Restructuring of the Belgian banking sector and financial stability

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1. Introduction

Over the past two decades banking has undergone similar changes in most market economies: deregulation, disintermediation, internationalisation and technological innovations have all helped to intensify competition in ever more globalised financial markets. But the banking sectors of the various developed countries still have widely differing characteristics, even within the European Union.

The introduction of the euro in January 1999 will blur this diversity. The element of segmentation due to national currencies will disappear and EMU will also be a catalyst to extend or reinforce current trends. The fact remains that it is from their current specific structures that the various national banking sectors must adapt in order to meet these new challenges.

This paper will first examine the distinctive characteristics of Belgian banks, then detail the types of responses that they are attempting to make to the changes in progress and finally highlight some of the implications for the prudential authorities.

2. Distinctive characteristics of Belgian banks

2.1 Type of business

As the single currency will compel the Belgian banking sector to fit into a larger whole, it seemed appropriate to compare, as far as possible, this sector's position with that of four neighbouring countries – Germany, France, the Netherlands and the United Kingdom – and the average for these countries. These countries are in any case some of Belgium's main commercial and financial partners. It turns out that the balance-sheet and trading structure of Belgian credit institutions is markedly different from that of the four neighbouring countries (Table 1).

For one thing, interbank operations account for 41% of liabilities against an average of 26% in the other countries. Corresponding assets are 33% of the balance-sheet total in Belgium against only 23% in the other countries. Belgian credit institutions therefore have a large net debit position on interbank operations. This structure has a negative impact on the profitability of the sector, which funds part of its lending to customers by means of relatively costly resources.

The size of interbank operations in Belgium results in part from the high degree of openness of the economy, as evidenced by the presence of numerous branches and subsidiaries of foreign banks. These institutions, not all of which have a traditional deposit-taking network, account for a proportion of interbank operations that is substantially greater than their share in the overall balance sheet of all banks established in Belgium. In addition, they mainly carry out these transactions in foreign currencies, as reflected in the high volume of operations transacted with non-residents. These operations represent respectively 39% and 43% of claims and liabilities in the Belgian banking sector as a whole, against 19% and 21% in the other countries.

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Table 1
Credit institutions' balance-sheet structure
At end-1996, in percentages of balance-sheet total

	Belgium	Germany	France	Netherlands	United Kingdom	Average of other four countries
Assets						
Interbank lending[1]	33.0	23.6	38.8	17.2	12.5	23.0
Loans	31.9	53.5	36.3	64.0	55.3	52.3
Stocks and shares	29.9	20.4	18.9	16.2	18.5	18.5
Other assets	5.2	2.4	6.0	2.6	13.7	6.2
Total	100.0	100.0	100.0	100.0	100.0	100.0
of which: claims on non-residents	*38.9*	*19.4*	*19.0*	*23.8*	*n.a.*	*20.7*[2]
Liabilities						
Capital and reserves	2.5	4.1	4.1	4.1	4.2	4.1
Interbank borrowing	41.2	26.6	39.9	23.4	12.9	25.7
Non-bank deposits and commitments	48.9	61.7	46.9	58.5	67.0	58.5
Other liabilities	7.4	7.6	9.1	14.0	15.9	11.7
Total	100.0	100.0	100.0	100.0	100.0	100.0
of which: liabilities to non-residents	*43.3*	*14.8*	*18.4*	*24.5*	*n.a.*	*19.3*[2]

[1] Including assets in cash and with the National Bank of Belgium. [2] Germany, France and Netherlands only.
Source: OECD.

The high share of interbank liabilities and liabilities to the rest of the world is also in part explained by the recycling, through the Belgian banking sector, of Belgian franc funds collected by foreign, particularly Dutch and Luxembourg, credit institutions. Many Belgian investors place part of their savings with these institutions to avoid withholding tax on investment income.

The second major characteristic of the balance sheet of Belgian banks is the relatively high level of securities, mainly public debt securities, representing 30% of assets against 19% in the other countries. Conversely, the share of loans is proportionately smaller for Belgian banks (32%) than for the other countries' banks (52%). Belgian individuals have a relatively low level of indebtedness while companies are mainly family-run small and medium-sized businesses which prefer to be self-financing rather than borrow from banks.

The composition of Belgian banks' assets enables them to make do with a lower percentage of capital since claims on the government are exempted from the capital requirements imposed by EU directives, while interbank lending is subject only to a lower ratio. Capital and reserves are thus only 2.5% of banking liabilities in Belgium against 4.1% in the other countries.

Belgian banks' expansion policies have long been centred on developing a highly dense distribution network in order to maximise collection of private savings, as shown in the profit and loss account structure (Table 2). On average, from 1990 to 1996, staff costs were equivalent to 43% of banking income, 6% above the other countries. In addition, banking income remains firmly reliant on traditional intermediation. Over the same period interest income accounted for 75% against 67% for the other countries' banks, which are more advanced in developing alternative sources of income.

Table 2
Credit institutions' profit and loss account structure
Averages for 1990–96, in percentages of bank income

		Belgium	Germany	France[1]	Netherlands	United Kingdom[2]	Average of other four countries
1	Net interest income	74.9	77.2	63.7	68.7	58.4	67.0
2	Other net income[3]	25.1	22.8	36.3	31.3	41.6	33.0
3	Bank income (1+2)	100.0	100.0	100.0	100.0	100.0	100.0
4	Staff costs	43.2[4]	39.3	36.8	37.9	35.8	37.5
5	Other operating costs	25.9[4]	24.3	31.4	29.5	28.7	28.5
6	Provisions	13.6	15.7	21.1	8.4	16.3	15.4
7	Profit before tax (3–4–5–6)	17.3	20.7	10.6	24.2	19.3	18.7
8	Tax	5.5	11.3	4.4	6.9	7.2	7.4
9	Profit after tax (7–8)	11.8	9.4	6.2	17.3	12.1	11.3

[1] Adjusted to exclude in 1994 a large bank that recorded an exceptional loss. [2] Commercial banks only. [3] Includes commissions, results of foreign exchange and trading business, income from shares and financial fixed assets, proceeds of disposals of investment securities, and other operating income. [4] For 1990–92, commercial and savings banks only.

