The likely impact of changing financial environment and bank restructuring on financial stability: the case of France since the mid-1980s

Sylvie Matherat and Jean-Luc Cayssials[1]

Part 1: Changes in the banking environment and structures since the mid-1980s

1. Introduction

The structure and operating conditions of the French banking system have undergone far-reaching changes since the Banking Act was passed in 1984.

Among the most significant of these developments have been a transformation of shareholder structures and a gradual return to the private sector. The trend is continuing, since despite these changes the level of concentration in France still remains average.

The banking industry has also been marked by gradual liberalisation and booming capital markets, which have contributed to greater competition against a background of slower economic growth in the early 1990s. Keener competition has hit margins and profitability in the French banking system.

This environment has led to a sharp decline in intermediation business, which has been offset by accelerated growth of trading activities, through the rapid growth of securities portfolios and off-balance-sheet transactions. Another effect of this new environment has been a steadily growing volume of international activity, both in increasingly interlinked capital markets and through the redeployment of foreign investment.

The result has been a change in the composition of net banking income over the last 10 years and greater volatility and sensitivity of results. First, the share of trading activities in net banking income makes profitability more volatile and highly vulnerable to a downturn in capital markets. Second, the growing share of international business creates uncertainty as to the recurrence of profits (the Asian crisis has given a first warning of this).

The new environment has given rise to an unprecedented wave of financial restructuring, an area in which continental Europe seems to have been lagging behind. Paradoxically, the poorer profitability record of French banks had previously shielded them from the trend towards concentration. The return to profitability in 1997, combined with a relatively low stock market capitalisation, has made French banks attractive takeover targets, at a time when the changeover to the euro is likely to further exacerbate competition.

2. The reshaping of the French banking system

The structures of the French banking system have been completely overhauled in the last ten years. Privatisation, which began in the mid-1980s, has been stepped up in recent years, and a movement of concentration is now underway. Some 238 changes in control took place between 1984 and 1997,

---

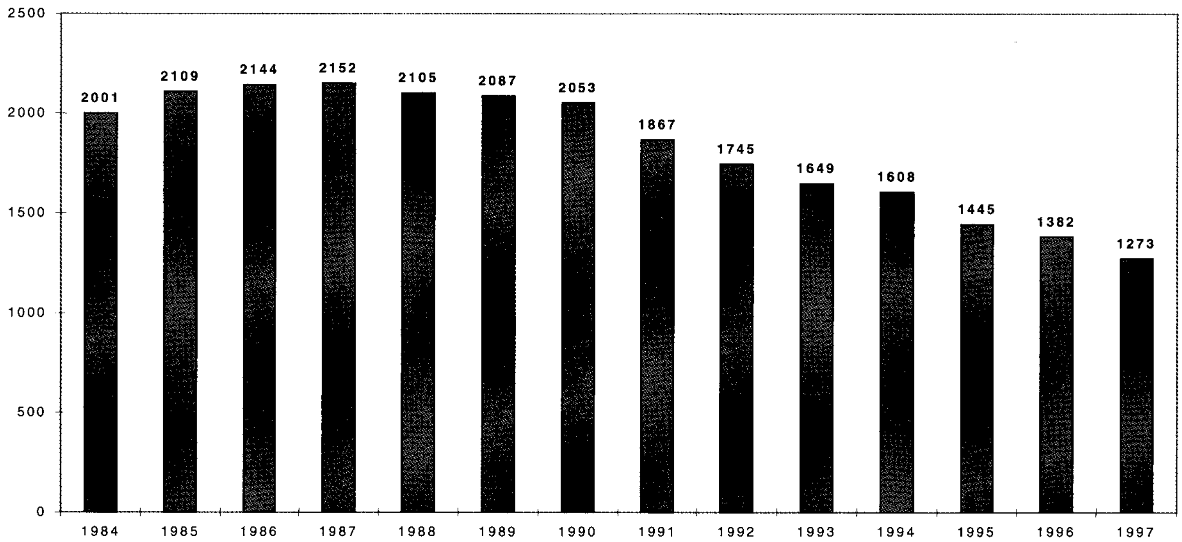
[1] Views presented here are those of the authors and do not necessarily represent the view of the Commission bancaire.

while the creation of new institutions and the disappearance of old ones has been a regular feature of the banking landscape.

2.1 Ongoing renewal of shareholder structures

One of the most striking features of the French banking system has been the sharp drop in the number of credit institutions. Since 1984, the number of credit institutions established in France (excluding Monaco) and authorised by the Credit Institutions and Investment Firms Committee has fallen from 2,001 to 1,273, a drop of more than 36%. After a period of stability lasting until 1990, when there were 2,063 institutions, the numbers have been falling steadily between then and 1997.

Graph 1
Number of credit institutions



Source: D.E.C.E.I.

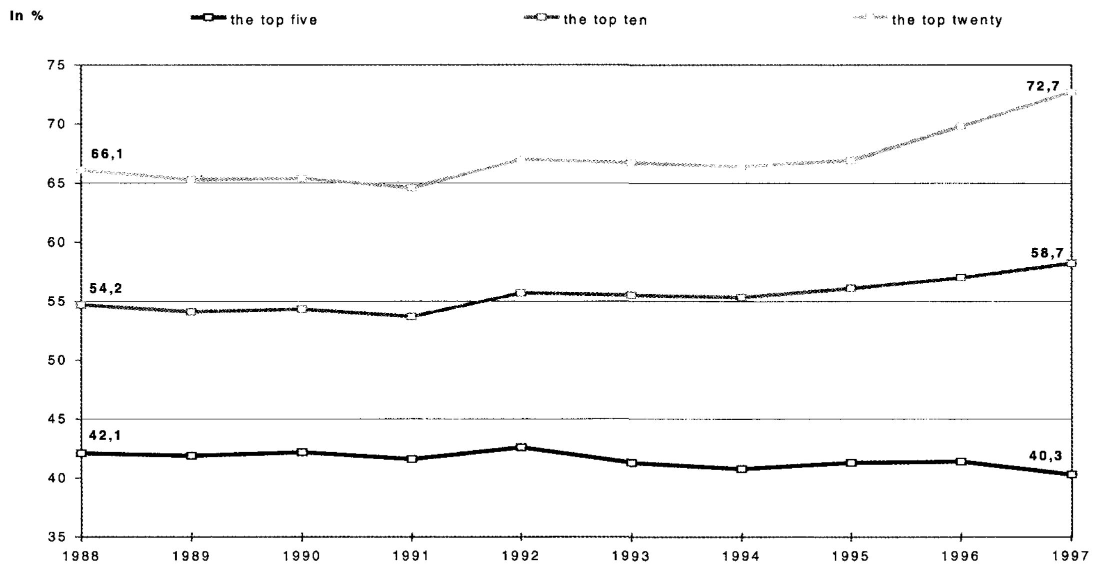
Much of this decline has been due either to the discontinuation of business by institutions which, in a climate of keener competition, offered no further growth prospects, or to the consolidation of institutions with similar characteristics. It also reflects large-scale restructuring and renovation of banking structures. Altogether, 688 new institutions were created in twelve years, representing 54% of the total number of institutions by end-1997.

Broadly speaking, the largest institutions have grown bigger in recent years. On a parent company basis, the share of the twenty largest banks in terms of total assets thus rose from 65.1% in 1988 to 72.7% in 1997. The share of the five largest institutions in terms of loans to clients rose from 43.8% in 1988 to 48.3% in 1997, and in terms of funds collected from 61.9 to 68.6% over the same period. It should be pointed out that these indicators are calculated from data compiled on a parent company basis and do not take account of subsidiaries. On a consolidated basis, the same institutions are probably even more dominant.

Overall, however, the level of concentration in the French banking system remains average and, with some rare exceptions, there are few French banks sufficiently well-capitalised to confront the major international players. The stock market capitalisation of the world's biggest banks clearly demonstrates this, since French banks lag well behind the major international banks, especially American and British ones.

