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CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY

Prof. dr. L.A.A. Van den Berghe
Dr. K. Verweire
S.W.M. Carchon

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Insurance and Private Pensions Unit
Financial Affairs Division
Directorate for Financial, Fiscal and Enterprise Affairs

TABLE OF CONTENTS

PART A

CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY

A BUSINESS ECONOMIC PERSPECTIVE

Before we can outline the impact of the growing convergence within the financial sector, it is important to have an overview of what is really happening in that industry. This supposes a view on the actual situation and the historical background. Of even greater importance is the analysis of the underlying driving forces and of the different strategies that have been adopted by insurance companies, pension funds and other financial institutions. This is all the more true, since the convergence within the financial sector is developed in a very heterogeneous way, not only from a geographical perspective, but also within a given country and even within a given financial group.

This section analyses these different dimensions of the convergence between the banking, the insurance, the investment and the pension industry. The emphasis is more on the business economic perspective.

The first four chapters deal with the convergence within the financial sector. In chapter 5, we will pay attention to the convergence between insurers and pension funds. As will be shown there, banks also are (becoming) important partners in the pension market.

Quite a number of financial firms act as true financial supermarkets, offering a very broad range of products (covering credit, insurance, savings and investment aspects). Due to deregulation, financial institutions are allowed more and more to offer complimentary or competing products, that were originally the closed privilege of neighbouring financial sectors. This leads to a blurring of the boundaries between the different sub-sectors of the financial system and to the formation of financial conglomerates. We will try to prove that financial conglomerates are the most prominent institutionalisation of the convergence within the financial services industry.

Since the terms "financial convergence" and "financial conglomerates" are central in this report, we will outline briefly what we mean by these two terms. We refer to "financial convergence" as the general term, relating to all types of interfaces between financial suppliers and the demand of all types of financial products and services. Part of the interface is of an institutional nature, and this is where the term "financial conglomerates" pops up. More particularly, we consider a financial conglomerate as a group of enterprises that is formed by different types of financial institutions (banks, insurance companies and investment institutions). Most of the time, the term financial conglomerates is used to denominate groups with both banking and insurance subsidiaries. But in principle, a financial conglomerate can consist of a bank and an investment company (without having an insurance subsidiary). These types of groups are often referred to as "universal banks".

One of the most striking observations in this convergence process is the huge heterogeneity in structures and strategies that have been adopted by these financial institutions. Unless we accept a rather approximate and rough overview by comparing apples and oranges, we will need to develop a clear understanding of the differences in approaches and strategies of financial firms. This will be the subject of chapter 1. The general framework developed there is called the financial conglomerates control board. This instrument can also be used to describe the convergence of the insurance and pension industry as well as make the inventory of potential synergies and potential risks.

We will use this framework to show that the convergence in the financial services industry is taking place on different levels. The most familiar or well-known is the convergence at the distribution level (cross-selling). This is discussed in chapter 2.

However, more and more financial institutions realise that there is more than cross-selling. Put differently, in order to gain a lasting competitive advantage, firms will have to do more than merely cross-sell the different products of companies within the group (or from an allied partner). This is shown in chapter 3.

In chapter 4, we will go one step further and have a look at back-office operations of financial institutions and investigate whether there are opportunities for "integrating" banks, insurance companies and investment institutions.

In chapter 5, we will turn our attention to the convergence of the insurance and the pension industry. Insurance companies not only broaden their scope in the direction of financial services, but there is also an increasing competition with pension funds. We will show that some of the trends that are occurring here are quite similar to the trends of financial conglomeration.

This part of the report should give the reader some insights into how the convergence in the financial services industry is taking place. Where possible, we will try to highlight some important trends or give some concrete examples (by means of case studies, statistics or product examples). A warning is however necessary in this respect. We have been collecting data for more than 15 years now and although our database has grown over the years, the quality of the statistics is rather poor. This becomes very clear when one compares statistics that relate to the same market: there is a great lack of reliable market information and the different sources of statistics use different definitions and measure different samples so that comparison is hard to make. This is all the more striking since supervisors, business firms as well as researchers, are all in great need of reliable statistics and benchmarks. A joint venture to establish such a reliable database between supra-national organisations, market supervisors and academic circles could perhaps tackle this worldwide need.

1. A FRAMEWORK FOR THE ANALYSIS OF THE CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY:

THE FINANCIAL CONGLOMERATES CONTROL BOARD

1.1. Introduction

The growing convergence in the financial services industry, and more particularly, the convergence between the banking and the insurance industry, has received widespread attention in both academic as well as in business literature. Most articles focused on:

- the drivers of this trend;
- the main strategies followed and the organisational forms used;
- the potential advantages and the risks associated with convergence mainly between banking and insurance.

In the beginning of the nineties, the OECD issued two important and still relevant studies in this respect: "*Insurance and other financial services: structural trends*" (1992) and "*Financial conglomerates*" (1993).

Especially relevant for our purpose are the studies that analysed the main strategies and the different organisational forms adopted. What is striking is the huge *heterogeneity* in this development process. It would be a mistake to consider the convergence of financial firms as being an homogeneous trend with similar characteristics worldwide. Some researchers have acknowledged this heterogeneity and have developed a typology of financial conglomeration.

1.2. Link with the corporate diversification literature

Before we discuss these studies, we think it is appropriate to establish a link with the corporate diversification literature. One could argue that the convergence in the financial sector can be considered as an example of *diversification*. The breaking down of the boundaries between banking, insurance and investment markets is strongly associated with the creation of financial holdings (conglomerates), with business units in the respective industries. Therefore, it seems not illogical to apply the literature of corporate diversification (which has most of the time focused on the industrial environment) to the financial services industry. The critical results of these studies certainly influenced the rather sceptical evaluation of a number of diversification ventures in the financial services market. It is therefore of interest to point to some of the main results of this general diversification literature. Although applying the general literature to the financial services industry is extremely dangerous, we could "borrow" some of the more general frameworks developed in this literature.

Diversification has been one of the most extensively researched topics in the strategic literature. Some of the seminal works were written in the early 1960s, but "diversification" was put on the top of the academic agenda after Rumelt published one of the most influential books in 1974, "Strategy, structure and economic performance"[1]. In this book, Rumelt showed that related diversifiers outperformed unrelated diversifiers. That is, diversifiers who concentrated on some central skills or competencies outperformed all other categories of firms (i.e. specialised firms, unrelated diversifiers, vertically-integrated firms).

This study was the start of a huge stream of literature which refined and redefined the tools used by Rumelt. It is impossible to comment on all these studies here, but we can easily summarise these studies in the following, somewhat disappointing, conclusion:

“The use of alternative approaches for measuring diversity has not led to greater insights into the impact of diversification on performance. The results of most studies have merely extended or marginally modified Rumelt's (1974) original findings" (Ramanujam and Varadarajan, 1989)[2].

Although this statement is 10 years old, it is still very up-to-date. Researchers have tried to come up with answers as to why no conclusive relationships could be detected. And more and more, they acknowledge that diversification is a *multidimensional* concept. There is scientific evidence that each of these different dimensions is important in explaining the degree of success of a diversification strategy[3]:

- Diversity status - which gives an indication of how diversified a company is. It is clear that the larger financial conglomerates with substantial banking and insurance (and investment) activities, like ING, Crédit Suisse-Winterthur, Fortis, are more diversified than banks with a small insurance subsidiary (or vice versa). The idea is that more diversified firms have more potential to exploit synergies, and therefore should be more successful. A large number of empirical results do not support this hypothesis for non-financial firms. Recent research of financial conglomerates[4] has shown that the main performance driver is certainly not the diversity status. The reason being that potential synergies are often hard to realise. Other factors seem to be more relevant (e.g. implementation).

- Degree of relatedness - which indicates how related the new business is compared to the existing business. If this is the case, we call this related diversification. If the different businesses have no marketing or other forms of relatedness, the diversification is labelled unrelated. The common idea is that related diversifiers should outperform unrelated diversifiers because they have more opportunities to exploit synergies. The empirical results have not always confirmed this hypothesis.

- Mode of diversification - researchers have examined whether start-ups were more successful than mergers and acquisitions (and joint ventures). No conclusive answers were obtained in this respect.

- Implementation aspects of diversification - researchers focus on different aspects, e.g. which organisation structures have been set up, do managers share the same "culture", etc. In these discussions the concept of integration is central. Because of the importance of this factor for

1 Rumelt, R.P. (1974) "Strategy, structure and economic performance", Graduate School of Business, Harvard University, Boston, MA.

2 Ramanujam, V. and Varadarajan, P. (1989) "Research on corporate diversification: a synthesis", Strategic Management Journal, 10, 6, November-December, 523-551.

3 Consequently all of these dimensions are relevant variables when analysing the convergence in the financial sector. By lack of reliable statistics this report will not be able to provide this in-depth analysis.

4 Verweire, K. (1999) "Performance consequences of financial conglomeration with an empirical analysis in Belgium and the Netherlands", Thela Thesis Publishers, Amsterdam.

realising the potential synergies and benefits of financial conglomeration, we will come back to this point later in this chapter.

In what follows, we will show that academicians who have described the convergence process in the financial services industry have implicitly used these dimensions the backbone of their typologies.

1.3. Making an inventory of the types of interfaces between the banking and the insurance companies

Some researchers have acknowledged that the formation of financial conglomerates is not a homogeneous process and that different forms of financial conglomeration exist. We refer to appendix A.1 for a more detailed overview of the three different typologies we found in the literature.

The three typologies each focus on a particular dimension of the diversification decision.

1. The typology of Herring and Santomero (1990)[5] is based on the corporate structure of the financial conglomerates and is based on differences in the legal and operational separateness. This typology, which is based on implementation aspects of diversification, distinguishes between 4 different financial conglomerate models:
    - complete integration
    - bank parent - non-bank subsidiaries
    - holding company parent - complete legal separateness
    - holding company parent - complete legal and operational separateness.

2. The second typology was developed by the Verzekeringskamer, the supervisor of the Dutch insurance companies and pension funds, and was used to effectively control financial conglomerates. This classification used the diversity status as a criterion to distinguish between the different alternatives.

3. Some early publications (e.g. Lafferty Business Research, 1991 and 1994[6]; Hoschka, 1994[7]) have used a typology based on the entry strategies of banks into the insurance industry (i.e. the mode of diversification). Of course, this methodology may also be applied to insurance companies entering the banking industry. A distinction was made between:
    - de novo entry (start-ups)
    - mergers and acquisitions
    - joint ventures
    - distribution alliances.

5 Herring, R.J. and Santomero, A.M. (1990) "The corporate structure of financial conglomerates", Journal of Financial Services Research, 471-497.

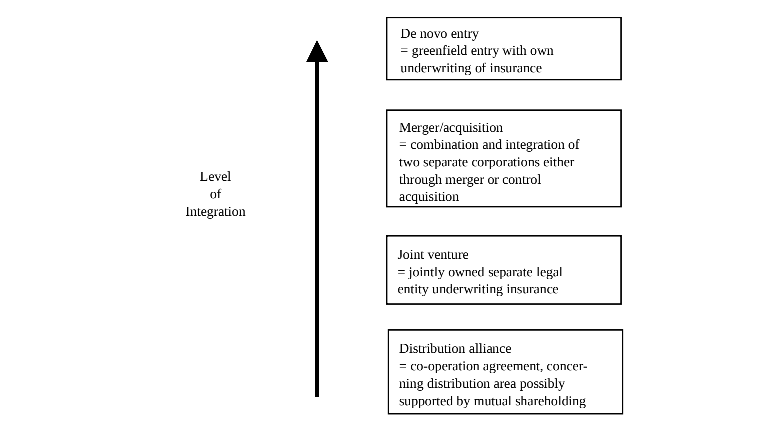
6 Lafferty Business Research (1991) "The Allfinanz revolution: winning strategies for the 1990s", Lafferty Publications Ltd., Dublin.

Lafferty Business Research (1994) "Allfinanz 2000: how retail financial institutions worldwide organise to provide total financial services", Lafferty Publications Ltd., Dublin.

7 Hoschka, T.C. (1994) "Bancassurance in Europe", The MacMillan Press Ltd., Houndmills.

The typologies focusing on the implementation aspects of diversification and the mode of diversification have implicitly tried to provide arguments for the relative success of some diversification strategies. For example, the studies which used the typology based on the mode of diversification found that de novo entries and mergers and acquisitions (M&As) were more successful than distribution alliances and joint ventures. One of the main explanations was that the degree of integration was higher in the start-ups and M&As, as is shown in Figure 1.

Figure 1 - Alternative entry vehicles for banks entering insurance



Source: Hoschka (1994)[8]

1.4. Towards a new theoretical framework: The Financial Conglomerates Control Board (FCCB)

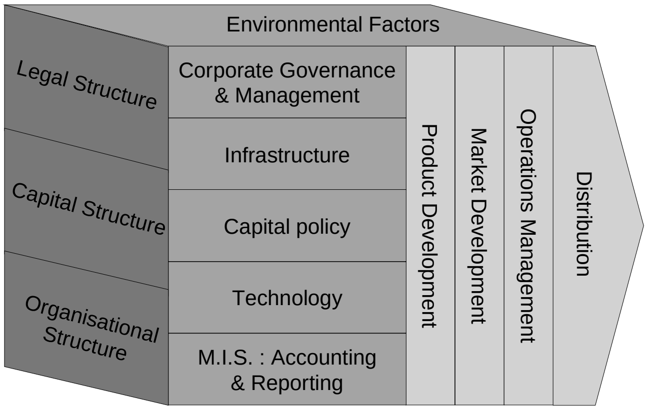
We are convinced that the degree of *integration* is a key concept in explaining differences in financial convergence strategies. However, the typologies we just described only consider part of the problem [see e.g. Hoschka (1994)] or consider this level of integration on a too theoretical level [see e.g. Herring and Santomero (1990)][9].

We have tried to elaborate a useful *theoretical framework*, by combining the concept of the value chain with the service operations system (the servuction system). This standard reference base, called the *financial conglomerates control board* makes it possible to gain a better understanding of the types of financial conglomerates, their structure and strategy, their potential synergies as well as the types of *potential* risks.

8 Hoschka, T.C. (1994) "Bancassurance in Europe", The MacMillan Press, Ltd., Houndmills.

9 See appendix A for a more detailed comments on the different typologies.

Figure 2 - The Financial Conglomerates Control Board



Source: Van den Berghe and Verweire (1998)[10]

The concept of the *value chain* has been developed by Porter. The value chain highlights the different activities to create added value for the customer. Every step costs money and creates value. The higher the total added value, the better the perspective for a competitive advantage and a profitable margin. This tool is mainly used for an industrial firm. In order to be able to integrate this concept into the analysis of financial conglomerates a fundamental adaptation is necessary. Such a translation can best be based on the structure of the service operation system, which pictures the banking and insurance firms. The details of this framework must be so that they make it possible to test for:

- the drivers for and the different types of synergies within financial conglomerates, and the degree to which they are realised;

- the drivers for and the different types of risks within financial conglomerates, their size and possible consequences;

- the classification of financial conglomerates and possible correlation with the performance level. In the future we hope to classify conglomerates according to differences in this reference framework. In addition the specific macro/market environment is also relevant and should be considered as well.

This reference scheme is divided into three main parts. The arrow on the *front side* (containing the boxes *Corporate Governance & Management* to *Distribution*) is comparable to the value chain. It depicts all primary and support activities where synergies can be found and which determine the risk level of the conglomerate.

At the *back side* of the instrument, we find some structural aspects (such as the legal structure, the capital structure and the organisational structure) which also influence the potential for synergies and the risk level.

At the *upper front*, we take along some environmental factors. These are control variables that could also be important in the comparative study of financial conglomeration and financial convergence.

We refer to appendix A.2 for a more detailed explanation of this financial conglomerates control board.

10 Van den Berghe, L.A.A. and Verweire, K. (1998) "Creating the Future with All Finance and Financial Conglomerates", Kluwer Academic Publishers, Dordrecht.

In the remainder of this first part, we will analyse the convergence in the financial services industry based on this reference framework. More particularly, in chapter 2 attention is paid to the convergence in the financial services industry at the distribution level.

We will, however, show that pure cross-selling of banking, insurance and investment products through the same outlet is only a first step, and perhaps even a minor step, in creating a competitive advantage. In order to build a lasting competitive advantage for their clients, financial institutions will probably have to go one step further by developing all finance solutions. That means that they will have to examine the whole marketing cycle of their financial products (product development, market development and to some extent the operations management). This is the subject of chapter 3.

In chapter 4, we will show that the convergence between different types of financial institutions is taking place on other levels as well, namely more and more in the back-office and the rest of the organisation.

In chapter 5, we will describe the convergence between the insurance industry and the pension industry.

2. CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY (BANKING-INSURANCE): CONVERGENCE AT THE DISTRIBUTION LEVEL

2.1. Introduction

In countries where the boundaries between the different sub-sectors have broken down, the majority of the banks and the insurance companies have engaged in cross-selling each other's products. Even in countries where deregulation hasn't proceeded that fast (the most notable example being the US), distribution alliances between banks and insurance companies are very common.

In this chapter, we will first create some definitional clarity. The different terms that have been used throughout all the studies and reports may have completely different meanings for different countries, companies and individuals. We proceed by outlining some historical trends, which show that the convergence at the distribution level has been going on for decades (long before the concepts of "bancassurance" and "assurfinance" or "assurbanque" were invented).

We will then give you an idea of the current situation and we end with describing some new developments in this respect.

2.2. Some definitional clarity

Banks and insurance companies have been joining forces in the provision of a complete range of financial services for quite some time. Most researchers have referred to this phenomenon by the term "bancassurance", but other terms like "assurfinance", "assurbanque", "allfinanz", "all finance" and "financial conglomerates" have been used to identify the phenomenon of financial convergence. Little uniformity can be found, however, in the definition they attach to each of these terms. Therefore, we want to clearly define what we mean with the different terms.

For what concerns the collaboration on the distribution level[11], there is considerable agreement regarding the definition of bancassurance and assurfinance (sometimes the term assurbanque is used):

- Bancassurance is the strategy of a bank to cross-sell insurance products through its own distribution channels, usually branches.

- Assurfinance can be defined similarly and is used to designate the strategy where an insurance company and/or an insurance intermediary cross-sells financial products.

[11] The other concepts will be further detailed in the next chapter.

The banks and the insurance companies can opt for different ways to realise these strategies. If we take the example of the bank, the following approaches have been used in practice:

- The bank can produce the product itself (through an insurance subsidiary or sister company) and become the risk bearer through its own insurance company. The risk-taker is always an insurance company.

- Banks can offer insurance products with the help of an insurance partner through an own (creative) joint venture.

- The bank can limit herself to a pure agent or brokerage role (respectively with one insurance partner or as an independent intermediary).

It is worth noting that some recent studies [e.g. the LOMA study, 1997[12]] define bancassurance as the sale of insurance -*manufactured by the bank's own insurance company*- through the bank's distribution channels. In such a definition, the researchers explicitly exclude those cases in which joint ventures or distribution agreements are the approach used. This alternative was popular in the beginning but in the last couple of years, mergers and acquisitions have been used more frequently (see the current merger and acquisition wave in the financial services industry).

Sometimes, the term "allfinanz" has been used to indicate both bancassurance and assurfinance strategies. For example, Lafferty Business Research (1991)[13] used the term "allfinanz" (which some people have translated into "all finance") because it better conveys the dissolution of barriers that has been taking place, not just between banks and insurance companies, but among all types of financial service providers. We will come back to the term all finance in the next chapter.

2.3. Historical background

2.3.1. From a co-operative interface between banking and insurance

The analysis of bancassurance (and assurfinance) to a large extent coincides with the analysis of financial conglomerates, because the banking and insurance groups mainly focused on distribution synergies (at least in the beginning). The formation of financial conglomerates does however not coincide completely with the growing market interface between insurance companies, banks and investment firms. Belgium for instance has been a country of financial holdings which did not operate in the market as financial conglomerates for quite a long time. On the other hand, even before such large financial groups were formed there were important operational relations between different players in the financial market.

The financial conglomerate movement mainly started with banks who elaborated separate subsidiaries for a wide range of financial services such as leasing, consumer finance, mortgage, financial engineering, unit trust management, insurance brokerage and consulting services. The diversification strategies within the banking sector were driven by different forces.

One of the most significant forces has been the desintermediation in commercial banking. The traditional function of a credit institution is to act as an intermediary between economic agents with financial

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12 Crooks Gora, J. (1997) "Bancassurance: positioning for affiliations - lessons from Europe, Canada, and the United States", Loma Publications, Atlanta.

13 Lafferty Business Research (1991) "The Allfinanz revolution: winning strategies for the 1990s", Lafferty Publications, Dublin.

surpluses and agents with financial shortages. During the former decade, some structural trends have evolved both on the assets as well as on the liabilities side of the bank balance sheet. On the assets side, credit institutions are confronted with the replacement of straight bank loans with market-determined sources of financing. For example, large corporations with a good rating prefer the issuance of bonds and other securities to get the necessary capital. On the liabilities side, there is a substantial outflow of deposits to a wide range of new financial products offered by companies of different sectors.

In addition, banks faced new capital adequacy rules which put further pressure on banks' profitability. Examples of significant moves in this respect are the increase of off-balance sheet transactions (e.g. securitisation) and increased fee-based business (e.g. financial engineering, investment advice and insurance selling).

Therefore, banks have looked for new sources of profit, preferably without increasing their necessary solvency level. All fee income was therefore a welcome source of diversification. By acting as agents (or brokers) for insurance companies, banks could increase their fee income and enlarge their service assortment with some *high touch* products. To a certain extent, also insurance companies benefited from this development: they disposed of an additional distribution channel. The agency role that was played by banks (for insurance companies) has a long history. It partly arose because of the complementary nature of banking and insurance products. Another explanation lies in the fact that both banks and insurance companies can reduce the search costs for their customers, if these wish to extend the range of financial products purchased.

It is remarkable that insurance companies, at that time, did not show the same intensity to diversify into non-core business activities.

2.3.2. Towards a competitive interface

The situation changed when banks decided to set up their own insurance companies, from this moment on banks were considered as competitors for insurance companies.

We will show that it is not surprising that banks tried to recapture their cheap ways of funding by diversifying primarily into the life insurance industry.

Lafferty Business Research (1991)[14] sums up the factors that have prompted banks to do so, and which have created an entirely new environment for the financial services sector:

- a dramatic alternation in demographic patterns;
- a shift in the emphasis of consumer demands;
- corresponding changing savings trends.

In the 1980s the population growth rates significantly slowed down whereas the average life-time increased significantly. The combination of these two trends leads to a *greying* population. This demographic pattern has serious consequences on the overall economic environment, and especially on the provision of social security. The increasing proportion of the elderly relative to the working population is placing a strain on public pension systems. As these systems generally work through a redistribution scheme, the financing base comes under pressure (a decreasing number of contributors) while at the same

[14] Lafferty Business Research (1991) "The Allfinanz revolution: winning strategies for the 1990s", Lafferty Publications, Dublin.

time the financing needs increase drastically (a growing number of beneficiaries who live longer and have earned higher wages). This tendency is putting more severe pressure on governments trying to maintain state pension levels. For the higher-income groups the public provisions are generally not enough to ensure the same standard of living. As a consequence, people try to set up their own additional pension scheme. Given the financial pressure on the state pension systems and the drive towards decreasing the government deficits the level of public pension could well decrease in the (near) future. Consequently also the lower income levels feel more and more the need for extra private pension savings.

Thanks to the growth in prosperity and the expectations of a higher standard of living the budgetary margin for pension savings increased creating a growing emphasis on long-term, high-yield financial savings. This partly explains the success of alternative investment vehicles such as unit-linked and universal life products, but also investment or mutual funds. This evolution shows the link between the financial conglomeration at the one hand and the converging trends with the pension market at the other hand.

Life insurance in general has been a booming industry since the eighties. Of course the just mentioned retirement issue has certainly had a positive impact on growth in the life insurance sector, but other factors have been at work as well. The level of inflation is another determining factor for the economic potential of life insurance. Due to the discipline imposed by the European exchange rate mechanism, inflation was relatively low during the last decade. As inflation was low and real interest was relatively high, the consumers had a stimulus to invest in long-term oriented savings. Moreover the life insurance product became a very attractive long-term saving instrument because the average long-term interest rate offered by insurers (actuarial interest rate) was more competitive than in a high inflationary environment. Thus, life insurance accounted for an increasing share of total savings in some EC countries which underlines its rising significance and the successful inroads in which insurers were able to make into the savings pool that traditionally was monopolised by banks.

This strategic move of banks into insurance was further stimulated by other factors such as the growth perspective in the insurance industry, the support of an advantageous tax regime, and the gradual regulatory liberalisation within the financial services industry. The regulators realised it was not necessary to rely on direct interference by imposing restrictions on activities of banks and insurance companies. In the Netherlands, the liberalisation of the *Structure Policy* in 1990 has been one of the main causes of the accelerating pace of take-overs in the financial services sector.

2.4. The current situation: facts and figures[15]

Time has shown that the bancasssurance and assurfinance are more than just a fashion and that these trends are here to stay. After years of regulatory battle over whether banks should be allowed to sell insurance, banks and insurance companies are recognising that bancassurance (and assurfinance) is finally becoming reality. Moreover also the most fervent specialist insurers (like AXA or AEGON) acknowledge these trends and use the bancassurance potential in their own way.