Source: OECD.

2.2 Importance of strategic risk

Over the past few years, the Belgian banking sector has been characterised by a fair degree of stability, there having been no disaster or generalised crisis. Traditional risks, in particular credit risk, were generally well controlled. As was seen in the preceding section, it is true that Belgian banks enjoy a fairly solid asset structure. Claims on the government predominate, thereby reducing the relative share of claims on individuals and companies and limiting provisioning. Between 1990 and 1996 provisions accounted for only 13.6% of banking income against 15.4% in the other countries.

In return for more limited risks, credit institutions have had to content themselves with fairly low profitability. They have, however, partially succeeded in offsetting this handicap by greater leverage (ratio of total assets to capital). Credit institutions have thus maintained a return on equity which is comparable to that in the other countries despite the fairly low level of their return on assets (Graph 1).

However, the lower capitalisation of Belgian banks has drawbacks. It curbs the possibilities for developing operations with private customers that require greater capital cover. It complicates the financing of costly programmes to introduce new technologies that can only be justified by sufficient profitability. And it exposes Belgian banks up to greater shareholder pressure and increases the likelihood of their being viewed as potential takeover targets by their competitors.

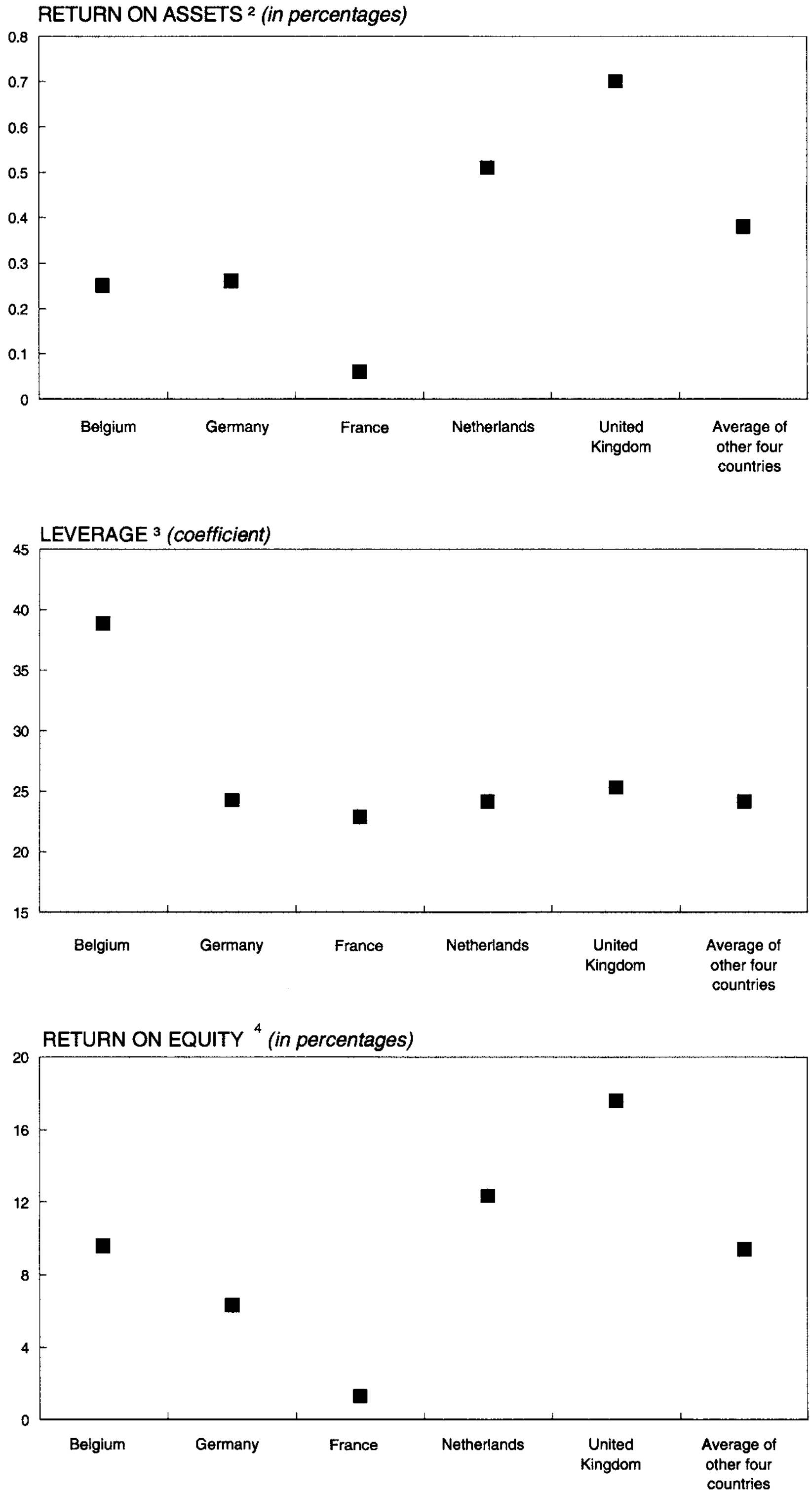
In this environment the main risk likely to affect Belgian banks' stability is strategic in nature. The disintermediation and internationalisation of financial flows, the emergence of new technologies for distributing banking products and the introduction of the euro are forcing credit institutions to review their business. This effort at adaptation is made more difficult by limited capitalisation and low overall profitability. Banks might thus be driven to adopt strategies which are too risky or unsuitable.