Graph 2

Share of big credit institutions in total assets

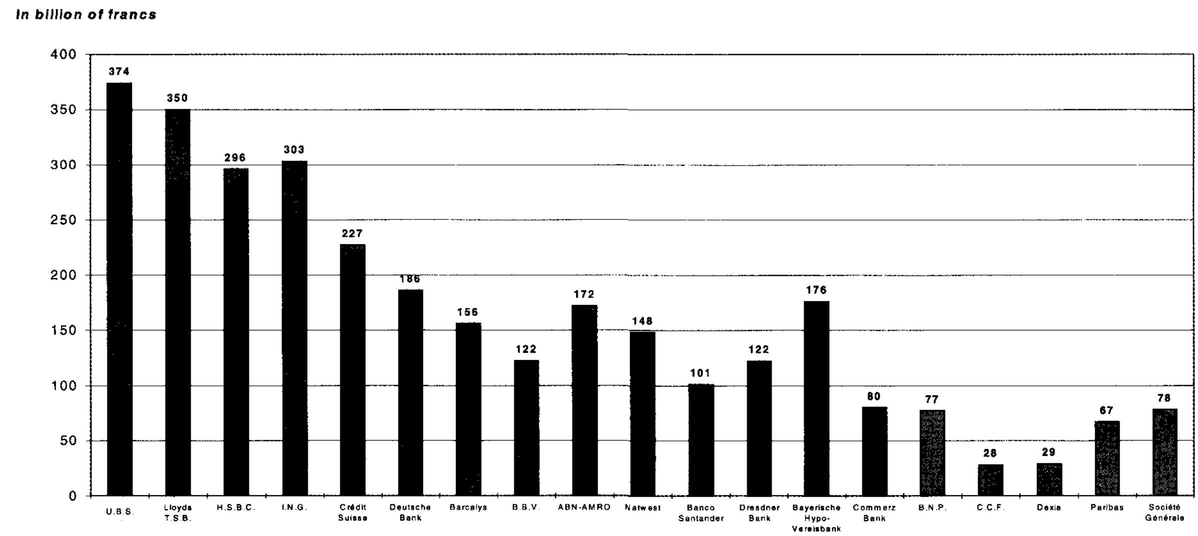


Source: Banking Commission.

Graph 3

Market capitalisation

At 15th September 1998



Source: Bloomberg.

In structural terms, the French banking system has thus been in flux over the last ten years. In particular, this has resulted in deep-seated changes in the classification of banks by type of shareholder, notably the growing place taken by mutual and co-operative banks in a shareholder structure long dominated by the State. Thus the number of publicly-owned banks fell sharply from 112 in 1984 to 30 in 1997 as a result of two successive waves of privatisation, first in 1986-87 and then from 1993. Consequently, a large number of credit institutions left the public sector, either directly or indirectly. At the same time, the number of family-owned institutions also declined from 34 in 1984 to 14 in 1997. This highlights another major change in the French banking landscape, now dominated by large groups at the expense of small banks whose family shareholders do not have the resources to ensure a durable presence and robust growth.

Table 1
Breakdown of French-owned banks*

Category	1984	1995	1996	1997
Public banking groups	92	34	26	23
Private banking groups	0	66	59	57
Public banking groups excl. major groups	20	7	7	7
Mutual groups	5	17	23	28
Subsidiaries of specialised financial institutions	2	10	9	4
Insurance	10	12	14	16
Manufacturing, retail, etc.	18	29	26	30
Diversified financial groups	9	14	13	6
Shared ownership	18	14	14	14
Family ownership	34	16	15	14
Total	**208**	**219**	**206**	**199**

* Banks where a majority of the share capital is owned by French shareholders.
Source: D.E.C.E.I.

The growing influence of large banks has gone hand in hand with the strengthening of mutual and co-operative groups: the number of banks belonging to mutual groups has risen from 5 to 28. In addition to growing organically, mutual groups have also taken an active part in the reshaping of the French banking system in recent years. The Crédit Agricole group acquired Indosuez in 1997 and Crédit Mutuel acquired the CIC group when the latter was privatised in 1998. The Banques Populaires have also taken successive stakes in Natexis.

As a result of keener competition, all banking groups – whether public, private or mutual – have embarked on major rationalisation programmes. The restructuring of the Caisses d'Épargne involved a series of mergers between 1984 and 1991 designed to create entities of a more suitable size. This movement also had a significant influence on the decline in the number of institutions. Likewise, groups with central organisations encouraged alliances between similar institutions in order to achieve economies of scale and increase technical and commercial efficiency. Furthermore, some institutions seeking to specialise in certain types of activity disposed of their portfolios in sectors where they no longer wished to operate. The Paribas group, for example, sold Crédit du Nord to Société Générale. Conversely, other institutions sought to strengthen their presence in core businesses or to extend the range of services offered to their traditional clients. In a general context of limited market growth, their strategy involved the acquisition of existing institutions, as was the case with Crédit Agricole and Indosuez or Banques Populaires and Natexis.

Another major feature of the transformation in the French banking system is greater openness. The number of foreign-owned banks rose from 140 in 1984 to 187 in 1997. This openness is a direct result of the liberalisation of a system long protected, but now subject to competition and attracting growing numbers of foreign operators. The banking trade has changed (see below), in particular with the rise of trading activities, which are relatively easy to develop for institutions without a network in France. At the same time, major European banks have set out to acquire networks in order to improve their scope of business with non-financial clients. Lastly, the principles of freedom of establishment and the free provision of services within the European Union set out in the Second Banking Co-ordination Directive of December 1989 have established a legal foundation for the single banking market which officially came into existence on 1 January 1993.

2.2 Rationalisation of the French banking system with no loss of capacity

The liberalisation and rationalisation of the French banking system has taken place in an environment infused with the idea of public service. Under these circumstances, it was not inconceivable that opening the sector up to competition would result in a rationalisation of supply leading to the restructuring of networks, as in the United States or the United Kingdom. But although the reshaping of the French banking sector has led to a fall in the number of banks and radical changes in their shareholder structure, it has not entailed a reduction in the supply of banking services. On the contrary, capacity has been maintained or even increased.

First, the number of bank branches nation-wide has remained stable, falling only marginally from 25,782 in 1985 to 25,464 in 1997. At the same time, credit institutions have modernised the services offered to their clients. The number of ATMs, the increasing number of transactions using bank cards and the growth of remote transactions have helped to increase the overall supply of banking services. Likewise, although credit institutions have done much to cut costs and staffing levels, in most cases the number of sales staff has increased.

The preservation of banking capacity, combined with stiffer competition, has resulted in relatively little change in banks' market share, in a context where each institution has fiercely defended its positions. Despite the many changes in the composition of the French banking system, the large groups have thus seen relatively little variation in their market share. In terms of total assets, however, specialised financial institutions have fallen back (from 9.1% in 1988 to 5.3% in 1997), to the benefit of mutual and co-operative banks and savings banks. The mutual and co-operative banks had 16.5% of the market in 1997 compared with 15.9% in 1986, while the market share of AFB banks rose from 54.9 to 60.1% over the same period.

The pace of change in the French banking and financial services sector is thus accelerating, partly because of the vital need to adapt to the globalisation of financial markets, but also because of structural changes in demand such as the stagnation in credit demand and the rising demand for services and advice from both corporate and private clients. The imminent introduction of the single European currency is likely to further amplify these trends.

3. Keener competition, especially in retail banking

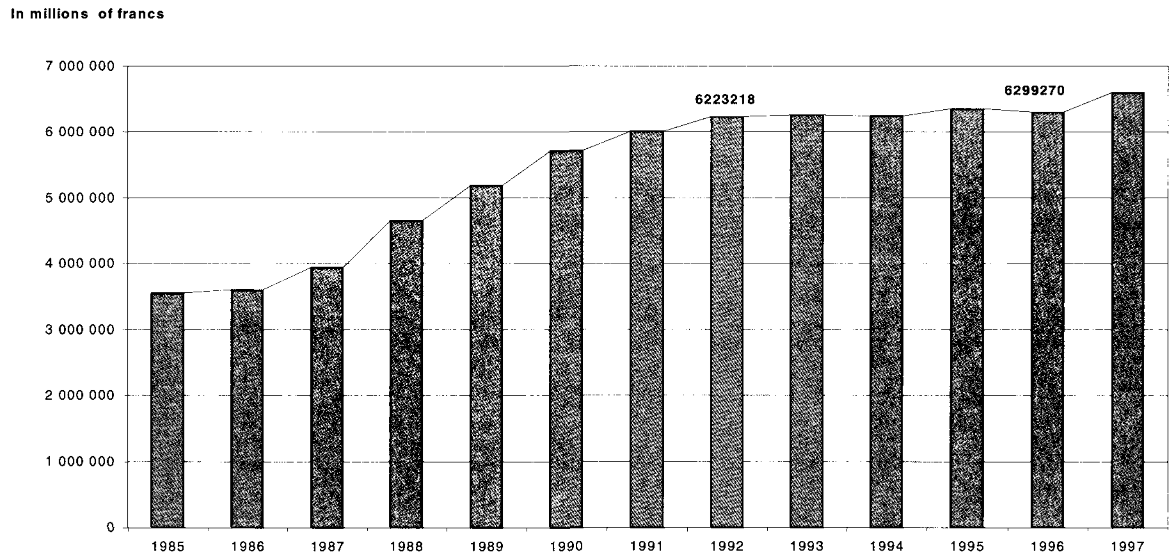
The modernisation and liberalisation of financial markets since the mid-1980s have fostered competition from non-banks (UCITS and insurance companies) and the markets. Many administrative barriers that compartmentalised banking business in European countries have been lifted or eased since transposition of the European Directive of 24th June 1988 on the liberalisation of capital movements (lifting of credit and foreign exchange controls, opening and rapid growth of specialised markets like the MATIF, etc.). The effects on traditional banking intermediation have been especially keenly felt, leading to the disintermediation of credit and capital and the "marketisation" of bank financing. The trend was exacerbated by the general sluggishness of the economy in the early 1990s.