2.4.1. Bancassurance

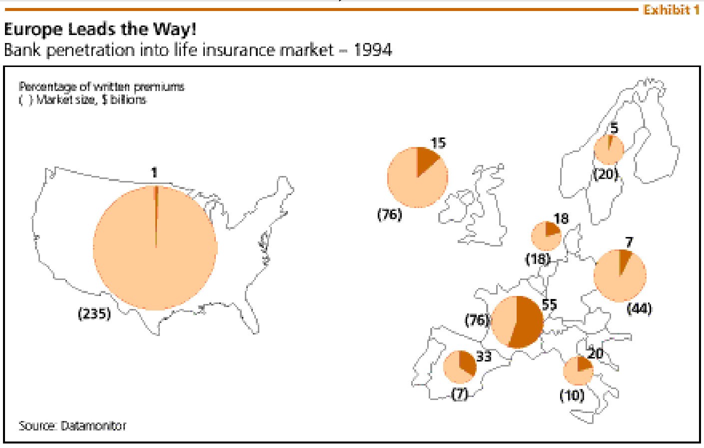
Most attention has been paid to bancassurance. This can also be deducted from the numerous articles, written about the (successful) inroad of banks as distribution channel for insurance products. A distinction is however necessary between the life and the non-life business. The statistics given below show that distribution via the bank branches is most successful in the life insurance industry.

[15] We would like to refer here to the remark made (in the introduction of this report) in relation to the quality of the statistics available.

The life insurance business

An overview of some international statistics of the penetration of banks in the life insurance market is given in Figure 3.

Figure 3 - Bank penetration into life insurance market (new life insurance contracts)



Source: Flur, Huston & Lowie (1997)[16]

More recent data are available for some European countries. We collected them from different sources. It must be mentioned that different sources have come up with figures, which might differ significantly. The reasons behind these differences are multiple:

- the definitions of the relevant variables differ,
- the sample differs,
- it is often more approximate evaluations than hard statistics,
- banks rarely reveal the penetration rates of their own customer base with life products, whereas conglomerate insurers mostly hide the division of their insurance premiums over the different types of distribution outlets. We must limit ourselves to those cases where the bank owns the insurance company so that it is nearly impossible to have a global view of the total impact of banks in the insurance business.

Taking these remarks into consideration, Table 1 gives an overview of the penetration of banks in the life insurance market. The figures exclude bancassurance arrangements in which the bank acts as the agent or broker of the insurance company. Stated in another way, in order to be included in these statistics, the premiums sold through the banking network have to be paid to an insurance company that forms part of the financial conglomerate to which the bank belongs or the insurer must be owned by the bank. We therefore must warn that the real impact of banks selling insurance products is probably substantially higher than the statistics given below.

[16] Flur, D.K., Huston, D. & Lowie, L.Y. (1997) "Bancassurance", The McKinsey Quarterly, 3, 126-132.

Table 1 – Penetration of life insurance markets by banks			
	1992	**1994**	**1995(*)/96(°)**
Belgium	16%	19%	23%°
The Netherlands	20%	18%	15%*
United Kingdom	20%	15%	17%°
Germany	8%	7%	15%*
Spain		32%	
Italy	8%	20%	32%*
France		55%	56%*
Sweden		10%	26%°
Finland			44%°

Note: penetration is measured as the bancassurer's share of new annual gross premiums or new premiums written.

These statistics reveal that the bancassurance movement shows considerable geographical differences. France is the clear leader: almost 60 per cent of new life insurance contracts is estimated to be written by banks. Banks have been very successful in Finland, Italy and Spain. But also in the other countries, bancassurance has proven to be more than a marginal phenomenon. Holsboer (1998)[17] explained the differences in penetration between the different countries along developments at the demand side. In a country like France, vast middle-class segments had been underserved, and banks were in a better position than insurers to reach these segments. In countries with mature private pension markets, such as the Netherlands, the success of bancassurance has been less pronounced, due to a stronger market position of local insurers. In the German market, which is less developed in terms of private life and pension plans, bancassurance in the strict sense (banks entering insurance for their own account) has gained less ground. This is attributed to a market structure that is characterised by longstanding close links and cross-shareholdings between insurers and banks [Holsboer, 1998: 28]. But Holsboer expects some changes, due to the growing competition from direct writers and other European insurers.

Table 1 also shows that for most countries the share of the banks as distribution channel for life insurance products is still increasing. This trend is expected to continue, at least for most countries. At the same time, we must say that the move of banks into the life insurance business is more a defensive reaction to the trend that took place during the 1980s and 1990s, when a substantial part of the banking deposits has moved to the (life) insurance industry. In fact, the increasing market share of the banks can lead to some form of cannibalisation. Indeed, the banks are in fact reshuffling their portfolio and substitute (out of sheer necessity) traditional banking products with new forms of savings products.

17 Holsboer, J.H. (1998) "Repositioning of the insurance industry in the financial sector and its economic role", Paper presented to the Geneva Association, Dresden, June 25-27.

The success of bancassurance in the life insurance industry has been explained by a number of factors.

- Banks disposed of an extensive branch network which can be used to sell insurance products.

- Banks had more frequent contact with their clients. This advantage is rapidly decreasing due to technology-driven banking services. Insurance selling can therefore be seen as a hedge against this leakage of client contact.

- Banks could use a much more detailed database to approach the customer and deliver tailor-made products with a one-stop-shopping convenience.

- Banks mostly had a better reputation: banks were rather seen as trust persons, as opposed to insurers who were thought to be sellers.

- Bancassurance is considered to be much more cost efficient compared to the traditional insurance selling.

- A final reason for the success of bancassurance can be attributed to the fresh look banks have given to the insurance business, developing a strong customer focus, resulting in simpler and more transparent products, mostly designed for the large middle classes.

The non-life business

Table 2 gives the comparable figures for the non-life insurance market.

Table 2 – Penetration of non-life insurance markets by banks

	1994
Belgium	3%
The Netherlands	15%
United Kingdom	1%
Germany	2%
Spain	3%
France	5%

These figures show that bancassurance has been less successful in the non-life market. The main argument is that non-life insurance is much more different from the banking products, while the life insurance products have more similarities. Since non-life products have different features, it is more difficult for the bank branch staff to sell these products. However, there are financial conglomerates that indicated to put more pressure on selling non-life insurance products through the bank branches. Some of these non-life products (e.g. car insurance) have a "trigger function": if banks are able to sell these products, there is a higher probability that they can sell other insurance and financial products. Although banks have long been afraid of the claim settlement and the potentially negative effect on their image there are some signals that also this trend is turning now (cf. EFMA conference on claim settlement).

Are the US and Canada lagging behind in this bancassurance trend?

The LOMA report by Brooks Groca (1997) paid special attention towards the bancassurance situation in the US and Canada. Operating in a restrictive regulatory environment, US banks have found a number of ways to enter the insurance business. Normally, national banks and subsidiaries of bank holding companies are excluded from providing insurance as principal, agent or broker (through the Bank Holding Company Act, amended in 1982). There are, however, some exceptions where banks are allowed to sell insurance:

- where the insurance is limited to assuring repayment of the outstanding balance due on a specific extension of credit in the event of death, disability, or involuntary unemployment (this provision permits banks bank holding companies to own credit insurance subsidiaries);

- where the bank owned the insurance company prior to 1982 (which was the case for 16 banks: "the sweet 16");

- where the bank is located in a town with a population of not over 5000;

- where the bank assets are only $50 million or less.

Given the legal limitations on insurance activities by banks, US banks have to take more indirect routes to bancassurance. Their involvement is still restricted, as compared to the European financial conglomerates, but has to some degree educated them about the business. Some of them are likely to apply this education aggressively when allowed to do so. According to the LOMA study, banks' involvement in insurance business has taken five main forms.

- Distribution alliances: which is the most significant route into bancassurance by US banks. Of banks with more than $10 billion in assets, 84 per cent market insurance. Savings institutions and credit unions are also distributors of insurance.

- Credit insurance: under US law, banks have long had the ability to manufacture credit insurance, but only few of them have exercised this authority.

- The bank-owned reinsurance company: some banks have the right to own captive reinsurance companies, which have been used to reinsure their credit insurance business and to reinsure directors' and officers' liabilities.

- Investments in insurance companies through venture capital subsidiaries: e.g. JP Morgan has an equity investment subsidiary (JP Morgan Capital Financing Corp.), which made a $200 mln investment in Travelers/Aetna Property/Casualty Comp.

- Credit relationships: banks are providers of credit and cash management services (to insurance companies). And some banks have played major roles in financing insurance acquisitions. Credit relationships have played on occasion an important role in bank distribution alliances with insurance companies.

In Canada, banks face a particular situation. Under Canada's 1992 Bank Act, banks and insurance companies can own one another. However, banks are barred from selling most kinds of insurance through their branches. The only exceptions are credit and travel insurance. Furthermore, strict limitations are placed on the use of bank customer data by affiliated insurance companies. These restrictions severely reduce the economies that can be obtained by integrating some activities (which are open to the European competitors).

2.4.2 Assurfinance

Insurers have reacted to the rise of bancassurance by strengthening and improving their existing distribution network. Serious efforts have been made to make the whole selling process more efficient or to focus towards more advice and service-oriented types of products. Furthermore, insurance companies have upgraded their new products with financial components. This is, however, restricted to the life insurance industry (except for Japan, where non-life insurance products sometimes have financial components as well).

As a more offensive response, insurers have also started cross-selling simple banking products to their customers. Some insurers decided to set up their own banking company from scratch (or by acquiring a small bank). According to Holsboer, this strategy has worked to some degree of success, e.g. for some Dutch insurers, which started quasi-banks, working from a direct marketing approach. But this approach has generally been confined to niches and simple products. For broader scale banking activities, acquiring or merging with existing banks seemed to be a better alternative.

Generally, one could say that the moves of insurers into the retail banking business were less noticed and didn't always seem very successful. In Germany, the rapidly expanding insurance group Aachener und Münchener really bought a problem with a former trade union bank, Bank für Gemeinwirtschaft (BfG). The problems had become too heavy and therefore, they reduced their participation in the bank to 25 per cent. Other problems originated in France where GAN, one of the largest insurers, had problems with its subsidiary CIC, because the latter one was too heavily exposed to the collapse in the French property market. Other *nightmares* were found in Australia (Chase-Australian Mutual Provident's) and New Zealand (General Accident and NZI Bank).

It's remarkable that insurance companies played a less important role as agents for banking products. Possible explanations are:

- regulatory restrictions: banks could sell insurance products without great regulatory barriers, whereas insurance companies could not easily attract public savings (deposits, term accounts, etc.) or operate as a monetary institution;

- distribution facilities: most banks (except the savings banks) operated through their own distribution network. This gives them the facilities to implement whatever marketing strategy they prefer. Insurers on the contrary operate in many countries through independent brokers so that they do not reach their final clients directly.

We may naturally not forget that insurers have always been important players in the financial market. Their institutional investor function made insurers important players in the investment field as well as in the field of mortgage loans.

Another aspect in the assurfinance trend is the fact that independent intermediaries themselves have to a certain extent been involved in the distribution of financial services. For a long time already they not only offered mortgage loans (coupled with life insurance and eventually with fire insurance) but many of them operated also as agents for a savings bank. Research in Belgium[18] has shown that 65 per cent of the independent small and medium-sized intermediaries also offered financial services. However, the contribution of these financial products towards the turnover is much smaller: financial products represented only 17 per cent of the total commission earned by the interviewed intermediaries. The market percentage of profits attributable to the financial products can even be lower because it is frequently heard that the commissions on these products are (very) small compared to those of insurance products.

More recently, a number of insurance companies have made well-noticed inroads into the banking industry. For example, in the UK, Prudential, Scottish Widows, Sun Life of Canada, Friends Provident,

18 Van den Berghe, L.A.A. & Baeten, X. (1996) “Risico, beleggen, sparen, verzekeren, zorg”, (a survey of the Dutch market), Research project, Vlerick School voor Management, Gent.

Direct Line and Legal & General had all moved into banking by July 1997. The trend has become quite prominent in Scandinavia. According to Sorcha Corcoran[19], the new breed of banks was designed, at least in part, to stem the outward flow of funds when policies mature. These latter moves seem to be more successful than the assurfinance strategies of the earlier days.

2.5. Beyond bancassurance and assurfinance

More and more financial conglomerates now have the disposal of different distribution channels. In these companies, managers believe that it is not a question of bancassurance or assurfinance. But managers of financial institutions believe that the best distribution strategy encompasses all different distribution alternatives. The purpose is to develop an integrated distribution system, where customers are free to select the distribution channel they want. In some instances, this might be the bank (e.g. for financial or simpler insurance products), in other cases this might be the insurance broker, and in still other cases, the customer might contact the financial services provider more directly. Although this might still be wishful thinking for most financial companies, we believe that this distribution model will become the model of the future.

It is worth noting that less traditional distribution channels will gain in importance. The volume of sales and service transactions conducted through lower-cost remote channels (e.g. telephone or internet) is growing dramatically. And in many sectors of personal financial planning, remote channels are already widely used. A study by McKinsey[20] revealed that in 1996, 65per cent of consumers claimed to have used their bank's telephone service, and 1000 banks had web sites, up from only 20 in 1994. Roughly 1.2 mln households currently use PC banking. These new trends will force financial institutions to reinvent -but not eliminate- the traditional face-to-face channels. For the McKinsey analysts, it is, however, clear that the role of traditional insurance agents or bank branches may shift.

At the same time, financial institutions face competition from non-traditional competitors. The UK shows us some interesting examples in this respect. Food retailers such as J Sainsbury and Tesco have successfully set up a joint venture with Bank of Scotland and Royal Bank of Scotland. But in these cases, the banks are behind the scenes, and the retailer owns the customer. Furthermore, it are the retailers' brand names that have been used.

Other (UK) examples of successful inroads from non-traditional competitors include Marks & Spencer Financial Services, and Virgin Direct.

2.6. What about the corporate market?

So far, we concentrated ourselves on the retail market. Indeed, bancassurance and assurfinance have largely been confined to retail segments and products. But leaders from the "all finance movement" movement proclaim that the actual focus on the retail market co-operation between banks and insurance companies is only the *tip of the iceberg*. Also the corporate market could offer many opportunities for joint and integrated projects. For example, Holsboer (1998)[21] showed that extending pension plans for individuals to small businesses is only a logical step further.

> *"Especially in countries with emerging private pension markets, such as Spain and Italy, there will be significant opportunities for corporate life insurance. In these countries, insurers have no*

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19 Corcoran, S. (1999) "Bank-insurance mergers: synergies or sham?", Lafferty Publications Ltd., Dublin.

20 Flur, D.K., Mendonca, L.T. & Nakache, P. (1997) "Personal Financial Services: a question of channels", McKinsey Quarterly, 3.

21 ibid.

traditional relations with corporate customers, while banks can easily leverage their existing corporate client relationships.

A similar reasoning is true for non-life insurance. Bancassurers have entered into individual lines insurance with increasing success. Commercial lines is a more specialised field, making entry more difficult. Yet we expect that banks will increasingly seek to acquire this expertise and that they are well positioned to compete in the corporate segments (p. 30)"

At the same time, there is a growing convergence trend underway in US financial markets involving commercial insurance companies, reinsurance companies and leading investment banks. Certainly, this trend is not unique to the US. It is, however, beginning to change significantly the very nature of risk management and the methods of financing risk. This trend is driven largely by corporate needs and demands for more effective types of financial protection for a broad range of financial and non-financial risks. For example, In the US, providing financing arrangements for corporate risks is becoming big business in the investment banking industry. Virtually all large investment banks in the US have now developed large risk management divisions that focus on new products that utilise capital market tools for financing a broad array of corporate financial risks.

Investments banks, insurance companies, reinsurers and insurance brokers are also coming together to jointly form catastrophic property and liability insurance companies to write high limits of traditional insurance. Some examples include significant capitalisations from J.P. Morgan for the formation of Bermuda-based EXEL, Limited and Mid-Ocean Reinsurance, and Morgan Stanley’s investment in ACE, Limited. The opposite trend can also be observed: a number of large insurers companies and insurance brokers develop capital management companies. For example, American International Group established AIG Capital Management, a division focusing on global investment banking. In 1992, Marsh & McLennan established a new division, Marsh & McLennan Risk Capital, to focus specifically on investment activities, primarily in the insurance industry. From these examples, it is clear that investments and risk are considered to be complementary. This can also be seen in the redefinition of Swiss Re's mission and core business: "the mission of Swiss Re Group is to be the authority on managing capital and risk, based on the core competencies risk transfer, risk financing and asset management".

More and more examples can be given of the growing convergence between these different types of financial institutions. In conclusion, many new developments are underway in the convergence of commercial insurance, reinsurance and investment banking. While it remains uncertain just how extensive this trend will become, probably we will see more and more innovative blending of the products, services and operations of the different sectors. This convergence provides compelling evidence that commercial insurance market will not remain the sole province of traditional insurers and reinsurers.

3. CONVERGENCE BETWEEN BANKING AND INSURANCE: THERE IS MORE THAN CROSS-SELLING

3.1. Introduction

In the previous chapter, we have extensively described the bancassurance and assurfinance development. The main conclusion was that banks and insurance companies have been working together on the distribution level for quite some time, but only from the middle of the 1980s on, a real convergence in the financial services industry has taken place.

In this chapter, we try to show you that more fundamental forces are at work. We will argue that the growing convergence in the financial services industry is taking place because financial institutions reconsider their core business and come up with appropriate strategic answers. One of these answers, is what we call "all finance".

This discussion is also very relevant with respect to the discussion on the convergence between the insurance and the pension market. We will come back to this point in chapter 5.

3.2. Redefining the core business of financial institutions : from a technical (product) to a client-oriented (functional) approach

The current changes that take place in the financial services industry make that today's and tomorrow's financial sector will look very different from the financial sector of 10 years ago. Strategists often agree that in most markets, and in particular the financial services market, the definition of the core business has traditionally focused on the kind of products offered. Typically, this is reflected in the words used to denominate the different types of financial institutions: life insurance companies, mortgage companies, pension funds, car insurance companies, etc.

But as the product and geographic boundaries disappear, this traditional definition of the core business might not work well anymore. Managers of financial institutions should rather adopt a client-oriented (functional) approach, instead of the traditional technical, product-oriented approach.

This is also acknowledged by the managers of insurance companies. For example, we cite Dean O'Hare, CEO of The Chubb Corporation:

> *"Our industry [the insurance industry] is constantly assessing the regulatory, economic and financial landscapes. We spend precious little time assessing the landscape of our customers and the economic, social and political problems they are facing. We need to redirect our efforts, because these problems define their protection needs and therefore our future opportunities […]*
>
> *The insurance industry historically has been product driven. We have done an excellent job of developing new products, coverages and packages of coverages, which we have taken to our customers and told them, "you need this." Much of the time, they agreed with us […]*
>
> *This relationship is changing, however. In an uncertain economy -and a soft insurance market- many customers have seen fit to re-evaluate the way they interact with their insurer. The smart insurers have picked up on this change. They are listening to their customers. They then are finding ways to address customers' problems and to identify new customer needs. It may*

sound simplistic, but listening to customers and understanding their problems in detail will prove to be our most important strategic activity" [O'Hare, 1995].

Such a redefinition of the core business by means of a more functional approach will enable financial firms to:

- better join in with the real needs and wants of the customer;

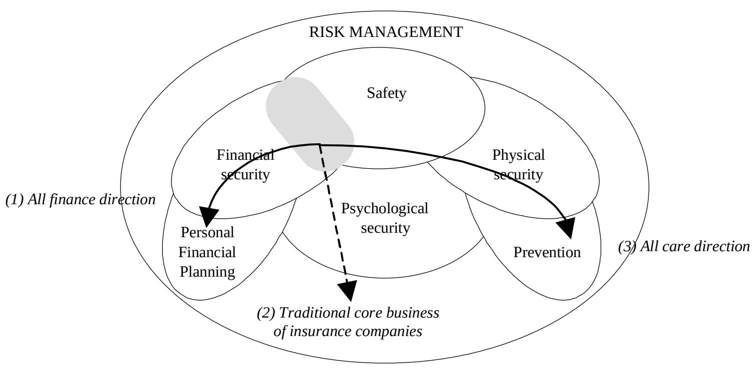
- face all different forms of non-traditional competition; this was already noticed in 1987 by Prof. Matthias Haller, who stated:

"With which products and services can our competitor solve the problems of our clients better and pick in part of our current market share? And how can we protect our core product and services by filling in our scope of activities with broader functions and services? [Haller, M. (1987)].

- exploit opportunities which have come up, due to changes in society (e.g. changes in the welfare state).

Defining the core business from the perspective of the customer can open a far broader field of services than when one sticks to the pure technical approach or product focus. The following figure, based on our own market research (Van den Berghe & Baeten, 1996) shows clearly that the traditional insurers focus their core business on a very small part of the whole risk management spectrum.

Figure 4 - Insurers' core business from a broader perspective



Although the tendencies are not yet completely clear in practice, we see two main options for further integration:

- *All finance*, into the direction of personal financial planning (for the retail market) and employee benefits (for the commercial market). This is an option followed by a large number of insurance companies. However, it is not always clear whether insurance companies are in the best position to offer such solutions. For example, in case of employee benefits, it might be that human resources consultants have developed more competencies than the traditional insurance companies in this respect.

- *All care*, into the direction of family risk management (retail market) and integrated or holistic risk management (commercial market). Here too, we see a broadening of the scope of the insurance company, e.g. by offering laundry, catering and home care services.

Similar arguments can be forwarded with regard to the *banking industry*. Robert Merton (1990)[22] published an article where he suggested that a functional approach may provide a more useful organising perspective than an institutional approach, especially in an environment of rapid technological changes and movements towards increasingly global connections among financial markets.

Applied to the banking industry, Crane and Bodie (1996)[23] elaborated on the Merton article and described the transformation of banking. They argue that the functional view of the financial system will provide a valuable framework to understand how the future of financial institutions might evolve. The point of departure is the underlying functions that all financial systems must provide, in order to make an economic system work. Specifically, the financial system serves six core needs:

- payment methods in order to facilitate the exchange of goods and services;

- resource pooling mechanisms to fund large scale enterprises;

- ways to transfer economic resources over time and across distances, as in lending and investing;

- methods of managing risk, such as insuring, diversifying, and hedging;

- price information, such as interest rates and securities prices, to help co-ordinate decentralised decision making in various sectors of the economy;

- ways to handle incentive problems that interfere with efficient business transactions.

This set of functions does not change, although there are large differences between the different countries. Crane and Bodie believe that the search for higher performance and efficiency increases direct competition between banks, insurance companies, securities companies, mutual fund companies and other finance companies. With these authors we believe that this fragmentation of traditional institutions is part of a transition to more efficient arrangements. This whole development is definitely not an end point. Although some niche companies will continue to be successful, other companies will recombine functions to meet the needs of customers better and to take advantage of new technology to produce and deliver products at lower cost.

The insurance and the banking industry will change dramatically:

> *"In the short run, banks will continue to compete by cutting costs and striving to be more efficient […] But in the long run, there are important and legitimate reasons for functions to be combined into new packages […] The winners of the future will be those who best package functions to meet customers' needs, not those who cling to old institutional arrangements" [Crane and Bodie, 1996: 111].*

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22 Merton, R.C. (1990) "The financial system and economic performance", Journal of Financial Services Research, 263-300.

23 Crane, D.B. & Bodie, Z. (1996) "The transformation of banking: for follows function", Harvard Business Review, March-April, 109-117.

3.3. From bancassurance and assurfinance towards "all finance": bundling and rebundling of financial services

The traditional definitions of most financial and insurance services are based on technical criteria and institutional sectoral barriers. The discussion regarding the core business of financial institutions reveals, however, that the real market needs are often not in accordance with the traditional product concepts.

It is our firm belief that the combination of banking and insurance products, as is now done through bancassurance and assurfinance, is just the first step of a more profound development. The complementarity in time and space between different financial and insurance products not only creates natural incentives for cross-selling and packaging but also for innovative product integration. Through unbundling (old traditional products) and rebundling (in accordance with the real market needs) new service bundles are created.

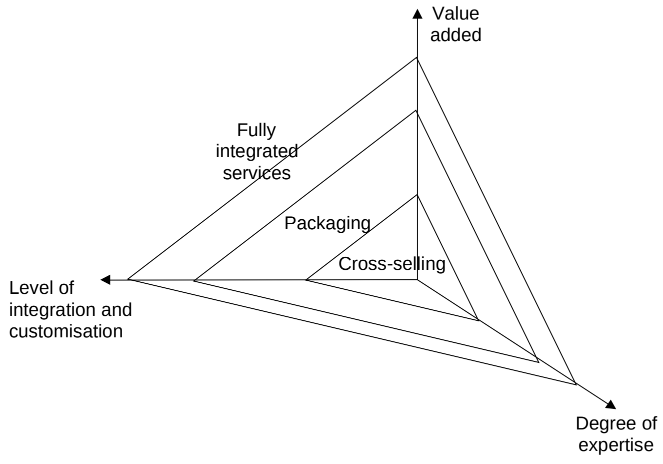
Bundling can mean different things to different suppliers or customers. It is therefore necessary to analyse into more detail the elements that differentiate the many forms of bundling that exist in practice. This analysis will help to make the distinction between bancassurance (resp. assurfinance) and what we call "all finance".

The many forms of bundled services can be differentiated with the help of the following criteria:

- the level of customisation and integration between the different products and services involved;
- the underlying degree of expertise with the service provider for each of the products and services involved;
- the value added for the customer, which finally is the ultimate goal of this bundling.

These three elements can be combined in one graph to give a visual picture of the different types of bundling.

Figure 5 - The different forms of bundling



Source: Van den Berghe & Verweire (1998)[24]

[24] Van den Berghe, L.A.A. and Verweire, K. (1998) "Creating the Future with All Finance and Financial Conglomerates", Kluwer Academic Publishers, Dordrecht.

Two extreme cases can be observed and in-between a whole bunch of variations are possible.

At the one hand stands *cross-selling* with the lowest degree of integration and customisation, with a limited scope of different expertise involved and a relative lower level of value added. Here the accent of the supplier's strategy is more on the volume of business and this from a perspective of transactional marketing.