Faced with these challenges, credit institutions are in very different starting positions. Belgian banks' profitability is widely dispersed: whereas almost a quarter of Belgian banks enjoyed a return on equity greater than 12% in 1997, 30% of banks had a return on equity of less than 4% (Graph 2). Moreover, it was the small banks that suffered most from insufficient profitability. This is clearly not an absolute rule: some small institutions enjoy high profitability by focusing on business segments with high added value. In most cases, however, small Belgian credit institutions confine themselves to providing fairly standard services. A large part of their operations consists in taking deposits through traditional savings products and using them to fund investment in public debt securities.

Graph 1

INDICATORS OF BANKS 'PROFITABILITY'[1]

(averages for 1993 - 96)



Source: OECD.

[1] All banks, except for the United Kingdom (commercial banks only). Figures for France are adjusted to exclude in 1994 a large bank that recorded an exceptional loss.

[2] Profit after tax as a percentage of total assets.

[3] Ratio of total assets to capital.

[4] Profit after tax as a percentage of total capital.

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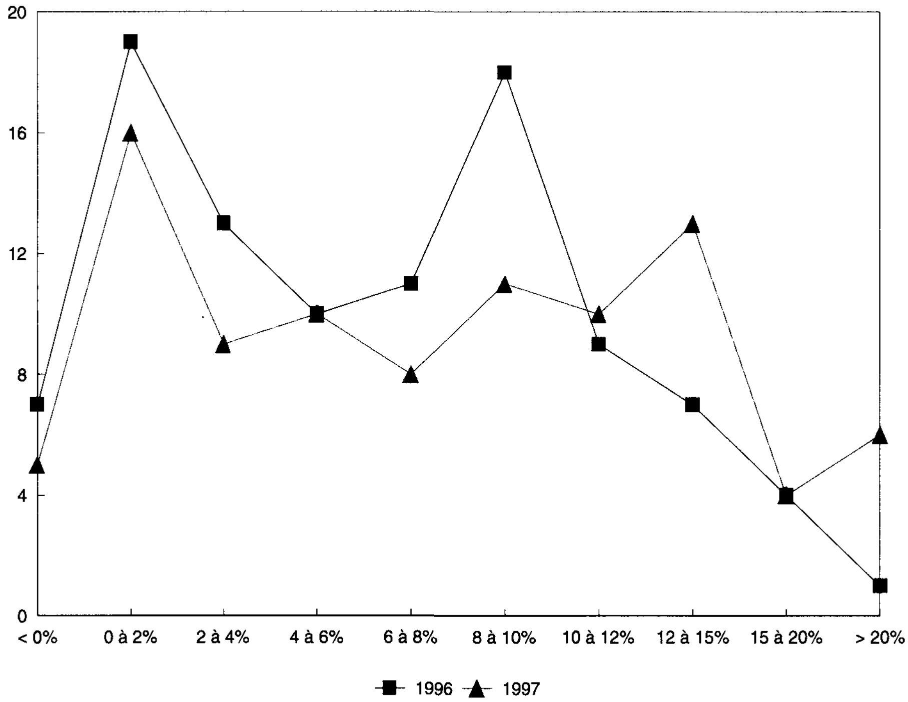
DISTRIBUTION OF RETURN ON EQUITY* OF BELGIAN-LAW CREDIT INSTITUTIONS

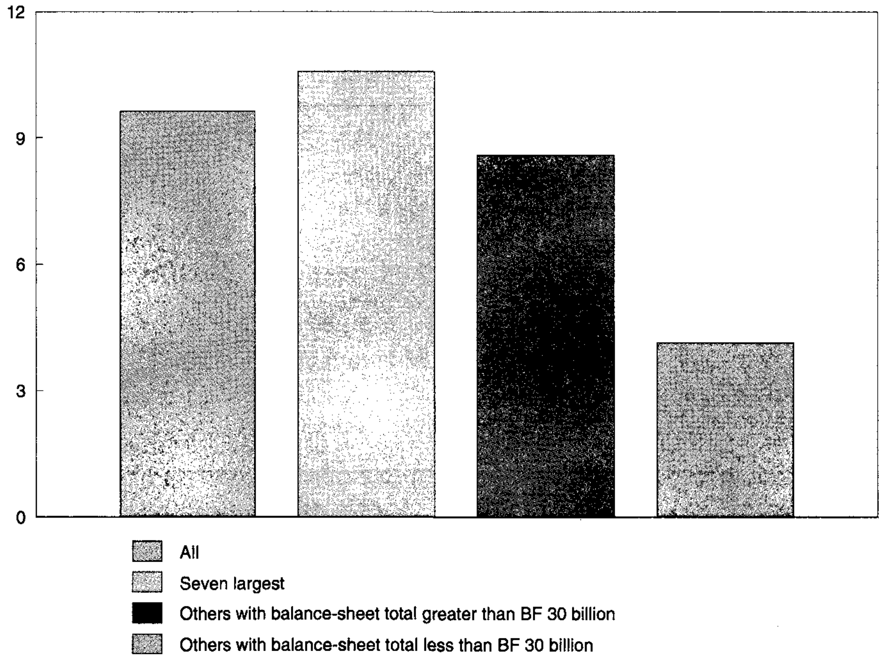
(Number of institutions and percentages)



Source: Banking and Financial Commission.

