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FINANCIAL SERVICES INTEGRATION WORLDWIDE: PROMISES AND PITFALLS

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

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INTRODUCTION

Will financial services integration lead us straightaway to a brave new financial world in which operational and marketing efficiencies and innovation ensure ever greater consumer value and choice and a safer financial system? Or will it result in a handful of financial giants exercising their market power to sell high priced, unsuitable products to all but their wealthiest customers, while abusing their privacy and exposing the entire financial system to greater risk?

This paper attempts to summarize and synthesize the current knowledge and opinions on these and related issues. We begin with a discussion of the many meanings ascribed to the phrase financial services integration. We then offer a brief summary of the existing economic literature on the subject and of the key issues that managers of integrated firms face. To provide context, especially for our U.S. audience, there follows an overview of financial services integration in selected countries. Next we attempt to classify and summarize the numerous public policy concerns that have been raised with integration. The paper closes with some speculations about the future of financial services integration.

THE MULTIPLE MEANINGS AND FORMS OF FINANCIAL SERVICES INTEGRATION

Because the term "financial services integration" is subject to multiple meanings, we need to be clear about how it is used.[1] Additionally, because firms offering integrated financial services can be structured in multiple ways, we also should understand these different structural possibilities.

The Meaning of Financial Services Integration

Perhaps the most familiar definition of *financial services integration* is that it occurs whenever production or distribution of a financial service traditionally associated with one of the three major financial sectors is by actors from another sector. Terms such as *bancassurance, allfinanz*, universal banking, and financial conglomerates are all used to convey some notion of integration. Terminology, however, is not yet standard, so these terms carry different meanings for different people.

The above definition embraces either or both production and distribution of financial services. The degree of integration may range from shallow to deep. The definition is not completely satisfactory, however, unless production is understood to include two dimensions: product and management. To understand this importance, it will be useful, first, to consider a *financial conglomerate* – commonly defined as any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two of the three major financial sectors. The three sectors are commercial banking, investment banking, and insurance.

[1] In a 1982 article on this subject (Skipper, 1982), I referred to the "homogenization" of the financial services community. While the word seems odd today, it perhaps conveys a clearer sense of the integration trend.

Consider two financial conglomerates that, from a legal point of view, are identical. Each is composed of a non-operating holding company that owns a commercial bank and an insurer. In one conglomerate, the bank and insurance company are managed as separate profit centers, with no effort made to integrate overall management and operations. Activities are aligned precisely with legal form. The other conglomerate, by contrast, has global control functions allowing management and operations at the group level. Activities align with target markets, not legal form. Profit centers cut across sectoral lines.

Both conglomerates might sell the same portfolio of products, so this dimension of production is indistinguishable. They are, however, managed quite differently. The latter group is more integrated, believing that economies can be secured through operational integration.

The French term *bancassurance* most commonly refers to banks selling insurance products (and usually vice versa[2]). The German term *allfinanz* usually is synonymous with *bancassurance*, although it sometimes suggests integration via distribution across all three major sectors, as does *bancassurance* at times.

Universal banks usually are thought of as representing a greater degree of integration. According to many scholars, a theoretical definition of a universal bank allows it to manufacture and distribute all financial services within a single corporate structure (Saunders and Walter, 1994). As a practical matter, perhaps the most common concept of a universal bank is that of a financial institution that combines the production and distribution of commercial and investment banking within a single firm. Some universal banks distribute insurance but through a separate subsidiary.[3]

The term financial conglomerate probably connotes the greatest degree of integration. Under the earlier definition, a conglomerate must involve firms under common control, suggesting the possibility of integration at the level of production (both product and management). Note, however, that the definition does not specify the structure of the conglomerate, insisting only on common control. Thus, two conglomerates may each contain a commercial bank, life and nonlife insurers, and an investment bank, yet they may exhibit vastly different degrees of integration if one has global controls and integrated management and the other does not.

The business of a conglomerate consists exclusively or predominantly of providing services in at least two financial sectors. Thus, a universal bank ordinarily meets the definition, as would a *bancassurance* arrangement involving affiliated firms. A conglomerate that contains one or more financial services firms, but which is predominantly commercially or industrially oriented, does not meet this definition. Such a conglomerate is commonly referred to as a *mixed conglomerate*.

Financial services integration also occurs when firms in one sector create and sell products containing significant elements traditionally associated with products of another sector. Thus, variable (unit linked) annuities and life insurance combine elements of insurance and securities. The securitization of banks' asset cash flows (e.g., mortgages, credit card balances, and other debt portfolios) combine important elements of investment and commercial banking. Alternative risk transfer techniques such as catastrophe options, bonds, and equity puts; standby letters of credit; and finite risk transfer mechanisms offer other examples. Money market mutual funds, offered by investment banking firms, are effectively demand deposit accounts. This product convergence trend can be expected to be an important force toward operational integration among commercial banks, securities firms, and insurers.

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2 Van den Berghe and Verweire (1998) use assurfinance to signify banking products being marketed through traditional insurance distribution channels.

3 Some scholars, following the German model, further distinguish universal banks from other financial institutions through their holding of important equity positions and voting power in non-financial companies.

Finally, financial services integration can occur at the level of the advisor, without necessarily any supply-side integration or even cooperation. Thus, personal financial planners, accountants, attorneys, risk management consultants, agents, brokers, and other personal and corporate advisors often effectively integrate financial services for their clients. They may sell products themselves or direct the client's purchasing behavior based on an integrated financial or risk management plan. Integration also occurs when employers or affinity groups offer a range of financial products to employees or group members, as, for example, when an employer offers a "cafeteria" of employee benefits that may be self-funded or not.

For purposes of this paper, we focus on integration at the supplier level. Thus, product and advisory integration receive scant attention here, although we recognize the importance of this type of integration.

Structures for Delivering Integrated Financial Services

Integrated financial services may be delivered through several structural forms. In general, however, they fall into one of five classifications.[4]

Full Integration. The most fully integrated operational form is one wherein all financial services are produced (underwritten) within and distributed by a single corporation, with all activities supported by a single capital base. Figure 1 illustrates this form which probably exists presently only in theory as no financial institution actually is structured in this way legally. The form, nonetheless, is important as it might represent a future structure of such firms, and provides a schema for thinking about the issues associated with regulation and management of financial conglomerates that, while sectorally separate for legal and regulatory purposes, might be operationally integrated.

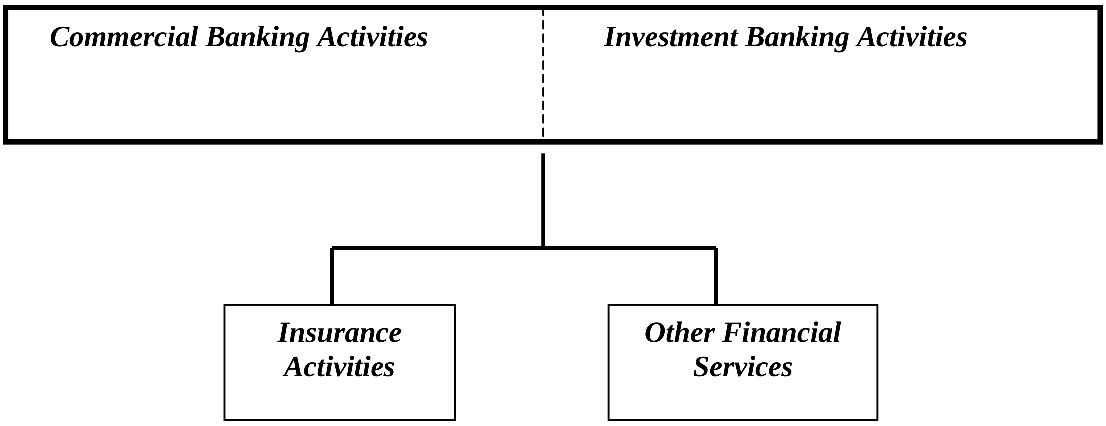
Figure 1:
Full Financial Services Integration

Commercial Banking Activities	***Investment Banking Activities***	***Insurance Activities***	***Other Financial Services***

Universal Bank – German Variant. German universal banks, a step removed from the fully integrated firm above, represent the next structural form of integration. As illustrated in Figure 2, such firms combine commercial and investment banking within a single corporation but conduct other financial activities through separately capitalized subsidiaries owned by the universal bank. The German *grossbanken* ("big banks"), including Deutsche Bank, Dresdner Bank, and Commerzbank, are organized in this way as are many regional banks. The large Swiss banks also are structured in this fashion, as are many other continental European financial institutions.

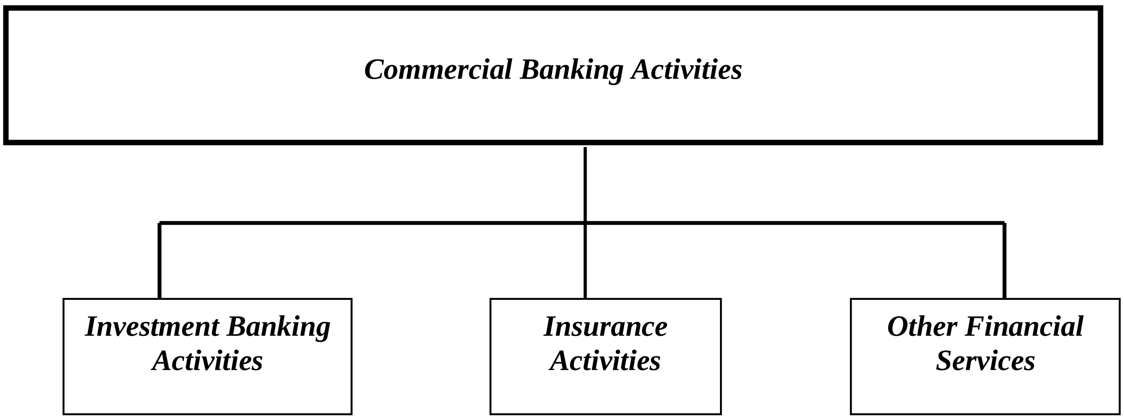
4 This classification scheme is a variation of that of Saunders and Walter (1994), p. 85.