At the other extreme we find the *fully integrated services* with a high degree of integration and customisation, many experts involved and a high value-added for the customer. Here the supplier is looking for a competitive edge in tailoring different complementary products and services, personalised from a life-time perspective or built around specific needs or events. This is a typical approach for relationship marketing and builds on customer loyalty.

In-between all types of *packaging* can be found with intermediate positions on the level of integration, customisation, expertise and value added.

Our argumentation is that bancassurance and assurfinance are nothing more than cross-selling strategies. Nevertheless, there are firms that have adopted a more integrated product development strategy, which we call "all finance". We define *all finance* as a more product and market-oriented approach, whereby products produced in different 'factories' are unbundled and rebundled to tailor them to the needs of specific client segments in order to offer them an integrated personalised solution. Recall that this is different from the traditional definition given to the concept of "allfinanz", which is merely the same as bancassurance and assurfinance.

In the next paragraph, we will give some examples of cross-selling, packaging and fully integrated solutions in the financial services industry.

3.4. Examples of cross-selling, packaging and integrated solutions

Many types of bundled services are developed at great speed in the market for financial services. Although it is not always easy for an outside observer (and a supervisor?) to evaluate the degree of integration and customisation as well as the level of expertise of the service providers and consequently the value added for the customer, some broad lines are clearly observable.

3.4.1. Cross-selling - bancassurance and assurfinance

Historically, *cross-selling* was defined within one sector such as the supply of life insurance products by an insurance intermediary, specialised in non-life products (e.g. car insurance and family liability covers) or the offering of saving accounts as well as current income accounts by bank tellers. Diversification of financial firms and the blurring of the boundaries between the different sectors enlarge the scope of cross-selling to an assortment that contains insurance products as well as banking and other financial services. The most prominent example being today the cross-selling of life insurance products by the banks (see previous chapter).

3.4.2. Packaged products

The insurance sector as well as the banking sector more and more realise that customers are better served if they offer them a more fine-tuned offer of *packaged services*. Some of the frequently sold banking and insurance products are then put together in a standard package bank and insurance product.

There are numerous opportunities for bancassurers to integrate insurance and credit. Credit insurance products are a staple of bancassurance in many countries. Similarly banks have numerous opportunities to market auto insurance in conjunction with auto loans and homeowners insurance in conjunction with mortgage loans. The LOMA study[25] has summed up a number of alternatives, commonly sold in the US and the UK.

- *Credit insurance*: credit insurance products guarantee repayment of a loan if the borrower dies, becomes incapacitated or in some cases loses a job. The credit insurance can be linked to many consumer loans such as mortgages, automobile loans, personal loans, revolving lines of credit and credit cards. In the US, credit insurance is the one form of insurance that banks have traditionally been allowed to underwrite. Many banks do not take advantage of this power but instead have long-standing credit insurance relationships with US insurance companies. Banks have a big incentive to offer their customers credit insurance because it increases the likelihood that borrowers will repay their loans. In Europe this type of packaged product has been sold as well through banks as through insurance companies. In the bancassurance model the mortgage is mostly of the annuity type linked with a pure risk cover (in case of death or disability). In the assurfinance case the mortgage is mostly repaid through a mixed life insurance contract.

- *Life insurance enhancements to traditional mortgages*: in the UK, one of the most popular bancassurance products is the endowment mortgage, which is an endowment life insurance policy linked to a traditional mortgage. Although this product is not simple, until recently it offered tax advantages that made consumers willing to tolerate its complexity. The same holds for other European countries (e.g. Belgium).

- *Auto and homeowners insurance*: auto and homeowners insurance have close relationships to auto loans and mortgage loans and, therefore, also represent useful bancassurance products. For example, the Bank of Scotland offers a GAP insurance product that covers gaps in a customer's automobile insurance. This product is designed primarily for customers of the bank's automobile loans. It pays the difference between the market value of a car and the remaining balance due on the automobile loan if the car must be written off in the event of a total loss or theft.

- *Medical savings accounts (MSAs)*: are new US bank products that integrate with health insurance. These products allow individuals to obtain health insurance coverage with high deductibles. They use the funds accumulated in the savings account to pay for out-of-pocked medical expenses that fall within the deductible. According to the LOMA study, this product has a promising future given the difficulties many countries are likely to have funding medical care for ageing populations.

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[25] Crooks Gora, J. (1997) "Bancassurance: positioning for affiliations - lessons from Europe, Canada, and the United States", Loma Publications, Atlanta.

- *Asset management accounts*: asset management accounts are traditional stock brokerage accounts that incorporate money-market funds (mutual funds that invest in short-term instruments). Account holders can use the money-market funds as the functional equivalent of interest-bearing checking accounts. This product was first introduced by Merill Lynch, a decade ago.

The success of packaged products can also be deducted from the following list. In a Dutch magazine intended for the insurance intermediaries an overview was given of personal insurance packages. Besides the name of the insurer and the insurance package, we also have mentioned the year of introduction and the percentage of the new production coming from these packages.

Table 3 - Packaged insurance products

Aegon	1995	Woonpakket-plus	60%
De Amersfoortse	1994	Domino Pakket Plus	
AMEV Particulieren	1993	Combinatiepakket	40%
Avéro	1993	Comfort Plan	
De Noordhollandsche		Combipolis Particulieren	35%
Delta Lloyd	1989	Het Verzekeringspakket	
ELVIA Verzekeringen	1986	Alles-onder-één-dak polis	50%
	1974	Vier Sterren Polis	50%
Erasmus	1996	Multi Polis	40-50%
FORUM	1996	Voordeelpakketpolis	35%
General Accident	1993	Pakketpolis	50%
GENERALI	1976	Eén-Gezins-Polis	50%
Goudse	1996	Privé Woon Polis	
Guardian	1990	Comforta Polis	
Hooge Huys	1997	Totaalplan	30-40%
Interpolis	1997	Alles in één polis	Almost 100%
Klaverblad	1997	Verzekeringspakket voor Particulieren	
Levob	1983	Privé CombiPlan	45%
	1983	Auto CombiPlan	77%
Nationale-Nederlanden	1992	ZekerheidsCombinatie Particulieren	
Nieuwe Hollandse Lloyd	1995	Odeon	60%
NOG	1997	Verzamelpolis	
Reaal	1993	Totaal Plan	25%
Royal Nederland	1985	Wel-Thuis Pakket	
	1985	Weg-Wijs Pakket	
Stad Rotterdam	1995	Autopakket	40%
	1995	Huispakket	40%
Tiel Utrecht	1995	Privé Pakket	
UAP-Nieuw Rotterdam	1994	Gezinspakket	50%
	1993	Uit & Thuis Combinatieplan	50%
Unigarant	1994	Pakket Verzekering	
Zevenwouden	1992	Particuliere Pakketverzekering	75%
Zürich	1996	Rubriekenpolis rondom het huis	50%
Zwolsche Algemeene	1985	Modulair Privé Pakket	85%
	1970	Auto Pakket Verzekering	85%

Source: Het Verzekeringsblad (VB), April 24th, 1997.

3.4.3. Fully integrated solutions

More *integrated services* can be found in the directions of personal financial planning, personal or family risk management and flexible employee benefits and cafeteria plans. This supposes a pro-active research of the service provider into the formal and informal needs, attitudes and customer behaviour. Integrated customised service bundles not only need such an up-front analysis but also a dynamic and flexible perspective that goes hand in hand with a long-term client relationship. The degree of personalisation and flexibility can differ quite a lot as well as the type of products and services involved. The list is long of potential combinations:

- banking accounts and payment services;
- savings and investment instruments;
- different types of loans and credit formulas;
- all types of private life and non-life insurance;
- risk management instruments other than insurance;
- social insurance covers and partly privatised categories;
- legal aspects (family, succession, contracts);
- etc.

Such an approach supposes a great deal of individual information per client, a long-term planning in relation to the life cycle of the client with different event scenarios and a dynamic approach for flexible updating and adaptation. It is clear that most financial institutions have only started working on this type of solutions, so it is quite difficult to point to the current success or problem factors.

It is clear that these newly integrated products are -for the moment- more exception than the rule. Nevertheless we found the following examples.

- *Employee Access Accounts*: the Employee Access Account is a product, recently developed by Merill Lynch, and is based on the asset management account (we described when discussing packaged products). Merill Lynch distributes the account through large employers to their employees, who can have their pay directly deposited in it. The Employee Access Accounts provides a comprehensive menu of banking, securities, and insurance products and services. Holders of the account can use it for check writing and bill payment, investment (money-market funds, mutual funds, and securities trading), credit cards, other loans, insurance, and financial planning -in sum, for their total financial activity. This product allows full integration of an individual's financial relationship. This example gives an idea how a modern "employee benefits" solution could look like.

- *"Proveniersplan"*: certainty for the elderly: The Proveniersplan is a product, developed in the Dutch financial market by the Achmea Group, one of the larger financial conglomerates in the Netherlands, and focuses on servicing the segment of the older people. The opinion of Achmea is that products and services towards this segment not always meet the needs of these people. The purpose of this *Proveniersplan* is to provide the elderly with products and services tailored to their needs so that they can stay as long as possible in their actual way of living. This product also is the appropriate answer for the more general economic problems in the social security. More and more there is made appeal on the responsibility of the individual and contributions are asked for provisions made by the government.

- The Proveniersplan consists of different elements and is about *integral home care*: the provision of an alarm system, help at home, security systems and meal preparation are all forms of servicing in kind. All the products of the Proveniersplan can be considered as variations or complements of existing products such as pensions, annuities, mortgages, general insurance, etc. The products will be adapted to the wishes and the needs of the elderly and are composed modularly so that everyone can make up his own product.

- The success of the Proveniersplan was still limited. The spokesmen of the different parts of the Achmea Group acknowledged that the new product was nothing more than a package of existing financial products and that for the products in kinds the Group is still in a testing phase. Furthermore the reactions on the new product are relatively modest so there is also a need for more promotion and publicity.

- *The capital care concept of OHRA*: OHRA is a Dutch direct writer and now part of the Delta Lloyd Bank and Insurance Group, with a clear customer-oriented strategy. The creation of the capital care service has the purpose to provide full financial advise. In this way OHRA strives for a lasting relationship with its clients by providing the client with professional help for banking, insurance, investment services. The financial group does this on a continual basis taking into account the particular situation and some characteristics of the client (such as the risk profile). The starting point is the capital position of the client. This capital position is formed by an inflow, a capital position, and an outflow. If there is something left after the flows are taken into account then there is room for financial planning. A financial target is proposed based on the current capital position and on the risk profile of the client. All these factors determine which actions are taken and which products will be used. It's clear this is a very customer-oriented approach, as this is the basis for further actions. This is certainly not comparable with the selling process of a lot of other financial institutions.

3.4.4. The future of financial products: the modular approach

The main idea for the future is to work with modular concepts. These modules form the building blocks around which new financial products will be built. This new approach allows for some standardisation (there are only a few modules) but on the other hand the combination of different modules and other features makes it possible for a financial firm to develop products tailored to the specific needs of a customer. For the moment this is at best in the planning phase: a small number of companies are thinking of applying this idea in practice shortly.

4. CONVERGENCE BETWEEN BANKING AND INSURANCE:

INTEGRATION ON OTHER LEVELS

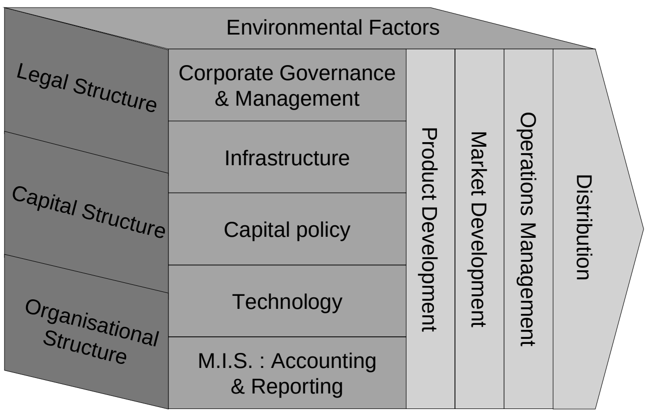
4.1. Introduction

In the preceding chapters, we outlined the integration of the financial services industry on the distribution level. Indeed, the convergence mainly between banking, insurance and investment started with the development of bancassurance and assurfinance. But in the previous chapter, we showed that the convergence at the distribution level is only a small dimension of a much broader trend. More particularly, we believe that financial institutions (will have to) reconsider their core business. Only if firms can give an adequate answer to the changing customers' needs, they will be able to be successful. We showed that all finance, which is here defined more from a customer-oriented perspective (as opposed to the pure cross-selling strategies: bancassurance and assurfinance) could be such an answer.

4.2. Integration of support activities

If we recall the financial conglomerates control board, as presented in the first chapter, we see that up until now, we focused on distribution, product and market development and to a lesser extent operations management. The integration of these *primary activities* has indeed received most attention, also in the academic and business articles.

Figure 6 – The Financial Conglomerates Control Board



Source: Van den Berghe and Verweire (1998)[26]

During the last couple of years, we also notice more integration between banking and insurance at the support activities (which can to some extent be considered as more back-office activities). This is especially the case for the asset management activities, which we put under the heading "capital policy". In this chapter, we will show that substantial benefits of integration come from a combined asset

[26] Van den Berghe, L.A.A. and Verweire, K. (1998) "Creating the Future with All Finance and Financial Conglomerates", Kluwer Academic Publishers, Dordrecht.

management. But we will show that despite the legal prohibition of integrating banks and insurance companies, some financial conglomerates try to integrate on other levels as well.

4.2.1. Management and corporate governance

The *corporate governance and management* level consists of different activities: the governance and management itself, including also strategy development, human resource management, and initiatives to manage the different cultures. These activities all have in common that they are involved with the way the strategy is implemented.

An increasing number of financial conglomerates opt for tight management structures and strive for an integrated group approach (two notable examples are ING and Fortis). The whole group is then led by an integrated management team (of bankers and insurers) who mostly have the *strategic control* over the business units. The business unit managers have operating autonomy.

In order to create the necessary flexibility these groups make use of a quite integrated human resource management. Mostly the personnel department is centralised. Furthermore these groups make use of job rotation and cross-overs, i.e. techniques whereby managers and other personnel are rotated through the whole company, once in a banking subsidiary, once in an insurance company. Sometimes these companies have created collective agreements per industry for all companies of the group (within a particular country). Attention is paid to prevent culture clashes and to stimulate synergies.

4.2.2. Capital policy

Under this heading, we group all activities associated with funding and investing the funds collected by the banks and the insurance companies. We will focus on two main activities where considerable efforts have been made regarding the integration: (1) asset management and (2) risk management.

Asset management.

Financial conglomerates often cite the opportunities of combining their asset management capabilities as a major benefit of the deal. Asset management as a business in its own right is increasing in importance, and massive growth in the area is expected in the coming years, mainly due declining state pension provisions and the changing savings needs of individuals and households. Managers of financial conglomerates believe that larger asset management companies will be in a stronger position to compete on a wider geographic scale and more likely to attract higher skilled staff. Furthermore, substantial economies of scale can be achieved through combining the back office operations and in eliminating excess offices and staff. In addition to the economies of scale, there exist economies of scope, e.g. through the combination of investment management skills of banks and insurance companies. It is, however, difficult to get reliable and accurate data on the cost savings in this respect.

In practice, we see that an increasing number of financial conglomerates have integrated their asset management departments. ING and Fortis were among the first to integrate the asset departments of their banks and insurance companies. But in more recent mergers, increasing the asset management business and exploiting the economies of scale and scope seems to be key motivation as well. Examples include SEB Asset Management (asset management department of merged SE Banken and Trygg-Hansa) and SSB Citi Asset Management Group (which is a combination of three existing asset management business within the newly formed Citigroup, namely Salomon Brothers Asset Management, Smith Barney Asset Management and Citibank Global Asset Management).

In the US, banks and insurance companies are also heavily involved in the pension fund management business (in contrast to Europe). In fact, both banks and insurance companies have very similar kinds of expertise in the areas of pension funds and mutual fund management. It is therefore expected that, when the legal barriers are removed, the similarities in these areas are likely to affect partner selection and the ultimate structure of the bancassurance and assurfinance ventures (Crooks Gora, 1997[27]).

It is worth mentioning that not only financial conglomerates have integrated their asset management department. Independent banks and insurance companies have set up joint ventures in order to benefit from an integrated asset management. Examples here are the joint venture between Allianz and Dresdner Bank, Allianz Dresdner Asset Management, set up during 1998.

Risk management.

Financial conglomerates not only try to benefit from an integrated asset management, they also try to link their risk management techniques. Risk is a central element in banking and insuring. More specifically, financial firms are fundamentally different from all other businesses because they must seek out and attract risk in order to make money. Where other businesses try to avoid and pass off risk, financial firms absorb, intermediate and advise on risk.

In the previous chapter, we already indicated that the core business of banks and insurance companies might converge. This is highlighted once again by the following statement:

> *"In their traditional roles, both banks and insurance companies operate as intermediaries. As financial intermediaries, they obtain funds by issuing claims against themselves to market participants, and then investing those funds. Banks invest these funds in loans. Insurance companies invest them in securities, mortgage loans, and mortgage-backed securities. Both try to make money from the spread between their assets and liabilities. Both intermediate maturities (when their liabilities have one maturity and their assets another). Both reduce risk for their liability holders by diversifying their assets. Both reduce their liability holders' costs of gathering information about assets and contracting with asset holders" (Crooks Gora, 1997[28]).*

Perhaps these statements might somewhat simplify the differences between banks and insurance companies; however, people agree that banks and insurance companies now employ many similar approaches to risk management and that there is a complementarity between the risk management techniques of the different partners. Some empirical evidence for this statement was forwarded by Verweire (1999)[29], who found that the overall risk profile of financial conglomerates was better than the risk profile of specialised banks or specialised insurance companies.

From an historical perspective, banks have been more aggressive than insurance companies in applying their risk management skills to financial engineering. The example in this respect is *securitisation*. As such, securitisation is one of the main trends in the banking and the insurance sector which could have serious consequences for the definition of the core business of financial firms. What is it all about? For the past 20 years, mostly US banks and their investment banking counterparts have been pooling large numbers of similar loans and issuing securities against them in the capital markets. This process started in

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27 Crooks Gora, J. (1997) "Bancassurance: positioning for affiliations - lessons from Europe, Canada, and the United States", Loma Publications, Atlanta.

28 Ibid.

29 Verweire, K. (1999) "Performance consequences of financial conglomeration with an empirical analysis in Belgium and the Netherlands", Thela Thesis Publishers, Amsterdam.

the residential mortgage area and has since been extended to other forms of credit including short-term commercial loans, trade and credit card receivables, auto loans, etc. Some of the US insurance companies (with mortgage banking subsidiaries) also participated in asset securitisation.

The last couple of years, securitisation has become an instrument, increasingly used by insurance companies. The insurance industry has been seriously hit by a record number of natural catastrophes. Potential losses from these catastrophes exceed(ed) the available capacity in the insurance and reinsurance markets and the insurance sector faced a capacity problem. Due to this problem, the idea was raised of trading insurance risks not only *within* the insurance system but also transferring them to the more liquid financial markets (Swiss Re, 1996[30]). Although, securitisation of insurance risks is -for the moment- only rarely accomplished, the size of the capital markets that securitisation seeks to tap and the apparent success of some recent securitisation deals confirm that a risk securitisation growth can be expected.

The expected increase in the importance of securitisation in the insurance sector is just part of a broader trend in risk management and insurance. The shortage of traditional insurance capacity in some specific areas has led to the emergence of *alternative risk financing techniques*, where capital markets serve as ultimate bearers of risk. As such, we might expect an increased convergence between traditional insurance markets and the capital markets.

4.2.3. (Information) Technology

The costs of (information) technology are increasing rapidly. The merger wave in the financial services industry is often explained in terms of creating the necessary scale to bear these immense (information) technology costs. It is often argued that the creation of financial conglomerates can result in substantial economies of scale. But it is difficult to test whether these economies are effectively materialised.

There are only a limited number of examples where the use of IT was really a source of process improvement with regard to the bancassurance process. Some financial conglomerates make use of an integrated front-office system. In most banks there is an electronic acceptation system so that the personnel of the bank branch can handle the insurance contract. In this way there is only one input procedure which decreases potential mistakes. In some cases there is a direct link with the insurer's back office so that the necessary documents can be printed in the bank's outlet. There are examples where the green card of the car insurance rolls out of the bank's printer some minutes after the insurance contract was signed. This certainly opens up opportunities for large productivity gains.

Another example is the electronic handling of securities. We have already mentioned that at the investment level banks and insurance companies work together for the administration of securities. Banks have a range of funds to which the insurance product can be directly linked (unit linked products) or indirectly invested (investment of the technical reserves). As more and more consumers are interested in these kind of savings vehicles the electronic handling of these securities may rise in importance, and thus IT may be an important means to control efficiency.

Finally, it is often mentioned that both the banking and the insurance partner can have access to each other's customer base. In Norway, several banks have adopted particular front-office support software that allows a full integration with existing office support products. The system, supplied by market leader Fellesdata, consists of four independent modules -sales, lending, everyday banking, and teller services- which are brought together in a customer information module. In this way, the customer consultant in the bank branch (or call centre) has access to a complete overview of customers, products, contracts,

30 Swiss Re (1996) "Insurance derivatives and securitisation: new hedging perspectives for the US catastrophe insurance market?" Sigma, No. 5.

completed and planned activities, customer rating, customer profitability and cross-selling opportunities. We know that there are at least a number of financial conglomerates from different European countries that have developed such software for at least part of these functions.

4.2.4. MIS: Accounting and reporting

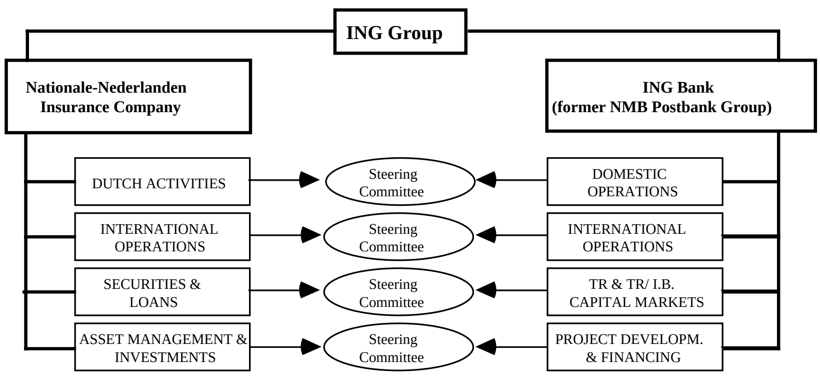
The challenge for financial conglomerates is to build up a comprehensive accounting and reporting system necessary for monitoring and managing the financial conglomerate. This is not always easy: banks and insurance companies have their own reporting and valuation methods so that a comparison of the banking with the insurance activities is not always easy.

The creation of an integrated Management Information System is not merely intended to achieve substantial cost economies. Rather, it should allow managers to better monitor the financial conglomerate. Since this is very strategic information, we have no clear view on how well financial conglomerates are integrated yet.

4.3. Creating new organisational structures

The quest for integration has made some financial conglomerates to set up new organisational structures, which have hardly anything to do with the traditional legal structures. We already mentioned that legal restrictions prohibit banks and insurance companies to fully integrate. Because of supervisory reasons, most financial conglomerates group their insurance subsidiaries in an insurance holding, while the banking subsidiaries are brought into a banking holding. Either the insurance holding or the banking holding may act as the holding company for the whole group. In some cases, however, a new holding company is created which has controlling stakes in both the banking and the insurance holding. The most notable example in this respect is ING Group.

Figure 7 – ING's former organisation structure



From 1991 on, the moment the ING Group was formed, it had always considered banking and insurance as part of the same market for financial services. ING considered the traditional separation between banking, investment and insurance out-of-time. Moreover they believed that developments at the demand side created the need for a more integrated approach. The first three years after the merger, ING retained the legal structure as its main organisational structure, but tried to establish links (by means of steering committees) between the banking and insurance subsidiaries, at several levels.

However, in 1994 a new corporate structure was created. The management of ING felt that in order to create a more flexible and integrated group, fundamental changes were necessary. A major decision was to create a new organisation structure, which went beyond the traditional separation within the financial services industry. The following business units were created:

- ING Nederland, which comprises the financial services to personal and corporate customers in the Netherlands;

- ING Financial Services International, which encompasses all the insurance activities outside the Netherlands in combination with the banking activities for private customers and small and medium-sized enterprises in local markets;

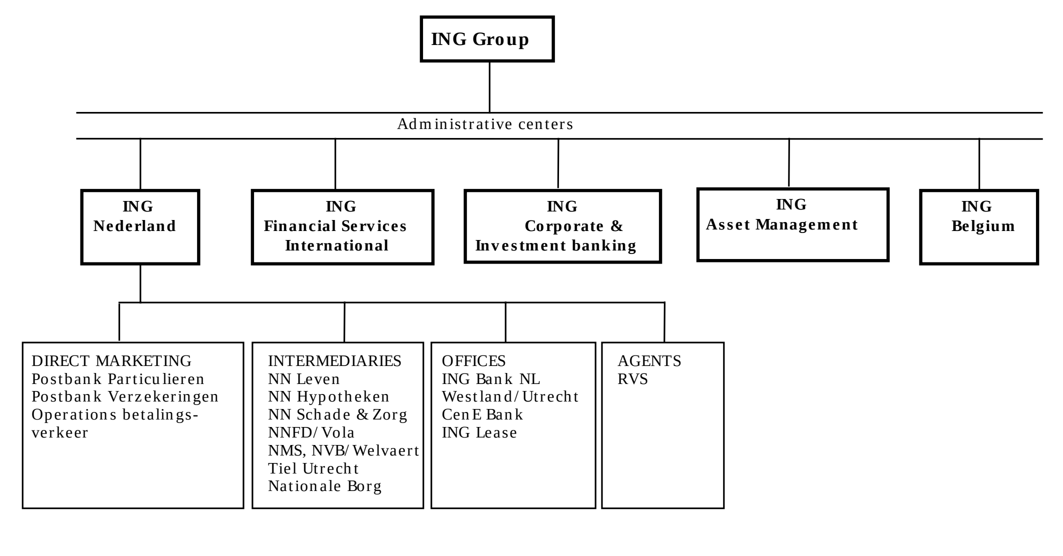
- ING Corporate & Capital Markets, which includes the operations in the money and capital markets as well as the international banking activities for corporate clients;

- ING Asset Management, which acts as the property and the relation manager (both for the clients as well as for ING itself): in this way it unites the asset management, real estate and private equity operations.