RETURN ON EQUITY* OF BELGIAN-LAW CREDIT INSTITUTIONS BY SIZE

(In average percentages for 1993-97)



Source: National Bank of Belgium.
** Profit after tax as a percentage of capital.*

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Different problems arise for large Belgian banks which enjoy markedly higher profitability than their smaller competitors. In the Belgian market, most of these large institutions have traditionally sought to present themselves as universal banks offering a full range of banking products to every type of customer. However, to be able to do this on a European and even a worldwide level, such a policy entails attaining a substantially greater size.

Large Belgian banks are thus confronted with a choice. If they wish to continue offering a full range of services, they will have to pursue a policy of external growth by mergers and acquisitions. However, the difficulty in reaching and maintaining the size required to realise this aim could induce them to opt for specialisation in certain types of business or in certain geographical markets.

3. Types of responses to changes in progress

Some of the transformations affecting the banking sector are not recent. In fact, credit institutions started their efforts at adaptation several years ago.

In the first instance, these efforts were mainly aimed at integrating developments under way within the context of existing business. Whereas this type of reaction was often effective in the past, it is not certain that it will continue to be appropriate, given the acceleration and multiplication of changes in progress.

It is therefore important to distinguish between banks responses, responses on the form of "internalisation" within existing structures and responses changing business structures.

3.1 Integration within existing structures

3.1.1 Integration of disintermediation

Retail banking was undoubtedly the first activity affected by changes in the financial system. This is not surprising in view of the high rate of saving in Belgium and the importance of this activity to Belgian banks, whose main macroeconomic role is to channel the financial surplus from households to finance the government.

From the early 1980s the internationalisation of markets induced individuals to diversify their investments. This behaviour was reinforced by tax considerations, depositing money abroad being a convenient way of avoiding withholding tax on interest income. This competition from foreign institutions was accompanied by competition within the Belgian banking sector itself. The liberalisation of markets brought about the demise of the more or less formal systems of restrictions on rates that existed in Belgium within the framework of the *Comité de concertation pour l'harmonisation des taux d'intérêt créditeurs* (consultative committee for harmonising creditor interest rates) and the *Comité d'examen des conditions débitrices* (committee on lending terms).

Belgian banks therefore sought to offer new investment products which, while being more attractive to their customers, still guaranteed them a stable source of income. This reaction paved the way for the exponential growth in mutual funds.

For investors, this type of investment offered possibilities of diversification into numerous different categories of assets and geographical markets. Mutual funds also enabled individuals to benefit from professional management of their assets. As for the banks, they were able to collect substantial investment and management commissions which acted as a substitute for the margin on traditional intermediation. The success of investments in mutual funds also relied on tax advantages. Insofar as investors opt for the capitalisation system, the mutual funds procure income in the form of tax-free capital gains.

The success enjoyed by mutual funds is clearly illustrated by the changes in the investment channels used by individuals for their assets. Between 1980 and 1997 the share of financial assets held directly with resident credit institutions fell from 54.8% to 37.9%, while the share of assets in mutual funds rose from 0.5% to 11.0% (Table 3). Almost all these mutual funds are set up, marketed and managed by Belgian banks even though they are often registered under Luxembourg law for tax reasons.

Table 3
Structure by investment channel of individuals' financial assets
At year-end, in percentages of total

	1980	1990	1997
With resident credit institutions	54.8	45.2	37.9
Notes and ordinary deposits	17.7	12.3	8.6
Regulated savings deposits	18.4	14.1	15.2
Fixed-income securities	18.7	18.8	14.0
With institutional investors	7.7	13.4	21.7
Mutual funds	0.5	5.3	11.0
Insurance companies and pension funds	7.2	8.0	10.7
On the Belgian financial market	27.4	24.9	19.9
Fixed-income securities	10.1	5.8	2.1
Shares	17.3	19.1	17.8
quoted	3.1	4.8	3.9
unquoted*	14.3	14.3	13.9
By other channels (mainly abroad)	10.1	16.5	20.5
Total (in billions of francs)	5,723	14,492	23,173

* Mainly securities issued by family-owned small and medium-sized companies.
Source: National Bank of Belgium.

It can thus be seen that, until now, disintermediation has scarcely represented any threat to Belgian banks. On the contrary, it was a development that they turned to their profit in response to foreign competition. This competition has been lively over the past few years and explains the increase in the share of individuals' investments placed outside the Belgian financial market which amounted to 20.5% at the end of 1997 against 10.1% in 1980.

The rapid expansion of mutual funds also enabled Belgian banks to develop synergies with other business. The experience acquired was thus utilised to market life assurance products, bancassurance representing a strongly growing segment in Belgium. Mutual funds also represent an important outlet for commercial paper and asset-backed securities, which several Belgian banks are endeavouring to develop.

3.1.2 Integration of new technologies

In order to collect individuals' savings, Belgian banks set up a very extensive branch network, which peaked at the end of 1990, with 1,025 branches per million inhabitants against only 451 in the other countries (Table 4). Such a density could be justified up to a point in a context where price competition was suppressed. This encouraged banks to seek other comparative advantages and the proximity provided by a large number of branches was one way of setting oneself apart from the competition.

Deregulation of the financial markets has made this approach all the more questionable since it has been accompanied by the introduction of new technologies, opening up alternative possibilities for distributing banking products. In this matter as well, Belgian banks have until now reacted by integrating changes into their existing structures.

Table 4
Distribution networks
Number per million inhabitants

	Belgium			Average of other four countries		
	1990	1996	% change	1990	1996	% change
Branches	1,025	747	–27	451	406	–10
Number of employees	7,926	7,560	–5	7,865	7,545	–4
ATMs	94	414	340	218	407	86
POS terminals	2,828	7,997	183	1,384	6,569	375

Sources: BIS and OECD.

