective or insufficient - is that it encourages moral hazard. The necessary financial discipline is reduced by providing incentives for excessive risk-taking by either banks and/or depositors (those who benefit from the protection of the insurance). Experience has shown that moral hazard - historically as well as today - is one of the most serious problems, not only in developing a balanced safety net for financial institutions in a country, but also internationally. In particular, it is problematic as regards devising a balanced lending policy for the IMF by which neither the borrowing country nor private sector investors in, or lenders to, that country see opportunities to engage in riskier behaviour in the

[4] Ibid, pages 8-10 and 28.

expectation that they will be bailed out by public sector institutions.

In analysing the features of a deposit insurance system that can and should mitigate the occurrence of moral hazard, two elements can be singled out. The first is that the amount of deposit insurance coverage for individual depositors should not be set so high as to encourage irresponsible behaviour by banks or depositors, or both, by stimulating the growth of claims on aggressive, low quality (high risk) banks. The second way to avoid moral hazard is probably even more important, namely the technique of funding the insurance system[5]. Premiums should be set at different levels, based on the outcome of the risk assessment of each institution. In many countries (particularly where the private sector credit rating agencies are hardly active or where the national bank regulatory and supervisory systems are not well developed), such risk assessment of individual banks is not easy to implement. Yet a flat-rate premium system greatly increases the likelihood of developments that one wants to avoid: namely, bank failures. This is because flat insurance premiums for different financial risks stimulate the (deposit) activities of the weaker banks. They also lead to distortion of competition among banks. Prudent and strong banks face unfair competition from weaker institutions that can offer a lesser quality product (deposit) without having to offer a higher price (interest rate), thanks to the “subsidy” from the official deposit insurance system. Indeed, flat-rate premiums encourage excessive risk-taking by banks, which is undesirable.

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[5] Ibid, pages 26-28.

Regulatory policies

The other main aspect of official policies relates to bank regulation and supervision. Because the responsibilities and policies of the bank regulatory authorities are not only important in general, but may also have a decisive influence on developments in the structure of the financial services sector, such as a trend towards transformation of the character of private financial institutions, including consolidation, some general observations on this matter may be useful.

The first question is whether the national authorities follow a liberal approach with regard to any preference among the financial institutions in their countries for consolidation - either with their peers or cross-category - or whether they want to stick to a more rigid and regulated status quo. This issue will be elaborated on below.

The second question concerns the attitude of the regulators in situations where the banking sector is, or individual banks are, confronted with real or emerging problems. More precisely, do the authorities adopt a proactive and strict approach, whereby they take the tough measures they deem appropriate to resolve the problems at an early stage, or do they follow a passive and/or soft approach? If one analyses the developments during recent decades in bank regulation and supervision in various countries and under varying economic conditions, one can observe clear differences between countries in this respect. The differences also have an impact on other areas, such as bank consolidation. Experience in both Europe and the USA indicates that, in general, the approach involving proactive and strict policies by bank (and insurance) regulators is preferable.

Bank regulation and supervision should be strict and effective. Strict in the sense of setting high standards of prudential control to reduce the risks of individual banks - or worse, the entire banking system in a country or region - from becoming insolvent or illiquid. One of the most effective tools is to impose conservative minimum capital ratios for bank activities.

The rules on capital adequacy introduced by the Basel Committee in 1988 have made a major and positive impact in this respect, even though one may argue that several elements of the Basel rules are not perfect. Strict standards of bank regulation and supervision are not effective, however, if the regulators themselves are not sufficiently equipped in numbers or in personal qualifications (training, experience). This element is still frequently lacking in developing countries. It is therefore appropriate that the BIS and the Basel Committee are widening their area of coverage beyond the original, limited number of industrial countries to many emerging countries. The same applies to the work of the FSF. Similar shortcomings of ineffective application of bank regulation and supervision in day-to-day practice continue to haunt certain important industrial countries such as Japan and Korea. Here, large parts of the banking system have suffered for too long from bad assets, high but still insufficient write-offs, weak balance sheets and capital ratios, low profitability, demands for government bailouts, weak management, etc. It would be unfair to seek the explanation for this unsatisfactory state of affairs solely from the banks themselves. Part of the blame lies with the regulators in those countries.