After the take-over of the Belgian bank BBL, the management created a fifth administrative centre: ING Belgium, which comprises the financial services to personal and corporate customers in Belgium.

This new organisation structure is presented in the following figure.

Figure 8 - ING's new organisation structure



Of particular interest is the way ING Netherlands is structured. The structure is based on the different distribution channels used: (1) direct marketing, (2) intermediaries, (3) agents, and (4) bank branches (offices). In each of the four parts, both banks and insurance companies are included, as can be deducted from the figure.

Although the ING case is quite innovative, we think that the more the different parts of the financial services industry converge, the more integrated organisational structures will be developed, which might differ substantially from the traditional legal structures. Interesting in this respect, is that ING has just announced that, given the need for the realisation of potential synergies, the actual structure will be changed further in order to gain additional synergies. This might be an important lesson for supervisors and regulatory authorities.

5. CONVERGENCE BETWEEN THE INSURANCE AND THE PENSION MARKETS

5.1. Introduction

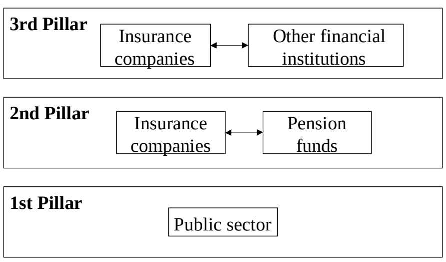
In the chapters 2 to 4, we have extensively described the growing convergence between the banking, the insurance and the investment industry. We have outlined the major drivers of the financial conglomeration trend. We showed that the financial conglomeration trend was initiated by the banks who looked for an appropriate answer to the desintermediation problem. From the moment the regulators removed the barriers that existed between the different sub-sectors, the number of financial conglomerates increased rapidly. We also showed that more fundamental forces are at work: the different types of financial institutions reconsider their core business due to the changed financial and economic environment. This redefinition of the core business can lead to a further convergence of the financial services industry. This was also proven by the fact that banks and insurance companies try to integrate not only the primary activities, but are looking for synergies in the support activities. Of particular interest, are the efforts by banks and insurance companies to integrate asset management and risk management techniques.

In this chapter, we argue that the convergence between the insurance and the pension industry follows the same pattern. More particularly, we will show that deregulation will only be the first step in a more comprehensive process, where insurers and pension funds need to reconsider their core business (due to the changed financial and economic environment). This will be demonstrated by the case of the Dutch pension market.

5.2. The pension system: three pillars

Traditionally, the pension system is composed of three pillars, as presented in the following figure.

Figure 9 - The pension system - the three pillars



- The first pillar is the public pension system, which is usually characterised by pay-as-you-go, mandatory and defined benefit.

- The second pillar comprises the occupational provision of pensions, which is usually pre-funded[31], often mandatory but sometimes voluntary, and either of the defined-benefit or the

[31] A notable exception is France.

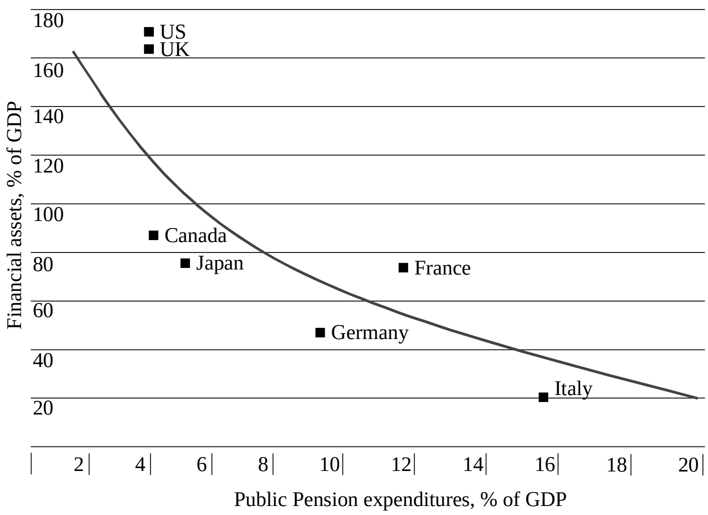
defined-contribution type. Pensions are managed by either affiliated or independent pension funds, group life insurance contracts, or enterprises themselves that built up their own book reserves.

- The third pillar consists of voluntary individual savings managed by life insurers, mutual funds, investment companies, or by individuals themselves. In general, it is of the defined-contribution type and most often enjoys tax privileges.

Since the three pillars differ considerably there has been a heated discussion as to which pillar is best suited for pension provision. There is however no obvious answer: as a rule, a balanced mixture of all three pillars serves as a good solution and makes it possible to reap advantages of all three pension systems and, in addition to spread the risks.

An international comparison demonstrates that there exist considerable differences between countries. Some countries primarily rely on the first pillar (e.g. Italy, France, Germany), while in the Anglo-Saxon countries, the second and the third pillar are far more developed. This is graphically represented in Figure 10.

Figure 10 - Size of financial asset stock managed by institutional investors and public pension expenditures



Source: Swiss Re (1998)[32]

In this figure, for each G7 country, we have shown the importance of the first pillar (by means of public pension expenditure as per cent of GDP) and the importance of the second and third pillar (by means of financial assets as per cent of GDP). The importance of the second and third pillar can best be seen from the size of accumulated assets managed by institutional investors. Swiss Re acknowledges that private savings can also be used for retirement provision, but for the scope of this investigation, they only considered savings via institutional investors.

The differences between the countries are very large. The main observation is that institutional investors' assets are especially high in countries with lower public pension expenditures and vice versa. This may reflect that in countries, with lower burdens imposed by public pension schemes, households are more

32 Swiss Re (1998) "Financial difficulties of public pension schemes: market potential for life insurers", Sigma, No. 8.

inclined to make private provisions. (For more detailed information regarding the importance of public and private pension schemes, we refer to the Swiss Re study.)

5.3. Public provision under pressure and implications for the financial services industry

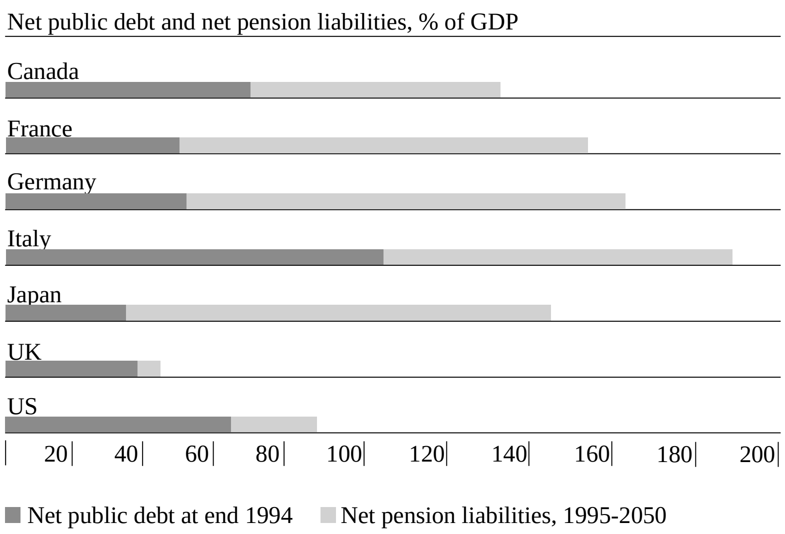
The demographic changes taking place in the Western industrialised countries are likely to lead to a dramatic increase in the proportion of elderly relative to the working population, which is likely to place a strain on public pension systems which finance themselves through contributions of the working population. In these *pay-as-you-go systems*, total pension payments must in principle equal total contribution payments at every point in time. The missing gap can be filled in different ways :

- by government subsidies, which probably will have to be financed by taxes or through the creation of government debt and hereby transferring the problems to future generations;
- by increasing the contributions to the social security system (increasing the pension premiums);
- by decreasing the level of the actual and/or future pension benefits;
- or by a combination of some or all of the above methods.

The pay-as-you-go system is thus particularly vulnerable to the ageing process. As a result, reforms of public pension systems seem to be inevitable in many countries.

We thought it might be interesting to briefly show the funding burden of current public pension schemes the G7 countries face. The study of Swiss Re (1998) made some preliminary calculations and came to the following figures:

Figure 11 - Net public debt and net pension liabilities (% of GDP)



Source: Swiss Re (1998)

Note that the figures reflect the potential funding burdens if current public pension systems remain unreformed and the underlying assumptions regarding demographic change prove to be true. Considering the long-term horizon and the resulting high degree of uncertainty, the figures should be taken with care. Nevertheless, we believe that they can be taken as a good proxy for the funding problems.

Different solutions have been proposed, e.g. the building up of a significant fully-funded pension pillar inside or outside the public pension system. Everyone is convinced that in the field of pensions, the transition from an unfunded to a funded pension scheme creates an enormous potential for (life) insurance companies and can make an important contribution to financial market developments. Holsboer (1998)[33] believes that the reform of social security and pension systems may prove the most significant trend to affect the insurance industry. The changes in social security systems will bring opportunities for new businesses on both the retail and wholesale side. That is why the concept of *employee benefits* has received very much attention the last couple of years. Employee benefits is a two-speared concept: it can be divided into group benefits (such as group pension plans, group medical insurance and disability) as well as group-related benefits (additional products offered to the employee through the employer whereby the employee participates voluntarily). In other words: employee benefits can turn into personal benefits, and then we have a situation in which the boundaries between 2nd (group pensions, collective life insurance) and 3rd (individual savings vehicles) pillar provision start to blur. Moreover this new movement can give rise to a converging trend between the pension providers and other financial firms.

Thus, the shift from "government benefits" to "employee benefits" provides insurers with new opportunities to market growth. As governments continue to cut back social security provision (including pensions), the provision of many benefits is shifting more to the employer, either on a mandatory or incentive basis. In some European countries, like the Netherlands and Ireland, employee benefits packages are already widespread, but expected to grow further. In other countries, like Spain and Portugal, the employee benefits markets are underdeveloped, but expected to grow quickly. Some countries, like Belgium, are blocked by the government.

The study of Swiss Re (1998) tried to estimate the potential market volume for life insurers. The simulations showed that life insurance penetration (life premiums per GDP) would increase to 5per cent in Italy and the US, 6 per cent in Canada, 7 per cent in the UK, 8 per cent in Germany, 11 per cent in France, and 15 per cent in Japan. This is tantamount to life insurer's premium income tripling in Italy and Germany and doubling in Canada and France. The increase would be only moderate in the US and particularly small in the UK. One might conclude that, in theory, the life insurance industry has the strength to step in and shoulder part of the financial burden carried by the public pension schemes.

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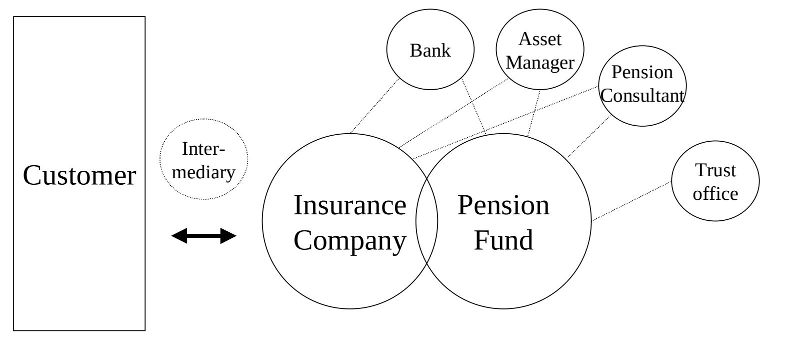
[33] Holsboer, J.H. (1998) "Repositioning of the insurance industry in the financial sector and its economic role", Paper presented to the Geneva Association, Dresden, June 25-27.

We believe that this trend will affect the competitive position of all market players from banks, life insurers, pension funds to asset managers, since all these different types of institutions are in some way involved in this market, as is shown in the figure below.

Figure 12 - The main players in the pension market



5.4. The Dutch pension market: an example of what could happen

5.4.1. Expansion of product scope thanks to the partial withdrawal of the government

The pension system and market in the Netherlands can be described as a mature one because government intervention is limited while, at the same time, private pension and life insurance contributions are important. The table below illustrates that a rather limited social security pension provision in most of the cases implies high private contributions, and that The Netherlands are trend-setter in this area:

Table 4 - Comparison between public pension expenditure and private pension contributions

	Public pension expenditure (in % GDP - 1995)	Per capita private pension contributions (Euro, 1994)
The Netherlands	5.2%	24.1
United Kingdom	8%	18.8
Germany	10.1%	7.1
Spain	9.9%	1.1
Italy	15.5%	2.5
Sweden	13.7%	1.1

The important role of the private sector in the Dutch pension provision is also made clear by the fact that pension fund assets represent 89 per cent of GDP. This is a huge amount compared to the European Union average (20 per cent).

Because of that mature character of the Dutch pensions market, nowadays' supplementary provisions have more than just a pension character. A modern disability provision for instance, is much more than just an insurance product; also prevention and reintegration play an important role. This integrated approach with regard to pensions, disability, financial planning, etc., gives a new meaning to the concept of "Employee Benefits".

In the second tier of pension provision (pension plans provided by the employer), the market is divided among insurance companies (counting for 20 per cent of the participants) and pension funds (80 per cent). This picture, and also the legal environment make clear that the *core business of pension funds* consists of executing pension arrangements caused by pension promises made by the employer, or pension obligations concerning an industry branch. The labour relation is the central aspect. Insurers on the other hand, mainly take care of individually arranged old-age provisions.

So far, the playing field of insurers and pension funds was clearly defined. Problems began to occur at the moment the government started its withdrawal in the early 1990s, changing the welfare state into an insurance state. Pension funds wanted to service their participants by offering insurance products to fill up the gap created by the partial withdrawal of the government in the field of social security. In two cases the government withdrew through decreasing the social allowances and through the establishment of stricter criteria: disability compensation (1993) and surviving relatives compensation (1996).

Nearly at the same time some social changes came up that that can be summarised by the trend towards individualisation and flexibilisation. In reply to all these movements, pension funds started to offer products belonging to insurers' monopoly in earlier times: the Dutch pension providers also offered pension products with an individual premium settlement. This was possible because employers and employees agreed on this in the collective labour conditions, although the employer's contribution was a very small one.

Due (or thanks ?) to these developments, the core business of pension funds was changing. While they had only been offering collective, standardised pension schemes in the past, new product lines were emerging:

- insurance products supplementary to social security, hereby filling up the gaps in social security;

- flexible and more tailor-made products: because of the changing life styles and working patterns, there are more and more double-income families; because of this double income, partners might prefer to have a higher pension instead of the surviving relatives benefits;

- some people also prefer to have a higher pension provision and are willing to pay for that on an individual basis without decreasing other provisions;

- others want to retire earlier and are willing to pay for a pre-retirement arrangement.

Insurers became very embarrassed because they felt they were loosing market share and potential. This became even more dramatic because pension funds have some important advantages in comparison to insurers:

- they aren't liable to corporate tax: because of their solidary character, Dutch pension funds have the legal form of a foundation, characterised by a very advantageous tax regime;

- insurers have to incorporate a profit margin in their prices, while pension funds have no profit aim;

- pension funds have access to a broad database of participants while insurers face huge acquisition costs;

- less supervision: pension funds have no solvency margins.

Because of these important differences, it is stated that competition was falsified and that pension funds should limit their activities to their former core business, collective pension arrangements. Pension funds from their side argued that their profits are used to increase their participants' benefits, while insurers distribute these profits to their shareholders. Another argument is that also pension funds have to adapt their offer to the changes in society, and that the new market created through the government withdrawal isn't the monopoly of the insurers. This discussion also got the attention of the political scene and the supervisory authority, "De Verzekeringskamer". One of the points of action was to define the term "pension promise", the core business of the pension funds. De Verzekeringskamer stated that the employer has to pay at least 50 per cent of the premium for the pension plan in order to be categorised as a pension promise.

Because the solution for the problems was not yet found, the decision was taken that the concerned parties should work out an agreement in consultation, so that direct legislative action wasn't needed. Only in November 1998, pension funds, insurers and the other involved parties reached that agreement: pension funds can continue to offer products supplementary to the collective pension plans insofar the employer carries at least 10 per cent of the costs. It is stipulated in the agreement that there should be enough solidarity in the arrangement. Because pension and policy distribution war has come to an end, the government wants to take initiative in order to give a legal framework to the agreement. A specific point of attention here will be the fit with the view of the European Union's competition rules.

5.4.2. Expansion of the product scope beyond the traditional pension business

The core business of pension funds is not only changing due to the above-mentioned government withdrawal and the need towards flexibility, but also because of the growing importance of communication and personal advice, e.g. towards financial planning. Consequently, pension funds are becoming service providers and they have to fulfil much more tasks than they did in the past when they were just administrators and investors of contributions within largely standardised pension schemes. Some pension funds even want to go further and want to offer private non-life insurance with the aim of becoming a total market player, specialised in the sector they have been servicing all the time. Because the pension fund can't and may not offer these products itself, an insurance company is set up. There are already some examples of big pension funds setting up insurance companies. This leads to some important advantages and makes it possible to realise synergies because of their notoriety and client-knowledge. Specific points of attention are knowledge of these new markets and commercial attitude. Pension funds have never been confronted with these things and consequently, they have almost no experience in these fields.

Very recently, the newspapers announced that two Dutch pension funds, ABP and PGGM, have acquired Nationale Investeringsbank. For the moment, the main aim of this take-over is to combine the asset management and investment activities of the three financial institutions. It could also be a first step of these pension funds in the direction of the banking industry and a further extension of the scope of activities.

To conclude, we can say that the pension war in The Netherlands has come to a provisional end, but that legal initiatives still have to be taken. In the past and still at this moment, the government, nor the supervisory authority, nor the insurers wanted the pension funds to move in the direction of private and individual products, complementary to social security. This might be surprising because one of the specific points of attention and aims of the whole deregulation and privatisation movement set up by the government was to create more market functioning. The whole discussion concerning the playing field of pension funds seems to be contrary to this.

5.5. The US situation

The Dutch case is just one example. Although quite different, the US example shows that we might expect increased convergence as well between mutual funds, insurance companies *and* banks.

We cite a well-documented overview of the US situation from the Lafferty report (1999: 20-22)[34].

In the US, the state has traditionally provided for a much lower level of pension provision than in Europe. A social security pension has been in place since the 1930s, but like in Europe, there are fears that it is unsustainable considering the demographic changes that are expected [...]

If the Democrats do not manage to save pension provision, such as it is, demand for private provision is likely to rise, which will present opportunities of financial service providers. Total pension fund reserves in the US have grown steadily from $2.4 trillion in 1987 to $7.3 trillion in 1997, according to the Federal Reserve. This includes private and public pensions.

Employees in the US have the option of participating in a 401(k) plan, which allows them to contribute part of their salary to a tax-sheltered plan. These plans were first permitted under federal tax law in 1980. Participation in 401(k) plans has grown steadily from 62 per cent of all US employees in 1985 to 78 per cent in 1997. The plans' assets are estimated to grow from around $1 trillion in 1997 to more than $2 trillion in 2003, according to research organisation Spectrem Group.

The emergence of 401(k) plans has resulted in welcome additional revenue for financial service providers. But it is the mutual fund companies that are dominating the business, rather than the traditional life insurers, who might have expected to be the main beneficiaries because of their expertise with long-term savings products. This is a result of a greater awareness of mutual fund brand names, and a perception among the general public that mutual fund companies are better at managing money than insurance companies.

Mutual fund companies' share of 401(k) assets under management has been growing steadily at the expense of insurance companies and banks. In 1997, their share stood at 42 per cent, compared to 22 per cent held by insurance companies and 21 per cent by banks. The figures for 1991 indicated that at that time mutual funds had 21 per cent of the market, insurance companies 37 per cent, and banks 28 per cent. As already indicated before, legislation in the US currently prevents bank-insurance mergers, but change is expected. To combat the threat from mutual fund companies in the 401(k) field, banks and life insurers could merge to pool their investment management expertise and generate scale. With larger asset management divisions, they would be in a stronger position and be able to attract high calibre fund managers.

In addition, the market for 401(k) plans for the larger corporations and companies has reached effective saturation, and most of the future growth will occur among small and mid-sized companies. Smaller companies should be easier to target on a local level through the bank branch. A merged bank-insurer company could target small companies with financial services packages that could include 401(k) plans.

[34] Corcoran, S. (1999) "Bank-insurance mergers: synergies or sham?", Lafferty Publications Ltd., Dublin.

PART B

CONVERGENCE IN THE FINANCIAL SERVICES INDUSTRY

POSSIBLE CONSEQUENCES AND CHALLENGES

In part A of the research project, we aimed at outlining the general trend towards convergence and integration in the financial services sector (and the pension market). We demonstrated that this growing interface takes many different forms and concerns many different types of players. Consequently, it is not possible to refer to this movement as a uniform, well-defined type of diversification.

Of course, this will pose more challenges to supervisors and regulators. In the remainder of this research report, we will consider the consequences of this financial convergence for:

- the regulatory environment and the level of competition (chapter 6);
- the consumers (chapter 7);
- the adaptations to prudential regulation and supervision (chapter 8).

These different areas are of main interest to regulators and supervisors. Regulators and supervisors have a responsibility to preserve a sound financial system and to provide the basis for a stable financial environment for all economic actors. As such, they need to establish a regulatory framework that aims at maintaining a strong and stable financial system that meets the needs of its constituents. The framework should consider three areas[35], i.e.

- prudential regulation, which dictates that financial services providers operate in a safe and sound manner;
- competition regulation, which ensures that providers of financial services observe proper market conduct, and;
- consumer protection, which sets out the rules that protect the (retail) customer.

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[35] McKinsey & Company (1998) "The changing landscape for Canadian financial services: New forces, new competition, new choices", Research Paper prepared for the Task Force on the Future of the Canadian Financial Services Sector.

6. FINANCIAL CONVERGENCE, THE REGULATORY ENVIRONMENT AND THE LEVEL OF COMPETITION

6.1. Introduction

In this chapter, we examine the implications financial convergence has on the level of competition in the different sub-sectors of the financial system. It must be mentioned that the impact of the financial convergence on the level of competition cannot be analysed without taking into consideration the effect of the changed regulatory environment. In fact there is a continuous interaction between regulation, market conduct and competition and vice versa. Although we will analyse the impact of the financial convergence for regulators and supervisors more in detail in chapter 8, we think that it is necessary to outline some major points already in this chapter.

We will pay attention to some more general issues of regulation in this chapter. In particular, we will briefly discuss the role of regulation in respect to competition and market conduct and give a short overview of the current trends towards deregulation and re-regulation. Then we will analyse in greater detail the impact of the changes in the regulatory environment, both in the banking as well as in the insurance industry. Special attention will be paid to issues concerning competition in each of these industries.

6.2. The regulatory environment: regulation and deregulation

Everybody agrees that the regulatory environment has (had) an important impact on the outlook of the financial services industry. It is clear that the current trend towards more competition cannot be seen without referring to the changes that have taken place in this respect.

It is useful to keep in mind that the financial market is in such a hectic change that regulators are continuously confronted with structural and operational changes in the financial services industry. Therefore, we can say that much of the public policy enacted in the area of financial services was merely catching up to developments which then continued apace [Harris, 1998[36]].

6.2.1. Finding the right balance: some general remarks

Before we can outline the effects of regulation and deregulation, we have to consider the potential advantages and disadvantages and the role of regulation in the financial services industry. Regulation has always received more attention in the financial services industry than in most other economic sectors, because of the special character of banks and insurance companies: they both have the attributes of public goods. Therefore, preserving the systemic stability of the financial system is of major concern, since confidence in the institutions that hold these liabilities is a public policy necessity.

Financial regulation is also necessary because of the existence of externalities (i.e. disparities between private and social costs or benefits, in conformity with the analytical framework of welfare economics). The most illustrative example in this respect is the issue of asymmetrical information. Investors' lack of

[36] Harris, S.L. (1998) "Regulatory reform in the financial services industry: where have we been? Where are we going?", OECD - Financial Market Trends, January.

information on the range of opportunities available in all sectors of financial markets is one important reason for installing regulatory control. The market power of financial service providers represents a second motive for regulation.

It is however clear that regulation creates also costs and can have quite a number of negative (side-)effects. For this reason every new regulation has to be analysed with care and a cost-benefit analysis should be made. On a periodic base, it is good to evaluate all existing regulations and supervision. In order to optimalise the economic benefits, deregulation can be necessary. This trend was prevailing clearly in the financial sector, especially under the stimulus of the globalisation of capital markets. In the EU, the creation of the single European Market, mainly focused on deregulations and free competition.

One must however be aware that these deregulation trends cannot be copied throughout the world. Depending upon the maturity of the market, the emphasis of the cost-benefit analysis can shift considerably. We therefore suggest that this analysis be done on a market by market base, and this from a geographical as well as from a sector or even product perspective. The following schemes can help in highlighting the potential benefits and disadvantages of regulation and deregulation.