The emergence of new technologies has of course resulted in a reduction in the number of branches. Nonetheless, the number has remained high and, at the end of 1996, there were still 747 branches per million inhabitants against 406 in the other countries. Moreover, this drop has not been accompanied by a corresponding reduction in employment in the banking sector.

In fact, technological innovations have led not so much to a pure and simple substitution of ATMs for ordinary branches as to the development of a new distribution circuit, complementing the traditional network.

In a first phase, ATMs, mainly of a universal type, and POS terminals were used to increase the role of banks in payment circuits to the detriment of banknotes. In a later phase, banks mainly increased the number of ATMs which are solely accessible to customers of the institution that installed them. This reversal was the result of the major institutions' becoming aware of the existence of externalities associated with networks of universal ATMs. Following the example of the larger banks, small credit institutions saw such ATMs as enabling them to offer access to an entire network for which they bear only a minimal share of the installation and management costs. Furthermore, private ATMs allow a fuller range of operations to be carried out than standard ATMs whose functions are limited to cash withdrawal and the checking of account balances. All types taken together, at the end of 1996 the number of ATMs installed was more or less the same in Belgium as in the other countries: around 400 per million inhabitants.

In addition, the narrowness of the national market and the magnitude of investments to be authorised for the development of a network, at a very early stage, encouraged Belgian banks to co-ordinate the introduction of new technologies. This approach led to the formation of a joint venture, Banksys, which manages the system of ATMs and POS terminals. The existence of this structure has enabled the creation of synergies and the acquisition of know-how in secure electronic payments as well as a more rapid development of new products such as the Proton electronic purse, which is likely to be distributed on a much greater scale than just the national market. The Proton card is being marketed in several foreign countries through international partners.

3.2 Change in business structures

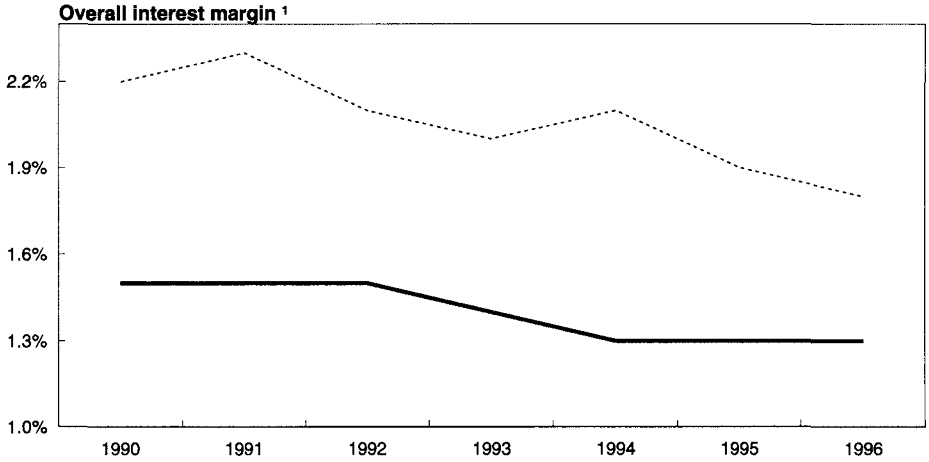
While it has had positive effects, the integration of changes in existing structures has not prevented a deterioration in Belgian banks' results. The overall interest margin has continued to decline and remains much lower than in the other countries (Graph 3). Despite its growth, non- interest income still represented only some 30% of gross income in 1996, a figure that had already been reached in 1990 in the other countries.

In many respects, the banking sector is thus handicapped in facing up to structural changes which the introduction of the euro will accelerate and intensify. This is leading banks to consider more profound changes to their business structures.

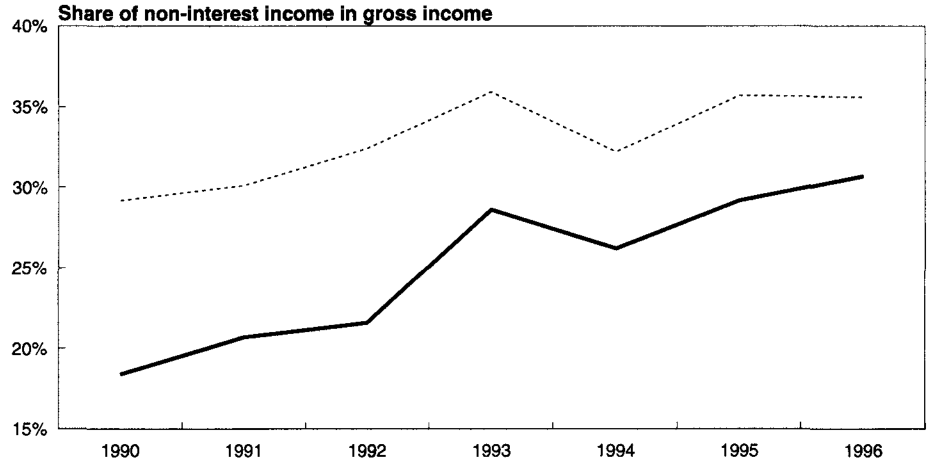
INDICATORS OF BANKS' INCOME AND COST STRUCTURES

(In percentages)