Figure 2:
Partial Financial Services Integration
(Universal Bank – German Variant)



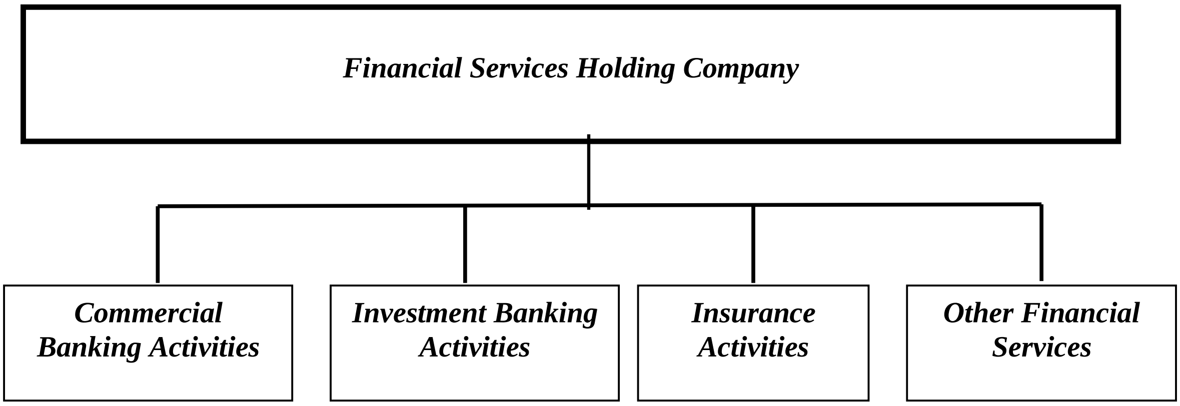
Bank or Insurer Parent. The third structural variation of financial conglomerates is one in which the parent company is a bank or an insurer. The parent owns one or more subsidiaries that produce other financial services and are separately capitalized. Figure 3 illustrates this approach, with the bank as the parent. This structure is common in the U.K., with Barclays and Lloyds TSB being examples.

Figure 3:
Financial Services Integration via Bank Ownership



Holding Company Arrangement. The fourth principal form of financial conglomerate is via a holding company arrangement. Typically, a non-operational holding company owns all or most of the shares in separately incorporated and capitalized sectoral subsidiaries, as illustrated in Figure 4. This arrangement is the evolving model for the U.S.

Figure 4:
Integrated Financial Services via a Holding Company Arrangement



Joint Venture and Other Arrangements. The final form through which integrated financial services are provided involves joint venture and other arrangements between unaffiliated financial services firms. In such structures, two financial intermediaries – such as a bank and an insurer – form a joint venture firm, strategic alliance, or other formal arrangement through which one or both firms' products are sold. Figure 5-a illustrates a joint venture and 5-b illustrates a simple marketing arrangement whereby a bank markets the products of an unaffiliated insurer, such as found commonly in the U.S. Less formal marketing arrangements are also common.

Figure 5-a:
Financial Services Integration via Joint Venture Arrangement

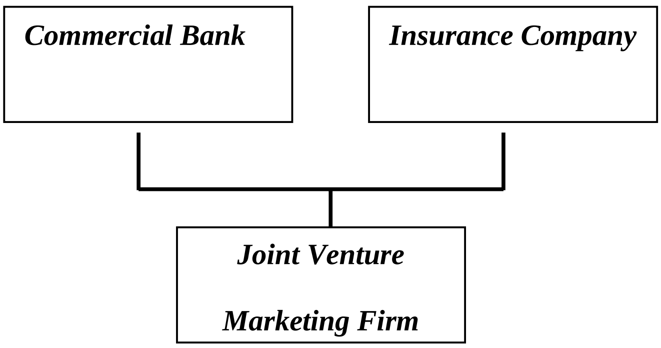
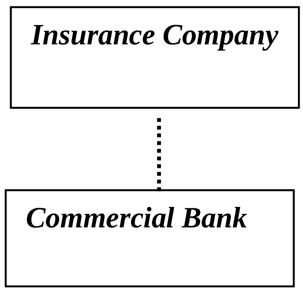


Figure 5-b:
Financial Services Integration via Marketing Arrangement
(*Bancassurance)*



The structure adopted in delivering integrated financial services is influenced by a myriad of factors. Besides the historical context of a country's financial services market, its regulation is critically important in this respect. But so too are issues such as market power, economies of scale and scope, operating efficiencies, and how best to address conflicts of interest. These and other issues are discussed later in this paper.

THE ECONOMICS OF FINANCIAL SERVICES INTEGRATION

Having set out definitions and structures for integrated financial services firms, we now explore our existing understanding of the economics of integration. Does integration bring about efficiencies? Integration is economically logical if it results in a reduction in operating costs, an increase in revenues, or both.

Cost Effects

Financial services conglomerates could enjoy cost advantages through realizing economies of scale, economies of scope in production, or operational efficiencies.

Economies of Scale. *Economies of scale* exist if the average cost of production falls with increased output, holding product mix constant. Economies of scale, in themselves, would not seem to justify the formation of multi-sectoral financial firms, although they may justify existing conglomerates growing larger through organic growth or mergers or acquisitions.

The majority of studies on economies of scale of financial institutions have been conducted on U.S. firms, and, therefore, hold less relevance for scale economies with financial conglomerates, given the U.S. practice of having segregated financial institutions. Saunders and Walter (1994) studied the world's largest banks, among which were included several universal banks, and found economies of scale only in the middle range of big banks.

The few other studies on economies of scale for universal banks find somewhat similar results. Growing from $1 billion to $10 billion in assets seems to gain scale, but growing from $10 billion to $100 billion seems to gain little.[5] Thus, we have some evidence for scale economies for financial conglomerates, but not for very large institutions. Walter (1997, p. 348) summarizes results as follows: "Overall, the consensus seems to be that scale economies and diseconomies do not result in more than about 5 per cent difference in unit costs."

Economies of Scope in Production. *Economies of scope in production* exist if multiple products can be produced at less cost than the sum of the costs of producing each separately. Economies of scope are likely to be important in financial services because of the ability to share overhead, technology, and other fixed costs across a range of products. Thus, the fixed costs of managing a client relationship would seem to lend themselves to sharing across a broad range of financial services (Herring and Santomero, 1990, p. 474).

Economies of scope could come about from investment operations (having a single investment unit for all sectors), information technology (having customer information consolidated and available for multiple uses), distribution (using distribution channels established for one sector to sell other products), and reputation (having the good reputation of one firm, e.g., a commercial bank, enhance the sale of other conglomerate products). As with studies on economies of scale, most scope studies are on U.S. single-sector financial firms, finding that, where they exist, they are exhausted at fairly low levels of output. However, most studies were conducted over periods during which financial firms were undergoing great change, perhaps incurring substantial sunk costs that may have distorted results.

Diseconomies of scope are not unlikely. Financial conglomerates are large firms with substantial bureaucracies. They may suffer from inertia and an inability to respond quickly to changing markets and customer demand. They may lack creativity, experience "turf" battles, realize internal compensation conflicts that erode synergy, and suffer from serious internal cultural differences across sectors that inhibit cooperation and coordination necessary for synergy (Walter, 1997).

Also, not all customers will want to purchase financial products from a single conglomerate. They may be concerned about being treated impersonally, about a large firm not passing lower costs of operation to its smaller customers, about having their financial purchases concentrated within a single group (and foregoing diversification), or about use of personally identifiable information within the conglomerate family to the customer's detriment.

Operational Efficiencies. Economies of scale and scope are static efficiency concepts, with studies focusing on size and product mix cost effects for a given time frame. *Dynamic efficiency*, involving product and process innovations and other operational efficiencies (also called X-efficiencies), might be even more important. Financial conglomerates might have an informational advantage over specialized firms in that they can more quickly develop products in response to changing technological or market conditions, especially products carrying attributes of multiple sectors. Indeed, several studies have found that technical inefficiencies (excess use of inputs) and allocative inefficiencies (suboptimal input mix) are large and dominate scale and scope economies.[6]

Considerable effort has gone into the measurement of X-efficiency of financial institutions. Berger and Humphery (1997) survey 130 studies on efficiency that covered 21 countries and used various efficiency and measurement methods. These studies included multiple time periods and all major financial intermediaries. It appears that the average unit costs in banking ranges from 20 to 25 percent above the costs of best practice firms.

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5 See, generally, studies cited in Berger (1999).

6 See Berger, Hunter and Timme (1993), for a review of the literature.

Revenue Effects

Two aspects of financial integration could give rise to important revenue effects: economies of scope in consumption and market power.

Economies of Scope in Consumption. Integration may enhance the earnings potential of a financial conglomerate through distribution of a greater product range. These *economies of scope in consumption* (demand-side economies of scope) could follow from the cross-marketing of investment, savings, credit, and insurance products. Many financial products are complements: mortgage loans and mortgage protection life insurance policies; auto loans and auto insurance; and wrap accounts and investment products. Customers could realize lower search, information, monitoring, and transactions costs by purchasing products from a conglomerate than by purchasing the same array of products from specialty firms. Private banking has always been designed to exploit such economies.

These economies may not entail lower priced products. In fact, if such consumption economies exist, customers presumably would be willing to pay more for products offered in this convenient way.

Evidence of such economies exists, although the literature is thin. Berger, Hancock, and Humphrey (1993) found that gains inherent in universal banking may lie more on the revenue than the cost side. Canals (1993) found that bank performance was improved from the increased revenues from new business units. Mutual fund activities were found to increase bank profitability (Gallo, Apilado, and Kolari, 1996). Various risk-simulation studies conducted by Saunders and Walter (1994) suggest that combinations of banking, insurance, and securities activities may lead to a more stable profit stream, as each sector’s cash flows are usually imperfectly correlated.

Boyd, Graham, and Hewitt (1993) found that simulated mergers of U.S. bank holding companies (BHCs) with life insurance and property/casualty insurance firms may reduce risk, but that mergers with securities firms would likely increase risk. Kwan (1997) found that U.S. BHCs gain potential diversification benefits from having securities subsidiaries because of low correlations between their returns and those of the other operating units of the BHC. Benston (1989) reports that returns for combined commercial and investment banking would be significantly higher, but without an increase in overall risk. Vander Vennet (1998) found that European financial conglomerates were more revenue efficient and enjoyed higher profits than specialized financial firms.

Further, Walter (1997) observes that network economies, a special type of economies of scope in consumption, are associated with some elements of universal banking. With network economies (positive externalities), relationships with end users represent a network structure wherein additional client linkages add value to existing clients by increasing the feasibility or reducing the cost of accessing them. These externalities tend to increase with the absolute size of the network itself and are characteristics of activities such as securities clearance and settlement, global custody, funds transfer and international cash management, foreign exchange and securities dealing, and the like.

Market Power. Large size can convey market power; i.e., the ability to affect price. To the extent that barriers to entry exist and a country’s financial services market tends toward oligopoly, financial conglomerates may be able to charge higher prices, at least to some market segments, than would be charged in a less concentrated, integrated market. In exercising their market power, such conglomerates would enhance their revenue (or at least profit) stream.