The main merits of free competition which disappear in a highly regulated market are:

Table 5 – The merits of free competition

Free competition	**High regulation**
• Market-oriented products that relate to real needs of clients	• Standardised products with bureaucratic and technical development process
• Product innovation as a main competitive driver	• Pressures to restrict product innovation
• Competitive prices	• Profitable and safe prices; competition mainly on service

The highly regulated environment has also some advantages over the competitive market:

Table 6 – The merits of high regulation

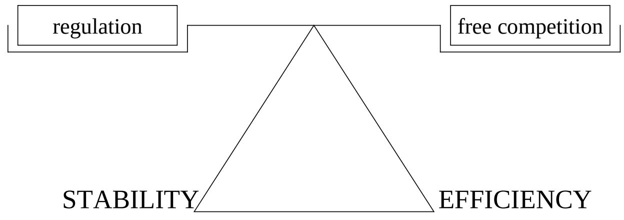
Free competition	**High regulation**
• no standardisation and tendency to over-segmentation ⇒ considerable information gap[37]	• Market transparency
• Danger for destructive (price) competition and instability	• Highly stable market

Given the potential benefits and costs of regulation, the optimal solution will often lay in a combination of regulation, deregulation, self-regulation and free competition. Such a combination is however a difficult and dynamic exercise, that can be best illustrated by referring to it as a magic triangle between *stability - (de)regulation - efficiency*.

[37] According to Uwe Haasen [1987] the explanation for this information gap lies in the following points:

- limited possibilities of the consumer to understand the insurance policy and the insurance technique;
- limited interest for and involvement in their insurance contracts.

Figure 13 - The magic triangle



6.2.2. Regulation and deregulation and financial services

In summary, we can state that the objectives of financial services regulation are:

- maintaining a safe and sound financial system;
- correcting market failures and enhancing competition;
- providing an environment for effective implementation of financial policies;
- achieving redistributive and social goals.

Financial industry regulation in the U.S. (but also in other major countries) prior to the 1980s can be traced back to the Great Depression. It was intended to prevent such an event ever happening again. But the 1980s witnessed a great change in attitudes towards the government regulation of business in general, and regulation of the financial services industry in particular [Barron e.a., 1998[38]].

The ultimate liberalisation, that did take place, occurred as countries and their financial industries found themselves at a competitive disadvantage as the momentum of globalisation proceeded. Authorities responsible for financial regulation wanted to ensure that their financial hubs would not become backwaters because of a failure to respond to international competitive pressures. Furthermore, uncertainties created by inflationary pressures in a number of countries and the associated boom and bust cycles in economic activity (which originated in the early 1970s) made clear to macro-economic policy managers (e.g. central banks) the need for more flexible financial market processes.

However, at the same time, it became clear that deregulation had to be accompanied by re-regulation.

> *"Rapid growth and diversification of financial transactions, technological change, new market dimensions, securitisation and financial innovation proper, all required new approaches to 'market design'. Innovative regulation was -and is- required to create efficient market structures. Operative rules on intermediaries; methods, techniques and transparency of brokerage, dealing and settlement in securities and money markets; rules of conduct and definition of standard products and qualities in markets for financial futures, options and swaps: all these are instances which require specific, innovative and mutually consistent regulatory frameworks."*

38 Barron, D.N., West, E. & Hannan, M.T. (1998) "Deregulation and competition in the financial industry", Industrial and Corporate Change, Vol. 7, No. 1, 1-32.

In summary, we can say that liberalisation is a process which originated a number of decades ago, due to

- some global phenomena: e.g. emergence of multinational corporations, information and communication technologies;
- the reactions of the government: to liberalise certain elements of their financial services industry, especially a global capital market, free trade in financial services, etc.;
- and this all stimulated by overarching framework policies: such as the creation of the European Union's single passport, the creation of the EMU and the EURO, initiatives by the General Agreement on Trade in Services (GTS) and the OECD.

According to Stephen Harris[39], it seems that most of the major impediments that would seriously interfere with market efficiencies have been eliminated -although in some countries the opacity of the regulatory system interferes with market efficiency. That is to say, obstacles that were formerly tied to prudential factors and which have outlived their usefulness have been eliminated. Most of the barriers to trade in financial services have disappeared and where countries displayed some reluctance, the overarching international agreements pushed those stragglers into action. Where prudential oversight seemed lax, countries have taken steps to tighten-up prohibitions. This is especially true, for example, in securities market trading, institutional capital adequacy requirements, and the risk-proofing of clearing and settlement systems. Some countries have reviewed or are in the process of reviewing the question what powers financial and market intermediaries ought to have -notably in the US, Japan, Canada, Australia and Korea. Other regulatory issues lingering on the horizon relate to uses and abuses of communication technology, derivatives and other financial engineering constructs, early warning systems and early response capabilities of banking supervisors and securities regulators.

6.3. Implications of the changes in the regulatory environment on the financial services industry in general

6.3.1. From industry-based competition to product-based competition: the gateway to financial convergence

In part A, we stressed that financial convergence coincides with the changing view on the core business of financial intermediaries from a product oriented towards a functionality and needs oriented perspective. The fulfilment of the different financial core needs, as mentioned in part A section 3.2, has made the financial institutions rethink their core businesses. Consequently, there is an accelerating transformation of the financial services industry towards product-based competition (e.g., several types of firms offering similar financial products), rather than competition within traditional industry segments. In the United States, the House of Representatives have recently passed legislation that would eliminate regulatory barriers and allow federal regulators to engage in product-based rather than industry-based regulation. As the FTC states:

> *"One of the implications of product-based competition is that, while there is a trend toward greater consolidation within the traditional financial services industry, there has been growth in the number of firms outside that industry that provide financial services and products. Opening up markets to new firms has the potential to result in increased*

[39] Harris, S.L. (1998) "Regulatory reform in the financial services industry: where have we been? Where are we going?", OECD - Financial Market Trends, January.

competition, but it may also lead to competitive scenarios that are unfamiliar to traditional regulators" [Federal Trade Commission (1999)[40]].

In this particular case, anti-trust authorities play a significant role in assisting the financial regulatory and supervisory authorities to ensure the two functional requirements for a free market free competition, i.e. competitors provide a range of options for consumers and consumers have the ability to make informed decisions from among those options. Anti-trust legislation protects the range of options in the market, preventing firms from engaging in illegal price fixing, restricting entry, or limiting the choices available to consumers.

6.3.2. The scope of competition: national and international competitive pressures

The economy of many countries is becoming increasingly internationalised, or as it is sometimes called, globalised. Thomas Hatzichronoglou, a researcher at the OECD, considers globalisation as a more complex stage in the process of internationalisation. According to Hatzichronoglou, internationalisation is a phenomenon of the 1950s-1960s and a large part of the 1970s, whereas globalisation refers to changes that took place during the 1980s.

Worldwide competition has led to the emergence of a new type of corporate organisation, which is often labelled the *global firm*. This trend has profound consequences for financial firms and financial markets, in the sense that financial institutions and financial markets are striving to become more internationalised themselves. This trend has potential increased competitive implications, but not uniformly for all types of customers. New "foreign" financial players enter the markets that bring extra competition in the "national" financial services industries.

The effects of internationalisation and globalisation on competition are quite different. As long as a firm internationalises its operations and operates as a multinational, the competition is organised per market and local rules and guidelines will prevail. From the moment the firm shifts gear to launch a globalisation strategy, the competitive game changes drastically. Although local elements will always affect the competitive position, the global players organise their competition strategy with the broader global position in mind. Once deregulation allows global competition, protection of local markets will become much more difficult. This has become extremely relevant in the financial services market for the following reasons.

- Competitors increasingly approach the competitive game from a global perspective.

- Also the client base becomes increasingly globalised. The larger clients are more and more looking for globally integrated risk management solutions. Small and medium-sized enterprises as well as a growing number of private customers will get access to worldwide shopping around, especially through the Internet.

- The competitive struggle forces national and regional players to cope with these global competitors. This often leads to a "me-too" strategy, whereby most of the market partners realise that they need to expand their scope to stay competitive in this tough market environment. Consequently many opt for both national and international expansion, hereby looking for economies of scale and economies of scope to increase their competitive edge. Another feasible strategy for companies who only work in the local market is to take advantage of being embedded in the local roots.

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[40] Federal Trade Commission (June 3, 1998) "The effect of Consolidation on the State of Competition in the Financial Services Industry, 9 p.

As we just said, the rules of the game in a global competitive environment are quite different from those in a multinational competition. Although the Michelin-Goodyear case is from outside the financial services industry, it perfectly illustrates what could happen.

Michelin vs. Goodyear

The famous competitive struggle between Michelin and Goodyear gives an excellent idea of the difference between multinational and global competition.
At the beginning of the seventies, Michelin -producer of tires- had a strong position in Europe, while Goodyear was especially active in the US market.
Michelin decided to expand internationally and started attacking the US market with an aggressive marketing policy. Goodyear felt that his strong competitive position in the US was being threatened by a multinational competitor, entering his market.
Two possibilities of counterattack were studied: the multinational and the global approach.
The multinational competitive strategy of Goodyear would have been to react immediately to Michelin's attack by countering the aggressive marketing approach in the US by an even more aggressive marketing. Such a solution would have harmed Goodyear, because the US was its main market.
The second option, namely the global competitive strategy, was chosen. Because Michelin was more vulnerable in its European home market, where Goodyear was a marginal player, they decided to attack Michelin in Europe with the same aggressive strategy used by Michelin in the US This global approach proved to be successful, since Michelin shifted gear to a more moderate approach in the American market.

6.4. Implications of the changes in the regulatory environment on the banking industry

Financial deregulation has led to considerable benefits analogous to those flowing from deregulation of other sectors. Deregulation, both directly and through the increased competition it has spurred, has raised productivity and quality and lowered prices for the services provided by the financial sector itself. The allocation of resources throughout the economy, and therefore overall economic efficiency, have been improved by the removal of regulation-imposed distortions in the allocation and pricing of credit. In addition to these improvements, financial deregulation has had important broader consequences for financial and macro-economic behaviour that reflect the central role of the financial system in economic decisions and which enter into overall assessments of the efficacy of deregulation. While clearly beneficial in important respects these changes have complicated the functioning of key economic policies, at least temporarily. The changes have also been associated with a number of economic problems that raise questions about the risks of the financial deregulation process.

Before we outline the main consequences of deregulation and financial convergence, two points should be kept in mind in evaluating the benefits of financial deregulation.

- Because the benefits and the costs of financial deregulation are multi-faceted and very widespread, they are more difficult to quantify than for most other sectors. The effects of deregulation on resource allocation, or on financial volatility, for example, are diffuse and almost impossible to disentangle from the impact of other factors. Gains from introduction of new products, or the extent of productivity gains in service sectors generally, are notoriously difficult to measure. Largely for these reasons, very few studies have attempted to provide quantitative measures of the effects of deregulation and then only of certain aspects. Much of the evidence for the benefits of deregulation therefore comes from historical studies of experiences with financial reform as well as inferences drawn from economic theory.

Nevertheless this body of evidence make a very persuasive case that deregulation has brought considerable benefits.

- Many of the benefits and other effects of explicit deregulation are virtually impossible to distinguish from the changes resulting from financial innovation or other changes in market practices not directly related to regulation. Deregulation clearly has been an important stimulus to financial innovation, while, as noted earlier, innovation has served to spur and force the process of deregulation. Comparisons of the benefits of the present financial environment with those offered by the previous regulated environment to some degree tend to overstate benefits from deregulation to the extent they arise from changes that would have occurred in any event. However, those changes also make re-imposition of many of the old regulatory policies either not feasible or much more costly than before; in this respect comparisons with the past tend to understate the benefits of a deregulated versus a regulated economy.

6.4.1. Increased competition in banking

Increased competition has been an issue in banking for years. As a consequence, bankers all over the world have focused strongly on attempts to improve their cost/income ratios.

But banks did not only experience competition from industry peers, they more and more face increasing competition from unregulated "non-banks". For example, many large corporations are increasingly carrying out their banking business “in-house” (e.g. Volvo, BP and Renault). In the United States, General Electric and Ford are now two of the largest financial services companies, and the former is expanding vigorously into Europe (and Japan) in direct competition with local providers of financial services. We already described the examples in the United Kingdom: Sainsbury, Marks and Spencer and Tesco, which are all now taking deposits as well as making loans to their retail customers. Specialised companies are also targeting the markets for credit cards, mortgages and the leasing of certain kinds of equipment. Here again, increasing inroads are being made into European markets. The central point is that the fixed costs of entering these markets have come down with advances in technology and many financial services can now be produced by specialised providers very efficiently and at low cost. The fact that many of these companies have extremely well-known brand names gives them a further competitive advantage. Whether unregulated entities have a competitive advantage simply because they are unregulated is moot given that regulation of banks in the past was often directed to maintaining the rents associated with cartel-like behaviour. It is the case, moreover, that the costs of regulation are to some degree offset by certain benefits (e.g. access to lender of last resort facilities) [White, 1998[41]].

Another area where competition seems set to increase is electronic payments processing and the provision of services over the Internet. This is a global phenomenon that will certainly affect continental Europe. Non-financial firms that control communications networks, and the gateways to them, could set themselves up as "brokers" directing customers to the most suitable product for them. The loyalty of the customer would increasingly be to the broker rather than the ultimate producer of the product. At the very least, this process will squeeze margins of traditional financial service providers. At most, these non-financial firms could use the information made available to them through data-mining technology to design new products themselves to compete with products from traditional financial service providers. Moreover, in this virtual world where concerns about security are naturally heightened, the possession of a brand name inspiring confidence will become ever more important as a marketing tool. This may further encourage non-banks to

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[41] White, W.R. (1998) "The coming transformation of continental European banking?", Bank for International Settlements (Monetary and Economic Department), Working Papers No. 54.

contemplate new forms of competition against European banks whose brand recognition does not tend to be very high [White, 1998].

6.4.2. Efficiency improvements in the provision of financial services

Deregulation and financial convergence has not only increased competition but at the same time raised efficiency and lowered costs considerably. Indeed, the removal of regulatory restrictions gave financial firms more freedom to adopt the most efficient practices available and to develop new products and services than in the past. The increased competition in turn has spurred reductions in margins in financial services and raised efficiency by forcing the exit or consolidation of relatively inefficient firms and by encouraging innovation. The need to compete on a global basis arising from the development and integration of international financial markets has been particularly important in this respect.

These effects of deregulation are manifest in declining relative prices for financial services and productivity growth well in excess of that for the economy as a whole. Transactions costs in stock, money and capital markets have declined considerably since the 1970s. Productivity gains in financial services are partly reflected in lower costs required for processing financial transactions. In particular, staff costs, and in many countries overall operating expenses, have also fallen in relation to total income. Users of financial services have benefited not only from lower prices for traditional services but, perhaps even more, from the considerable improvements in the quality, variety, and access to new financial instruments and services that have resulted from liberalisation.

6.4.3. Gains from more efficient resource allocation

The improved ability of consumers and private businesses to allocate their spending over time constitutes one of the most important resource allocation gains from deregulation in industrialised economies.

Significant improvements in the capacity of financial markets to direct funds to their most efficient uses have come from the dramatic increase in the mobility of international capital flows over the last three decades arising (in large parts) from reduction in official barriers to international capital flows.

Increased capital mobility has also brought significant benefits to industrial countries. Returns to their savings have increased beyond what would be available from domestic outlets alone; the ability to diversify individual risks, and thereby lower overall risk, has increased; and, improved access to external financing has become an important buffer against disturbances to the domestic economy.

6.4.4. Broader consequences for the macro economy and macro-economic policy

Financial deregulation also has led to extensive changes in the financial and macro-economic environment. Some of these changes have been clearly beneficial, others have considerably altered the implementation and functioning of key economic policies but without obviously greatly increasing or decreasing their overall effectiveness.

Changes in financial markets resulting from deregulation have had pervasive consequences for monetary and fiscal policies, some beneficial, others more problematic. Particularly in Japan and a number of European countries, the broadening of securities markets -due to the combined effects of deregulation, innovation, and increasing government budget deficits- has helped in the management of public debt by improving the marketability of government securities and increasing the variety of instruments that can be issued.

In other respects, however, financial liberalisation has to some degree complicated macro-economic policies, at least for a time. The relations between traditional credit and other indicators and monetary policy objectives have broken down in many cases, and can no longer be used as reliable indicators for policy to the degree they were in the past.

6.4.5. Problems arising in conjunction with financial deregulation

Financial deregulation in many OECD countries has been accompanied by several economic developments that have either been problematic themselves or raises concerns about the potential risks or other drawbacks from financial deregulation.

These developments include:

- wide swings in financial market prices that have given rise to concerns that markets have become more unstable and excessively volatile; there is, however, little evidence that there has been any lasting increase in the volatility of stock or bond prices (as measured in terms of their variability on a daily or monthly basis); exchange rate volatility did rise during the first part of the 1980s over the prior decade but fell back during the 1990s;

- credit market booms leading to build-ups in private sector debt to historically unprecedented levels in relation to income and, in some cases, boom and bust cycles in real estate and stock markets;

- the international debt crises experienced by Mexico and several other countries that emerged in the mid-1990s in the wake of very large inflows of private capital over the previous several years.

However, the problems do not seem to be an inherent feature of the liberalisation process, but more the result of its interactions with other economic problems and distortions present as liberalisation was occurring. The experiences do underscore the importance of key linkages between macro-economic, financial and other policies for the relative success of the financial deregulation process.

6.5. Implications of the changes in the regulatory environment on the insurance industry

A similar analysis can be made concerning the impact of deregulation on the insurance industry. But the same elements should be taken into account when evaluating the benefits and drawbacks of financial deregulation. For example, for the European insurance industry, the impact of deregulation is to a large extent interlinked with the consequences of the creation of the EMU. Changes will take place in market structure, market behaviour and market result.

6.5.1. Changes in market structure

The changing regulatory environment has one of the most profound effects on the contestability of the insurance markets. New entrants wanting to take advantage of the additional entrepreneurial freedoms will be specialist suppliers, banks and foreign insurers (through direct sales or some form of cooperation). In some cases, market shares are being completely redistributed and dominant insurance companies of today are confronted with a weakening market presence. Focused specialist insurance suppliers and direct writers are likely to use the deregulation of rates and conditions to consolidate their market position. According to

Jan Holsboer (1998)[42], the rise of non-industry competitors is most prominent in the personal lines business, although the success of companies like Virgin demonstrates that there is a distinct segment that is willing to purchase life and pensions from non-industry competitors and through direct distribution. New entrants like Virgin have prospered not only from a powerful brand name, but convenience of access and a sharper customer focus have also stripped the insurance industry of its jargon, creating more transparency for consumers.

Sector specialists expect that the insurance companies will face more difficult periods. Since the European Central Bank is sure to conduct a deflationary policy, interest rates will fall and probably lead to stagnant market volume of insurance companies as a result of falling premium rates and (structural) economic problems. It will also become increasingly difficult to rely on national government-decreed price increases, because transparency and pan-European comparability of insurance products will eventually prevail over temporary discretionary government aid. These things make it virtually inevitable that restructuring, mergers, cooperations (particularly in the field of sales) and insolvencies (i.e. an increase in supplier concentration) will occur -particularly in fragmented markets. However, from the Sigma Report (1991)[43], we can tell that in the insurance industry, growth through economies of scale is not necessarily synonymous with commercial success. From their study, economies of scale have only a noticeable effect up to a premium volume of $400 to 500 million.

Foreign branches will become more important. The "Home Country Control" principal gives foreign business opportunities to operate under the supervisory legislation of their home country, together with the benefit of a local presence in the target country. Countries having a higher number of independent agents and brokers should be easier to enter. Notwithstanding this unprecedented opportunity, barriers of entry like customer loyalty, insurance customers' attitudes to alternative sales methods (e.g. via the telephone or over the counter in banks) and a well-developed sales force structure of local insurers will complicate foreign entrance.

Insurance products will tend to be more similar and global insurers will have an advantage against local insurers.

In the industrial market, small or local insurers will have less and less opportunities when companies will prefer pan-European industrial risk insurance.

6.5.2. Changes in market behaviour

In regulated markets, government-guaranteed minimum prices made it logical to pursue a strategy of turnover maximisation, and sales played a key role. In deregulated markets, as the EMU increasingly will be, competition takes place via prices, products, underwriting criteria, innovative sales methods services and credit worthiness.

Cross-subsidisation of industrial business by bulk business is likely to decline. The increasing competitive environment will put pressure on profits and hence the development of new organisational structures (i.e. profit centres) will be promoted thereby.

The "spirit of cooperation", which frequently manifested itself in the form of cartel-like agreements, will be replaced by more competition. In the deregulated and liberalised environment, price and product competition will prevail over these "gentlemen's agreements".

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42 Holsboer, J.H. (1998) "Repositioning of the insurance industry in the financial sector and its economic role", Paper presented to the Geneva Association, Dresden, June 25-27.

43 Swiss Re (1991) "Economies of scale in the insurance industry", Sigma, No. 4.

The increased competitive environment will shift the attention more and more to shareholder value. Narrower profit margins and more volatile results increasingly put higher demands on the insurance companies' capital management. The trend will be promoted by increasingly demanding, globally-linked financial markets and the increasingly important rating agencies. The survival of insurance companies will depend on their ability to attain the corresponding return on equity and pay greater attention to capital productivity.

6.5.3. Changes in market result

Prices will become increasingly flexible, which will result in more volatile technical results and probably more volatile corporate results. The causes for this trend can be found in:

- deregulation of premium rates;
- competition for "good" risks;
- the development of alternative sales methods;
- greater competition from new (foreign) suppliers and financial markets (e.g. risk securitisation);
- increased downward pressure on interest rates resulting from deflationary monetary policy of the European Central Bank;
- the cost of adapting the accounting, management and information systems will temporarily affect the overall corporate results.

7. FINANCIAL CONVERGENCE AND THE CONSUMER

7.1. Introduction

To what extent do consumers benefit from the convergence between the different sub-sectors in the financial services industry (and eventually the pension industry)? It is clear that the financial convergence will inevitably have a profound impact on both financial services providers and on consumers. This can be discussed from a more general perspective, as well as from a consumer point of view.

We will start this chapter with some general remarks on financial convergence and the consumer. A number of more general issues have been raised in the papers of the Joint Forum and of the European Community. We will discuss the most frequently cited comments in this chapter.

When we talk about financial convergence from a customer point of view, we will present a theoretical framework which can be used to evaluate the value added of integrated financial services solutions (which are the ultimate outcome of the financial convergence).

7.2. Financial convergence and the consumer: a general perspective

The question whether convergence in the financial services industry is beneficial to consumers is a central element in the whole discussion of financial convergence. The main idea behind deregulation is that it leads to greater competition, greater efficiency, increased economies of scale and scope, and greater consumer choice. In the previous chapter, the main conclusion was that a number of benefits brought about by deregulation (and financial convergence) have been materialised: increased competition, increased efficiency, lower costs, more efficient resource allocation, ...

7.2.1. Risks associated with increased deregulation and financial convergence

One must, however, not forget that the role of regulation was to protect the consumer. Recall that we showed in the previous chapter that financial regulation is necessary because of the existence of externalities (see the example of asymmetrical information). The trend towards deregulation (and financial convergence) can have negative effects for the consumer to the extent that no appropriate actions have been taken to guarantee consumer protection.

Furthermore, the large financial conglomerates might *exploit the market power* they have. Since (large) financial conglomerates are also (large) institutional investors, they might have substantial shareholdings in a number of companies. A comparison can be made to the German situation where the "universal banks" not only grant credits and loans, but also have equity participations in the German industrial companies.

Finally, one could point to the *risk of potential conflicts of interest*. Such conflicts can exist if a supplier has the choice between two or more options, and this choice is not neutral for himself or for his enterprise. In this case the interests of the client and of the supplier can be opposite. Another example of conflicts of interest can be found in the potential opposition between the best choice for one client and the repercussions on another one. Research of the European Commission revealed that the risk of conflicts of interest increases with the number of activities or products offered. Nevertheless we want to stress that the risk of conflicts of interest is not only relevant for financial conglomerates, but does exist in all types of enterprises that offer substitutable products or services.

7.2.2. Consumer protection

Furthermore, the financial institutions themselves are well aware that a reputation for honesty and good customer service are among the most effective marketing tools in an increasingly competitive market.

In addition, consumer protection has remained a major issue in national financial legislations. For example, various aspects of consumer protection in the field of financial services have been addressed -directly or indirectly- by the existing texts of the European Union law. We will present a brief overview of some issues, as they were forwarded by John Mogg, Director-General of DG XV[44] in his Green Paper (May 1996).

- Consumer information: financial services directives contain a number of provisions requiring financial institutions to provide their clients with appropriate information (for banking, this is e.g. information on credit limits, termination procedures etc.; for insurance, the policy-holder must be informed about the duration, right of cancellation, applicable law, etc.; for the securities and stock exchange, directives seek to ensure investor protection by means of maximum transparency).

- Legal protection: certain provisions in a number of directives strengthen the consumer's position vis-à-vis the financial institution and protect the consumers' legal interests should something go wrong. According to Mogg, in all three sectors, host countries may impose rules they have adopted to protect the interest of the general good.

- Systems of redress: both in banking as well as in insurance, the existing union law has addressed some aspects that indirectly affect consumer protection. For example, in banking, Member States must ensure that the depositor's rights to compensation may be subject of an action by the depositor against the deposit-guarantee scheme. In legal expenses insurance, the policy-holder must be explicitly informed in the event of a conflict of interest with the insurer, about his or her rights to have the free choice of a lawyer, and to have recourse, if necessary, to an arbitration procedure.

- Trustworthy financial services industry: one of the main objectives of the financial services directives is to maintain the stability and the trustworthiness of the financial sector and all directives contribute to this goal. Examples include the fit and proper regulations (for staff and major shareholders), regulations concerning the transparent structure of financial firms, etc.