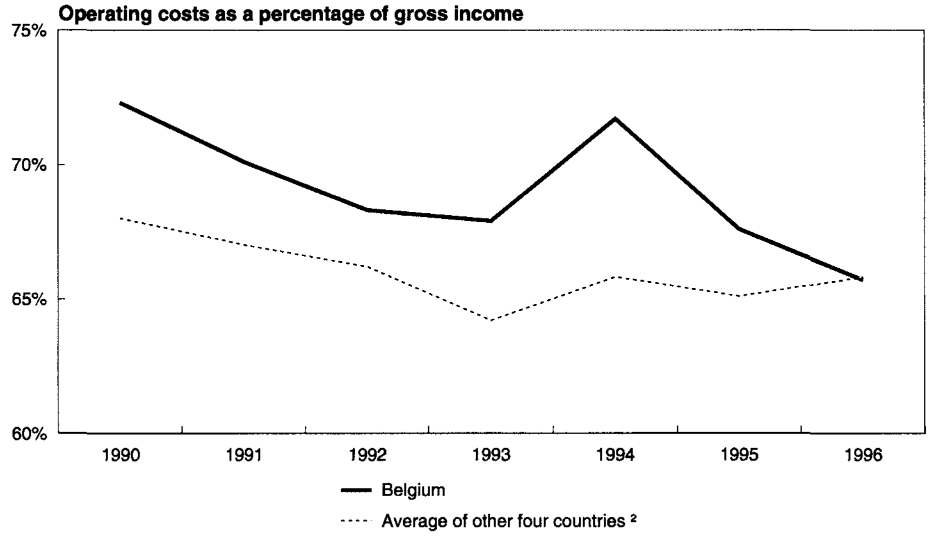
Overall interest margin [1]



Share of non-interest income in gross income



Operating costs as a percentage of gross income



Source: OECD

[1] *Net interest income as a percentage of balance-sheet total.*
[2] *All banks, except for the United Kingdom (commercial banks only). Figures for France are adjusted to exclude in 1994 a large bank that recorded an exceptional loss.*

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3.2.1 *Reduction of costs and changes to the network*

The most immediate need is to reduce costs and efforts are already being made in this regard. Operating costs have been appreciably reduced, from 72.3% of gross income in 1990 to 65.7% in 1996. However, this drop took place from an unfavourable position in relation to the other countries and could, moreover, be explained in part by a temporary growth in income (cf. Section 3.3).

Given the surplus capacities mentioned in Section 3.1.2, a reduction of costs will without doubt involve a modification of the network structure. New methods of remote access to banking services are now being developed. However, the introduction of PC and Internet banking systems necessitates sizable investments. In view of these costs, many banks will undoubtedly find it increasingly difficult to simply juxtapose new technologies and old networks.

Strategic choices must therefore be made. While some banks continue to offer all access possibilities, others will choose to become more selective. Large institutions might also prefer to develop certain specific methods of distribution through subsidiaries. A subsidiary of this type has recently been set up in the form of a direct bank operating by telephone only, without a traditional branch network.

Two factors could, however, complicate the implementation of these cost-reducing programmes. The first is the social environment. The relatively high level of unemployment in Belgium means that staff cuts create an obvious image problem for credit institutions. As a result of the economic climate, the improvement in banks' profitability would aggravate this image problem. The second challenge is the necessity of linking a quantitative reduction to a qualitative improvement in the workforce. The transformation of banking business requires increased and diversified skills which it may be difficult to assemble and keep if the social climate deteriorates.

Furthermore, in some areas, such as IT, a labour shortage is emerging. The adaptations required by the introduction of the euro and the year 2000 issue mean that banks are competing with other business sectors in the market for IT specialists. Using subcontractors can only be a partial solution: for credit institutions, it raises specific problems of control and dependence on external suppliers.

3.2.2 *Adaptation of the product range*

As seen above Belgian banks have made use of disintermediation to protect their retail banking business. Disintermediation of financial investments could, nonetheless, take other forms that are more difficult for banks to "internalise". Thus, constraints faced by social security systems will undoubtedly accelerate the development of pension funds.

More generally, the introduction of the euro will further intensify the competition that prevails for most banking business. Financing operations carried out by Belgian banks remain focused on the government, which offer less potential for developing collateral business than does financing companies. Furthermore, company financing mainly comprises small and medium-sized companies as Belgium has only a small number of large multinational companies which might serve as a bridgehead for their own expansion abroad.

On the other hand, these small and medium-sized companies offer possibilities for developing investment banking business, in particular initial public offerings of previously family-owned capital. Likewise, the very high individual saving rate constitutes a base for private banking business.

However, as these are relatively new activities for many credit institutions, they need to develop specific skills. In addition, a large number of banks are contemplating similar diversification plans in these business niches. There is therefore the risk of a whole group of banks entering these markets and canvassing the same types of customer.

Risks linked to herding are undoubtedly most evident in respect of operations in international markets. The growth in lending by Belgian banks to emerging markets provides an illustration of this. These banks were late arrivals in these markets, where they did not generally have a historical presence. In 1996 and early 1997 they sharply increased their volume of lending, mainly short-dated and to the banking sector. In the short term this structure enabled a more rapid reduction of positions in response to the crisis in South-East Asia. However, in the longer term this stop-go approach will not facilitate the structural development of new business and the establishment of lasting relationships.

3.2.3 Tie-ups with other credit institutions

Reducing costs and diversifying business are strategies that can be pursued individually. They can also be implemented by way of tie-ups with other credit institutions. Such grouping operations started in the small bank segment many years ago. The number of credit institutions with majority Belgian participation fell from 117 in 1980 to 63 in 1997; in the same period, however, the number of subsidiaries and branches of foreign banks rose from 59 to 71. But from 1996 the scale of operations changed decisively. In three years the structure of each of the nine largest Belgian banks was radically transformed:

- CGER, SNCI and Générale de Banque were grouped together in stages under the aegis of the Fortis holding company, itself the result of a tie-up between the Belgian insurance company AG and the Dutch insurance company AMEV;
- Crédit Communal de Belgique formed with Crédit Local de France the Dexia banking group;
- BBL was taken over by the Dutch bank ING;
- the banking group CERA, the financial group KB Almanij and the insurance group ABB merged within the KBC group; and
- BACOB took over the business of Paribas Belgium and Paribas Netherlands.