3.1 Competition and the volume of intermediation business

The behaviour of economic agents has changed with the modernisation and expansion of financial markets. Access to capital markets has been made easier, enabling firms to raise funds directly in the markets without going through banks, the traditional intermediaries. The creation and promotion of commercial paper is the most striking feature of this trend, even though some of the paper is bought up by banks. This has resulted primarily in a decline in bank lending as a share of the total financing of the economy, from 70% in September 1993 to 58% in September 1997.

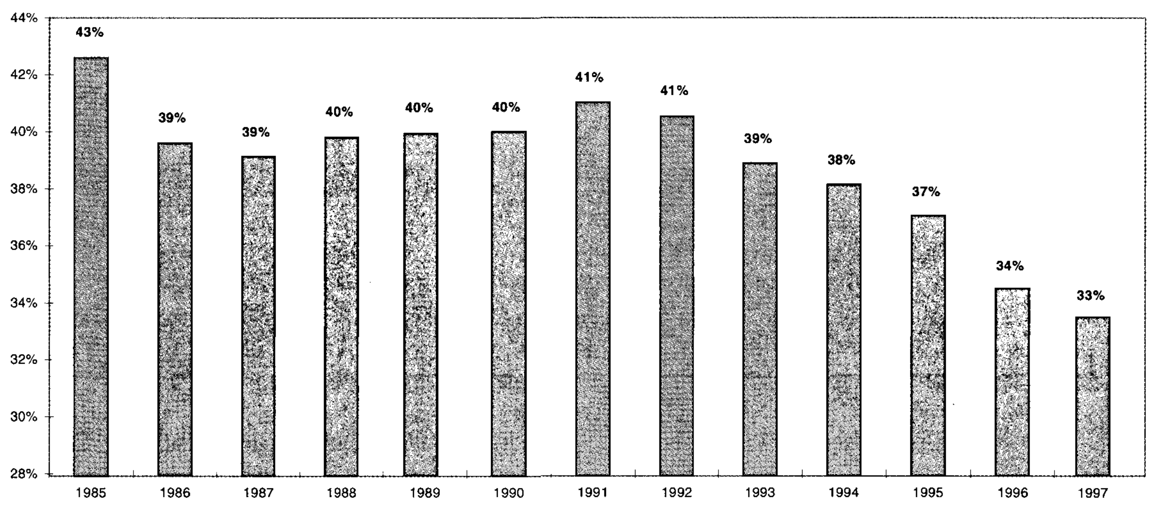
At the same time, economic agents of all kinds have largely favoured a debt-reduction strategy associated with the fall in inflation, creating a context that is hardly conducive to credit demand. As far as possible, firms have preferred to finance their investments out of cash flow, bearing in mind the rise in real interest rates from the early 1990s. In a general climate of uncertainty, households have given priority to precautionary saving. Credit demand, which had been relatively firm until the end of the 1980s, fell back sharply in the early 1990s. Between 1992 and end-1996, outstanding loans to clients in the French banking system as a whole rose by only 1.2% and credit demand did not recover significantly until the second half of 1997. As a result, lending to clients has diminished steadily as a proportion of total assets, falling from 43% in 1985 and over 40% in 1992 to 33% in December 1997.

Graph 4
Customer loans



Source: Banking Commission.

Graph 5
Share of customer loans to total assets



Source: Banking Commission.

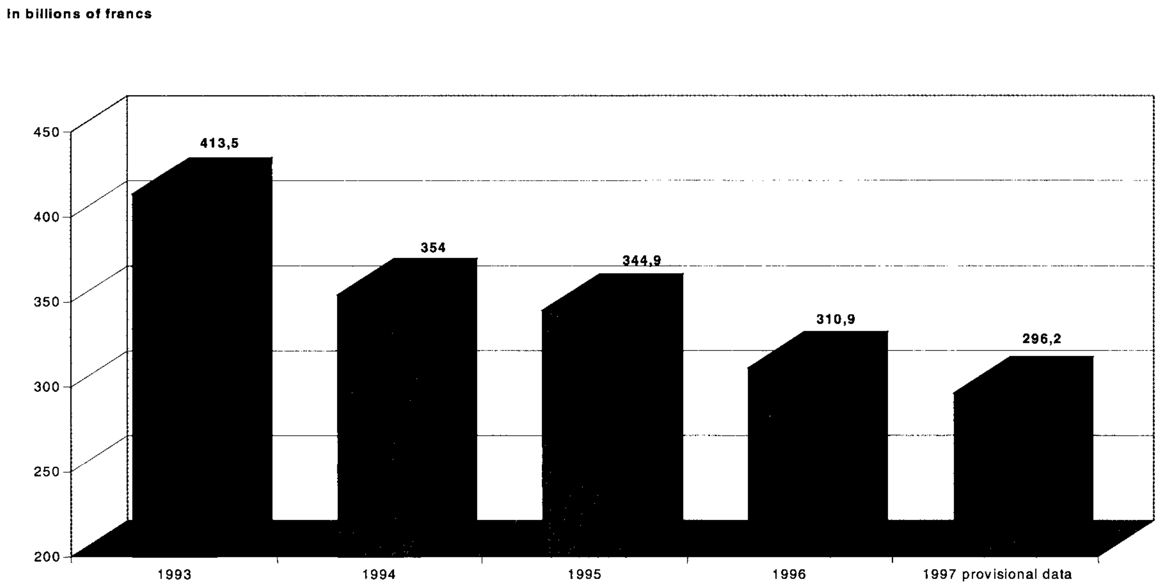
In addition, competition on the liabilities side has been notably increased, especially in connection with the growth in UCITS, which has led to a rise in the cost of bank funds, only partially offset by income from the management of collective investments. Moreover, insurance companies, retailers and other non-banks are becoming increasingly vigorous competitors in the development of financial products.

Lastly, the French banking system has had to adapt itself to an increasingly competitive environment, reflected in the lack of growth in core banking business. This competition from non-banks, combined with the slowdown in credit demand, has had a major impact on both the volume of intermediation business and profitability.

3.2 Competition and the profitability of intermediation business

The profitability of retail banking services has therefore been badly dented in recent years, which has resulted in a major change in the composition of bank income. The net retail banking income has been falling steadily for a number of years, in both absolute and relative terms. In five years, it has fallen from FRF 414 to 296 billion, a drop of over 28%. Despite an appreciable recovery in credit demand, this decline has continued over the past year, though the rate has slowed somewhat to –4.7%.

Graph 6
Earnings on customer loans
All credit institutions

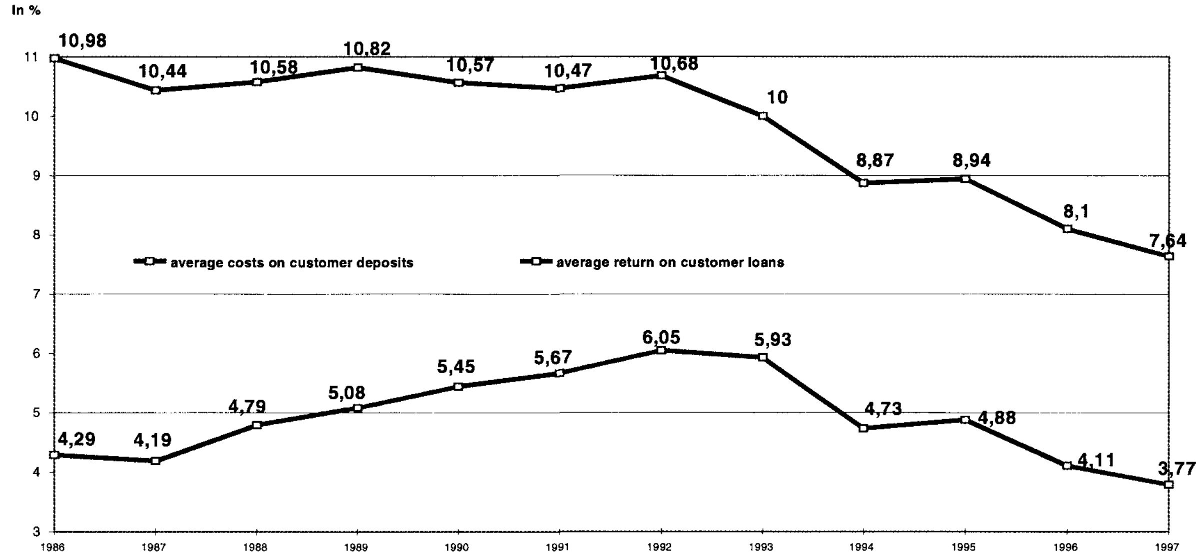


Source: Banking Commission.