Until the mid-1990s, many countries strictly limited access to their financial services markets, especially to foreign firms, and sheltered a highly concentrated market. Government-sanctioned market power flows naturally in such markets. With the deregulation and liberalization trend worldwide, such markets seem likely to be the exception rather than the rule for the future. With fewer barriers to entry, more competitive markets with fewer opportunities to gain market power should evolve.

Relationship between Effects and Operational Structure

If integration yields positive microeconomic cost effects, i.e., through economies of scale or scope or through operational efficiencies, one would expect to find conglomerates moving toward production and operational integration. Back-office operations such as investment, accounting, information technology, risk management, and the like would more likely be the basis for realizing economic gains. Synergies would likely relate to both the corporate and retail markets.

If integration yields positive microeconomic revenue effects, i.e., through economies of scope in consumption, one would expect to find financial integration more toward distribution. It may be that little or nothing is gained by production and operational integration. In such instances, *bancassurance* arrangements, with or without affiliation, would be sufficient. Synergies would likely relate more to the retail than to the corporate market.

MANAGEMENT ISSUES IN INTEGRATION

The preceding discussion highlighted several management challenges associated with financial services integration but did so in the terminology of the economist. This section translates some of those economic concepts into practical management concerns.

Group Structure

After establishing the group's mission and strategy, management must decide on the most desirable operational structure. We can distinguish between *de jure* and *de facto* structures. Whereas the formal structure must comply with legal requirement (e.g., conduct insurance operations in an insurance subsidiary), this should not necessarily dictate the operational structure. In fact, adopting the legal structure as the operational basis could fail to capture hoped-for economies, as alluded to earlier.

Group structure decisions relate also to whether the necessary manufacturing platforms for financial services will be acquired or created *de novo*. Of course, such decisions need not be the same from market to market or over time.

In general, organic ("greenfield") growth leads to fewer cultural difficulties and allows operations to be oriented more quickly and efficiently toward the group's mission. Many observers believe that organic growth has been more successful than growth through acquisition.

On the other hand, organic growth means that the group is unlikely to be a major player within a country's financial services market in the near term. If, as many financial conglomerates believe, being among the five or so largest financial institutions in the market is important for operational efficiency and profitability, organic growth may not be the best choice. This is especially true for mature markets, where consolidation is already well under way and opportunities for acquisitions abound. Organic growth tends to be more common in emerging markets than in mature markets.

Complexity

Integrated financial services firms are complex operations. This observation seems especially relevant when integration is accomplished via merger or acquisition. As noted in a recent issue of *The Economist,* "Managers are finding that, in practice, consolidation brings such nightmarish complexity that it often threatens to undo any costs savings or revenue synergies that the mergers might have achieved in the first place."[7]

Such complexity, however, is not associated solely with consolidation. For example, it has been observed that long-established European universal banks consistently subsidize unprofitable activities, seem reluctant to out-source nonessential operations, and rarely excel or become innovative in any one sector. Many are said to operate with a "silo" mentality. These observations may explain why they achieve a lower return on equity than U.S. commercial banks, with some observers contending that no European investment banks are capable of competing with U.S institutions such as Morgan Stanley Dean Witter, Goldman Sachs, Bankers Trust, or J. P. Morgan (Kraus, 1998).

The problem of complexity seems largely to be ignored at present. As reported in *European Banker* (1999), it is as if consolidation and being big were not just necessary but sufficient conditions for success in financial services. Again, this seems particularly true for Europe's universal banks. In an examination of the annual reports of Europe's 50 largest banks, Lafferty Business Research found only one bank that questioned whether merger and consolidation were the appropriate answers to the advent of the European Monetary Union. Banco Popular, perhaps prophetically, noted: "It is, to say the least, surprising that there should be such widespread and critical [sic] acceptance of this need, with no precise distinction between types of business and without meticulous analysis of the many drawbacks that these processes may involve and of the problematic nature of their purported advantages" (*European Banker*, 1999).

Complexity (or perhaps just poor management) is evident in problems experienced by some of the world's leading financial institutions. Consider the "rogue trader" at Barings, the world's oldest and one of the most respected private banks; trading losses at Bankers Trust (which spurred its sale to Deutsche Bank), one of the world's most respected banks; multi-million dollar market conduct settlements by Prudential, New York Life, Metropolitan, and many other U.S. life insurers, all highly respected firms; and property losses at Yamaichi, one of Tokyo's largest stockbrokers.

Corporate Cultures

Corporate cultures vary across firms and across financial sectors and can lead to potentially crippling management problems. The investment bank corporate culture is one of entrepreneurship, risk taking, and incentive compensation. The commercial banking culture is one of relationship building, little risk, stability, and compensation schemes less related to performance. The insurance culture is bi-polar. Life insurance is associated with aggressiveness, marketing innovation, consultative selling, and incentive compensation. The nonlife insurance culture falls between that of life insurance and commercial banking. Nonlife products are largely demand pull, not demand push products like life insurance.

These cultural differences pose challenges for management of financial conglomerates, especially those resulting from merger and acquisition (M&A). Indeed, one-half of all mergers and acquisitions are unsuccessful, with the most frequently cited reason for failure being cultural differences (Tuohy, 1999). Cultural differences seem less of an obstacle when integration is organic.

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[7] "Complex Equations," *The Economist* (June 5, 1999), p. 69.

Thus, a frequently reported difficulty with *bancassurance* is indifference by bank employees to insurance. They treat such products as sidelines or as too complex to sell within the traditional banking relationship (Higgins, 1999).

Another dimension of corporate culture seems to be related to national differences in management dedication to shareholder value. Economists classify this as an agency problem. In a study touching on this issue, Lafferty Business Research found that European banks clustered around two distinct business approaches: focused banks and universal banks (*European Banker*, 1999).

Lafferty concluded that focused banks operated within a culture of shareholder value, used internationally acceptable accounting standards, had a sharper focus on retail banking operations, and were consistently more profitable than the European average. Universal banks, in contrast, operated within a managerial culture, followed inferior accounting practices which prevented shareholders from gaining an accurate picture of the business, believed in universal banking as a concept, and were consistently less profitable than the focused banks. Focused banks tended to be found in the Netherlands, the Nordic countries, the U.K., and Ireland. Universal banks tended to be found in Austria, Finland, France, Germany, Italy, and Spain. The study noted that the boundary between the two groups was blurred, in constant movement, and rapidly losing its geographic consistency. For example, several banks in Spain were highly focused and the leading Swiss banks, formerly strong advocates of the universal concept, were moving to a more focused approach. The study further noted that virtually every bank in the study had formerly subscribed to the universal concept (*European Banker,* 1999).

Inexperience/Lack of Expertise

Admittedly not a problem for the long run, the lack of experience in managing an integrated financial services group can pose vexing short-term problems. This issue is particularly relevant in markets where financial integration has not existed formerly, either because of practice or regulatory prohibitions, such as in the U.S. and in many Asian countries. Financial conglomerates from other countries, particularly Europe, may have a competitive advantage over domestic financial institutions in such markets.

Joint ventures and strategic alliances between domestic and experienced foreign firms may prove most appealing to both domestic and foreign entrants. Although foreign financial conglomerates have greater knowledge and insights into how to make integration work, local firms have a competitive advantage in understanding the local culture and in local relationships.

Marketing/Distribution Issues

Distribution issues can be among the most challenging for management of integrated financial institutions. Among the most troubling for financial conglomerates created via M&A has been how to deal with channel conflict. The concern, of course, is that marketing intermediaries, especially agents and brokers, that have been the primary distribution outlet for one of the formerly independent institutions face the possibility of disintermediation by new channels, such as a bank branches, direct response, or the internet.

The situation of ING – the first large-scale merger of a bank and an insurer – offers an example. ING was formed in 1991 by the merger of the insurance group Nationale-Nederlanden (NN) and the banking group NMB-Postbank which was itself a result of a 1989 merger between two important Dutch banks. At the time, NN was the largest insurance group and NMB-Postbank was the third largest banking group in the Netherlands.

In announcing the merger, NN indicated that it would design special insurance products to be sold through Postbank. Such products would compete with and be less expensive than those sold by NN's army of independent agents, which accounted for some 85 percent of NN's sales. Their agents promised a boycott. Only after agreeing to limit Postbank distribution to very simple products, such as travel accident insurance and certain types of annuities, was the boycott canceled (Van den Berghe and Verweire, 1998). The channel conflict for ING has since eased, but remains a challenge for the group in the Dutch market, arguably causing the group to forgo some demand-side economies of scope.

Channel conflict seems to be less of a management challenge for (1) de novo *bancassurance* operations (e.g., the creation of Deutsche Lebensversicherungs AG by Deutsche Bank and the creation of Predica by Credit Agricole), (2) integration that does not involve agents or brokers (e.g., USAA Life and USAA and Maybank Life and Maybank in Malaysia), and (3) integration in countries with less mature financial markets (e.g., the Philippines and Poland).

Marketing issues are associated largely with demand-side economies of scope. As such, they usually are of greater concern with *bancassurance* integration than others, especially those related to investment, risk management, and other back office integration possibilities.

Target Market Clarity

Management must be clear about the group's target market. History is littered with attempts at financial services integration that were unsuccessful largely because of ambiguity in this regard. For example, when Prudential acquired Bache many years ago, it was expected that Prudential – with its largely blue collar, lower middle-income target market – and Bache – with its largely white collar, upper income target market – would cross-market each other's products. That the experiment failed is unsurprising, in retrospect.

To date, most success in financial services integration has been in the retail market. Within the retail sector, greatest success has been with middle and lower-income markets.

The affluent market seems largely to be the province of financial planners and independent agents and brokers. Indeed, some years ago it was predicted that *bancassurers* would capture one-third of the U.K life insurance market. Their share today is about one-eighth. Independent financial advisors, by contrast, now control more than one-half of the market, up from less than one-third a few years ago (O'Conner, 1999). These advisors have expanded their own product offerings; in effect, offering integration at the advisory level and blunting bank distribution.

In selecting the target market, management will simultaneously be determining the classes of products to be offered. The emphasis might be on the retail market, the corporate market, or both. Different demographic, economic, and geographic emphasis will be taken with each broad market segment.

Management will decide which asset accumulation, debt management, and asset protection products to manufacture and through which channels to distribute them. In this connection, an issue confronting all financial conglomerates is the extent to which it is better to manufacture the desired product or to market other institutions' products through their distribution channels.