- Strong financial institutions: in all three sectors providers of the relevant financial services are subject to a formal authorisation procedure and to detailed and strict minimum capital requirements both initially and on an on-going basis. Firms that are not authorised may not provide the core services covered by the directives.

- A wider choice of financial services and products: deregulation has led to a wider scope of financial services and products offered. This has also been one of the main objectives of creating a single market in financial services. Any financial service benefiting from mutual recognition may, if it is legally provided in the home country, be offered in the host country, via a branch or on a cross-border basis, even if the service in question does not exist in the latter country or even if domestic institutions may not offer it. As a result, savings and insurance products are already being offered on markets where they were previously unavailable.

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44 Mogg, J. (1996) "Financial services: meeting consumers' expectations", Green Paper, May 1996.

- Pricing of financial services: in the previous chapter, we indicated that deregulation and financial convergence has led to lowered costs and increased efficiency. It is a question whether this also implies lower prices. The financial services directives do not seek to interfere with the free determination of prices. Indeed, the only direct intervention in this area has been in the insurance sector, where imposed and approved tariffs have been abandoned. Having removed this obstacle, the insurance directives have opened the way for more competition.

7.3. A theoretical framework for the evaluation of integrated financial services

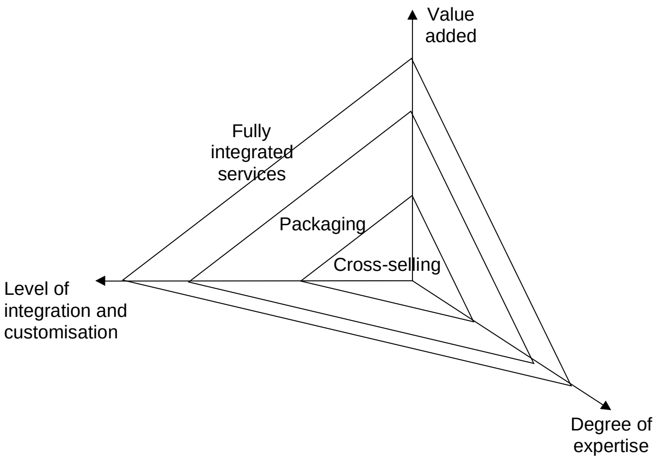
We think it is worth analysing the impact of financial convergence from the customer's point of view as well. The previous chapter was based on the general idea that customers are a homogeneous group of people with the same needs and expectations. It is clear that this is not the case.

Before we present the theoretical framework, it is good to bring you back to chapter 3, where we argued that the cross-selling of banks and insurance products is only a first step in the growing convergence of the financial services industry. We argued that the complementarity in time and space between different financial and insurance products not only creates natural incentives for cross-selling and packaging but also for innovative product integration. Through unbundling (old traditional products) and rebundling (in accordance with the real market needs) new service bundles are created.

Recall that in chapter 3, we distinguished between three main bundling approaches:

- cross-selling;
- packaging;
- fully integrated financial services.

Figure 14 - The different forms of bundling



Source: Van den Berghe & Verweire (1998)[45]

In what follows, we will show that - from a customer's perspective- each approach has its benefits and drawbacks. This evaluation is based on the approach developed by J. Heskett e.a. (1997)[46]. It allows us to identify in greater detail where potential value added is situated, and where possible negative side effects can prevail.

In this framework, the value-added for the client depends upon the following elements:

$$\frac{\text{result (3)} + \text{process quality (4)}}{\text{price (1)} + \text{non - monetary costs (2)}}$$

1. Thanks to economies of scale as well as economies of scope the *price* of bundled services can be lower than for services bought separately. In practice most bundled services are sold at a price discount. It can however be more difficult to compare the respective prices because bundled services are often less comparable than the standard ones. Critical customers can evaluate this lower transparency as a negative side-effect of bundling.

2. The *non-monetary costs* consists of different sub-elements:
   - The *search costs* will decrease drastically if a supplier offers bundled services, especially less-informed customers can find it very difficult and are even afraid to shop around and look for the most convenient supply in the market. This is even the case for more informed customers when it relates to complicated products and complex determinants of the best needs. Quite a number of financial products are rather complex.

   - On the contrary the *switch costs* or the cost of changing suppliers will increase the higher the integration of the services involved. Moreover suppliers often expect that customers sign more longer-term contracts in case of customised or personalised integrated service bundles.

45 Van den Berghe, L.A.A. and Verweire, K. (1998) "Creating the Future with All Finance and Financial Conglomerates", Kluwer Academic Publishers, Dordrecht.

46 Heskett, J.L., Sasser, W.E. Jr. & Schlesinger, L.A. (1997) "The service profit chain: how leading companies link profit and growth to loyalty, satisfaction, and value", The Free Press, New York.

These factors can be an argument favouring the supply of bundled services: the suppliers -in fact- buy more loyalty because of the longer-term of the contracts and the higher switch costs for the customers. However they can entail a disadvantage, especially for critical customers and shoppers. These observations are very useful for applying such theoretical concepts in practice: our market research (Van den Berghe and Baeten, 1995)[47] clearly showed that some customers are considering this non-monetary cost as the main hurdle to accept the one-stop shopping idea of bundled services or the integrated approach of all-finance. Fortunate for these suppliers that not all customers are approaching this factor with the same attitude: some customers do not consider these non-monetary costs that important because they attach more value to the higher quality and result. Our research also revealed that even critical customers can be convinced of the net surplus-value of integrated services as far as they see the advantage on the price level being more important than the disadvantage on the level of the switch cost.

- Another element of the non-monetary costs is related to the fact that bundling leads more or less to the principle of *all eggs in one basket*; especially critical customers can see different potential disadvantages in this respect. They fear that one institution knows too much about them: this is a real fear in relation to financial services. Some also see a potential danger of *concentration of power* within the hands of the service provider. These dangers are often expressed by informed or critical customers, whereas less eloquent customers often feel more comfortable when they do not have to detail to every service provider the personal needs, situation and problems. A familiar intermediary is often best situated to become the thrust person for the personal financial diagnosis and recipes.

3. The more the services will be bundled and integrated the higher the result for the customer and this from different perspectives.
    - Suppliers of integrated services often offer a *result commitment,* thereby working more solution-driven than volume- or product-driven. In the case of a pure cross-selling approach it is very well possible that over-selling goes hand in hand with white spots or failing covers of service components. Eliminating these over- and undersupply through integration and customisation creates a higher value-added for the customer and a better competitive position for the supplier.

    - The integration also supposes a considerable degree of individualisation or at least customisation. This certainly improves the value for the customer who receives solutions fine-tuned to his specific needs and expectations.

    - The components of the bundled services can be produced by different *specialists* as far as it is offered by a large conglomerate or an integrated network of specialist service providers. According to many management experts, the networking road looks promising, but potential dangers remain. First, are all partners in the network delivering the same quality? The chain is as strong as its weakest link: therefore bundled services suppose an integrated management of the whole service supply-chain. Secondly, how strong is the network? Will the collaboration last? This question is especially relevant in sectors like insurance, where a customer buys a promise that will have to be honoured in the future, which sometimes can be as far away from the signing of the contract as 30 to 40 years (e.g. long-term care contracts or pension provisions).

[47] Van den Berghe, L.A.A. & Baeten, X. (1995) "Survey with regard to the management of an insurance broker's office, Research project Vlerick Leuven Gent Management School, Gent.

4. The *process quality* will be improved from different perspectives:
    - The one-stop shopping leads to more convenience.
    - The customisation supposes a relationship marketing whereby the client receives a personalised approach instead of a standard client approach of the transactional marketing type inherent in cross-selling.

This theoretical framework shows that there is not a univocal answer to the question whether integrated financial solutions are better than separate banking and insurance products. We saw that much depends on the type of consumer and what he/she thinks is important.

Similar conclusions were reached in the Lafferty study by Sorcha Corcoran (1997)[48]: customer segmentation is necessary. According to Corcoran, the more sophisticated customers want to shop around for the best deal and spread their assets around to more than one institution. They do not want their bank or (life) company to know too much about them. By contrast, there may be a customer segment that likes the idea of one organisation looking after all of its financial needs.

All these arguments show that one of the most important tasks of financial services companies is to gain an in-depth knowledge of the needs and profitability of each of its customers. The Lafferty Study showed that many providers are still a long way from reaching this goal. Corcoran mentioned a Deloitte Consulting survey, which indicated that few executives are very confident that their current approach is meeting the evolving needs of their customers. The survey showed that a mere 19 per cent said they were highly confident that they were successfully locking-in customers across a range of products, and only 20 per cent were highly confident that they could customise products as required.

According to the Lafferty study, one of the main problems in this respect is to integrate the various databases in order to gain a view of the total relationship with each customer. Here, financial institutions are also hampered by privacy issues. Indeed, they are not allowed to use information they gathered in the banking side for the insurance part of their businesses. It is clear that this will remain a major issue for financial services providers.

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[48] Corcoran, S. (1999) "Bank-insurance mergers: synergies or sham?", Lafferty Publications Ltd., Dublin.

8. FINANCIAL CONVERGENCE AND PRUDENTIAL REGULATION

8.1. Introduction

Although financial convergence and in particular financial conglomerates are well under way, up to now few regulatory initiatives are taken towards legislation on financial conglomerates. Indeed, most national regulatory and supervisory systems are structured in view of the traditional boundaries between banks, insurance companies, pension funds and investment firms (the so-called vertical division of activities). The market evolution in the direction of financial conglomerates, all finance, packaged solutions, integrated product development etc. leads to the further blurring of the traditional boundaries (the so-called horizontal integration and product clustering). This raises the question whether the actual legal solutions and structures are adapted to the new wave in the financial sector.

To come to a number of regulatory issues on financial convergence, we start with identifying the differences and parallels in the philosophy behind the current regulation of the different types of financial institutions. The headlines behind the regulation on financial services have been highlighted in chapter 6. In this chapter the emphasis will mainly lay on the specific differences between the institutions involved and on the concrete measures taken to regulate and supervise the financial institutions. For simplicity, we will limit this comparison to the EU rules and we will not enter into the details of the national applications of these EU rules[49].

The main goal with this analysis is to identify potential domains for discussion and improvement.

8.2. Parallels and differences in approach of regulation and supervision within the financial sector

The financial convergence and the creation of financial conglomerates with substantial banking and insurance activities necessitates that more attention is paid to the supervision of these financial groups. In most countries, there is still a fragmentary supervision. As the boundaries between the banking, the insurance and the investment industry slowly disappear, we might expect that changes in regulation and supervision will occur.

This was also acknowledged in the Joint Forum paper of February 1999:

> *"The solo capital adequacy requirements of each of the banking, securities and insurance sectors are different with varying definitions of the elements of capital, and varying approaches to asset and liability valuations. Each sector's capital adequacy requirements reflect the nature of the different businesses undertaken by each sector, the differing risks to which they are exposed, and the different ways in which risk is managed by the firms and assessed (and/or constrained) by supervisors [...]*
>
> *The requirements within each sector are not in all cases uniform, but the trend is towards convergence of capital adequacy requirements in the insurance sector is however*

[49] This does not mean that these differences are of no importance, but our research focuses on the potential EU regulation of financial conglomerates and not on national adaptations to these EU directives. Moreover the national differences tend to decrease due to the home country control, the single licence and the harmonisation of supervisory approaches.

desirable, including for insurance groups" (Joint Forum on Financial Conglomerates, 1999: 6-7[50]*).*

Any difference in regulation and supervision in each of these industries could either cause a (competitive) advantage or a disadvantage for the particular financial institutions. Therefore, we think it is necessary that both regulators and supervisors must be aware that -in a financial system where the companies from the different sub-sectors are becoming more direct competitors- it is necessary to create a level playing field.

8.2.1. Parallels and differences in the philosophy behind regulation and supervision

A necessary precondition, however, is that we understand the parallels and differences in the regulation and supervision of credit institutions and insurance companies[51]. The philosophy behind these different types of regulation has to be analysed at three different levels : the micro-, the market- and the macro-level.

The philosophy behind the regulation at the *micro-level* is quite parallel for banks and insurance companies. The main aim of the supervision of both sectors is to protect the clients that own "financial assets" or "receivables" that are the "liability" of the banks or insurance companies. Especially the solvency regulations have to cover these needs for protection of the clients. In the case of credit institutions these liabilities relate to banking accounts, term deposits, saving accounts, etc. For life insurers it can be "contractual savings" and for all other types of insurance this relates to "non-individualised liabilities" of insurers against their policyholders and other parties concerned, whom they promised to refund eventual losses. Other types of regulations, such as the accounting and disclosure rules are set up to cope with the problem of asymmetric information. In fact most of the mass clients suffer from an information gap, when they have to value the reliability of the institutions in general, and of their promises more specifically.

The philosophy behind the regulation *at the market-level* is also quite parallel between banks and insurance companies. The third generation directives try to install the free competition, since that would be at the advantage of all clients: greater choice, innovation and better conditions (see also chapter 6).

The philosophy behind the regulation *at the macro-level* is however quite different. The credit institutions are not only performing a function as "financial intermediary" but they also are crucial to the *monetary system*. Consequently the volume of their transactions and the remuneration of the different types of deposits and credits do influence the monetary system to a great extent. Therefore, the supervision of credit institutions is a fundamental instrument for the development of monetary policy (e.g. interest rate structures, monetary mass, inflation rate, etc.). Here insurance companies only play a minor role, and are certainly not the leading institutions to develop the necessary monetary policy instruments.

The regulation of the financial sector should procure the necessary macro-stability. In this respect there exists a greater parallel, but not a complete comparable situation between the banking and the insurance sector. Although *"stability" and "thrust"* are important ingredients of the "products" sold by both sectors, it is clear that these characteristics have more far reaching consequences in the banking sector. This again has to do with their "monetary" function; by transforming "banking accounts" into "credits" they influence the buying power, but this transformation process is built upon the premises of stability and thrust. Although the national banks can perform their function of "lender of the last resort", the financial payment system could become under great pressure when all clients ask simultaneously to cash their receivables (cf. the

[50] Joint Forum on Financial Conglomerates (1999) "Supervision of financial conglomerates", Paper prepared by the Joint Forum on Financial Conglomerates, February.

[51] It is essential that attention is paid to the rules for investment firms. This regulation, which has to be applied before January 1996 is not included in this document.

liquidity crisis of the thirties). This is certainly not comparable to the insurance business, where the largest amount of the "technical" liabilities is not "liquid". In fact, life insurance companies even transform a financial intermediation function in an opposite direction: they invest long term capital (even up to 40 years) into shorter term instruments (and consequently they suffer from a problem of matching assets with liabilities). That this duration mismatch can create extra problems has been observed lately with the negative effects of the low interest rates on life insurance companies. The discussion on the need and magnitude of an increase of their mathematical reserve has been on the agenda of all supervisory authorities and board meetings of life insurance companies.

8.2.2. Consolidated and solo-regulation and supervision

There do not only exist differences in the philosophy at the macro level between the banking and insurance industry, another important distinctive feature is the approach used to supervise the financial institutions.

In principle, regulatory authorities have a choice between two "extreme" basic models:

- They can apply a *consolidated regulation (and supervision)*, where regulation is applied from the top, to all members of the group engaged in financial activities, or;

- they can apply a *separate or solo regulation (and supervision)*, which attempts to insulate or ring-fence the regulated entity from other group members.

Bank regulators and supervisors have opted for the first alternative, whereas the insurance sector opted for a separate control per legal entity (whether an independent company or a partner within a larger group or conglomerate).

However, for a number of years, there is an open debate on whether the supervision of the insurance sector should be focused on the group level or rather on the level of the individual companies.

Moreover the financial converge in general and the growth of financial conglomerates more specifically forced the insurance sector to reach a consensus on the way towards an extra level of supervision on top of the solo-supervision, which is the so-called *solo-plus approach*. Since financial groups are characterised by more integration and since intra-group relationships are becoming more important, a fragmented (solo) approach will have to incorporate an increasing amount of extra supervision (supervision plus) if sufficient information is obtained about the complex reality of these relationships.

Traditionally, the supervisors of the banking and the insurance sector of some countries established a sort of mutual information procedure. In as far as this movement is, however, becoming more important, the cooperation between the respective supervisors will have to become more prominent. This is probably why more and more people suggest that *one integrated supervisor* should be established (see e.g. the UK and Japan). It is worth mentioning that in this respect, the insurance sector is often more on the defensive side, while the banking supervisors are mostly more offensive in this respect. In our opinion, it is necessary that the insurance sector develops a more pro-active approach !

Even the different supervisory systems do not change, it will become necessary to compare the different rules and guidelines that govern the respective "sectors" involved. In as far as the regulatory philosophy and the regulatory instruments differ, a competitive level playing field will not be possible. The more the financial world integrates, the more these differences will become unacceptable. Again, this pressure could easily lead to a more integrated and consolidated supervision on insurance groups, credit institutions, securities businesses and financial conglomerates. And again the question is to what extent insurers are pro-active in forcing adaptations or are merely trying to prevent changes.

Finally, we would like to point to an important aspect regarding the supervision of financial conglomerates. As long as one uniform supervisor is not in place, the division of duties between the respective supervisory authorities remains an important question. The nomination of a lead-supervisor can, however, be based on questionable criteria.

- For example, the division of duties in the Netherlands has been based on the "required" solvency level. But, the calculation of the required solvency level is based on completely different assumptions for the different types of financial institutions. Moreover these criteria do not take into consideration the degree of integration, nor the type of collaboration. E.g. many, if not all joint ventures between banks and insurance companies have an important element of distribution networking; these interfaces can never be measured in terms of solvency requirements.

- Most players in the insurance sector accept that the solvency requirements, as prescribed, e.g. by the European directives, are (by far) too low, so that regulators themselves demand levels that are 200 per cent and more of these regulatory measures. By consequence the major insurance companies have by far more solvency capital than the required level. In the banking sector the opposite evolution can be noticed. A first observation is that many major banks do not have large "overweight" in the level of own funds vis-à-vis the required solvency level. Moreover, banking regulators accept more and more types of "near" capital and allow individualised calculations of required solvency levels.

Consequently the definition of the type of financial conglomerate (insurance, banking or mixed) can be totally different whether the definition is based on the required versus the actual solvency level.

8.2.3. Differences in solvency regulation and the supervision of products

In addition to differences in the philosophy (at the macro level) and the unit of supervision, there exist considerable differences between the solvency regulations of the banking and the insurance industry, and the supervision of products. Since these differences are quite important and fundamental, we come back to this issue in the next paragraph.

8.3. Differences in the reference base to supervise the stability and confidence of banks and insurance companies

We already argued in the introduction of part B that it is of utmost importance to have a sound and stable financial system. In order to guarantee the soundness and stability of the financial institutions involved, careful attention is paid to the solvency of the financial institutions. The calculation of the required level of solvency as well as the definition of the components forming the solvency fund and the supplementary buffers to guarantee confidence in the financial system differ to a great extent between credit institutions and insurance companies. This will be further explained in the following paragraphs.

In addition to solvency issues, there are other elements that must guarantee the stability and confidence in the financial and insurance sector. These different elements differ considerable between the banking (credit institutions) and the insurance industry.

- **Credit institutions**. Besides the solvency fund (which is discussed in section 8.3.2), the confidence in the financial system is also guaranteed through the existence of a deposit insurance system. Such a system creates a safety net for clients (saving, depositing their money) within certain limits and certain conditions, against the risk of failure of their credit institution. Most industrial countries have a deposit insurance system but the institutional form and coverage differ markedly across countries. However, the EU has issued a directive, implying that all member states will have to adapt their deposit insurance schemes in such a way that certain minimum requirements are met.

- **Insurance companies**. The EU rules do not require the insurance companies to set up a guarantee system or a "deposit insurance mechanism". This does not mean that clients of insurers can only rely on their solvency fund held by an insurer. On the contrary, quite a diverse set of instruments must guarantee the stability and reliability of the insurance sector:

  – the technical provisions form the first buffer; in the case of life insurance with an important saving element, these liabilities are the individual claims of the clients, comparable to any deposit or saving account with credit institutions; but for pure risk insurance these liabilities are the collective claim of the insured;

  – for insured losses that have occurred, but for which the insurer has not yet received any concrete claim, an extra reserve is formed (the so-called IBNR reserve);

  – for cyclical risks an extra reservation is made (legalisation reserve); this reservation has quite a great resemblance with the "general banking fund"; contrary to the credit institutions this fund is not considered as an element of the solvency fund of insurance companies, whereas for banks it is a component of the tier 1 funds;

  – besides these "obligations to reserve" for liabilities, also numerous aspects of the investment of these reserves are regulated:

    - obligation to diversify the investments;

    - requirement of congruency and localisation of assets;

    - rules for the evaluation of these representative values.

8.3.1. Calculation of the required level of solvency

In this section, we will briefly describe the headlines for the calculation of the required level of solvency, both for credit institutions (banks) and for insurance companies. A more detailed analysis is presented in appendix A.3.

This analysis gives neither a complete overview of all actual regulations, nor is it aimed at evaluating the different aspects of these regulations. The only aim is to be able to better observe the parallels and differences between the approaches for respectively banks and insurance companies.

Credit institutions

The determination of the required solvency level of banks has been broadened from a capital-to-assets ratio to a risk-assets ratio. According to the *capital-to-assets ratio* the required level of the solvency fund is proportional to the volume of assets. Important evolutions in the international banking activity necessitated the introduction of a new "risk assets" ratio, based on the credit risk of the assets of the credit institution.

The introduction of all types of off-balance sheet transactions (securitisation, derivatives) increased the risks run by credit institutions. This development was (partly) a method to circumvent the solvency requirements, previously based on the balance total. Supervisors have taken appropriate actions and now, off-balance sheet components are also taken into account to calculate the solvency margin (by means of a credit conversion ratio).

Besides this credit risk, the important interest rate risks and exchange risks must eventually be taken into account. The introduction of the new rules on investment activities will also lead to the integration of other market risks. It has been decided recently that also "large exposures" must lead to higher solvency requirements.

It can be argued that new instruments, developed recently within the banking sector like RAROC and RORAC, do offer a far better method for risk analysis than the methods used up to now. Although it is not the aim of this report to discuss these issues, it must be stated that these new risk management instruments for banks could well help to solve the supervision of financial conglomerates. By adapting these rules to the insurance activities, it must be possible to come up with an integrated risk analysis for financial conglomerates. This could well solve the actual problems of so different regulations that endanger a true level playing field within a converging financial sector.

Insurance companies

For insurance companies, a distinction must be made between life and non-life companies. For the life companies, the reference base is partly the liabilities (mathematical provisions) and partly the insurance risk (capital under risk). For the non-life companies no balance sheet elements at all are taken into account. There, the reference base differs according to the profitability of the business. We refer to appendix A.3 for more detailed information in this respect.

8.3.2. Calculation of the solvency fund for credit institutions and insurance companies

Once the required level of the solvency margin has been calculated, one must analyse whether the institution involved has enough "free" funds to cover these solvency requirements. This means that we have to look at what types of funds can be taken into account to represent the solvency needed, but also at the degree to which these funds can be integrated as "representative values".

Neither of these elements are defined in the same way for credit and insurance institutions. Although the differences between the banking and the insurance sector decreased since the last EU-directives became into force[52], a separate analysis of the respective regulations is still necessary. Like in the previous section, we summarise the main headlines, more detailed information can be found in appendix A.4.

Credit institutions

The calculation of the solvency fund for credit institutions distinguishes different types of funds: the tier 1 capital, tier 2 capital and tier 3 capital. Besides these factors, also some correction factors have to be taken into account.

52 Think for instance at the integration of "subordinated loans" in the calculation of solvency funds for the insurance sector.

Insurance companies

For the insurance industry, the definition of "free funds" that can constitute the solvency fund, has been adapted to include quite a number of new elements. Most of these elements are in fact copied from the definition of solvency components for credit institutions, such as subordinated loans and cumulative preferential share capital. These new regulations bring the definitions of solvency for both sectors more in line with each other. There remain however some important differences, which are described in greater detail in appendix A.4.

8.3.3. Philosophy behind the solvency regulations

As a summary, we briefly outline the major differences in (1) the calculation of the required level of solvency, as well as in (2) the definition of the components forming the solvency fund.

1. Solvency level.

The calculation of the necessary level of solvency is based on the insights into the risks, from which the institutions under consideration can potentially suffer. Comparing the minimum solvency requirements, it must be observed that the banking risks need more solvency than the insurance risks; within the insurance sector the credit insurance is considered the most risky business, while the other non-life insurance branches consume less capital.

For credit institutions no attention is given to potential liability risks; the only reference base is asset risks and "off-balance" risks. These risks are mainly credit risks, although also interest rate risks and exchange risks can be taken into account. These risks are measured on an institutional level; if a group structure exists, it will be the holding company that has to fulfil the solvency requirements.

Insurance companies on the contrary, are less supervised on an institutional level; it is more the technical working level that is taken into account. This is logical in as far as the measures of the risks carried by insurers are mainly of a technical nature and differ according to the type of insurance branch. Moreover, the EU directives oblige the insurance companies to specialise in either life, non-life, credit insurance etc.[53].

Due to the inversion of the exploitation cycle the insurers' risks are first of all "liability risks". These are measured on the basis of certain liability components (for life insurers) but especially on the basis of underwriting risk indicators (premiums, claims, capital under risk). For non-life insurers even sanctions are foreseen if they do not use sufficient profitable tarification schemes.

Asset risks are more supervised through specific prescriptions for investments and their valuation than through risk based solvency requirements. For life insurers however there is an important solvency requirement in relation to the investment risks carried by the insurer: three quarters of the solvency requirements (based on the specific liabilities - mathematical reserves) can in fact be considered as a buffer against these investment risks[54].

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53 Exceptions to this generalised specialisation requirement are possible for "existing" multi-branch companies.

54 This is deducted from the comparison of the rules for life insurance with and without investment risk (respectively 4 per cent and 1 per cent of the mathematical reserve).