The deteriorating profitability of retail banking can also be seen in trends in the average return on loans and the average cost of funds, the latter declining at a slower rate than the former. The average cost of funds fell from 4.29% in 1986 to 3.77% in 1997, a drop of 12.1%, while the average return on loans has deteriorated from 10.98% in 1986 to 7.6% in 1997, a decline of some 30.8%.

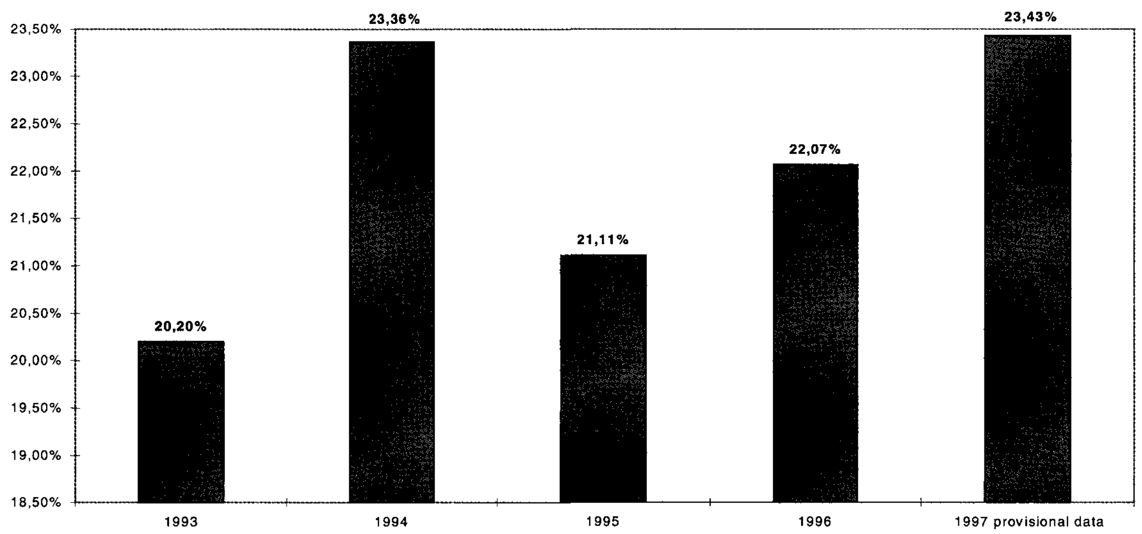
However, this trend has been accompanied by a change in the structure of retail banking income, with an increase in the contribution of service charges (for counter services, advice, automated transactions, etc.). The growing share of fees relative to interest margins as a proportion of net banking income has partially offset the low level of net interest income. For the largest three French banks (BNP, Société Générale, Crédit Lyonnais), which form a group with similar characteristics, net fees amounted to 29.5% of net banking income in 1997.

Graph 7
Return on loans and cost of funds



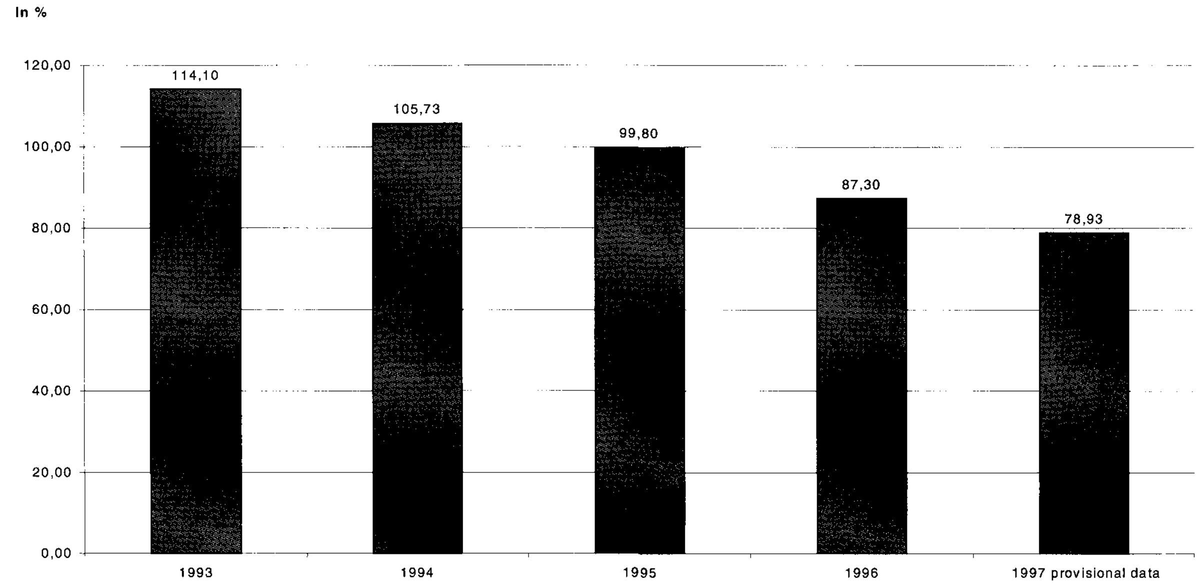
A radical change has thus taken place in the structure of French credit institutions' net banking income. The share of retail banking has declined steadily from 114.1% of net banking income in 1993 to 78.9% in 1997, while net income from trading (off-balance-sheet transactions and securities transactions) has risen sharply. In 1997, profits from off-balance-sheet transactions amounted to over FRF 33 billion. The residual balance from securities transactions, which also includes the charges relating to the debt constituted by securities, fell 19.3% in 1997 to FRF 50.6 billion, compared with FRF 162.5 billion in 1993.

Graph 8
Share of fees in operating income
All credit institutions



Source: Banking Commission.

Graph 9
Share of customer loans in operating income
All credit institutions



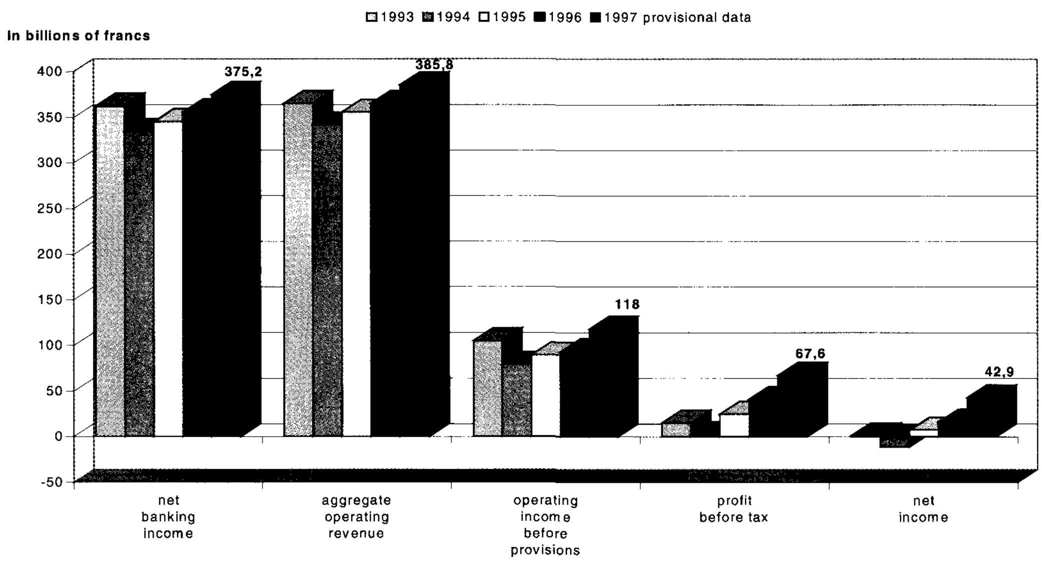
Source: Banking Commission.