Another element of importance for an effective system of bank regulation is related to a proactive approach in its implementation. If regulators wait a long time before taking action - even if their action as such is appropriate - much damage will occur in the meantime. This delayed action approach can be explained by cultural factors (reluctance and/or embarrassment about confronting important institutions and senior bankers about their shortcomings and the required painful corrective measures), by political factors (bank regulators who are insufficiently independent of political pressure, which induces them to refrain from taking action) or by their inexperience or slowness. Elements of the first can be found in Japan; elements of the second occur in several developing countries and elements of the third existed in the USA in the 1980s (the Savings and Loans debacle) and in some countries in Europe in the early 1990s.

The third general aspect is related to the international dimension, which is of growing importance. It has two components. In the first place, there is an increasing need for international coordination among the national regulators and supervisors. Their coordination should secure an international “level playing field” for banks (or other financial institutions) that engage increasingly in activities outside their own country, through local activities in other countries as well as cross-border transactions. There is, therefore, a growing need for conditions which ensure roughly equal competitive opportunities - from a regulatory point of view - for institutions from different countries that are offering similar banking products in the same country. The cooperation of national regulators in the Basel Committee and the Basel capital adequacy rules certainly contribute much to this level playing field, but more is needed.

The other international aspect concerns the policy adopted by the national authorities as regards cross-border mergers and acquisitions. Do they more readily approve domestic banking consolidation than acquisitions of the same national banks by foreign ones? This is another facet of the international level playing field. Current practices show that some countries follow “neutral” policies in this respect, whereas others are, regrettably, more restrictive on cross-border than on domestic consolidations. Certainly, within the EU the latter policy would be incompatible with the rules of the internal market. The European Commission, hopefully, will take rigorous action against such practices.

One way of addressing and solving these issues in Europe[6] would be to shift the regulatory and supervisory responsibilities for financial institutions from the national level

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[6] See also H Onno Ruding, *A review of proposals for redesign of capital regulations*, in: Global Financial Crises: Lessons from recent events; papers of the conference organised by the BIS and the Federal Reserve Bank of Chicago, Chicago, 1 October 1999, pages 239-243.

- as currently is the case - to the European level. In other words: one pan-European regulatory institution, with probably a certain degree of delegation of executive functions to the existing national regulators. This structure could follow the example of the European Central Bank (ECB). No view will be expressed in this paper as to whether such a new European financial regulatory or supervisory role should be entrusted to the ECB, or to a newly established, separate entity[7]. This decision is important in itself, but less so for the goal I am advocating: to achieve a level playing field within the EU which is non-discriminatory against foreign financial institutions, and which enables the banks and insurance companies in the EU to achieve an optimally strong competitive position. The current situation really complicates life for banks that are active everywhere in the EU, because they have to deal with a large number of national regulators whose policies are different and/or not always well coordinated and sometimes even contradictory.

It is important to note that the authorities in the various countries hold different views on the desirability (or otherwise) of consolidation in the financial sector. This applies even to the members of the EU. On the one hand, in The Netherlands the relevant authorities (Minister of Finance and President of the central bank) decided early on to liberalise the financial sector by abolishing their long-standing policy to retain the status quo ("structure policy"). This happened in 1989 and was carried out in the widest sense: large banks were permitted to merge with other large banks, insurance companies with insurance companies, and large banks with large insurance companies. Moreover, all this applied to domestic mergers as well as cross-border consolidation. The impact of this liberalisation, or

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[7] Charles A E Goodhart, in *The organisational structure of banking supervision*, Occasional Paper 1 of the Financial Stability Institute (FSI), Basel, November 2000, expresses a general preference, in developed countries, for separating banking supervision from central banks, and placing this within a unified financial supervisory agency.

deregulation, became immediately visible in several major transactions. In 1990, the merger between AMRO Bank and ABN Bank, both in The Netherlands, and the merger between AMEV Insurance in The Netherlands and AG Group in Belgium, which - together with later acquisitions - now form the Fortis Group, took place. In 1992, the merger between NN Insurance and NMB-Postbank, both in The Netherlands, created the ING Group. This early move towards deregulation and consolidation has enabled the financial institutions in a relatively small country like The Netherlands to form new groups that were and are better able to play a meaningful role, both locally and internationally, in a rapidly globalising and liberalising world of industrial companies (their customers!) and financial institutions.

The same cannot be said of financial institutions in several other EU countries, as well as non-EU countries. The more reluctant or slower attitudes on the part of regulatory or monetary authorities or the financial institutions themselves, or both, have led to the current situation in which consolidation among the national institutions, particularly banks, has not been as far-reaching or rapid as in other countries. Consequently, several large banks are either no longer independent, having been acquired by foreign institutions, or hardly play a role of importance internationally. Any country following a policy of blocking mergers between large domestic banks or acquisitions of domestic banks by foreign banks runs the risk of making the local banking system less consolidated, less international and less competitive than other banking systems. The Central Bank of Italy seems to favour such an approach. In France, the traditional governmental influence and continued presence of state-owned financial institutions, although several previously nationalised banks and insurance companies have been privatised, is combined with reluctance to allow foreign banks and insurance companies to acquire French institutions.