Management of some financial conglomerates seemingly is concerned that some financial products carry the easy potential for creating diseconomies for scope. Property/casualty insurance is perhaps the most commonly discussed product line in this regard. An insightful story making the rounds is that of a superb banking customer taking her entire account elsewhere because the group's insurer denied automobile insurance to her 17-year old son who had two speeding tickets. What is the anticipated effect on a good securities customer of being dissatisfied with a property insurance claim settlement? Many conglomerates have chosen to avoid the manufacture of property/casualty insurance for reasons of this type, with some not even making it available via marketing arrangements.

Financial Management Issues

For financial institutions and conglomerates interested in manufacturing their own products, financial management should be a core competency. Two areas of financial management seem to be particularly important: risk management and performance appraisal.

Only in the past few years have risk management issues been addressed in anything resembling an integrated way by financial institutions. Even then, this has occurred chiefly within individual financial institutions, not across institutions within a group, with some notable exceptions. Moreover, the focus of risk management differs considerably based on sector and product line. Credit risk, interest rate risk, liquidity risk, operating risk, and foreign exchange risk vary greatly from line to line and even product to product within the same line.[8] For example, interest rate risk for an investment bank ordinarily is far less important than it is for a life insurer.

A challenge for management of financial conglomerates is, first, understanding the risk profile of the group as a whole rather than its parts in isolation. Second, management must develop risk management policies and techniques appropriate for the entirety of the group. If synergies are to be realized through integration, one would fully expect them to arise, among other places, through a holistic approach to measuring and managing risk.

Related to holistic risk management is the issue of how best to appraise the financial performance of the entire group. Banks, insurers, and securities firms have used different techniques. Banks historically have focused on interest spread, with return on equity of more recent importance. Life insurers increasingly use embedded value analysis. Property/casualty insurers use combined ratios and return on equity. How are these diverse techniques to be reconciled (if at all) for the benefit of management and ultimately shareholders?

Conflicts of Interest

The potential for internal conflicts of interest (agency problems to the economist) is endemic to financial services integration.[9] Conflicts of interest exist when incentives within the group do not align with the customer's best interest. The major classes of conflicts of interest include the following:

- *Salesperson's stake.* It has been argued that when one financial institution within a conglomerate has the power to sell affiliates' products, salespeople and managers are less likely to offer objective product advice to customers. Rather they will have a stake in pushing the conglomerate's products, possibly to the disadvantage of the customer.

- *Stuffing fiduciary accounts.* In underwriting securities, the investment operation of a financial conglomerate may seek to minimize a potential loss by "stuffing" the unwanted securities into customers' accounts over which it has discretionary authority.

- *Bankruptcy-risk transfer.* Because of its relationship with its commercial loan or commercial insurance customers, the group may secure private information that a customer's bankruptcy risk has increased. The group may have an incentive to induce the firm to issue bonds or equities – underwritten by its securities operation – to an unsuspecting public. Proceeds could be used to reduce

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8 For an overview of the risk profiles of different financial intermediaries, see Santomero and Babbel (1997), chap. 25.

9 This section draws heavily from Walter (1997).

the bank loan, thus effectively transferring the bank's credit risk outside the group, and earning fees or underwriting spreads.

- *Third-party loans.* A conglomerate may have an incentive to make below-market loans to customers of its securities operation on the condition that the proceeds are used to purchase products sold by other units, such as securities or life insurance.

- *Tie-in sales.* A bank could use the threat of withholding or rationing credit to coerce a customer into purchasing other conglomerate products, such as insurance or securities.

- *Internal information transfer.* One unit of the conglomerate may secure material, private information about a customer that enables other units to charge higher prices than otherwise to that customer. (The result also could be lower prices.) For example, in underwriting a life insurance policy, the insurer might discover that the proposed insured had a substantial health problem. Information about this problem might influence a mortgage loan decision by the group's bank. Irrespective of whether the customer might suffer harm, the important issue of the extent to which he or she should be able to control the flow of personally identifiable information within a financial conglomerate remains an important public policy (and, therefore, management) concern.

Incentive conflicts are managed by rearranging the incentives to be more compatible with the desired result (a market solution) or through regulation. Most universal banking systems are said to rely on market incentives (Walter, 1997). The U.S. historically has relied more heavily on regulation, including "firewalls" between activities potentially giving rise to incentive conflicts.

In general, conglomerates deal with potential conflicts of interest by seeking to instill a sense of professionalism and ethical conduct within salespeople and employees. Training, close supervision, and internal monitoring are essential. Further, the group's reputation and competition act as disciplinary mechanisms. The value of future business (goodwill) is greatly affected by the group's market reputation (franchise), as recent market conduct and trading scandals have demonstrated.

Preventing or mitigating the adverse effects of internal conflicts of interest is expensive. Training and monitoring systems are costly. Building internal firewalls or creating other substantial limitations on information sharing within the group can defeat the very reason for integration.

FINANCIAL SERVICES INTEGRATION INTERNATIONALLY

It will prove insightful to compare and contrast markets in some of the major financial center. The focus will be on the national regulatory and political environments and on the extent and nature of financial services integration in each center.

Overview of Regulation of Financial Conglomerates Internationally

The regulation of financial institutions varies greatly in detail from country to country. This observation applies particularly to prudential regulation, although some harmonization has been achieved in banking through the Basle Accord. Some generalizations can be drawn, however, in the extent of financial activities that countries permit within a financial conglomerate and the overall mode of regulation.

Permissible Activities. In a survey of 52 of the world's major financial centers, the Institute of International Bankers (1999) found that the majority, especially the largest centers, permit financial conglomerates to undertake banking, insurance, and security activities. The survey does not speak to the important issue of consistency of prudential oversight across sectors. Also, it does not include the recent reforms in the U.S.

Table 1 is a summary of the survey. It shows that the overwhelming majority of countries allow joint banking and securities activities, with many permitting banks to undertake securities activities within the bank itself. Several others require some or all securities activities to be undertaken through subsidiaries or affiliates. Of the countries surveyed, only China prohibits any joint undertakings.

Table 1:
Permissible Activities for Banking Organizations in Various Centers (1998)

Securities			**Insurance**	
Permitted Through the Same Legal Entity	Permitted Through Subsidiaries or Affiliates Only	Not Permitted	Permitted	Not Permitted
Argentina	Brazil	China	Argentina [2]	Bahrain
Australia	Canada		Australia [2]	China
Austria	Colombia		Austria [2]	Colombia
Bahrain [1]	Egypt		Belgium [2]	India
Belgium	Greece		Bermuda [2]	Israel
Bermuda	India		Bolivia [2]	Japan
Bolivia	Indonesia		Brazil [2]	Pakistan
Cayman Islands	Ireland		Canada [2]	Panama
Chile	Israel		Cayman Islands	Peru
Czech Republic	Japan		Chile [3]	Russia
Denmark	Korea		Czech Republic [2]	United States[1]
Estonia	Mexico		Denmark [2]	
Finland	New Zealand		Egypt [2]	
France	Panama		Estonia [2]	
Germany	Peru		Finland [3]	
Hong Kong [1]	Philippines		France [2]	
Italy	Poland		Germany [2]	
Latvia	Romania		Greece [1]	
Luxembourg	United Kingdom		Hong Kong [1]	
The Netherlands	United States		Indonesia [2]	
Nigeria			Ireland [2]	
Norway			Italy [1]	
Pakistan [1]			Korea [2]	
Portugal			Latvia [2]	
Russia			Luxembourg [2]	
Singapore			Mexico [2]	
South Africa			The Netherlands [2]	
Spain			New Zealand [2]	
Sweden			Nigeria [2]	
Switzerland			Norway [2]	
Turkey			Philippines [2]	
			Poland	
			Portugal [2]	
			Romania [1]	
			Singapore[2]	
			South Africa [1]	
			Spain [2]	
			Sweden	
			Switzerland [2]	
			Turkey [1]	
			United Kingdom [2]	

[1] With limits.

[2] Through subsidiaries or affiliates only.

3 Brokerage or agency only.

The situation with regards to insurance is somewhat different. Although the information source is not completely clear, it appears that few, if any, countries generally permit insurance underwriting within a bank. The majority allows joint arrangements, but through subsidiaries or affiliates. Several countries prohibit any affiliation between insurance and banking, with a few others prohibiting banks from owning insurers but allowing them to act as agents or brokers for unaffiliated insurers.

Structure of Regulatory Authority. The majority of countries regulate financial conglomerates on a functional basis; that is, banking and insurance (and often securities also) oversight are separate, with each sector having its own regulator. Several countries with functional regulation, however, establish a lead regulator for conglomerates, based on its principal activity. Thus, if a conglomerate's main activity is commercial banking, the bank regulator is the lead regulator. He or she is responsible for overseeing the entire group's operation and ensuring coordination of responses among functional supervisors. This does not mean that the lead regulator usurps the power of other regulators, however.

An important trend during the past few years is the implementation of consolidated financial services regulation within several countries. For example, new regulatory agencies with responsibilities for consolidated oversight of banks and other financial institutions have recently been established in Australia, Korea, Japan, Singapore, and the U.K. Canada, Denmark, Norway, and Sweden have had consolidated regulation for several years. Plans for the creation of such an agency are underway in Estonia, and the Netherlands has decided to establish a Council of Financial Supervisors consisting of supervisors of the banking, insurance, and securities sectors. There is as yet no international consensus on consolidated or some variation of functional regulation. Table 2 summarizes the regulatory approaches of several major financial centers (Institute of International Bankers, 1999).

Table 2:
Regulation of Financial Conglomerates (1998)

Single Regulator Oversees Activities of Financial Conglomerates as a Whole	**Identity of the Lead Regulator for a Financial Conglomerate Determined on the Basis of the Financial Conglomerate's Principal Activity**	**Financial Conglomerates Operate without a Single or Lead Regulator**
Australia	Argentina[2]	Czech Republic
Bolivia	Austria	Finland
Canada[1]	Belgium	France
Cayman Islands	Chile	Germany
Columbia	Estonia[3]	Hong Kong
Denmark	Greece	Italy
Japan	Ireland	Luxembourg
Norway	Israel	Netherlands
Peru	Latvia[4]	Panama[7]
Singapore	Philippines[5]	Poland
Sweden	Spain	Portugal
United Kingdom	United States[6]	Romania
	Venezuela	South Africa
		Switzerland
		Turkey
		Uruguay[8]

[1] The Office of the Superintendent of Financial Services oversees the operations of financial conglomerates at the federal level. Certain companies within a financial conglomerate (e.g., securities firms and insurance companies) may also be subject to supervision by provincial authorities.

[2] Only financial conglomerates headed by banks are subject to consolidated regulation.

[3] The Central Bank is the lead regulator of financial conglomerates that include banks. Financial conglomerates that do not include banks do not have a lead regulator.

[4] Effective January l, l999, but only with respect to conglomerates headed by credit institutions.