4. A return to profitability after the crisis of the 1990s

4.1 A gradual return to a more satisfactory level of profitability

The trend in bank profits over the last 10 years clearly shows the impact of the crisis in the 1990s. The last years of the 1980s were marked by an increase in risks and a substantial rise in the related charges after a strong rise in credit demand. The high level of business failures in France (58,000 a year on

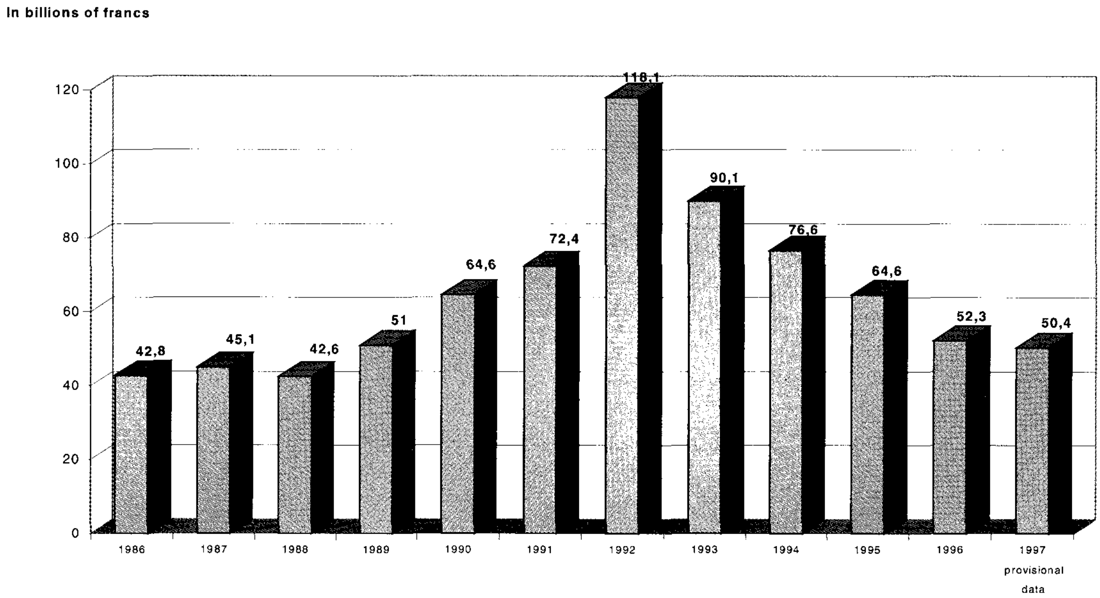
Graph 10
Earnings
All credit institutions



Source: Banking Commission.

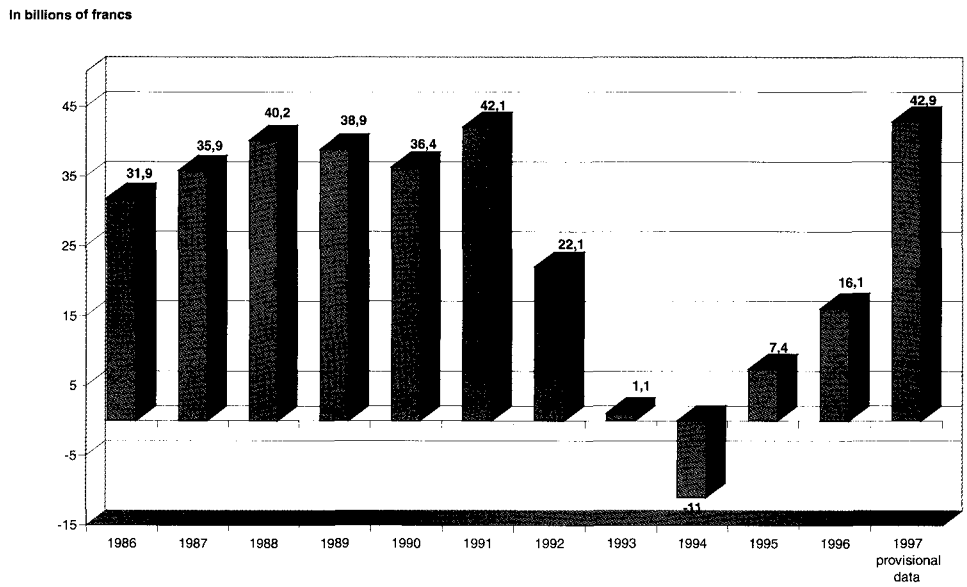
average in the early 1990s) presented the banks with a problem. Small- and medium-sized enterprises, especially in the construction and retail sectors, were particularly hard hit. The problems encountered by many of them had direct repercussions for the banks, who are their main and often only source of finance. Firms facing financial difficulties included property companies affected by the cyclical downturn, especially in the office market in the Paris region. The property slump and the difficulties encountered by SMEs gave rise to the booking of a large amount of provisions, which increased from FRF 43 billion in 1986 to over FRF 118 billion in 1992.

Graph 11
Provisions
All credit institutions



Source: Banking Commission.

Graph 12
Net income
All credit institutions

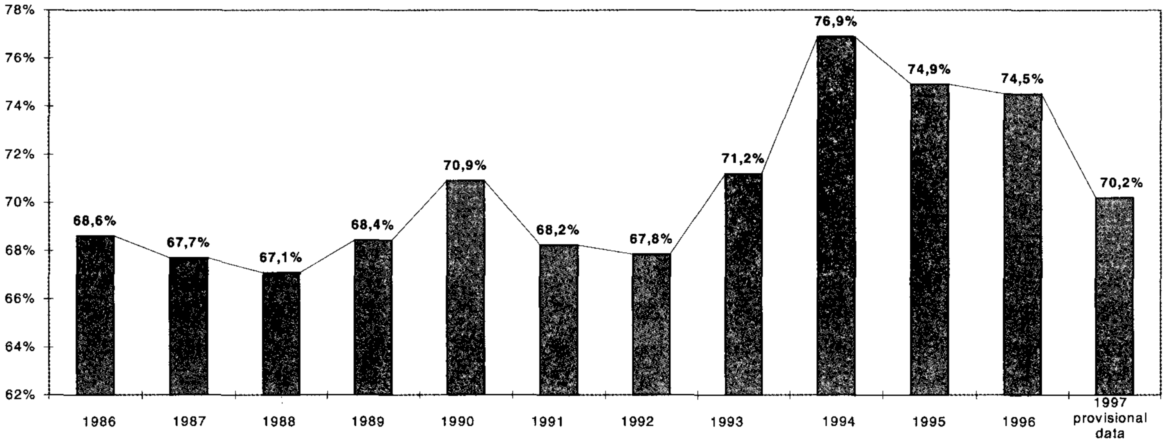


Source: Banking Commission.

As well as further weakening the economic fabric and adversely affecting banks' portfolios, the economic downturn starting in 1993 led to a virtual halt in the growth of credit demand. Combined with currency turbulence at the beginning of the 1990s, this caused a fall in net banking income that year, so that the French banking system created less value added in 1994 than in 1993. Illustrating the deep slump which had engulfed it, profitability collapsed and significant losses amounting to FRF 11 billion were reported in 1994.

Since then, the French banking system has gradually worked its way back into profit. In 1997, the net profit of French banks as a whole amounted to almost FRF 43 billion, the same level as at the end of the 1980s. The best-performing major French banks have now achieved a profitability ratio in excess of 10% and are steadily nearing the 15% target that most of them have set themselves.

Graph 13
Cost to income
All credit institutions



Source: Banking Commission.

Other factors have also contributed to the return to a more satisfactory level of profitability, such as efforts to contain operating expenses and better productivity. The total cost-income ratio,[2] which had peaked at almost 76.9% in 1994, fell back to 70.2% in 1997. Cost controls have been a priority for several years, reflected in job cuts and significantly improved productivity. Overall, employment in the banking sector is continuing to decline, falling by around 5% over the last five years.

4.2 International and trading activities as an offset to the decline in domestic intermediation business

Disintermediation has encouraged French credit institutions to diversify their activities and to take an active part in the growth of trading activities. They are the main source of orders and funds for investment in market products; they distribute and also hold a large proportion of government securities; they provide financial engineering for large firms; they have developed a substantial proprietary trading activity and act as both market makers and securities underwriters. The share of securities transactions has increased sharply, while derivatives trading has grown exponentially in recent years.

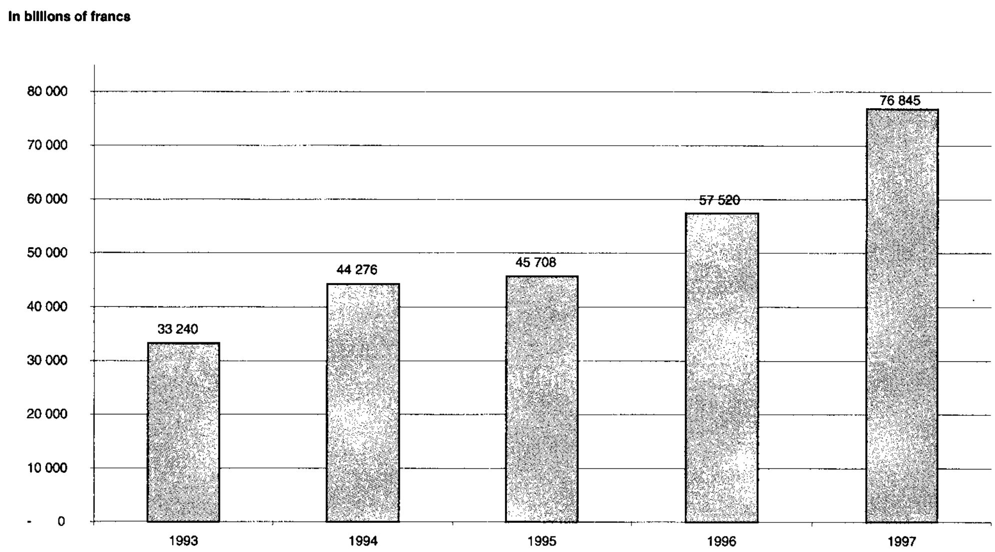
The outstanding amount of securities portfolios has increased substantially in the last few years, especially the amount of trading securities marked to market. The total outstanding amount of