On the other hand, one can take the case of the USA, where until the 1980s the legislators and regulators followed rigid policies, blocking any meaningful possibility for consolidation in the banking sector through the ban on interstate banking as well as cross-category mergers and acquisitions (Glass-Steagall Act, Bank Holding Company Act). In the late 1990s, wide-ranging deregulation took place, partly through liberalising legislation (Gramm-Leach-Bliley Act) and partly through a liberal interpretation of the Bank Holding Company Act by the Federal Reserve as the banking regulator. As indicated above, this has enabled, since 1998 and several years behind similar developments in Europe, the creation of real financial conglomerates for the first time in the USA. Now a merger of a commercial bank, an insurance company and an investment bank/securities broker is possible.

Conclusion

All the above-mentioned factors together favour further consolidation, domestically as well as cross-border, single-category (banks with banks, insurance companies with insurance companies, securities firms with securities firms) as well as cross-category consolidation (bancassurance, All-Finanz, financial conglomerates). These developments will result in a relatively limited number of huge financial institutions worldwide. Many of them will remain engaged in banking only, but a growing number will combine the different sectors of financial services. All these mega-institutions operate internationally, though to varying degrees. In addition, we should expect a shrinking number of banks that can be characterised as medium-sized - in comparison to the mega-category - although by historical standards their size is substantial. Many are the largest banks in their own country. However, with the growing internationalisation of trade, investment and financial services, being one of the largest banks in one country no longer goes hand in hand with the advantages of a large market share, in the light of the liberalisation of financial services and the growing competition from banks based in other countries. Many medium-sized banks face difficult times. Next, a rapidly declining, but still large, number of smaller institutions with the general character of commercial and/or retail banks with a local or regional presence only is expected to emerge. Again, many, although not all, in this category will struggle with combining sufficient profitability and independence. Finally, several small, specialised and profitable “boutique” financial firms that may or may not qualify for the status of “bank” will continue to exist.

On balance, further cross-border consolidation of the financial sector would be desirable. Although in practice it sometimes doesn’t work out that way, in most cases the institutions that remain after these mergers are stronger and larger than before. They are better able to face competition internationally.

These trends in consolidation will further complicate the work of bank regulators and supervisors. On the one hand, the good news is that most of the banks that survive as independent institutions enjoy healthy balance sheets with a substantial capital base, thanks largely to the globally accepted standards of the Basel capital requirements. On the other hand, the less good news is that there will be a growing number of “mega” banks or conglomerates that will probably qualify for protection as “too big to fail” under deposit insurance schemes or lender of last resort facilities. It is true that the amounts of support involved can be huge. However, the monetary authorities no longer have to worry about the many banks which - rightly or wrongly - in the past were supposed to be protected on the basis of the “too big to fail” criterion but no longer exist as independent institutions. The other complication for the authorities is related to the growing number of financial conglomerates, particularly those that are active in many countries. Proper handling (both preventive and corrective) of large and complex financial institutions requires effective coordination and cooperation between supervisors within one country, as well as between the national supervisors in different countries. In that context I favour the creation of a European regulator for the banking industry, which will gradually replace the national regulators in the EU. Over time, this should be transformed into one European supervisor for the entire financial sector. This is admittedly an ambitious and longer-term goal, but a necessary one. Whether European regulatory responsibility should be entrusted to the

ECB or to a separate and new institution is in principle a less crucial issue, though of great practical and even political importance.

Fortunately, as a result of the work of the Basel Committee, the cooperation between national bank supervisors has intensified and improved significantly in recent years. I am more worried about the progress in this area for insurance companies and even more for financial conglomerates. Many countries still struggle with the - admittedly not easy - coordination or integration of the work of the various supervisors for banking, insurance and securities/brokerage in a country. In several cases the current situation is still unsatisfactory and those countries that have found a workable solution have mostly opted for a different construction to that chosen by other countries (this even applies within the EU). This outcome reduces the likelihood of effective international coordination in handling problems facing a complex financial conglomerate.

Finally, there is a growing need for cross-sectoral financial supervision, as well as cross-border financial supervision. Every effort should be made to avoid lacunae in supervision (“nobody cares”) as well as overlapping and duplication in supervision (“everybody cares”).