[5] The Central Bank has supervisory authority over banks and their subsidiaries and affiliates, as well as nonbank financial institutions with quasi-banking or trust authority. The Office of the Insurance Commissioner supervises insurance companies that are subsidiaries or affiliates of banks. Nonbank financial institutions that are subsidiaries and affiliates of banks and other financial institutions where their charter provides that they will be under the Central Bank's supervision are regulated jointly by the Central Bank and the Securities and Exchange Commission (SEC). The SEC regulates other nonbank financial institutions that do not fall under these classifications.

[6] Financial conglomerates that include banks are regulated at the holding company level by the Federal Reserve. Nonbank financial conglomerates (i.e., those comprised of only nonbank financial institutions such as securities firms, insurance companies, and commercial finance companies) are not regulated at the group level, although the Securities and Exchange Commission requires registered broker-dealers to file with it quarterly risk assessment reports regarding their material affiliates. Banks may affiliate with securities firms and insurance companies.

[7] Only financial conglomerates that include banks are regulated on a group-wide basis.

[8] The Central Bank regulates separate companies within a financial conglomerate (e.g. banks, insurance companies, investment fund managers, and pension fund managers) but not the group as a whole.

Other Governmental Actions Affecting Financial Services Integration. Other governmental actions, not explicitly aimed at financial services integration are, nonetheless, having or promise to have potentially important effects on integration. Thus, the trend towards allowing mutual insurers and banks to convert to shareholder-owned firms opens up new opportunities for financial conglomeration. Demutualization has been particularly important in Australia, Canada, South Africa, the U.K., and the U.S.

Privatization of banks and insurers in several countries continues similarly to create opportunities. Privatizations have recently occurred or are occurring in Belgium, the Czech Republic, Finland, France, Israel, Norway, Peru, Poland, Turkey, and Venezuela.

Significant combinations of banks and insurance companies occurred recently in Denmark, Norway, Switzerland, and the U.S., while consolidation of domestic banks, insurers, and securities firms continues in many countries. Foreign financial institutions developed, expanded, or were given new authority to develop or expand their presence in other countries such as Canada, China, Poland, and Singapore, with the most significant recent cross-border transaction being Deutsche Bank's acquisition of Bankers Trust in the U.S.

Asia-Pacific Region

Except for Australia, financial services integration in the Asia-Pacific region is at an early stage. With recent liberalization and deregulation efforts, many spurred by the Asian economic crisis, we can expect accelerated integration in several markets, particularly in Japan, Korea, and Singapore. Here we examine briefly two of the region's most important markets.

Australia. The Australian financial services market, in some ways, might offer other markets a glimpse into the future of financial services integration. The Australian market is comparatively small but sophisticated. It is dominated by financial conglomerates.

The Regulatory and Political Environment. Australian experience with financial integration and, thus, regulation dates back several decades. The government has never prohibited the creation of financial conglomerates. Its approach to their regulation, however, has changed dramatically.

Until 1998, financial institutions were regulated on a functional basis. The Reserve Bank of Australia (RBA) was responsible for banking supervision, the Insurance and Superannuation Commission (ISC) was responsible for supervision of insurance and superannuation (retirement) firms, the Australian Financial Institutions Commission (AFIC) regulated various non-bank depository institutions, and the Australian Securities Commission oversaw securities firms, mutual funds, and finance companies.

In 1992, in response to concern about appropriate oversight of financial conglomerates, the Council of Financial Supervisors, composed of the four major regulators, was established. The Council was to facilitate informal cooperation among the functional regulators, but with no one regulator having a lead role.

As the market witnessed continued product innovation and integration, perceived shortcomings of functional regulation emerged as firms engaged in regulatory arbitrage. In response, in 1998, the functional regulatory system was abandoned in favor of consolidated regulation under the auspices of the Australian Prudential Regulation Authority (APRA). Prudential supervision formerly handled by the RBA, ISC, and the AFIC became the APRA's responsibility. The APRA regulates both solo financial institutions and financial conglomerates.

Separate from the APRA, the Australian Securities and Investment Commission is responsible for corporate and securities regulation, consumer protection, and market integrity issues. It combines the functions of the former Australian Securities Commission with consumer protection functions of other regulators. The Council continues in a modified role to facilitate regulatory coordination.

Extent and Nature of Financial Services Integration. Bain and Harper (1999) observe that "the decades of the 1980s and 1990s have been amongst the most eventful in Australian financial history – rivaled only by the financial crises of the 1890s and the Great Depression of the 1930s." Australia began aggressively deregulating its financial services market in the 1980s, and continued throughout the 1990s. As is often the situation, the market led; financial services integration pushed governmental reform.

The Australian financial services market today is among the world's most sophisticated. Financial conglomerates account for 80 percent of total financial system assets. The 10 largest conglomerates hold one-half of Australian financial system assets. Financial conglomerates typically offer a full range of financial services and products. For example, the four major banks in Australia operate as conglomerates in all areas of commercial and investment banking, in life and nonlife insurance, and in pensions (Bain and Harper, 1999).

Financial integration is deeper than an examination of market shares might suggest. Several conglomerates have moved aggressively to acquire or create firms to be able to offer a wide range of financial products and advice and to offer them through multiple distribution channels. Integration via distribution might be among the most advanced in the world.

At the same time, with ever more sophisticated customers, competition has driven down distribution costs substantially, especially in life insurance. Traditional life insurance products continue to fade from the market, replaced by variable (unit linked) products with low sales loads.

Less visible is the integration occurring at the operational and production level. Managerial orientation and control functions increasingly are at the group rather than the sectoral level. Business operations and activities increasingly deviate from a pure alignment with legal structure. Both trends are consistent with the fully integrated model.

Japan. Japan is home to many of the world's largest financial institutions, a deliberate result of past government policy to create a small number of very large financial firms. These firms, unfortunately, are today among the developed world's least profitable and most poorly capitalized.

The Political and Regulatory Environment. The Japanese government's position on the regulation and structure of its financial services market has undergone a major shift over the past few years. Formerly, the view was that market access should be limited, competition should be circumscribed, and administrative guidance offered by government officials should be welcomed (and followed) by businesses. Additionally, the *keiretsu* system of cross shareholdings and other inter-corporate linkages was considered stabilizing and good for the national economy.

It is now generally believed that these market-constricting views and practices contributed to overvalued stock and land prices, the former plummeting 10 years ago and the latter eight years ago. Economic recession and stagnation ensured. Neither the Japanese economy nor its financial institutions have yet recovered fully, although some encouraging signs have recently emerged.[10]

Market Reforms. In 1997, the government undertook several deregulation initiatives in response to recommendations from its Financial System Research Council and others. The most significant changes, however, occurred in 1998 when Japan moved to consolidated regulation. Formerly, Japan's regulation of financial institutions was on a functional basis within the Ministry of Finance (MOF). Effective June l998,

[10] The sections that follow draw from Institute of International Business (1998 and 1999).

the bank and securities supervisory functions of the MOF were transferred to a new Financial Supervisory Agency (FSA).

Additionally, in March l998, a law lifting the ban on the establishment of holding companies took effect. Under this law, two different types of financial conglomerates are possible: (1) banks, securities companies, and insurance companies may own subsidiaries engaged in other financial services or affiliated businesses and (2) financial holding companies. Although bank holding companies are not allowed to own commercial entities, the other forms of holding companies can be affiliated with non-financial companies.

Also in 1998, other financial reform laws were enacted. This legislation included the comprehensive Financial System Reform Law that provided a means of moving forward with earlier enacted reforms. Some of the important features of the Law are as follows:

- introduced mutual funds and privately-placed investment trusts
- permitted sales of investment trusts directly by banks
- allowed securities companies to undertake other activities
- eliminated restrictions on the permissible activities of bank-affiliated securities subsidiaries
- allowed affiliations among banking, securities, and insurance businesses
- established a framework for consolidated disclosure
- formulated and expanded fair trading rules
- expanded regulations on the conducts of securities companies and other institutions
- expanded disclosure requirements of financial institutions.

Financial Failures and Scandals. Japan has seen a series of financial institution failures. Four major firms failed in 1997. Sanyo Securities, one of the second-tier brokerage firms, suspended part of its operations and filed for protection under the Corporate Reorganization Law. The Hokkaido Takushoku Bank, one of the smallest "city banks," failed because of cash-flow problems. Nissan Mutual, a life insurer within the Nissan *keiretsu*, became the first insurer in modern Japanese history to fail. Finally, Yamaichi Securities, one of Japan's big four brokerage firms, decided to undergo voluntary liquidation after suffering during the long stock market slump and investigation for illegal payoffs and illegally concealed losses.

During 1998, the government took action against several firms. Long Term Credit Bank of Japan and the Nippon Credit Bank were found to be insolvent and taken over by the government. The Kokumin Bank, the Kofuku Bank, and the Tokyo Sowa Bank were taken over by the government for reorganization. The latter two banks were also subject to the first-ever order for prompt corrective actions.

The problems experienced in the financial sector prompted legislation to amend the Deposit Insurance Act, as well as additional legislation regarding emergency actions for financial system stabilization. The law enables the use of up to ¥30 trillion in public funds for the protection of depositors and the stabilization of the financial system. To date, some ¥7.46 trillion has been injected into 15 large banks, a sum equivalent to one-half of their equity (Survey of International Banking, 1999). In applying for public funds, the financial institutions submit plans to streamline their businesses.

Japan has also suffered from several financial scandals. In 1997, the MOF imposed administrative punishments on Nomura Securities and Daiichi Kangyo Bank for making illegal payoffs. The Ministry also imposed administrative punishments on Nikko Securities and Daiwa Securities for related payoff scandals. Further administrative sanctions were imposed on Nikko for additional violations in 1998. Additional scandals hit the government itself within the MOF and the Bank of Japan.

Extent and Nature of Financial Services Integration. Before the recent reforms, financial conglomerates were illegal in Japan. Consequently, Japan has one of the least integrated financial sectors of any developed country. In light of the comparatively weak financial condition of so many Japanese financial institutions, consolidation would have been the expected reaction, yet Japan has only recently begun to experience consolidation.

This delayed reaction is attributable to several factors. The complexity and inherent conflicts of interest in trying to deal with the numerous interconnections in *kieretsu* relationships are enormous. Virtually every major bank and insurer is involved in such a relationship. Additionally, requirements for consolidation run counter to the Japanese cultural propensity to avoid direct conflict, including the termination of employees.

Even so, the pressures for action seem at last to have become too great. Consolidation seems to be a 1999 hallmark. In response to recent spate of merger announcements, *The Economist* (November 6, 1999, p. 71) remarked:

> Besides the odd bankruptcy, nothing had changed in Japan's financial industry for so long that the big firms seemed like fixed constellations: 20 "major" banks, 20 full-service life insurers, [and] four big securities brokers. Suddenly, a handful of groups remain – and the mergers are not over yet.