---

[2] Operating costs/Operating income

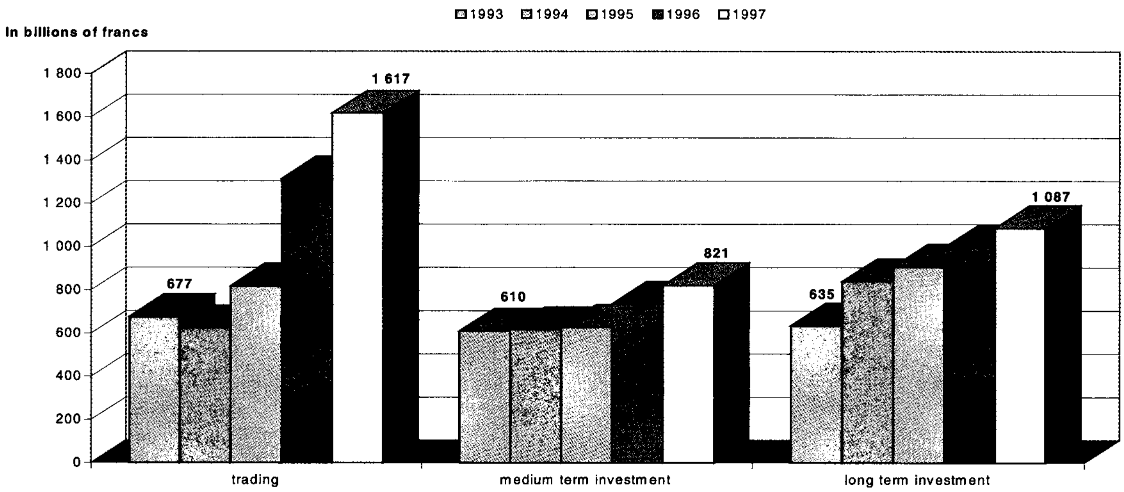
securities rose by 83.4% between 1993 and 1997, while the proportion of outstanding trading securities increased by 138.8%. Marking to market has given bank profits a boost, until the first semester of 1998, in a context of favourable market conditions and low interest rates. On the Paris Bourse, the CAC 40 index rose almost 30% in 1997 and 40% in the first six months of 1998, though it has slipped back 40% since then. Lower interest rates in all market segments have enabled the banks to generate substantial capital gains, offsetting the decline in the net income from retail banking, since the beginning of 1998. Conversely, the financial crisis in Europe since mid 1998 penalises such activities.

Graph 14
Total outstandings on financial futures instruments



Source: Banking Commission.

Graph 15
Securities portfolio



Source: Banking Commission.

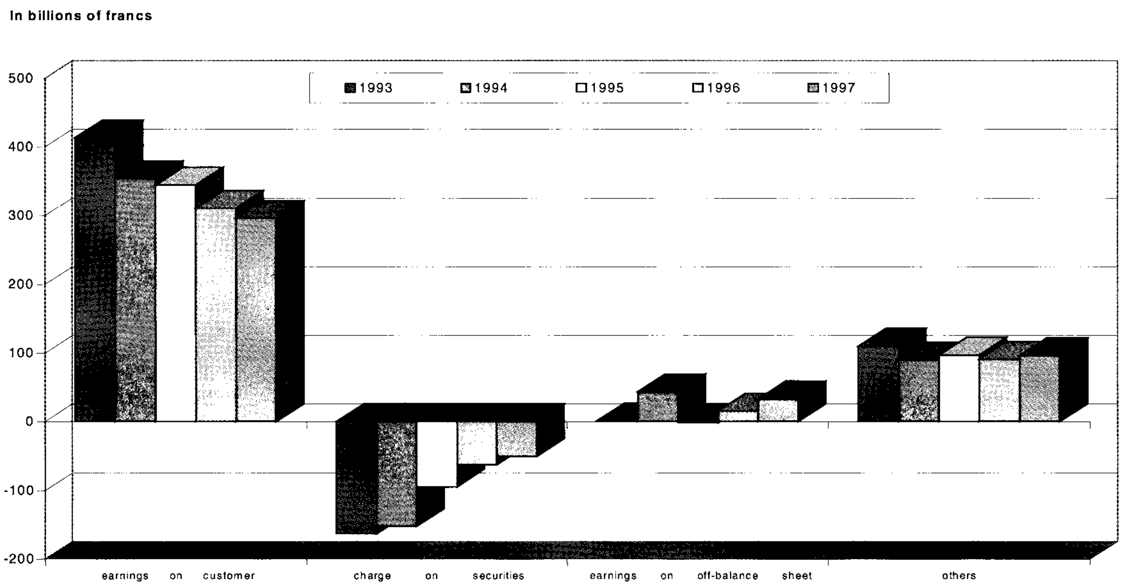
In a context of globalisation, the universal banks have naturally wanted to be present in all of the world's major financial centres and have also sought business development opportunities there. Diversification has thus gone hand in hand with internationalisation, and credit institutions have very rapidly expanded their international operations. The share of foreign branches has risen steadily from just 14.2% of total assets in December 1994 to 18.2% now. International business is also highly profitable, since foreign branches represented almost 10% of net banking income in 1997, compared with only 8.5% in 1996, corresponding to a 23% increase.

4.3 Banking profitability faced with new demands with regard to return on investment

Diversification has resulted in a wider range of sources of income, the discovery of sales methods and management techniques different from those customarily used in France, and above all in the ability to offer clients global services. All these factors have strengthened the financial position and stimulated the competitiveness and creativity of French credit institutions.

However, the greater use of markets imposes new requirements in terms of competitiveness and efficiency. In particular, the disciplines imposed by rating agencies have had a beneficial effect in terms of better profitability, better solvency, better ratings and lower borrowing costs. Above all, however, changes in banks' shareholder structures have led to a more demanding approach to return on investment. As a result of restructuring, banks have gradually moved towards a more shareholder-oriented corporate culture, bringing with it new profitability requirements.

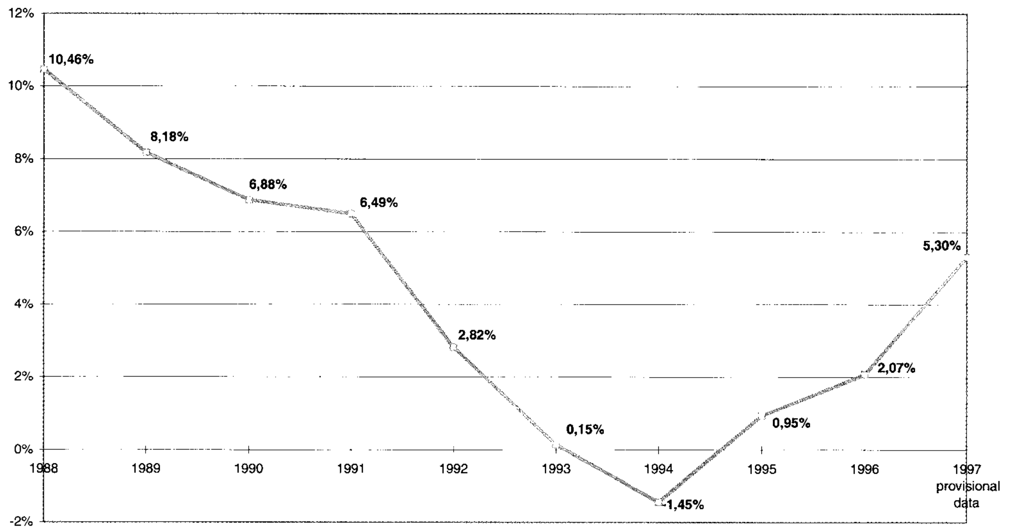
Graph 16
Composition of operating income
All credit institutions



Source: Banking Commission.

The privatisations which began in 1986 were accompanied by a modernisation of financial markets. Facing growing competition in open and deregulated markets, banks now have to ensure that they achieve satisfactory levels of profitability. Credit institutions have become diversified financial services groups no longer answerable only to the State and the supervisory authorities but also to private sector shareholders with demands in terms of return on investment.

Graph 17
Return on equity
All credit institutions



Source: Banking Commission.