These large-scale operations are still too recent to allow an assessment of their results in terms of income growth and cost reduction. The increase in size, however, should provide the institutions concerned with various benefits, such as a more extensive division of labour and a more efficient organisation of resources. It will also be possible to write off investment expenditures necessitated by new computer technologies on a large number of operations. Furthermore, offering a wider range of services will enable better exploitation of potential synergies and increase customer loyalty.

However, the timing of these operations is a source of concern. The groupings took place at a later date than in some neighbouring countries, in particular in the Netherlands, such that they are combined with an acceleration of structural changes, the introduction of the euro and the year 2000 issue. These various problems must be tackled together with the organisation and management of mergers and acquisitions. In Belgium, these often take place under complex conditions that make it more difficult to reconcile cultures and harmonise procedures.

3.3 Interaction between structural changes and economic environment

While Belgian credit institutions, like all their European counterparts, have to make difficult strategic decisions, they have, over the past few years, been able to benefit from favourable macroeconomic conditions. First, the improved economic climate has helped confine credit risks. Second, the transition to a low-inflation environment, a prerequisite for the introduction of the euro, has brought about a sharp fall in both short-term and long-term interest rates.

This generalised downturn in rates has temporarily enabled Belgian banks to increase income derived from their major activity of transforming short-term liabilities into longer-term assets. It has also allowed high capital gains to be made on public debt securities portfolios. Over the past three years these capital gains have represented on average 8.5% of Belgian banks' gross income (Table 5). However, this proportion only corresponds to booked capital gains. In Belgium, the principle of marking to market does not apply to the component of portfolios held for investment rather than trading purposes (a component which represents over 90% of total portfolios). For this reason, most Belgian banks have considerable latent capital gains on their fixed-income investment portfolios.

Paradoxically, these good macroeconomic conditions have not just had positive consequences. They have, of course, been beneficial for institutions which embarked on their strategic reorientation at a

sufficiently early stage. For many banks, however, they may have contributed to reducing the sense of urgency. Thus some credit institutions may have been tempted to put off their efforts at adaptation, not sufficiently realising the temporary nature of the growth in certain sources of revenue.

Table 5

Capital gains/losses on securities portfolios shown in Belgian banks' profit and loss accounts

In billions of francs

	1993	1994	1995	1996	1997
Trading portfolio[1]	8.9	–1.0	8.0	8.0	5.4
Investment portfolio[2]	26.3	18.5	31.3	31.6	44.7
Total	35.2	17.5	39.3	39.6	50.1
Total, as a percentage of bank income	7.9	4.0	8.4	7.7	9.4

[1] Realised capital gains/losses, plus positive or negative differences in valuation. [2] Realised capital gains/losses.

Source: National Bank of Belgium.

Paradoxically, these good macroeconomic conditions have not just had positive consequences. They have, of course, been beneficial for institutions which embarked on their strategic reorientation at a sufficiently early stage. For many banks, however, they may have contributed to reducing the sense of urgency. Thus some credit institutions may have been tempted to put off their efforts at adaptation, not sufficiently realising the temporary nature of the growth in certain sources of revenue.

Even if the downward trend in rates in Europe does not come to an end, it may at least slow down sharply. Although credit institutions profit from falling rates, they are penalised when interest rates are maintained at a low level, due to a compression of the interest margin obtained on liabilities such as sight and savings deposits that are remunerated at below-market rates or not at all.

Those negative effects linked to a low level of rates might be compounded by the negative effects of a potential reversal in economic activity, which would be all the more harmful for banks if they result from developments in the financial sector of the economy (stock market falls, financial and banking crises in Japan and in numerous emerging markets, etc.).

The short-term favourable effects of the drop in rates on profitability have perhaps deluded not only the banks but also the financial markets themselves. These two consequences may indeed be linked. Faced with shareholder pressure, many banks have underlined the improvement in their results. This type of reaction has not been limited solely to Belgian banks but has been a much more general phenomenon. It has often led banks to set ambitious objectives with a view to better positioning themselves in the face of the wave of mergers and acquisitions. The financial conditions in which some of these grouping operations were realised were clearly based on the achievement and maintenance of high profitability.

A large number of European credit institutions thus aim to match the levels of profitability attained by the US banks, for which the average return on equity is currently in the order of 20%. It is, however, questionable whether it is realistic to envisage maintaining such results on a lasting basis, when the long-term rate for risk-free investments has fallen well below 5% and, for a large amount of its business, the banking sector has undoubtedly reached maturity.

4. Implications for the prudential authorities

In view of the specific context in which Belgian banks have to adapt their structures and business, two major themes will guide the action of the prudential authorities.

4.1 Surveillance of strategic risk

The first concerns the attitude to be adopted by the supervisory authorities in the face of strategic risk. Selecting a strategy constitutes the fundamental task of a credit institution's senior management. Directly involving the authorities in this process would be not only inappropriate but also dangerous since it might entail certain liabilities in the event of failure of the options suggested.

At the same time, the prudential authorities cannot completely dissociate themselves from these decisions which will condition the nature and extent of risks incurred by banks.

The main protection resides in the quality of management. The Belgian authorities have always rightly attached great importance to the licensing terms for credit institutions and to the quality and expertise of senior management. This emphasis on essentially qualitative criteria must be strengthened and extended to all banking activities. The various types of banking risks cannot be exclusively measured on the basis of numerical indicators; they must also be evaluated by taking account of the degree of development and precision of the control procedures set up in the institutions themselves. It must be acknowledged, however, that this approach is less easy than a quantitative examination since it entails the assessment of essentially intangible elements.