The mergers announced in 1999 and 2000 include the following:

- Dai-Ichi Kangyo, Fuji, and Industrial Bank of Japan (IBJ) – forming the world's largest banking group with combined assets of ¥141 trillion. IBJ would focus primarily an investment banking, with the other two partners bringing strong retail banking expertise, making the first Japanese universal bank.

- Sanwa Bank, Tokai Bank, and Asahi Bank with combined assets of more than ¥100 trillion, creating the world's third largest bank.

- Sumitomo Bank and Sakura Bank with combined assets of ¥98.7 trillion.

- Mitsui Trust and Chuo Trust with combined assets of ¥14.7 trillion.

- Mitsui Marine and Fire, Nippon Fire and Marine, and Koa Fire and Marine with combined assets of ¥6.1 trillion (*The Economist*, November 6, 1999, p. 71)

Other consolidation has occurred among smaller trust companies and banks, usually at the insistence of the FSA. The above announcements make an important statement to other Japanese financial institutions – and no doubt pose a competitive threat.

Consolidation is occurring also via joint ventures. Nikko Securities and the Travelers Group established a joint venture brokerage firm, Nikko Salomon Smith Barney, Inc. as of March 1, 1999. This firm will specialize in wholesale securities, while Nikko itself concentrates in the domestic retail market.

Additionally, on April 5, 1999, Daiwa Securities SB Capital Markets Co. Ltd., a wholesale brokerage collaboration between Sumitomo Bank and Daiwa Securities, opened it doors for business. Shortly thereafter, Daiwa spun off its business divisions as independent companies and reorganized itself to become Daiwa Securities Group, Inc., Japan's first financial holding company.

Neither consolidation nor integration will come easy for Japan's big life insurers. The largest Japanese insurers are mutual life companies. M&A discussions are purportedly taking place among some of them and between them and banks and trust companies. Mergers of the life companies with other life insurers and with firms from other sectors would require demutualization. No Japanese insurer has initiated demutualization, although several are said to have it under active consideration.

Most trust companies in Japan are in financial trouble. Their investment management business, however, makes them attractive M&A targets given the rapidly growing private pensions business in Japan.

The Japanese financial services market is not renown for financial or product innovation, exceptional service to customers, low prices, or great product choice. In short, the market offers much room for improvement and, therefore, great opportunities, especially for foreign firms more accustomed to competitive markets.

On balance, therefore, Japanese financial institutions seem to be at the very beginning of meaningful change and integration. Neither *bancassurance* nor universal banks exist at present, but opportunities for financial conglomeration seem abundant. Unlike U.S. and U.K. or even continental European structural reform, true structural reform of Japan's financial services sector likely will prove painful and perhaps slow, given its cultural and historical traditions. Success will depend to a greater degree than in other markets on the extent to which the new FSA is able to maintain its arms-length position as independent regulator while ensuring the existence of a competitive environment.

Europe

The observations on the European financial services scene will be limited to the 15- member European Union and, within the EU, to selected countries. Of course, the EU single market in financial services continues to evolve, built on the principles of minimum regulatory harmonization of essential elements, home country control, and mutual recognition. Directives issued by the European Commission (EC) are the mechanism by which the single market is created. These directives are implemented through enactment of equivalent national law.

No directives oriented explicitly toward financial conglomerates have been issued, although some have dealt with various combinations (e.g., securities and banking). Financial conglomeration has been identified as a priority for the Commission (Thom, 1999). This failure to promulgate broadly applicable directives, however, has not impaired European financial services integration, as no EU country's laws or regulations prohibit integration. Moreover, those directives addressing consolidated supervision and capital adequacy of combined securities and banking activities effectively address the majority of European conglomerates, as most do not include insurance activities.

The EC's series of directives dealing with banking, insurance, investment services, information sharing, and cross-border mutual funds collectively have provided a framework for integration. Thus, the Second Banking Directive permits an EU-based bank to engage in securities activities anywhere in the EU to the extent permitted by the institution's home country. All EU member states permit both banking and securities activities within a financial conglomerate and most permit them within a single legal entity. Life and non-life insurance generally must be undertaken within separate corporations, although this can be within a single financial group.

The mature EU financial services markets are experiencing the same types of competitive pressures as found in the other mature markets. As a consequence, we see considerable consolidation, along with integration. Integration is advanced in Europe. The creation of the European Monetary Union has provided additional impetus.

We now examine five EU markets in more detail. They are France, Germany, the Netherlands, Spain, and the U.K.[11]

France. Several French financial service institutions are among the most integrated in the world. France, as with other mature European financial markets, continues to witness substantial consolidation.

The Regulatory and Political Environment. The introduction of the single market program has had a profound effect on French financial services regulation. Formerly, the French regulatory scene could be characterized as one of gentle competition, protected by a paternal state. State-owned institutions dominated the financial services market. All have now been privatized. Price and product competition is now encouraged.

The 1996 acquisition of UAP by AXA and the more recent hostile takeover of the investment bank Paribas by Banque Nationale de Paris (BNP) and the failure of BNP to secure a majority in Sociϑtϑ Gϑnϑrale highlight a changed competitive environment in France. Financial institutions believe that they must be large if they are to compete successfully in the European single market and internationally. Consolidation also reflects a desire of the major banking institutions to cross-sell products.

At the same time, the difficulties in achieving a single market in financial services in Europe are highlighted by these actions. That non-French interests were unwelcome in this play was clear.[12]

France permits securities activities within commercial banks but requires separately capitalized legal entities for insurers. Regulation is on a functional basis. There are no specific regulations on supervision of financial conglomerates, although recent proposals would strengthen cooperation between supervisors. If the parent company within a conglomerate is not a bank or an insurer, there is no specific authority to supervise the group on the basis of the holding company.

Extent and Nature of Financial Services Integration. The securities business in France is growing but remains below that found in several other mature economies. Some French banks specialize in merchant banking, competing with the subsidiaries of foreign banks. Some commercial banks offer investment banking services, either internally or through subsidiaries.

Banks' share of the life insurance market has grown dramatically since the 1980s, and some banks have recently begun selling nonlife insurance. Most French banks have either marketing agreements with unaffiliated life insurers or cross shareholdings with life insurers.

The French star of *bancassurance*, Predica, was established in 1986 by Crϑdit Agricole. Predica and other bank-owned insurers specialized in sales of *bons de capitalisation* contracts. These tax-favored life policies contain little pure life insurance protection, being mostly savings contracts. (They would not qualify for life insurance under U.S. tax law.) As simple contracts, they were easy for bank employees to understand and to explain to customers.

The most striking aspect of French *bancassurance* is the substantial market share banks achieved in a relatively short period. By 1998, banks accounted for 61 percent of total life premiums and 63 percent of new premium production in France (Daniel, 1999). A major factor for French *bancassurance* success has been the substantial savings in distribution expense in comparison with those insurers using traditional distribution channels.

[11] The insurance-banking elements of these discussions rely heavily on Genetay and Molyneux (1998).

[12] "Yes, but who won?" *The Economist* (August 21, 1999), p. 63.

This success is said to stem also from inherent weaknesses in the insurance industry (Genetay and Molyneux, 1998, p. 79). The French insurance industry has been characterized as relying too heavily on compulsory insurance and suffering from a lack of competition. General agents are said to have exerted a virtual monopoly on the distribution of insurance products until the 1980s. The dispersion and generally low level of qualifications of agents contributed to the uncompetitive nature of the industry. Agents lobbying to protect their privileged position met with little success. As a result of the entry of banks into the insurance market, the number of agents has fallen by about 50 percent.

Although the trend towards savings-oriented life assurance products is observable within other European countries such as the U.K. (with the development of endowment and unit-linked policies), it has been most significant in France. The tax-advantageous feature of these endowment policies has made the product attractive to customers and their simplicity has necessitated little training of bank staff.

In addition to selling simple, tax-favored contracts, another factor in French *bancassurance* development has been the authorities' implicit encouragement of the strategy. Formerly, the state had a substantial stake in leading French banks and insurance companies. The state encouraged bank entry into insurance because, among other reasons, banks were in need of new sources of cash flows to boost low capital bases and poor performance.

Finally, competition has driven financial integration in France. The French insurance market's past lack of competitiveness played a significant role in promoting integration by allowing banks to capture unprotected market shares. Banks, by contrast, operated in a more competitive environment. This meant that, as more banks embarked on insurance linkages, insurers and other banks believed that they too had to offer a wider range of financial products if they were to compete successfully. Ease of entry into the life insurance market convinced banks that insurance distribution was an effective way to utilize expensive branch networks to cross-sell a variety of products.

Germany. The German financial services market is recognized for its financial soundness and is reasonably well developed. Although changing because of the EU single market program, competition historically been circumscribed in favor of "stability."

The Regulatory and Political Environment. Germany has long permitted the conduct of commercial and investment banking activities within a single legal entity. Indeed, this joint production more or less defines a German universal bank. Banks may also produce insurance but only through separately capitalized insurance subsidiaries.

Banks are subject to regulatory oversight by the *Bundesaufsichtsamt für das Kreditwesen* – the Federal Bank Supervisory Office (FBSO) – in cooperation with the *Deutsche Bundesbank*. – the central bank. Before the creation of the European Central Bank, the *Bundesbank* was responsible for national monetary policy. Its focus today is more on systemic risks. The FBSO is responsible for regulation of commercial and investment banking activities. Insurance is subject to regulation by the *Bundesaufsichtsamt für das Versicherungswesen* – the Federal Supervisory Authority for Private Insurance (BAV).

Financial conglomerates with non-financial holding companies are permitted. There is no consolidated regulation in Germany and no sectoral supervisor is charged with a lead role. A nonbank which, as a holding company, owns a bank or investment firm is required, however, to report to the FBSO. The FBSO can prevent the parent from exercising its voting rights if regulatory violations are found.

Three important characteristics of the German financial services sector should be noted. First, under the *Hausbank* system, German businesses place heavy reliance on one main bank to be the prime supplier of all forms of financing (Saunders and Walter, 1994, p. 91). The bank is deeply involved in such customers' business affairs, with the relationship expected to last for many years. With deregulation and liberalization, this system of mutual loyalties, however, is eroding.

Second, German banks and insurers often hold substantial ownership interest in non-bank businesses. As a corollary, they also often hold positions on the supervisory boards of these companies. This too is eroding.

Third, German banks hold proxies to vote the large portfolios of shares held through their trust operations. This gives German banks a degree of control over industrial enterprises that is several times larger than their proportionate share ownership (Saunders and Walter, 1994, p. 92).