Part 2: Bank restructuring and financial stability

Like many of its European counterparts, the French banking system is currently in a transitional phase (see Part 1) affecting both its structures and its business conditions. This transition brings with it uncertainties and new risks and therefore makes an adaptation in banking supervision necessary.

5. A transition phase with uncertainty and risk

5.1 Concentration: a necessary pragmatism

The pace of concentration in the European banking sector has accelerated since the mid-1990s, especially among merchant banks. With the introduction of a single European currency now a certainty, concentration has been taking place on an unprecedented scale since 1997, affecting every business line of the banking profession.

Until 1995, most restructuring in the French banking sector concerned savings and provident institutions and mutual banks. Although French banks were also involved in the broad wave of restructuring that began after 1995, concentration in the French banking sector was still regarded as rather tentative, for two main reasons. First, French banks are less profitable and have lower stock market capitalisations than their European counterparts. Not only is their capacity to acquire other institutions limited as a result, but they also become potential takeover targets themselves. Paradoxically, French banks could be even more vulnerable following higher profits in 1997 and the first half of 1998. This makes them more attractive because one of the chief fears of potential buyers is that an acquisition with poor profitability will reduce the overall return on equity demanded by shareholders. In addition, the so-called "French exception" with regard to employment conditions is becoming less marked following, inter alia, the abrogation of the 1937 decree and denunciation of the AFB collective agreement. Moreover, the crisis in european stock markets since mid-1998 has increased the low level of banks capitalization. Second, the present degree of concentration, which puts the French banking system in the middle of the range, limits the scope for major combinations. One of the distinctive features of the French banking sector is the number of medium-sized banks.

Despite these forces of inertia, however, French banks have embarked on a genuine restructuring process, in particular with a view to the introduction of a single European currency.

Individually, credit institutions are seeking the optimum size that will enable them to improve efficiency and profitability via economies of scale or rationalised product ranges, achieve better risk diversification and gain significant market influence.

In France as in the rest of Europe, recent bank link-ups have been primarily domestic in scope. Banks have sought to strengthen their national base, within which synergies are easier to identify and implement, so that they can confront outside competition under the best conditions. From this standpoint, concentrations may be of two types: they may be designed to generate economies of scale or economies in product ranges.

Concentrations designed to generate economies of scale take place between two banks with similar lines of business: the total activity of the merging entities and the revenue generated are added together, while excess fixed costs are reduced by integrating their material and human resources. In France, the takeover of Crédit du Nord by Société Générale and of CIC by Crédit Mutuel could potentially generate economies of scale.

The aim of concentrations designed to generate economies in product ranges is to benefit from the diversity of activities carried on by the combining entities by offering a wider range of products and taking advantage of complementary client segments, banking services or geographical coverage. In France, this category includes the merger of Crédit National and BFCE (Natexis) and the takeover of the newly created entity by the Banques Populaires, the takeover of Banque Indosuez by Crédit Agricole and, to a lesser extent, the takeover of CIC by Crédit Mutuel.

European banks have carried out less domestic concentration, but cross-border M&A activity has gathered pace recently. Such transactions enable banks to diversify their risks, both geographically (if the banks have the same business lines) and, potentially, by diversifying their activities. In several recent cases, French banks have made acquisitions in order to strengthen their international presence. Société Générale, for example, has acquired Hambros, an English bank, Cowen Securities, an American investment bank, and increased its stake in Asia Credit, a Thai financial institution, from 18.5 to 51%. BNP has acquired the equities unit of Peregrine, a Hong Kong bank, for similar reasons.

Across the banking sector as a whole, combinations automatically reduce the number of players on the market. The economies of scale generated by concentrations also reduce over-capacity. Such rationalisation of the industry is especially necessary in France, where competitive pressures are notoriously excessive and may even be destructive. A reduction in the number of players will help to restore lending margins which have been cut to the bone.

As well as generating economies of scale or economies in product ranges, the aim of mergers and acquisitions may also be to impose a large entity on the market, both financially and commercially. With the introduction of the single currency at a time when no single player has more than 3% of the European market, the pursuit of market influence is a major reason for bank combinations. Size is all the more important given that clients are often attracted to large banks because they are assumed to be less risky.

5.2 Adapting risk management methods

The French banking system is going through an important period of change affecting not only its structures but also its activities. Over the last few years, French credit institutions have sought to compensate for deteriorating margins on domestic intermediation business by diversifying their sources of revenue (see Part 1). They have looked to two main sources of new growth: trading transactions and international business. The result has been a significant improvement in profitability in 1997 and the first half of 1998. However, it has also made French banks more sensitive to international economic conditions and market volatility, as seen since mid-1998.

Recent difficulties, such as the financial crisis in emerging countries and roller-coaster stock markets, have shown how important it is for credit institutions to develop and refine their risk management methods, especially by tightening up internal controls. There is clearly a close correlation between the appearance of difficulties and ineffective or even non-existent internal controls.

Under regulations in effect since 1st October 1997, internal controls in France apply to all activities (trading operations, traditional intermediation services) regardless of where they are carried on. Comprehensive internal controls of this nature can therefore be applied only within a consolidated framework. All operations appearing on the balance sheet of the bank or a subsidiary entirely or jointly controlled by the bank must be monitored and scrutinised precisely, whatever the context in which they are carried out, whether in France or elsewhere. The recent financial crisis in South-East Asia and the need to cope with it as best as possible have highlighted the importance of a consolidated global approach to internal control.

Regular monitoring and control of the risk and profitability of each transaction, while particularly important in trading activities, must also be systematic for intermediation activities. The regulations mentioned above lay particular emphasis on the monitoring and control of lending, the profitability of which must be measured precisely beforehand and verified afterwards. It must also be possible to convert all risk, whether credit risk or market risk, into a homogeneous unit of measurement so as to determine total exposure, on the basis of which the appropriate level of provisioning and allocation of own funds can be set. Risk analysis prior to decision-taking must be backed up by a detailed assessment of the profitability of each transaction. Costs arising from the conception, distribution, marketing, management and funding of a product must be analysed using the most suitable method (whole cost, direct cost, marginal cost, etc.) and charged to the loans in question. Banks are therefore required to carry out prior risk assessment and management.

Clearly, such requirements have a significant impact on French banks' management techniques, and many of them have had to adapt or even overhaul their management and information systems. Some French banks are already fully aware of the need to take this type of approach; systematic methods for assessing risk and the associated return on investment are becoming more widely used, with the implementation of RAROC[3] type systems or scenario methods, for example.

The widespread introduction of this type of approach should enable French banks to improve their responsiveness by encouraging them, as appropriate, to adapt their strategies to give priority to the most profitable products or client segments.

As well as requiring banks to adapt, the changing environment resulting from restructuring and trends in banking activities, in particular their internationalisation, also presents a major challenge to banking supervision.

6. Required changes in banking supervision

Change in financial structures and activities is a vector of risk, implying that security has to be further tightened for both the public and banking centres. Crisis management methods have to evolve, supported in particular by strengthened deposit guarantee schemes and an adaptation of the way in which both national and international supervisory authorities are organised and operate.

---

[3] RAROC: Risk Adjusted Return On Capital.

6.1 Crisis management methods and stronger deposit guarantee schemes

Through its off-site monitoring staff, the Banking Commission maintains close links with all banks subject to such procedures. In addition, inspection teams can take action in the context of more precisely targeted assignments. By these means, the Banking Commission seeks to forestall or, if the worst comes to the worst, to limit the cost of a crisis. In doing so, it can draw on a range of suitable sanctions and courses of action.

However, supervision cannot forestall every individual bank default: Banking Commission controls, however prompt and efficient, are always ex post facto and cannot justify interference in the management per se of credit institutions. There is no doubt that at a time of restructuring and change in the banking sector, there is an increased risk that a bank's situation might deteriorate very rapidly.

Forestalling a crisis of this type requires closer cooperation with two other bodies having control functions, namely the statutory auditors and the internal control managers serving the corporate supervisory bodies, i.e. the shareholders. Effective crisis management also requires a solid guarantee fund so that preventive or curative measures can be taken, reconciling the inevitable disappearance of failed banks with depositor security. The overall cost is much lower than if a failed bank were to be purely and simply liquidated. In addition, this solution offers the possibility of taking action against negligent managers, the adverse consequences of whose negligence are borne by the community. This aspect is important in forestalling moral hazard.

The French authorities have on several occasions shown their wish to reform the existing deposit guarantee scheme in order to increase the real protection afforded to clients, which is naturally one of the Banking Commission's chief concerns. Draft legislation along these lines is currently under discussion, raising new possibilities for preventive action and giving the Banking Commission a central role.