Without interfering in the running of banks, prudential supervisors could regularly discuss with credit institutions the strategic directions adopted and verify the adequacy of existing structures to the strategy envisaged. Such a suggestion would undoubtedly be controversial. However, it could be argued that simply organising such discussions would in itself force certain banks, particularly the smallest, to devise precise strategies and be aware of the demands associated with them. The dangers of incompatibility or emergence of excess capacities could thus be better appreciated. The emphasis could also be put on the nature and quality of the various sources of profit, bearing in mind their risks and potential cyclical character.

4.2 Cooperation between prudential authorities

The second theme follows naturally from the numerous mergers and acquisitions that have recently taken place in Belgium. These operations are only a manifestation of a more fundamental internationalisation of financial markets, and have, for some years now, been of concern to the various prudential authorities. Harmonisation measures have progressively been developed, particularly in the form of the Basle Committee's recommendations and EU directives.

Beyond these formal rules, exchanges of information and cooperation procedures between authorities have increased. These efforts must be intensified and expanded since tie-ups between financial institutions are taking on new forms by the day. In this matter Belgium is most particularly concerned by two major developments.

With Fortis and Dexia, the Belgian banking sector is directly involved in two of the three large cross-border groups that have recently been created following mergers between large banks of different nationalities (the third being Merita-Nordbanken which groups a Swedish bank and a Finnish bank). Such operations raise specific questions in respect of surveillance that are very different to those related to mergers between entities from the same country or mere acquisitions of foreign banks. It seems all the more important to develop appropriate control procedures since there is a high probability that such mergers will increase.

In addition, a large number of Belgian credit institutions have diversified into insurance in a big way. Although the development of bancassurance has by no means been limited to Belgium, the magnitude assumed by this type of diversification highlights the particular need to ensure better coordination between the authorities responsible for controlling financial activities that are sometimes very different in nature.

These two examples could obviously be supplemented by many others. Thus the recent upheavals in several Asian financial centres and in Russia are sufficient evidence that cooperation cannot be restricted to a limited number of countries but must be extended to emerging markets.

5. Conclusion

While the Belgian banking sector has not been sheltered from the numerous convulsions that have affected worldwide financial markets, it has until now shown a fair degree of stability. There has been no disaster or generalised crisis. This solidity is largely explained by the fairly traditional structure of Belgian banks' business. Assets comprise a very high proportion of interbank claims and public debt securities, reducing the relative share claims on individuals and companies.

The effects of this structure are positive in terms of risk but negative in terms of return. Belgian credit institutions have to make do with lower profitability. In financial markets in relative equilibrium, such a handicap can be offset fairly easily by reduced capitalisation, enabling a reasonable return on equity to be guaranteed despite a low return on assets.

But the margin for manoeuvre becomes much narrower when the markets are undergoing, as is currently the case, profound transformations. Banks have to diversify business, search for new markets and make heavy investments to improve the quality of services offered. They must also position themselves in the face of the wave of mergers and acquisitions. In such an environment, the main risk incurred by Belgian credit institutions is clearly strategic in nature. They must embark on a major effort at adaptation with limited capitalisation and fairly low profitability, while seeing that an appropriate strategy is selected.

This challenge is not new, as Belgian banks have already had to adjust to several changes. Until now this adjustment mainly took place within the context of existing business structures. Banks have thus juxtaposed several of the new banking distribution technologies and their traditional network and have also managed to integrate the phenomenon of disintermediation by turning it to their advantage. The development of mutual funds in particular has substantially enabled banks to maintain their market share in collecting savings.

But this process of adaptation by "internalisation" has its limits. The introduction of the euro will accelerate and intensify the changes under way, forcing banks to reconsider the very structure of their activities. The structure of the network and the adequacy of capacities will need to be reconsidered. New techniques will need to be explored.

These strategic measures may be undertaken on an individual basis or through mergers and acquisitions. Unlike the operations of the previous 15 years, which had mainly affected smaller institutions, the banking groupings of the past three years have been large-scale since they have involved each of the nine largest institutions active in the Belgian market.

Any change in strategy in itself raises difficulties of implementation which might be sharply accentuated by the recent development of the economic environment.

Over the past few years all European banks have been able to do business in especially favourable conditions. The transition to a low-inflation environment, imposed as a prerequisite to the introduction of the euro, has brought about a generalised fall in both short and long-term interest rates. The downturn in rates has temporarily enabled banks to increase earnings from maturity transformation and to achieve high capital gains on their securities portfolios.

But these favourable conditions are transitory. Stabilisation of rates at a low level has the effect of compressing the margins obtained on the reinvestment of resources with low interest rates such as sight deposits.

Those negative effects linked to the structure of rates might be compounded by a potential reversal in economic activity, which would be all the more harmful for banks if they result from developments in the financial sector of the economy (stock market falls, financial and banking crises in Japan and in numerous emerging markets, etc.). This deterioration in the environment could especially penalise the credit institutions that have put off reorienting their strategy. The organisation of a structural change which has for many banks taken the form of complex mergers and acquisitions will have to be combined with the management of a crisis in the financial markets, the introduction of the euro and the year 2000 issue.

These developments initially suggest that the prudential authorities need to monitor strategic risks. Without interfering in the running of banks, they should verify the adequacy of existing structures to the strategies envisaged by way of regular discussions with the senior management of credit institutions.

Insofar as mergers and acquisitions have the effect of blurring both geographical barriers and distinctions between categories of business, prudential authorities must also intensify their cooperation. Belgium offers two examples of situations where the need for coordination among supervisory authorities will make itself felt particularly: the formation of cross-border groups by merging large institutions of different nationalities and the growth of bancassurance.