These characteristics give large German financial institutions and large German industrial corporations a type of alliance. Universal banking has fostered these alliances, but not without important public policy questions having been raised. Three issues have been identified:

- Banks are perceived to possess excessive economic power, which they can potentially use for their own gain at the expense of the public interest.

- Domestic capital markets are perceived to be relatively inefficient.

- German financial technology has been viewed as uncreative and poorly developed, especially in relation to the U.K. and U.S.

A discussion of these issues is beyond the scope of this paper, but the market itself seems to be rectifying these concerns. Already, German financial institutions have reduced their ownership of shares in industrial firms. German capital markets, not well developed in comparison to those of the U.S., the U.K., the Netherlands, or France, have begun to liberalize. The EU single market program perhaps gets credit for bringing about greater competition and fewer inter-corporate linkages.

Extent and Nature of Financial Services Integration. Germany's four largest banking groups are Deutsche Bank, Hypo Vereinsbank, Westdeutsche Landesbank, and Dresdner Bank. Until last year, Dresdner was second largest, being displaced when two Bavarian banks merged. Allianz is easily the largest German insurer, with the Munich Reinsurance Company second. Deutsche Bank's securities operations represent the largest German play in that market.

The German financial services market is in a state of flux. As reported by *The Economist* (October 16, 1999), "these are uncomfortable times for Germany's banking behemoths." They have lagged behind other markets in consolidating, with the recently failed takeover of Dresdner Bank by Deutsche Bank seeming to confirm market difficulties. Low profitability continues to plague German financial firms, although the acquisition of Bankers Trust by Deutsche Bank is seem by many observers as an important move by Germany's largest financial institution. The recent sale by Deutsche Bank of almost a quarter of its holdings in Allianz is further evidence of change in the German market.

As suggested above, investment and commercial banking in Germany has been integrated for many years. *Allfinanz* is of more recent origin and is considerably less developed than in other European countries, although the concept dates back to the beginning of the century (Genetay and Molyneux, 1998, p. 80.)

Most German ventures in *allfinanz* have been via cooperative arrangements such as strategic alliances rather than acquisition or *de novo* entry. In most instances, the bank is the senior partner but not invariably so. Deutsche Bank was the first German bank to establish a life insurance company on a significant scale when it launched DB Leben in 1989. Prior to the launch, 4,000 employees underwent extensive training. DB Leben is now among the top 15 insurers.

Despite claims that Deutsche Bank's management was committed to a go-alone strategy in insurance, it bought 65 percent of Deutsche Herold in 1993 and transferred its insurance operations to Herold. Deutsche Bank now relies on bank branch sales as well as Herold's 15,000-strong sales force, and its wide range of life and nonlife insurance products.

Dresdner Bank has long operated a strategy of marketing insurance products of selected insurers. Its entry strategy has been one of regional cooperation with the insurance sector, a fact that perhaps can be explained by the 25 percent stake of Allianz in the bank. The privileged relationship between the bank and the insurer has meant that Allianz is one of the principal partners of the bank

The German financial services market has not experienced the same degree of integration as in other European countries, with the exception of commercial and investment banking. Even here, operations cannot always be regarded as fully integrated, with complaints of inefficient cross subsidization and management conflicts. While most banks have marketing agreements with insurers (and possibly some cross-shareholdings with them), it is said that the conservative nature of the German insurance market and regulation has hindered full integration (Genetay and Molyneux, 1998, p. 82). This conservatism made it difficult for German banks to profitably distribute insurance products. Moreover, the tradition of extensive cross-shareholdings within the financial industry has meant that banks chose to collaborate with insurance companies rather than develop their own in-house expertise.

The Netherlands. Consistent with the long Dutch tradition of promoting international trade, the Netherlands is home to some of the most international and most integrated financial firms in the world.

The Regulatory and Political Environment. The Netherlands has a history of offering a political and regulatory environment in which financial markets and institutions could flourish and prosper. Changes in the law in 1989 permitted full cross ownership within the financial services sectors.

Supervisory responsibility for banks is held by the central bank. Insurance is regulated by the *Verzekeringskamer* – the Central Insurance Authority – and other financial institutions are subject to oversight by the Ministry of Finance. Thus, the Netherlands has functional regulation but with oversight of financial conglomerates by the recently established Council of Financial Supervision.

The Council is composed of supervisors from the banking sector, the insurance sector, and the stock exchange. Besides having general oversight of conglomerates, the Council supervises “Chinese walls” within conglomerates and electronic commerce within the financial sector.

Dutch banks may offer commercial and investment banking services within a single entity, and most do so. Insurance may also be offered, but it must be through a separately capitalized insurance subsidiary.

Extent and Nature of Financial Services Integration. The Netherlands is home to some of the world’s most integrated and international financial services firms. At the same time, the domestic financial services market is quite concentrated, in part because of its relatively small size. Concentration resulted to a great extent from sectoral and cross-sectoral consolidations that have taken place over the past decade. The largest Dutch financial conglomerates market a full range of financial services. These firms include ABN-Amro, ING, Rabobank, and Fortis. All but Rabobank have major international banking and insurance operations. Aegon is the only major Dutch group that has eschewed moving into fully integrated financial services, preferring to focus chiefly in insurance.

Rabobank is a cooperative bank that also serves as the central bank for Dutch cooperative banks. Its insurance subsidiary, Interpolis, offers products through its 800 member banks. Both life and nonlife products are offered. Rabobank also has an alliance with Robeco, the largest independent European fund manager. The three entities (Rabobank, Interpolis, and Robeco) have developed joint investment, savings, and insurance products. The Rabobank-Interpolis link in 1989 is said to have marked the beginning of an era of consolidation in the Dutch financial services industry.

The next major consolidation took place in 1990 with the merger of savings bank VSB and AMEV, a large insurer that soon thereafter merged with the Belgian insurer AG, forming the Fortis Group. In 1996, the group acquired MeesPierson, an investment banking firm.

The ING Group resulted from the merger in 1991 between the then largest insurer, Nationale-Nederlanden, and the third largest bank, NMB Postbank. Despite the high publicity surrounding this merger, the process was not smooth, as noted earlier. Only after agreeing to sell only specialized products through the bank was an agent boycott lifted. Since then, the group has announced plans to offer insurance through multiple distribution channels, including its Dutch banking operations.

Early difficulties apart, ING has become the largest financial services provider in the Netherlands. In 1994, it reorganized its operations to further integration. One of the most important moves was to create a single Executive Board, rather than separate ones for the banking and insurance activities. The new structure involved creation of four business units: ING Financial Services International, ING Asset Management, ING Corporate and Capital Markets, and ING Nederland. The corporate legal structure, because of regulatory requirements, was unchanged.

Other factors in ING's development include its acquisition of the Belgium banking firm Banque Bruxelles Lambert and its perhaps most famous acquisition of the failed U.K. merchant bank, Barings.

ABN Amro is the result of the merger of the two largest banks in the country, in 1990. It launched a subsidiary insurer, ABN Amro *Levensverzekering*, in 1993. ABN Amro's strategy has been to expand abroad.

Today, a handful of large financial conglomerates controls virtually the entire national market. Nonetheless, the market seems reasonably well served. For example, mutual fund and equity purchases are among the highest and the fees among the lowest in Europe. Simultaneously, the Dutch experience is not trouble free. While Dutch financial institutions may be among the world's most advanced in terms of integration, they continue to experience management challenges that do not permit an unambiguous conclusion as to their success.

Spain. The Spanish financial services market is evolving rapidly. While not as sophisticated as many other EU markets, it is considered to be among the most promising and interesting.

The Regulatory and Political Environment. Spain has functional regulation, but with provision for a lead regulator in the case of financial conglomerates. Banks are supervised by the Bank of Spain and securities dealers are supervised by the Spanish Securities and Exchange Commission. Insurance oversight is by the Directorate-General of Insurance.

Nothing in Spanish law prohibits a financial group from being composed of firms in each of the three major sectors. Banks may engage in both commercial and investment banking within the same or separate legal entities. Insurance operations must be conducted in a separately capitalized subsidiary.

The law provides that a financial conglomerate's lead regulator will be determined by the group's dominant entity. Thus, if the dominant entity is a bank, the supervisory body is the Bank of Spain; if the dominant entity is a securities dealer, the supervisory body is the Spanish Securities and Exchange Commission. If the dominant entity belongs to neither of these two sectors, the supervisory body will be that which corresponds to the group's leading activity.

Extent and Nature of Financial Integration. The investment banking business is growing but remains small in comparison with its relative importance in more advanced European economies. Nonlife insurance has historically been more prominent than life insurance but this is changing, especially as banks have moved aggressively into life insurance marketing. For 1998, banks accounted for an estimated 75 percent of new life premiums.

The rapid growth of the Spanish life and pensions markets was due in part to the introduction during the mid-1980s of single-premium policies that were free of withholding tax and structured as bearer instruments. Euroseguros, the wholly owned insurance subsidiary of Banco Bilbao Vizcaya (BBV), benefited from this activity, but the eventual demise of the instruments did not halt the growth of the company or bank marketed insurance generally. In 1992, BBV joined with AXA Seguros which accounts for about 4 percent of Spain's life premiums.

La Caixa, Spain's largest savings bank, set up an insurance subsidiary Vida Caixa in 1988. The venture experienced strong growth. A holding company, CALIFOR, was formed jointly by La Caixa and Fortis (the Dutch group) in 1992. CALIFOR holds 80 percent of Vida Caixa with La Caixa retaining the balance. Vida Caixa distributes policies through La Caixa's branch network and two agency networks, accounting for somewhat less than 4 percent of the total life market in Spain.

Corporation Mapfre, Spain's largest insurer, offers an example of an insurer acquiring a bank, rather than the more common reverse approach. In 1989, Mapfre acquired Inverbank, the next year using it to create Banco Mapfre. Banco Mapfre contributes only modestly to Mapfre's overall profits, but growth is reported to be strong.

The Spanish financial services market has achieved impressive growth and development, mainly because it was relatively underdeveloped. This low level of development, coupled with an orderly deregulation and liberalization process associated with Spain's membership in the EU, provided unique opportunities for financial institutional growth and integration. That Spanish banks already had long-standing ties with insurance companies facilitated product cross-selling.

Banks have recently been the prime movers in introducing variable products, thus combining insurance and securities. Another feature of the market has been the entry of foreign companies, including Met Life, Generali, Allianz, and Winterthur. The net result of these forces is that the Spanish financial services market has become quite competitive.