6.2 Complex and international financial structures as a challenge to supervisors

The limits of prudential control organised on a national basis are thrown into stark relief by the case of banking groups that have activities in several different countries. The BCCI case clearly demonstrated that when a bank has its headquarters in one place, takes decisions in another and operates in yet another, the perception of risk is distorted unless better communication between the supervisory authorities of the countries concerned is established. Dilution of responsibility can also foster a less vigilant attitude towards international groups. It is tempting for the host country authority to take little interest in the branches of foreign banks as long as the parent company looks solid. Likewise, the home country authority may be tempted to neglect risks located in subsidiaries, hoping that any local difficulties will affect only the host country and will not contaminate the parent.

While the internationalisation of banking structures highlights the limits of purely national supervision, their growing complexity also raises questions about the very structure of supervisory bodies. The emergence of financial conglomerates, bringing together activities in at least two regulated financial sectors (banking, investment services, insurance) under a single management and control structure, clearly presents a challenge to prudential supervisory authorities, most of which are still organised along sectoral lines even though growing numbers of "multi-disciplinary" authorities are being created.

The rise of cross-sector conglomerates offering not only financial services (possibly in just one of the three sectors mentioned above) but also industrial and commercial services poses an additional problem, since the latter are non-regulated activities for which there is no prudential supervisory authority.

Conglomerates pose specific risks. Often multinational firms with complex structures (especially share ownership structures) and carrying on a range of activities, tend to reduce financial transparency, thus making prudential supervision more complex while increasing the moral hazard facing the supervisory authorities. They also increase the systemic risk of contagion resulting from the links between their different components: difficulties encountered by one company can contaminate healthy units as a result of intra-group exposure, the deterioration of the group's reputation and the loss of public confidence.

6.3 Need for cross-border and cross-sector cooperation

Diversification, increasingly international markets and the growing number of banks with networks in other countries all limit the effectiveness of supervision organised on a national and sectoral basis. The fact that markets are no longer compartmentalised or reserved for a single type of player has increased the need for cross-border and cross-sector cooperation between national and international banking supervisory authorities.

While the international organisations responsible for banking supervision have given particular priority to harmonising prudential rules, cooperation has also been a major concern, parallel to the internationalisation and integration of banking activities. In response to the spread of financial conglomerates, the closer relations initially established between banking supervisory authorities responsible for supervising the geographical entities of international banking groups have been extended to supervisory authorities in other financial sectors.

Quick to realise the limitations of a strictly local approach to supervision, banking supervisory authorities defined how responsibilities were to be shared and introduced a framework for cooperation between home and host country authorities. The initial work of the Basle Committee led in 1975 to the adoption of a Concordat on the supervision of banking institutions in other countries, revised in 1983 following the Banco Ambrosiano crisis and in 1992 following the collapse of BCCI. The Basle Committee and the group of offshore banking supervisors have also jointly worked out practical ways of securing a better exchange of information between home and host countries.

This move to set bilateral relations on a formal footing, necessary to overcome the obstacles to information exchange, has been particularly fruitful in Europe. Under the principle of home country supervision, the supervisory authorities of each Member State have full discretion to specify rules relating to the operation, approval, authorisation, off-site monitoring or on-site supervision and sanction of credit institutions on their territory.

The introduction of a single European market soon made it necessary, along with the harmonisation of prudential rules, to set up a framework for cooperation between banking supervisory authorities. The first banking directive of 1977 laid the foundations for institutional cooperation between supervisory authorities. The second directive placed particular emphasis on cooperation and exchanges of information between supervisory authorities, in particular by allowing for the lifting of professional secrecy between them. In practical terms, cooperation takes place through various channels, both bilateral and multilateral (contact group).

The transition to Stage Three of Economic and Monetary Union will not affect the current context of prudential supervision within the European Union. In accordance with the principle of subsidiarity, national authorities will continue to be responsible for the prudential supervision of credit institutions. The Member States have agreed that the role of the European Central Bank should primarily be consultative, described as "macro-prudential". As regards cooperation, the European Central Bank's Banking Supervision Committee will be responsible for encouraging cooperation between banking supervisory authorities on macro-prudential issues.

As well as meeting the challenge of globalisation of banking operations, banking supervisors also have to cope with the integration of banking, stock market and insurance activities within often multinational financial conglomerates. The risk of contagion implies supervising such groups as a single entity, in addition to supervising each line of business. The variety of different activities combined with the risk of contagion means that the traditional consolidation-based approach of banking supervisors needs to be supplemented by an assessment of intra-group exposure and a review of the allocation of own funds.

This raises the issue of the best structure for supervising increasingly integrated financial activities. Some economists suggest that supervisory bodies should be organised according to their objectives. Thus, Taylor (1995) and Goodhart (1996) argue that supervision has two aims: ensuring systemic stability and protecting users. They propose creating two agencies, one for each objective, covering all banks and financial institutions and all their lines of business. Others, such as Aglietta, Sessin and Sialom (1997), go even further and suggest the introduction of a "meta-level" of supervision, involving the creation of a single supervisory body covering all banking and financial lines of business and responsible for all supervision objectives. This globalisation of supervision is regarded as an essential response to the constitution of financial conglomerates.

Prudential authorities are far from unanimous on the subject. Davies[4] considers that banking supervision should be kept separate and carried out under special rules because banks are unique, especially where systemic risk is concerned. In a nutshell, there is no easy way of defining how many supervisory bodies there should be or what they should do.

Situations vary widely from one country to another. In most countries, each type of financial intermediary is supervised by one or more different authorities. The United States are at one extreme in this respect, due partly to the country's federal structure: in addition to the large number of supervisors at the federal level, there are federal state supervisors. Other countries concentrate the supervision of all financial operators and activities in the hands of a single supervisory authority. In Denmark, for example, a single body, *Finanstilsynet*, is responsible for supervising all financial activities. This type of system, prevalent in small countries especially, has tended to spread in recent years in response to the growing interpenetration of the different segments of the financial sector. In 1997, the United Kingdom decided to set up a single supervisory authority for the banking and financial sector, the Financial Services Authority (FSA), uniting the tasks of all the existing authorities.

France has opted for an intermediate solution. The Banking Commission has had the scope of its supervisory remit extended without being turned into a "mega-regulator". The Financial Activity Modernisation Act of July 1996 extended the Banking Commission's competence to investment firms, most of which were previously supervised by other bodies (brokerage firms and jobbing firms were supervised by the *Conseil des Bourses de Valeurs* (CBV) and by the *Société des Bourses Françaises* (SBF) respectively, while commodity brokers and floor traders were supervised by Matif SA). In other areas, supervisory responsibility has remained separate. UCITS and portfolio management companies are supervised by the *Commission des Opérations de Bourse* (COB). Insurance companies are supervised by the *Commission de Contrôle des Assurances* (Insurance Supervisory Commission) under the aegis of the French Finance Ministry. There is no significant convergence between banking supervision and insurance supervision: both the nature of the risks assumed and the approach to accounting and prudential regulation differ. However, these separations do not rule out exchanges of information and opinions between supervisors, which take place as often as necessary and can be extremely helpful.

At an international level, initiatives to encourage cross-sector cooperation were taken in 1994 with the creation of the international organisations of securities supervisory authorities (IOSCO)[5] and insurance supervisors (IAIS).[6] Their action has been placed on a more permanent footing with the setting-up of a "joint forum" on financial conglomerates in 1996. The Joint Forum has thirty members from three financial sectors, representing thirteen countries. France is particularly well-represented, since it has three members: the General Secretariat of the Banking Commission, the COB, and the

---

4 This view is cited in Goodhart et al. (1997), p. 158.

5 The International Organization of Securities Commissions (IOSCO) was founded in 1982 by expanding the Inter American Association of Securities Supervisors which had held an annual conference since 1974. Its membership consists of 135 authorities responsible for supervising investment firms and financial markets.

6 The International Association of Insurance Supervisors (IAIS), founded in 1994, has over 80 members, reflecting the spread of internationalisation to all financial sectors.

Ministry of the Economy, Finance and Industry (representing the Insurance Directorate and Insurance Supervisory Commission).

A European joint group on financial conglomerates has also been in existence for ten years or so under the aegis of the European Commission (the Commission has observer status). Its work has been suspended pending the results of the Joint Forum's discussions. Confronted with the difficulties of implementing operational cross-sector cooperation, Member States have often used other forums[7] to take action on a case-by-case basis.

Since the adoption of the investment services directive in 1993, however, financial activities complementary to pure banking activities are now covered by European regulations. Thus, the 1993 own funds directive applies not only to credit institutions but also to investment firms, i.e. to institutions seeking not to grant loans or collect deposits but to provide intermediation services on financial markets.

References

Études du rapport annuel de la Commission bancaire (1993): "L'évolution des principaux facteurs de risques bancaires".

Études du rapport annuel de la Commission bancaire (1994): "10 ans d'activité et de résultat des banques françaises".

Analyses comparatives de la Commission bancaire, Vol. 1 and Vol. 2.

Rapport annuels de la D.E.C.E.I.

7 Such as the contact group.