For the moment no attention is paid to potential off-balance risks. This was certainly justified in the past, since not many insurers used these instruments. There is however an increasing tendency that (larger) insurance companies try to sophisticate their financial management and integration of certain off-balance instruments is becoming more and more popular.

2. Components of the solvency fund.

The difference in the definition of the components, forming the solvency fund are decreased to a considerable degree since the third generation directives. Nevertheless there remains quite a substantial number of differences:

- integration of non paid-up capital for insurance companies;
- integration of general banking fund (for credit institutions) and no integration of egalisation reserves (for insurers);
- difference in the degree of integration of revaluation reserves (50 per cent for banks and 100 per cent for insurance companies) and value corrections (for banks);
- difference in the degree of integration of subordinated loans and cumulative preferential shares; integration of hidden reserves and future profits for life insurance companies;
- under-estimation of assets for non-life insurance companies;
- penalties for concentration of holdings of credit institutions in other credit institutions. In relation to this last factor, a discussion has been going on whether the same rules should not be applied to insurance companies. It is not possible to go into detail on this important question. The only remark we want to make here is the following: although it is reasonable to overcome also double gearing in the insurance sector, it is clear that insurers as institutional investors can have considerable holdings in other companies and enterprises with pure investment perspectives.

3. Extra buffers.

The extra instruments that guarantee the solvency, stability and confidence in the financial sector are completely different. The banking sector is relying on an extra deposit insurance that insures clients -within certain limits- against unfortunate or bad choices of their suppliers of financial services. The insurance sector is more relying on extra supervision and extra reservations. Another difference that should be mentioned is the fact that all banks are supervised while there is in principle no supervision of reinsurance companies (although there is an indirect control through the cession in reinsurance of the supervised direct insurers, but this does not relate to the so-called spiral effect of retrocessions).

8.3.4. What about financial conglomerates?

The calculation of the required level of solvency as well as the definition of the components forming the solvency fund and the supplementary buffers to guarantee confidence in the financial system differ to a great extent between credit institutions and insurance companies. This brings us to the question which global approach of the solvency requirements for financial conglomerates is necessary and what is feasible?

We have dissected this general question into a number of subquestions:

- Should the solvency requirements for banks and insurance companies be more in line with each other, and is a global approach for financial conglomerates feasible?

- Should the solvency norm for insurance companies also include a risk asset ratio?

- Should the risks of using derivatives and other off-balance sheet activities by insurers be monitored more carefully?

- Does the minimum solvency or guarantee fund for insurance firms need to be updated?

From the previous discussion, it is clear that a global approach for the calculation of the solvency requirements for financial conglomerates is not straightforward. Due to large differences in the activities involved, the accounting principles used and the legal requirements, it is not easy to develop a common measure for all risks involved.

It is often stated that the calculation of such a global solvency can easily be solved, by stating that the group should have the combined solvency of the constituting enterprises. Although this may be a solution in the short run, it is certainly not a sufficient one from a conceptual perspective. In order to give an adequate and well-developed answer to this question, we need to have more insights into the risk-increasing or risk-decreasing aspects in financial conglomerates. Are there synergies (in the form of economies of scale and scope) or are the combination effects negative? Today, academic researchers have not found an appropriate answer to this question.

The second question is whether the solvency calculation for insurance companies should not be amended to take into consideration the "increased" investment risks, run by insurance companies[55]. It was already explained that the solvency calculation for insurance companies mainly focuses on the underwriting risk. The risks involved with the investments of their technical provisions are monitored through a double regulation: namely (1) the regulation of the investment policy, and (2) the accounting rules and prescriptions for the evaluation of the "representative" assets.

For life insurance companies also the investment risk is taken into account in the calculation of the required solvency level. The evolution towards unit linked products and innovative combinations of investment, saving and life insurance products does not lead automatically to more investment risk for the insurer. In fact two opposing trends can be observed in this respect. Increased competition stresses the need for more competitive guaranteed returns, which ultimately lead to an increased investment risk for the (life) insurer. On the other hand, modern life insurance products give a substantial part or even the complete investment return to the clients, so that the investment risk is no longer carried by the insurer himself.

A comparison was made between the solvency level required for banks and for insurance companies. In order to come up with some well-founded answers, it was decided to use a simulation study[56]. Because of methodological difficulties, it was only possible to apply the banking rules to the insurance companies (4 Dutch insurance companies: life/non-life; large/smaller companies).

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55 The reverse remark, that banks should also integrate "insurance risks" into their solvency calculation has not been made, to our opinion. This can certainly be explained by the fact that banks must always set up a separate company to carry their "insurance risks", whereas insurance companies can offer certain saving products within their insurance corporation.

56 For a more detailed explanation, we refer the reader to Van den Berghe, L.A.A. (ed.) (1995) "Financial conglomerates: New rules for new players?", Kluwer Academic Publishers, Dordrecht.

Comparing the different companies studied, we can conclude that the impact of applying the banking rules to the insurance sector has rather different effects whether the company under consideration is a life or a non-life company. A non-life company is not a "financial intermediary" in the strict sense of the word, but the function of institutional investor is only induced through the insurance "capitalisation" technique and the "inversion of the exploitation cycle". Due to the relative "shorter term" of their commitments, the investment policy primarily focuses on liquidity; their assets have a lower risk profile and consequently need less solvency capital. Life insurers, on the contrary, focus more on return in the long term; a higher return is often associated with higher risks, so that their solvency needs, calculated on the basis of the "weighted assets" is considerably higher. If we compare this observation with the underwriting experience, than it becomes clear that the banking rules are not very useful for non-life companies. From a pure insurance perspective, the non-life business is far more risky than the life business.

The difference between larger and smaller companies is also important to mention. The larger the groups are the more sophisticated their financial management is. Consequently their assets tend to contain more risky elements, but at the same time the diversification degree is also quite larger. The application of the banking rules leads to a relatively higher solvency need for larger companies. This is again in contrast with the solvency measures, based on the underwriting risks. It can be proven, on the basis of the law of large numbers, that the underwriting risks of larger portfolios can be estimated more accurately than for smaller portfolios. Consequently, the solvency requirements for non-life companies are degressive, which means that larger companies have proportionally less solvency needs than smaller ones.

We already observed that the question is sometimes raised whether the solvency requirements for insurance companies should not be upgraded to incorporate also the "asset risks". We therefore calculated also the solvency level for insurance companies combining the requirements of the "insurance" regulations with those of the "banking" sector. Such a combination, however, is "overshooting" the required solvency level, certainly in the case of life insurance companies. We can prove this hypothesis on the following grounds.

- The life insurance regulations already integrate considerable solvency requirements to cover the "investment risk". The investment risk included in the solvency calculation, can be deducted from the comparison of the requirements for "classical" life insurance products with those for "unit linked" products (with no investment risk for the insurer); the first category needs 4 per cent of the mathematical reserves, while the latter only needs 1 per cent. Consequently the difference (3 per cent) represents the investment risks. The solvency needs, calculated on the basis of the "weighted" asset risks, should therefore be corrected for the investment risk already integrated in the "insurance solvency calculations".

- The application of the "corrected" banking rules to the life insurance companies of our sample must start from certain hypotheses in relation to the "risk indicators". It is therefore not possible to make absolute statements on the level of solvency required. From our calculation it is however clear that in most cases the insurance solvency calculations take *more* investment risk into consideration than the corresponding measures for the banking sector. It is therefore clear that the life insurance measures are probably not *underestimating* the investment risk.

A last question relates to the discussion whether *the minimum solvency or guarantee fund for insurance companies need to be updated* (because of the depreciation of the monetary value). This is especially questioned for the "older" definitions, such as non-life insurance (dates back to 1973) or life insurance (1979). The directives for credit institutions are from a more recent date (1989). The simulation also provided a first answer to this question.

On the European level, it could be argued that the minimum solvency requirements must be corrected to take into account the "EU-inflation". According to the difference in reference year, the correction must be the largest for the non-life branches (more than 3 times the actual level), followed by the life branches (more than the double of the actual level); only minor changes will be needed for the banking sector.

The impact of these changes will be different in each member state, according to the evolution of their currency rate against the ECU and to their specific inflationary experience. For the Netherlands the impact would be lower than the average EU adaptations, mentioned before. This can be explained by the fact that the Dutch economy performed better than the EU average and had a lower inflation rate over the period under consideration. The potential correction would be the following:

- for the non-life branches: x 2.25;
- for the life branches: x 1.5;
- for the credit institutions: x 1.13.

8.3.5. Differences in the supervision of banking and insurance products

Since most of the regulations and supervision is done on an institutional base the analysis of the differences at the product level can only be deducted by comparing the indirect effect of different regulations at the level of the producer or intermediary offering the products under discussion. This analysis is most relevant for products that are (nearly) identical, like mortgages. But the same analysis is also relevant for products that do differentiate but are competing one against the other. This is especially important given that the financial convergence is leading to an intensified competition between banking, insurance and pension products.

In this report we will limit the analysis to the mortgage product. Although banks and insurance companies can built different emphasis in their mortgage offers (e.g. with the focus respectively on annuities with death risk cover versus repayment of the loan by a mixed life insurance product), they are competing with a comparable product assortment. Nevertheless the solvency burden on mortgages is rather important for banks (on average 8 per cent solvency capital is needed), whereas insurers can offer an identical product without any extra solvency capital needed. This difference can easily be explained by referring to the analysis of (the difference within) the calculation of the necessary solvency capital. This can not only lead to a considerable disturbance of the level playing field between banks and insurance companies, but could well lead to regulatory arbitrage especially within financial conglomerates that house banks as well as insurance companies.

8.4. Other regulatory issues with regard to financial convergence and financial conglomerates

Besides the solvency issue, there might be other issues regarding financial convergence and financial conglomerates that deserve special interest. Indeed, it is sometimes argued that financial convergence, and in particular financial conglomerates, can bring about additional risks.

We will summarise these risk very briefly.

- **Risk of contagion**. Supervisors are very concerned with the risk of instability and insolvency. They think that, with the creation of large financial groups, problems in one part of the organisation could infect another (healthy) part of the group (risk of contagion). This risk is comparable to a certain extent to the risk of large financial exposures; however, also important psychological effects on the image, reputation and credibility can increase the risk involved. It is however questionable to what extent the total risk of the conglomerate is larger than the sum of the individual risks involved. Verweire (1999)[57] showed that for a sample of Dutch and Belgian financial institutions, the risk profile of the financial conglomerates was better (thus less risky) than the pure banking and insurance groups.

- **The risk of double gearing**. Another aspect, related to the problem of insolvency and instability, is the risk of double gearing. Supervisors are afraid that capital will be used several times in determining the adequate capital coverage for the group as well as for the different parts of the conglomerate. The supervisors are unanimous that this danger should be prevented.

- **The creation of opaque structures**. It is argued that financial conglomerates could be set up in such a complex way that the structure becomes opaque. In the first place this would lead to problems for supervisors, wanting to assess the real risks of the conglomerate or to control the activities in an effective way. An even more dubious practice could be feared whereby some activities are transferred to those entities which are subject to less prudential supervision or which are not subject to any control at all, thereby searching for the way of the least resistance. The opaque structure could even be used to hide doubtful activities.

- **External conflicts of interest**. We already argued in chapter 7 that one of the risks associated with financial convergence and financial conglomerates is the risk of potential conflicts of interest. For example, what will happen when a firm gets in trouble and the bank arm has a credit exposure, while the insurance part has an equity stake in that same firm? At this moment, the interests of the two parties are flatly opposed to each other. These potential conflicts of interest are, however, not restricted to the consumer, but can also harm investors and supervisors. To overcome these conflicts of interest *Chinese walls* will have to be built. It is our firm believe that more than any Chinese walls, it is a conduct of ethical behaviour that will be necessary. Whatever Chinese walls may be established within an integrated firm, there will always be inside information, certainly at the top level. Only strict ethical behaviour with a firm top-down control will lead to a good risk management in this respect.

- **Internal conflicts of interest**. Besides the external effects, conflicts of interest may also lead to a number of internal problems such as, which might (or might not have) consequences for the outside world: struggle between business units to get market share, danger of cannibalisation, cross-subsidisation, cultural conflicts, ...

- **Quality downgrading**. The overall quality level can be downgraded because some parts of the diversified scope of businesses are not well under control. The service chain will be as strong as the weakest of its elements. The number of products a distributor or selling representative or agent can tackle successfully is not unlimited! The limitation of the optimal scope of the product portfolio is not so much dictated by the consumers but by the operational limits and the limits of professional capacities.

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57 Verweire, K. (1999) "Performance consequences of financial conglomeration with an empirical analysis in Belgium and the Netherlands", Thela Thesis Publishers, Amsterdam.

The *Joint Forum on Financial Conglomerates* has addressed some of these risks in "Supervision of Financial Conglomerates", which formulates some guidelines on some of these issues. For example, considerable attention is paid to capital adequacy principles. The main objective of these principles is to provide banking, securities and insurance supervisors with principles and measurement techniques to:

- facilitate the assessment of capital adequacy on a group-wide basis for heterogeneous financial conglomerates, and;

- identify situations such as double or multiple gearing which can result in an overstatement of group capital and which can have a material adverse effect on the regulated financial entities.

Furthermore, the Joint Forum has also formulated "fit and proper" principles for managers and key shareholders, and developed a framework for supervisory information sharing.

8.5. The regulation and supervision of financial conglomerates: main recommendations

The regulation and supervision of financial conglomerates raises difficult issues with respect to:

- theory (what should be the appropriate regulatory approach and what is the precise nature of the special risks faced in financial conglomerates?);

- conceptual approaches (what should the broad regulatory strategy be in addressing the special risk characteristics of these complex firms, and how should these risks be addressed by regulation, e.g. prohibition of certain types of business, fire walls, consolidation, dedicated capital);

- practicality (how, in detail, regulation is to be framed once the first two dimensions have been settled).

These are problems being addressed by all countries and a series of official international study groups have addressed the difficult issues involved and have made recommendations.

Our main conclusion is that it is extremely difficult to create and apply one set of regulatory and supervisory rules for banks, insurance companies and financial conglomerates. Therefore, we argue that regulation and supervision should be diversified according to the different sectors. There are, however, a number of elements which should be taken into account.

- The focus of regulation and supervision should not only relate to the legal entities. Financial conglomerates are the institutionalisation of a wider trend towards financial convergence. Convergence also takes place through joint ventures and networking, which is not captured by financial conglomeration. Furthermore, we are convinced that in the future new competitors, coming from outside the traditional domains, will come into play. And consequently, the focus will be much more on functional aspects than on institutional aspects.

- No double supervision is necessary.

- It is important that the new regulation and supervision do not hamper the strategic development of financial firms.

All in all, regulators and supervisors should try to create a regulatory framework that helps to establish a level playing field, without limiting and hampering the innovation and expansion of the financial services industry.

PART C

9. FINANCIAL CONVERGENCE: SOME CONCLUSIONS AND RECOMMENDATIONS

This part wants to summarise the most important conclusions of the analyses done in part A and B. Moreover, it is the goal of this report to look for a number of recommendations; these recommendations must foster innovation and prosperity, without neglecting the important conditions of a stable and reliable financial sector.

9.1. Financial convergence is here to stay and supervisors must and cannot prevent this

In the eighties we started scientific research to investigate the drivers behind the financial convergence trends. The hypothesis analysed started from the idea that this trend was only beneficial for the suppliers and that in fact, it was for them, a fancy way of selling their diversification strategy to the public. The main conclusions of this research were that the financial convergence offered a number of advantages but disadvantages as well. For some consumer segments the balance was towards the advantages so that they favoured this movement. Others were more pessimistic about the outcome of this evolution in the financial sector. In follow-up research in the nineties it became clear that the camp of the believers had grown and that more integration into the direction of all finance and all care could shift the balance considerably in favour of this financial convergence.

Looking at the market scenery today, we can state that one or other form of financial convergence can be witnessed in many, if not all developed markets. It is striking to observe that even the strongest opponents of financial convergence do accept that this trend is irreversible. An even harder proof of the fact that financial convergence has gained tantamount acceptance is that specialist insurers start applying the formerly damned bancassurance in their own business. Other manifestations of the growing market acceptance can be found in the "neighbouring" markets:

- the sectoral agreements on labour conditions are shifting more and more into the direction of convergence (to an integrated base either per sector or per company);

- the sectoral education organisations are more and more collaborating or even integrating; our own MBA in Financial Services and Insurance is an example in this respect, but convergence is also taking place with great speed at other universities[58] and technical education institutes[59].

This convergence trend is not the propriety of the financial sector alone. In fact one can state that this financial convergence is embedded in a much wider trend towards integrated services; in an effort to offer convenience and switch from mass production to customisation and individualisation, bundling and unbundling becomes necessary.

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[58] In most Dutch universities this is already the case.

[59] See e.g. NIBE & SVV in the Netherlands.

The reaction of many of the supervisory authorities has been very market-friendly in that they allowed this convergence to happen. Notable exceptions that tried to restrict the playing field of the financial firms, like the US, show that market innovation always finds a way around strict regulations:

- look e.g. at the establishment of "near-banks" to cope with the strict limitations on interest payments by banks in the US;

- it is clear that the same circumventing movement could well evolve in other directions as well: e.g. in regulating intermediaries one will always have to cope with the famous Internet; the same could be the case by strictly regulating insurers or pension funds, whereby self-insurance or alternative risk transfer could offer a way around;

- a number of examples in part A showed how the strict limitations in the US on financial convergence have been bypassed (to a certain extent).

This does not mean however that there is no further need for regulation or supervision, even on the contrary, as will be shown in the next point.

9.2. Financial convergence creates many opportunities and advantages but can also create extra risks and disadvantages

It has already been stated in the previous point that financial convergence hides advantages as well as disadvantages. At the outset, the general feeling of critique against diversification of business firms, certainly influenced the sceptical evaluation of many types of financial convergence. Nowadays a more positive attitude is prevailing.

On the *consumer level*, it will depend on the personal needs and attitudes of the customers, whether the balance will strike in positive or negative sense. Some customer segments do prefer comfort and convenience and accept that this raises the need for detailed private information to be given to one supplier or that this can lead to tied-in sales. Other customers will sympathise with financial convergence because cross-selling can lead to price discounts, which they prefer above all. Other customers will be convinced that they do not need the patronage of a one-stop seller or an integrated service provider, but rather prefer shopping around themselves.

Consumer protection arguments must therefore be treated with care. Not all consumers have the same attitude towards financial convergence nor have they the same needs of protection. Supervisors will have to address the potential disadvantages in a flexible way.

Risks that will have to be tackled by the supervisors are e.g. conflicts of interests, abuse of power, tied-in sales etc.

On the *market level* financial convergence will certainly need to be tested against competitive criteria.

On the *macro level* it is clear that the growing accent of insurers on financial products will bring them more into the picture when setting monetary policy as well. On the other hand the banking business is shifting much of its attention from the traditional intermediation to the more fee-based services, consulting and financial engineering. This certainly influences the role of the financial market versus the one of the financial intermediaries. The new role played by financial conglomerates is another aspect that deserves attention, because this evolution is certainly not neutral from a risk perspective. Although the supervisors have feared that conglomerates created extra risk (e.g. risk of contagion), our research showed that the risk profile of financial conglomerates is better than that of specialised suppliers.

9.3. Financial convergence takes many different forms

9.3.1. It is (very) dangerous to categorise this whole evolution as one standard practice

In part A of the research project, we outlined the general trend towards convergence and integration in the financial services sector (and the pension market). We demonstrated that this growing interface takes many different forms and concerns many different types of players. Consequently, it is not possible to refer to this movement as a uniform, well-defined type of diversification.

In fact diversification is a multidimensional concept and financial converge will have to be analysed from all relevant angles, such as:

- the types of institutions involved (banks, insurance companies, pension funds, other financial institutions);
- the structure used (networking, distribution agreements, cross-shareholding, parent/subsidiary, holding structure, etc.) and the mode of diversification (de novo start-up, merger, acquisition, joint venture);
- the level of integration for all relevant steps in the value chain (cf. analysis on the base of the financial conglomerates control board);
- the diversity status, which gives an indication of the level of diversification per business unit (and sub-unit).

9.3.2. Supervisors should not focus their attention on the "distribution" or "cross-selling" nor on the "financial conglomerates" alone

In part A we made the distinction between cross-selling, packaging and integrated financial services at the one hand and bancassurance and assurfinance at the other hand. We showed in part A that it is our firm belief that the combination of banking and insurance products as is now done through bancassurance and assufinance is just the first step of a more profound development.

Bancassurance

The majority of the financial players do practice one or other type of cross-selling. The most popular, being the bancassurance trend, is where banks sell insurance products. Especially the life insurance products have proven to be a great success for bancassurance. From a statistical perspective it will certainly be necessary to make the distinction between distribution for own account (manufactured by the own insurance subsidiary or sister company within a financial conglomerate) and the pure cross-selling, whereby the bank acts as a distributor for another insurance company. Reliable information is completely lacking for this last type of financial convergence.

Assurfinance

The opposite trend of insurers selling financial products was referred to as assurfinance. Although the insurers have been successful in launching more financially-oriented (life) insurance products, it seems that their success in selling pure banking products has been less progressive and successful. Whereas bankers proved to be successful in establishing an insurance company from scratch, this seems a far more difficult route for assurfinance; the only (successful) route in this respect is buying an existing bank.

However the effect of this financial convergence on the traditional distribution outlets of insurance has been tremendous. A number of important consequences are:

- a generalised trend towards multi-channel and multi-distribution has gained a difficult but a certain acceptance; this trend goes beyond the bancassurance movement, because many non-traditional competitors are entering the arena (the same holds for the distribution of bank products);

- quite a substantial number of these traditional insurance intermediaries, that survived this though competition, developed a new, innovative and offensive strategy in order to create their own competitive advantage.

More than the retail market alone

Much of the attention has been given to the financial convergence in the retail market. In part A we have shown that much more potential is laying in the corporate market. Here, it seems that insurance intermediaries, reinsurers and investment bankers are taking the lead.

Integrated services

In part A we have shown that the supply of integrated services can be seen as a special application of the more general shift from product-oriented supply to a more client-oriented focus. Although the tendencies are not yet completely clear in practice, we suggested, based on market research, the following options for further integration:

- all finance, into the direction of personal financial planning (retail market) and employee benefits (commercial market);

- all care, into the direction of family risk management (retail market) and integrated or holistic risk management (commercial market).

Based on the fact that this integration can lead to a net advantage for customers and suppliers (economies of scope) we stated that far more integration can and will probably be fostered (realised?) in the financial sector. In this respect we do believe the following expression: "l'appetit vient en mangeant" or "appetite comes with eating". We believe that the fragmentation of traditional financial suppliers is part of a transition to more efficient arrangements. A functional approach may provide a more useful organising perspective than an institutional approach, especially in an environment of rapid technological changes and movements towards increasingly global connections among financial markets.

Examples of potentially far reaching integration are to be found in the following directions:

- asset liability management

- integrated (holistic) risk management

- alternative risk transfer

- personal financial planning

- employee benefits
- back-office integration and ICT.

Financial conglomerates and integrated financial services

Although the formation of financial conglomerates can lead to better conditions for integration, it is certainly no guarantee that (only) this route leads to the supply of integrated financial services.

Pension funds and financial convergence

Almost all of the previous analyses and conclusions also hold for the increasing interface between pension funds, insurance companies and other financial institutions. Two opposing converging trends occur: the pension funds entering the insurance and other financial markets at the one hand, and the insurers and other financial institutions entering the pension market.

- The inroad of the pension funds into the financial sector is based on the same principles of the financial convergence trend: shifting to a functional and client-oriented approach, whereby the bundling and unbundling must lead to integrated employee benefits (collective base) and even personal benefits (individual base). In fact they look for service bundles, starting to integrate the so-called first, second and third pillar of the pension system. The core business of pension funds is however also changing because of other factors: the need for flexibility, clear communication on future pension benefits, etc. Instead of being pure administrators of collective pension provisions, modern pension funds want to position themselves as competitive financial service firms.
- The most important difference being that most pension funds, and especially the largest ones, are not private companies, but do operate in a somewhat different (protected?) market environment.
- As governments cut back on social security provisions, the provision of many benefits shifts to the employer (either on a mandatory or incentive base), or even to the individual. The transition from an unfunded to a funded pension scheme creates an enormous potential for (life) insurance companies, ranging from a doubling or tripling of the market volume (according to the degree of accumulated savings). This can lead to new financial developments. We believe that this trend will affect the competitive position of all market players not only pension funds and insurers, but also banks and asset managers.

9.4. Given the diversity of the sectoral regulation and supervision it is hard to create a level playing field

The main question in this respect is: "what rules help to create a level playing field without limiting the innovation and expansion of the financial sector?" In the modern financial markets of today, the main difficulties the supervisors face can be summarised as follows:

- the supervision and most of the regulation is based on a sectoral focus; this can be observed when analysing the solvency rules (different approaches for defining the required solvency capital and the solvency fund) and the institutions under supervision (consolidated group level versus business unit level); but also the philosophy towards regulation and supervision differs quite substantially;

- this institutional approach proved to be a good solution as long as the sectoral barriers remained stable; once the barriers started to blur, the supervisors had to collaborate more intensively; the solution was mainly searched into the direction of solo-plus supervision;

- this solution supposed a clear division of tasks; such a division was (sometimes) based on the typology in mixed financial conglomerates, besides banking and insurance conglomerates. Such an approach supposes that a clear distinction can be made between these three types of conglomerates. We tried to prove that the actual approach is certainly disputable in a number of respects (e.g. reference base for this typology).

A number of specific critiques will be dealt with in more detail in the next points.

9.4.1. The solo-plus supervision is probably only a temporary solution

Up to now, most attention has been devoted to the question of reconciling the sectoral regulatory and supervisory approach with the creation of financial conglomerates. The solution has mainly been searched in the direction of the solo-plus supervision. For a number of reasons this solution seems in need of revision:

- the more financial convergence is evolving into the direction of integrated services, the more important the "plus" will have to be, creating the danger of double supervision;

- trying to solve the issue by establishing a separate regulatory system and supervision for financial conglomerates is not only a tough issue to solve, moreover it is only part of the potential answer to this challenge;

- the supervision is oriented mainly at the legal entities; business innovation leads more and more to a shift away from these legal entities into networks and joint venture agreements; the shift from product-oriented competition to customer orientation needs bundling and unbundling and leads to the creation of 'supply-chain management' where the emphasis is no longer on legal entities but on organisational and strategic networks; this general trend affects the supervisors in the financial sector more than in any other sector, because it is mainly in the financial sector that business regulation and supervision exists to such an extent;

- the new competition is certainly not restricted to the traditional suppliers in the financial market; the toughest competition often comes from outsiders; in part A we showed that quite a number of new, alternative suppliers and distributors are competing in the modern financial arena; extending control over these alternative suppliers will be a tough job, not only because they often work in other –more free- business environments, but especially because the innovation and imagination is great in challenging the traditional market players.

9.4.2. The magic triangle of regulation/deregulation and market competition will probably shift in more mature markets

As has been highlighted in part B, the advantages and disadvantages of regulation and market competition lead to a search for an optimal welfare level by combining market freedom with regulation and supervision. The less markets are developed, the more the balance will shift towards regulations and *a priori* supervision. The more markets become mature, the more a-priori supervision is replaced with *a posteriori* control and disclosure.

In an information age disclosure must be the cornerstone of all supervisory mechanisms. Such a system is only viable if sufficient and clear information is available. Today, this is certainly lacking in many respects; this will be highlighted in the next point.

9.5. There is a tremendous need for reliable and comparable statistics

As long as the market is strictly regulated and the supervisory authorities operate with a priori control, the need for information can be achieved on a one-to-one base. In stable market environments this information need, can be organised quite well. Once markets become more open, innovation starts, thus leading to an explosion in the number and types of market suppliers as well as in the services they offer. In such a market environment there is a great need for clear information.

Especially when financial convergence becomes important and all types of financial conglomerates are created, it will become important to prevent that opaque structures are created (which can lead to regulatory arbitrage); in such circumstances even information is not always a guarantee for effective disclosure.

Given the many dimensions of financial convergence, a better view on the types of convergence, the degree of integration and the products involved is more than necessary. Unfortunately this is completely lacking today. Part A showed how difficult it is to get an overall view on simple statistics like bancassurance. This is harmful for a better understanding of the financial sector from a supervisory perspective as well as from a research perspective. We therefore hope to convince the regulatory authorities and supra-national organisations to collaborate together to find a way to realise a better disclosure of this financial convergence in all its aspects. We are certainly willing to help in this direction.

A. APPENDICES

A.1. Making an inventory of the types of interfaces between banking and insurance companies

Researchers who analysed the convergence in the financial sector have developed classification schemes, based on one of the dimensions of diversification. In what follows, we will discuss three typologies, aiming at classifying financial conglomerates (and implicitly trying to find an explanation for the varying degree of success of the financial conglomeration strategies).

A.1.1. Typology based on the corporate structure of the financial conglomerate (implementation aspects of diversification)

Herring and Santomero (1990)[60], merely looking at the diversification of banks, have proposed a theoretical model to evaluate the alternative *corporate structures of financial conglomerates*. They distinguished between four basic models for organising a financial conglomerate, based on the degree of legal and operational separateness. According to Herring and Santomero (1990), *legal separateness* implies that different products are provided by separate corporate entities, each of which has its own management structure, set of accounts, board of directors, and capital. *Operational separateness* implies regulatory or self-imposed restrictions (which are generally called firewalls and/or Chinese walls) that inhibit the integrated production of different financial services.

Herring and Santomero distinguished between four models:

- Model 1: *complete integration* (German model)

In this model, managers are allowed to conduct all activities within a single corporate entity. In this case, there is no legal nor operational separateness, although the financial conglomerate may choose to establish Chinese walls in order to enhance the perceived value of its services to potential customers. In principle, the completely integrated conglomerate should be able to produce any given output at the theoretically lowest cost because it can exploit economies of scope. However, from the viewpoint of public policies, there might be strong concerns over such a form because of the potential for anti-competitive behaviour, conflicts of interest and the potential risk of contagion [see also Koguchi (1993)[61]]. Furthermore, the costs of supervision might be much higher than in the other cases. For the moment, there is no country that permits complete integration for the production of financial services.

- Model 2: bank parent - non-bank subsidiaries (British model)

In the British model, there is a legal separateness in that the banking function is conducted in the corporate parent and non-bank functions are conducted in separately incorporated subsidiaries. Compared to the German model, operational efficiency will be inevitably reduced. On the other hand, this organisational

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60 Herring, R.J. and Santomero, A.M. (1990) "The corporate structure of financial conglomerates", Journal of Financial Services Research, 471-497.

61 Koguchi, K. (1993) "Financial conglomeration", Financial Market Trends, (4), October, 7-62.

form has several merits: the loss in a business can be of limited nature[62], tax benefits can be exploited, and the costs of regulatory oversight are reduced.

- Model 3: holding company parent - complete legal separateness

The US model is comparable to the British model, but here the company shell is the sole owner of the banking subsidiary and its non-banking counterparts. According to Herring and Santomero, the legal separateness is more extensive than in the former model, and consequently there is less potential for economies of scope. But like in model 2, the social benefits might be higher than in the German model: the legal separateness simplifies regulation and supervision of the different activities. Furthermore, there is less risk that the safety net is used to distort the cost of funds to non-bank subsidiaries.

- Model 4: holding company parent - complete legal and operational separateness

In this last model, the holding company operates as an investment company and no operational synergies between the different parts are exploited. Herring and Santomero conclude that this model should not be considered as an integrated financial corporation, since this structure only benefits from financial synergies. Of course, this model yields only limited supervisory problems.

This classification is interesting because it points out that differences in corporate structure may have implications for the conglomerate's performance, its profit potential and risk level. However, the classification is too theoretical to be used in practice and focuses too much on the banking side of the financial conglomerate. For example, Herring and Santomero use the term "German model" to nominate the category of financial conglomerates with complete integration. It is clear that this model more reflects the universal banking model, which is a common organisation structure in German banking, but to our opinion, this model can hardly be used when insurance activities are included. Furthermore, the authors focus on legal separateness as the main determinant for potential synergies and risks. However, practice shows us that some financial conglomerates have set up organisational structures which might be totally different from the legal structure, and which might be a more important determinant of the economies of scope and the risk level within a financial conglomerate (Van den Berghe and Verweire, 1998[63]).

A.1.2. Typology based on the diversity status

A second typology has been developed by the Verzekeringskamer, the supervisor of the Dutch insurance companies and pension funds. This classification is used to effectively control financial conglomerates and as such has practical relevance (for the supervisors).

A distinction is made between:

- primarily banking financial conglomerates;
- primarily insurance financial conglomerates;
- mixed financial conglomerates.

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62 In practice, it is unlikely that the bank will allow a subsidiary to go bankrupt (due to reputation costs, loss of operational synergies, …). Therefore, the advantages of limited liability may be somewhat illusory.

63 Van den Berghe, L.A.A. and Verweire, K. (1998) "Creating the Future with All Finance and Financial Conglomerates", Kluwer Academic Publishers, Dordrecht.

Financial conglomerates are classified on the base of the relative proportion of their banking and insurance activities. The Verzekeringskamer proposed to use the balance sheet total as a criterion to distinguish between these categories. Other criteria had to be used because the balance sheet total distorts the results in favour of the credit institutions:

- in the banks balance sheet, all monetary transactions with clients as well as in relation to inter-bank funding are included

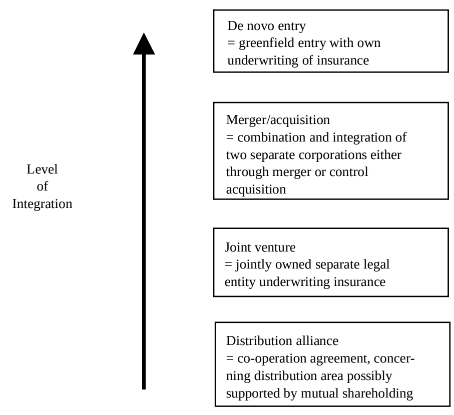
- the insurance balance only lists the technical reserves and their investment, while the monetary transactions with clients (premiums & claims) are included in the profit-and-loss account.

Therefore criteria must be developed that do not suffer from such a bias. The Dutch supervisors actually use the measure of the necessary solvency capital and define the mixed conglomerate on the base of the 80/100 limit. The great variety between the solvency calculations of banks and insurance companies is no guarantee that this measure is the best criterion either.

A.1.3. Typology based on the mode of diversification (method of entry)

Some early publications have set up a typology based on the entry strategies of banks into the insurance industry. Of course, this typology may also be applied to insurance companies who enter the banking industry. Indirectly this typology also helps to explain the differences in the degree of integration.

Figure 15 - Alternative entry vehicles for banks entering insurance



Source: Hoschka (1994)[64]

- *De novo entry* (start-ups): As we can deduct from the figure, a de novo entry is characterised by the highest degree of integration. As a matter of fact, there are some examples such as TSB in England, Crédit Agricole in France and Deutsche Bank in Germany, who proved that their de novo entry in insurance has been successful. The relative success of this method of entry is often explained by the fact that with a de novo entry, the strong cultural differences can be overcome more easily. The banks (c.q. the insurance companies) have a higher degree of control over the whole start-up process and they don't have to take into account an insurance (c.q. bank) partner with diverging ideas and a totally different culture.

64 Hoschka, T.C. (1994) "Bancassurance in Europe", The MacMillan Press, Ltd., Houndmills.

- *Mergers/acquisitions*: According to the earlier publications, mergers and acquisitions were seen as the next best option for banks and insurance companies. Several arguments have been forwarded as to why M&As can be successful:

1. both a merger and an acquisition have the advantage that it's easier to follow the same direction in the all finance approach,
2. the expertise and experience for both the banking and the insurance domain is available in the group from the start, and
3. M&As are suited when a quick entry is necessary.

- *Joint ventures*: A joint venture is defined here as a kind of a co-operation agreement between two or more independent companies, setting up a legally independent entity, owned and controlled by the parent companies (here a bank and an insurance company). A joint venture is considered to be a more formalised way of co-operation. It is commonly accepted that joint ventures are rather short-term solutions because nearly 80 per cent ends up in sale. Nevertheless this was a frequently used entry vehicle, especially in cross-border alliances.

- *Distribution alliances*: it's a loose form compared to the other approaches and therefore it is at the bottom of Hoschka's figure. However, marketing agreements can be completed with substantial cross-shareholdings. Anyway, this method of entry gives two (or more) companies the highest degree of freedom. This is, however, rather perceived as a disadvantage because they probably don't get the most out of this relation. The combined offering of insurance and credit services requires a lot of involvement to resolve the bottlenecks that surely will appear. With this method, the two parties will give up efforts more quickly and will pay attention to other priorities.

This typology is interesting because it also tries to provide an explanation for success of some financial conglomerates. More particularly, Hoschka argued that:

> *"A comparative analysis of the different entry vehicles shows that of the four different entry routes, de novo entry (start-ups) seems to be most successful. This stems primarily from the organisational and strategic flexibility which de novo entry offers, allowing a tailored solution to the idiosyncratic internal structure and organisational environment of the bank" (Hoschka, 1994: 137).*

Furthermore, a link is established with implementation aspects of diversification, e.g. the degree of integration. However, a recent study by Verweire (1999)[65] found hardly any significant differences in the degree of integration and centralisation between start-ups and M&As. Therefore, the explanation as to why some start-ups might be more successful than the other types of entry strategies is only tentative.

However one must not forget that this typology is only relevant in as far as the diversification strategies are analysed within a limited time frame and geographic scope. In practice these techniques are combined, either geographically within one firm or over the life-time of a firm. It can become rather difficult after a while to distinguish the effects from each of the different approaches used.

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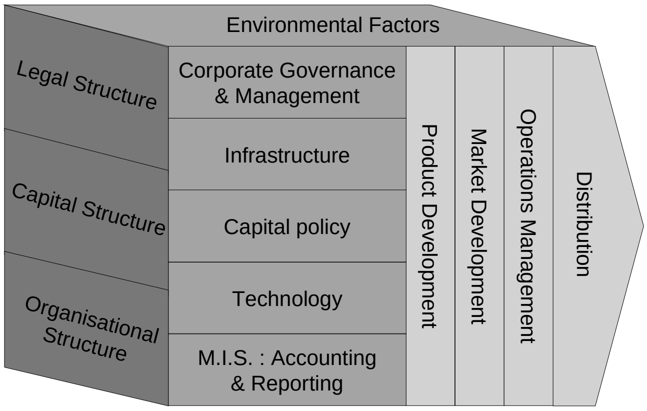
[65] Verweire, K. (1999) "Performance consequences of financial conglomeration with an empirical analysis in Belgium and the Netherlands", Thela Thesis Publishers, Amsterdam.

A.2. Detailed description of the financial conglomerates control board

Before we outline the different parts of this financial conglomerates control board, we first give a graphical representation of this instrument.

Figure 16 - The Financial Conglomerates Control Board



Source: Van den Berghe and Verweire (1998)[66]

This reference scheme is divided into three main parts.

The arrow on the front side (containing the boxes *Corporate Governance and Management* to *d. Distribution*) is comparable to the value chain. It depicts all *activities* where synergies can be found and which determine the risk level of the conglomerate.

At the *back side* of the instrument, we find some structural aspects (such as the legal structure, the capital structure and the organisational structure) which also influence the potential for synergies and the risk level.

At the *upper front*, we take along some environmental factors. These are control variables which could also be important in the comparative study of financial conglomerates.

Let us start by explaining the <u>structural factors</u> somewhat more in detail.

- The legal structure is the way in which two (or more) companies are formed. The early studies on financial conglomerates suspect a relation between the degree of success and what they call *the method of entry*. We can use the same subdivisions Hoschka and Lafferty Business Research made (see appendix A.1).

- The capital structure gives insight into the capital ties between the different companies of the group. One of the most important risks, namely the risk of contagion, is to a large extent of a financial nature. This means that the greater the ties between different companies on the financial level the greater the potential for contagion.

- Sometimes financial conglomerates set up a new corporate structure which should facilitate co-operation between the different parts of the group. However, not all financial

66 Van den Berghe, L.A.A. and Verweire, K. (1998) "Creating the Future with All Finance and Financial Conglomerates", Kluwer Academic Publishers, Dordrecht.

conglomerates adapt their organisation structure but stick to the legal structure. It would be very interesting to investigate if such an adaptation leads to better results.

The activities are the main part of the financial conglomerates control board. As in the value chain of Michael Porter, we have made a distinction between primary activities and support activities.

The *support* activities can be further subdivided into several categories:

- *Corporate governance and management*: we have identified some relevant issues in this respect. As management is a very important aspect to all matters, we try to identify which management structure is best suited to influence the synergy process. Furthermore, we will investigate whether this has consequences on the strategy process and the human resource management. We will also analyse the impact of synergy development and cultural projects on the diversification process.

- *Infrastructure*: it is a question whether a physical integration (infrastructure) is an essential element in achieving synergies.

- *Capital policy*: from our case studies we have seen that financial conglomerates try to achieve synergies in the investment department. The issue consists of different elements: we will look if the investment policy is integrated, if there is an integrated asset liability management, if there is an integrated risk management and if reinsurance activities are grouped together.

- *Technology*: we also want to analyse the technological issue. To what extent are technological systems of the different parts of the group used in other parts of the group and to what extent do they fit?

- *MIS: Accounting and reporting*: when a financial conglomerate is created, it is interesting to see what implications this decision has on the management information system of the two (or more) partners. Is an integrated M.I.S. set up or do they stick to the old system?

The *primary activities* of a financial institution are divided into the following categories:

- *Product development*: we see that some financial conglomerates go beyond cross-selling each others' products. They depart from the needs of the customers and they integrate different characteristics of different products into a new product. It is interesting to see how important these new kind of products are related to the whole product portfolio.

- *Market development*: when insurance companies are able to use the bank's database, they can approach those clients in a better way. Banks have entry to the financial transactions of the client and have generally more information than insurance companies.

- *Operations management*: there are a lot of examples which prove that synergies can be achieved in this domain as well. One of the most striking examples can be found in the Eureko Group, the joint venture between some financial conglomerates in Europe. The Dutch partner, Centraal Beheer, part of the Achmea Group, disposed of a very good claim handling department with respect to automobile insurance. The Portuguese partner, Ocidental, used this system for their car insurance department. Furthermore, they installed a link with the bank branches so that the green card could be delivered immediately.

- *Distribution*: many conglomerates were formed because the partners saw opportunities in distributing each others' products. It is seen as one of the most important areas where synergies can be achieved. Of course there are many different ways to organise the distribution. The Dutch ING Group has organised the home market according to the main distribution channels. Other groups just cross-sell products and try to fine-tune the selling process.

The last category of variables are environmental factors. The main point of the research is oriented towards synergies and risk factors. Furthermore, integration is another important concept in the whole research project. But of course, we should analyse whether there are no other variables that influence the degree of success. For example the country in which a financial conglomerate operates could be a determining element for the conglomerate’s performance. Other important variables could be the size of the conglomerate, the time period of the partnership, etc.

A.3. Calculation of the required level of solvency

In this appendix, we will describe the headlines for the calculation of the required level of solvency, both for credit institutions (banks) and for insurance companies.

This analysis gives neither a complete overview of all actual regulations, nor is it aimed at evaluating the different aspects of these regulations. The only aim is to be able to better observe the parallels and differences between the approaches for respectively banks and insurance companies.

Credit institutions

The determination of the required solvency level of banks has been broadened from a capital-to-assets ratio to a risk-assets ratio. According to the *capital-to-assets ratio* the required level of the solvency fund is proportional to the volume of assets. Important evolutions in the international banking activity necessitated the introduction of a new *"risk assets" ratio*. Two types of indicators are used to measure the credit risk of the "assets": the type of creditor and the country of the creditor. The creditors are divided into different categories (leading to four levels of risk which require respectively 0, 20, 50 or 100 per cent of solvency capital); the countries are classified into 2 categories (zone A with roughly the OECD countries and zone B with all other countries).

The introduction of all types of off-balance sheet transactions (securitisation, derivatives) increased the risks run by credit institutions. This development was (partly) a method to circumvent the solvency requirements, previously based on the "balance" total. Here the credit risk is not only measured on the basis of the former two elements (type of creditor and country of the creditor) but also on the basis of a third element, the "credit conversion degree".

Besides this credit risk, the important interest rate risks and exchange risks must eventually be taken into account. The introduction of the new rules on investment activities will also lead to the integration of other market risks. It has been decided recently that also "large exposures" must lead to higher solvency requirements. Large risks are defined as loans which are greater than 10 per cent of the own funds of the credit institutions. Two measures are taken to limit the exposure of those loans:

- such large loans are considered as high risks, so that they require a 100 per cent of the solvency capital;

- the exposure is restricted on an individual basis (may not be greater than 20 or 25 per cent of the own funds) as well as on a global basis (the total amount of outstanding large loans may not be greater than 8 times the own funds).

Insurance companies

The most important aspects for calculating the required solvency level of insurance companies are the following.

- The solvency margin required is completely different for life and non-life companies.

- For the life companies the reference base is partly the liabilities (mathematical provisions) and partly the insurance risk (capital under risk). In calculating the risk, a distinction is made according to the term of the contract and the degree of investment risk carried by the insurer:

  – short(er) term contracts carry less underwriting risk, so that the solvency needs are lower: 0,1 per cent or 0,15 per cent of the capital under risk instead of 0,3 per cent;

  – contracts, which do not guarantee a fixed return, transfer the investment risk to the insured (e.g. unit-linked insurance); consequently the level of solvency needed is much lower (1 per cent instead of 4 per cent of the mathematical reserves).

- For the non-life companies no balance sheet elements at all are taken into account. The reference base differs according to the profitability of the business. If an insurance company sets her tariffs too low (and has a technical cost ratio of more than ±70 per cent of her premium income) the indicator will be the "average claims due"[67]; on the contrary if the tarification is set at sufficient profitable levels, the premiums will be the reference base on which the solvency requirements will be based[68].

- The solvency requirements can be decreased through the use of reinsurance. For non-life business a maximum decrease up to 50 per cent of the necessary level is possible. For the life risks a distinction is made between the liability risk (with a potential decreasing effect through reinsurance up to 15 per cent) and the underwriting risk (with the same rule as for the non-life risks, i.e. 50 per cent maximum decrease).

- The minimum level of the solvency fund is different according to the line of business. For the life insurance companies the minimum is set at 800.000 ECU. Exceptions are possible (e.g. for mutuals), so that this minimum is decreased to a level between 100.000 and 600.000 ECU. For the non-life business, specialised companies should have the minimum level needed for their speciality branch. Companies with a mixed portfolio of non-life businesses must have the largest of the "relevant" minima. The levels vary between 200.000 and 400.000 ECU (but lower levels can be allowed for mutuals). Only for specialised credit insurance is the minimum much higher (1.400.000 ECU).

- These minimum requirements are set to a lower level (50 per cent) for companies which are not incorporated in the EU, but they will have to make a deposit (of 50 per cent of their minimum solvency level) to guarantee their commitments.

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67 The rule is that the average is calculated over the previous three years; only for insurance with a "longer cycle" (credit insurance, storm insurance) is the reference base the average claims due over the previous seven years.

68 According to the actual level of profitability of the insurance companies, most companies will have to calculate their solvency requirements on the basis of the claims due.

A.4. Calculation of the solvency fund for credit institutions and insurance companies

In this appendix, we will describe the headlines for the calculation of the solvency fund, again for credit institutions (banks) and for insurance companies.

Credit institutions

The calculation of the solvency fund for credit institutions distinguishes different types of funds:

- the tier 1 solvency is composed of the capital, reserves and the general banking fund; in principle, these components are taken for their total value;

- the tier 2 solvency is composed of funds with a lower quality or funds which are less secure (e.g. subordinated loans, revaluation reserves, value adjustments); consequently these funds are not taken for their total value but only for 50 or 25 per cent of their book value.

- Corrections are eventually needed e.g. for own shares hold, for intangible assets or for subordinated loans or participations[69] in other credit institutions; this last correction is intended to overcome the danger of the so-called double gearing[70].

- the tier 3 solvency is composed of the subordinated loans with an original duration of minimum 2 years.

- Besides these factors also some correction factors have to be taken into account.

Insurance companies

For the insurance industry, the definition of "free funds" that can constitute the solvency fund, has been adapted to include quite a number of new elements. Most of these elements are in fact copied from the definition of solvency components for credit institutions, such as subordinated loans and cumulative preferential share capital. These new regulations bring the definitions of solvency for both sectors more in line with each other. There remain however some important differences.

As was the case with the calculation of the required level of the solvency margin, also the components that can constitute the solvency fund differ between life and non-life insurance companies.

For *non-life companies* the solvency is composed of the capital and reserves for their full value. For non-paid up capital, cumulative preferential share capital, subordinated loans, etc. only part of the book value is taken as "free funds". Although these last two components are new in the definition of the solvency fund, it is clear that the new definition is potentially more severe, because elements of "over-estimation" of liabilities and technical provisions are no longer accepted. This is not completely justified to our opinion in as far as insurers face more and more difficult risks and can measure their "liabilities" less and less accurate (cf. liability crises, problems of reinsurers, etc.).

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69 In principle transactions larger than 10 per cent of the capital of the enterprise in question.

70 However, in the context of the discussion about financial conglomerates it might be opportune to outline that there are no time or quantity limits for participations of credit institutions in other financial institutions, but the weight of certain equity participations in the risk assets volume is 100 per cent and the calculation of the capital elements within the groups is subject to certain corrections.

Opposite to credit institutions, it is still allowed for non-life insurers to integrate "hidden reserves" and "under-estimation of assets" as solvency components.

Since *life insurers* face more upfront costs[71] and have "contractual" commitments over a much longer period of time, the calculation of their profitability and their solvency is more complicated than it is the case for non-life companies or for credit institutions. Besides the main solvency components, as defined for the non-life insurers, different types of hidden reserves and future profits can eventually be taken into account. The degree to which such extra solvency components can be integrated in the solvency calculations will differ according to the type of accounting system.

In this respect, quite diverging methods exist to account for the high up-front costs.

- At one extreme there is the very orthodox method of absorbing all up-front costs in the first year of the contract; this leads to net losses (on these contracts) in the first years and postponement of profits (and taxes) to later years. Consequently these companies have large hidden reserves, and these "implicit" funds can be taken into account for the calculation of the solvency fund.

- At the other extreme there are methods that are based on the appraisal value or the embedded value: the profits and reserves that are based on these calculation methods are much more in conformity with "economic" appreciation techniques in so far that the liabilities and the profitability accounted for are much more in line with realistic expectations. In principle, the resulting system doesn't allow for the existence of hidden reserves. Consequently the solvency calculation will not be based on implicit elements.

- In between are methods as for example methods referred to as "Zillmerisation"[72]. Different "degrees" of Zillmerisation are possible, but they all have in common that the "liabilities" towards clients (mathematical reserve, surrender values) are corrected for the "up-front costs" which have not been repaid (completely) at that moment in time. This method however does not take into account the potential profitability of the written contracts and consequently this goodwill is a source of "hidden reserves". The "implicit funds" can be larger, if the Zillmerisation is only partially applied

71 Such as acquisition costs, contractual examinations, contract administration, etc.

72 The "Zillmer-method" and other methods as the "Höckner-method" and the "release from risk method" are discussed from (among others) an accounting and an actuarial point of view in Oosenbrug (1993).