United Kingdom. The U.K. is one of the world's most sophisticated, competitive financial services markets. It is known for its financial innovations, facilitated by a historically liberal economic and political environment.

The Regulatory and Political Environment. The U.K. regulatory environment has been described as " . . . among the world's most well structured and carefully thought through, in a serious and relatively unpoliticized effort to balance safety and soundness with static and dynamic efficiency as a matter of the national interest" (Saunders and Walter, 1994, p. 117). Regulation in the U.K. has historically been heavily focused on prudential measures. Many observers attribute the great success of U.K. banks and insurers internationally to the government's regulatory approach that permitted innovation and entrepreneurship.

The U.K. has long permitted financial conglomerates, although with functional regulation and some limitations on ownership interests, especially for building societies. Securities and insurance activities must be conducted in separately capitalized subsidiaries.

The U.K. has moved to consolidated regulation of its financial services institutions.[13] The process was initiated in May 1997. In October 1997, the Securities and Investment Board, the U.K.'s then leading financial services regulator, changed its name to the Financial Services Authority (FSA) in preparation for the consolidation. Responsibility for banking regulation was transferred from the Bank of England to the FSA in 1998. Oversight for other financial institutions and activities, including insurance, was transferred in 1999.

[13] This discussion draws on Institute of International Bankers (1998 and 1999) and Genetay and Molyneux (1998).

With the expected enactment in 2000 of the Financial Services and Markets Bill (FSMB), the transition to a single regulator will be complete. The FSMB will give considerable powers to the FSA to regulate, investigate, and discipline regulated firms and individuals.

Important regulatory changes in 1986 set the stage for the above developments. First, the U.K. capital market experienced unprecedented deregulation that year under the so-called Big Bang. Among other things, it allowed 100 percent foreign ownership of U.K. investment banks and deregulated commissions. Lower fees and commissions followed, as did lower profitability, but an enhancement of the reputation of London as a financial center. As a consequence of this deregulation, several commercial banks acquired U.K. investment banking firms.

Second, the regulation of the investment industry was changed, including the management and marketing of investment products. Legislation placed reliance on self regulatory organizations (SROs) in insurance and securities. Three important principles adopted by the SROs were (1) disclosure to customers, (2) the best advice principle, and (3) the polarization principle.

The first principle meant that customers had the right to disclosure of commissions and expenses. The second principle meant that salespeople were required to give the customer their "best advice" as to product and product suitability. For independent salespeople, this meant that they were obliged to search the market for the best product. The third principle forced salespeople to work either exclusively for one financial firm or as independents. A tied intermediary had no obligations to include a market survey within his or her recommendations. An independent intermediary was effectively required to present an array of competing products to his or her clients. In combination, these requirements drove most insurers and other financial firms toward the tied approach to distribution.

The other important 1986 law was the Building Societies Act. It greatly expanded the powers of building societies, providing them with a level playing field vis-à-vis commercial banks. Among other items, the act and later amendments authorized building societies to own insurers and securities firms and, if they desired, to convert to commercial banks.

Much of the faith in the market and in SROs was shaken with the scandal in personal pension selling in the U.K. Under a 1988 law, employees could opt out of the State Earnings Related Pension Schemes sponsored by employers and invest their funds in private plans. Private pension plans became a high growth area, especially for life insurers. Misleading sales and other market conduct breaches, however, resulted in insurers having to pay millions of pounds in redress. Prudential (U.K.) was particularly hard hit. More importantly, the scandal led to enactment in 1995 of disclosure requirements that led to massive declines in the number of insurance agents. This issue, now the FSA's responsibility, continues to be contentious.

Extent and Nature of Financial Integration. The big four clearing ("high street") banks in the U.K. – Barclays, National Westminster, Midland, and Lloyds TSB – are financial conglomerates, with most investment banking activities conducted through subsidiaries. Each is involved in insurance. U.K. investment (merchant) banks are among the best known in the world.

Banks' entry into insurance has been primarily through de novo subsidiaries or joint venture corporations with insurers. The joint-venture route has been followed chiefly because of the perceived need to secure insurer's expertise, although, after some time, some banks (e.g., Midland) have increased their proportionate ownership of the joint venture operation. More recently, the market has witnessed some acquisitions but without always attempting to fully integrate the banking and insurance activities.

Life insurance subsidiaries of banks have relied on various distribution channels. The main objective remains selling insurance products to bank customers. Barclays Life provides an example of a subsidiary that relies on a variety of channels. It has three main aspects in its distribution strategy: direct sales, a regional force composed of brokers and representatives, and bank branches. The latter represents more than 90 percent of sales and relies on two forces: the branch staff and Barclays Life representatives who are allocated to branches. This scheme is common among bank-insurer linkages.

This system requires the cooperation of bank employees to pass leads to the insurance specialists. The specialists are likely to be assisted by a database that includes customer attributes. A problem associated with bank employees who sell insurance products is the possible lack of skill and qualifications. This has become a significant source of concern for regulators as well as insurance and pensions intermediaries in recent years (Genetay and Molyneux, 1998, p. 69).

Perhaps the most successful and profitable U.K. financial group is Lloyds TSB.[14] It was formed in 1995 by the merger between Lloyds Bank and Trustee Savings Bank (TSB). The former TSB Group had been involved in *bancassurance* since it created its own insurer in 1972. Lloyds acquired an insurer in 1984. Neither bank took a broad view of insurance, however, until the late 1980s. Unlike their major competitors, neither bank moved aggressively into the investment banking field post-Big Bang.

In 1999, Lloyds TSB acquired the Scottish Widows, a major insurer, for $11 billion, adding substantially to its insurance portfolio. With this acquisition, Lloyds TSB holds a 9 percent share of the U.K. life and pensions market, second only to the Prudential at 11 percent.

Lloyds TSB offers a full range of life and nonlife insurance products for individuals principally through three distribution channels. Not all products sold by Lloyds TSB are manufactured by its insurance operations. In fact, only about one-half of its sales are of its own products.

About 20 percent of total insurance sales is via direct response. The expectation is that electronic commerce will further enhance this channel. Lloyds TSB Insurance unit offers products through bank branches, following a low-key approach, and often as complements to banking services such as mortgage loans. No products sold in this manner are subject to the strenuous regulatory requirements discussed above.

Lloyds TSB Life Assurance sells investment, pensions, and life policies through 3,300 tied agents. These products are subject to full regulatory disclosure and other requirements mentioned above. The sales force relies on referrals from Lloyds TSB's 2,400 U.K. branches.

Within U.K. *bancassurance* generally, the main difficulty faced by bank managers is to motivate branches to make insurance sales. The first response of managers to this difficulty has been to integrate insurance specialists into the branch networks. By doing so, they ensure the contacts between the two parties are frequent and increase the feeling of belonging to the same entity. For example, Lloyds integrated sales consultants to the branches in 1991 to increase this type of co-operation.

The second response has been the initiative by some banks to integrate insurance sales into the assessment of branch performance. This is the case at all the main banks – it encourages branch managers to motivate their staff to sell insurance. At the Royal Bank of Scotland, commissions of sales referrals and completion are fed into the branch account.

The third response to avoid conflict between insurance specialists and branch staff is to base the remuneration of the specialists in line with that of bank employees rather than traditional insurance agents. Several banks in the U.K. have opted for a salary-based remuneration for branch-based agents. At Lloyds TSB, sales consultants at branches receive a salary that is based on reaching a target level of sales. At

[14] This discussion of Lloyds TSB relies heavily on O'Connor (1999) and "A Restless Quest for Perfection" (1999).

Abbey National, the Bank of Scotland, and National Westminster, the emphasis is also on a salaried insurance sales staff. Bonuses are also common.

A major factor in promoting U.K. bank/insurer linkages was the high costs associated with traditional insurance distribution. While the U.K. is home to highly competitive insurance companies, their long-standing reliance on expensive independent financial intermediaries gave banks the opportunity to develop less expensive alternative channels of distribution.

Another factor stems from the nature of the banking relationship in the U.K. Unlike in the U.S., British citizens must qualify with the bank to be a customer. Once an individual chooses and is accepted by a bank, he or she tends to be quite loyal to that institution, buying a wide range of services. Relationships, therefore, tend to be long term, although, with competition, this is changing (O'Connor, 1999).

North America

The North American financial services market is the world's largest. The Canadian market is sophisticated, having had consolidated regulation for more than 10 years. Mexico continues to evolve, with the North American Free Trade Agreement having a profound effect on its financial services market. The United States is among the world's most sophisticated markets in terms of sectoral financial products and innovation, distribution expertise, and risk management, but integration is not as advanced as that which we find in Europe and Australia.

Canada. The Canadian financial services market is sophisticated, offering both depth and breadth. Similar to Australia, it is a comparatively small market that has undergone important structural change during the previous two decades, with more change promised.

The Regulatory and Political Environment. Canada was among the first countries to adopt a consolidated system of prudential regulation with the creation of the Office of the Superintendent of Financial Institutions (OSFI) in 1987. Until comparatively recent times, however, banking and insurance were overseen within the OSFI by separate areas, and one could not assert that the government truly practiced consolidated regulation. While the OSFI retains sectoral specialists today, it new organizational structure promises greater consolidation and cross-sector consistency (Thompson, 1999).

Financial conglomerates generally were not permitted until 1992 at which time changes allowed any federally chartered financial institution to provide a broad range of financial services, mostly via subsidiaries. This legislation effectively eliminated what historically had been called the "four pillars" (banks, insurers, trust companies, and investment dealers). Further legislative changes were made in 1997.

These changes, however, went only part way to allowing integrated financial services, as important limitations on information sharing, holding company arrangements, and ownership, among others, were retained. These limitations are believed by many observers to have hindered the orderly evolution of the Canadian financial services industry. For example, depository institutions cannot use their extensive branch networks or customer databases to support insurance marketing. The government has tabled a set of reform proposals that would soften or eliminate some of these and other constraints.

Extent and Nature of Financial Services Integration. Canada has moved toward greater financial services integration since the 1992 changes, with banks owning insurers and vice versa. Even so, the market cannot be regarded as far along the integration continuum, except for commercial and investment banking. The great majority of life insurance continues to be marketed by independent life insurers, and independent mutual fund operations dominate that sector. Most of Canada's largest investment dealers have been acquired by the commercial banks over the past decade, with the big six banks controlling 70 percent of the investment market. Few independent securities firms survive, and none is the lead firm within financial conglomerates.

The Canadian financial services business is concentrated and becoming more so with consolidation and demutualization, driven by competition. The largest six banks control about 85 percent of the Canadian bank assets and the largest six insurers, most mutuals, control 70 percent of insurer assets. The life sector, in particular, promises great change as the four largest insurers are in the process of demutualization. The market is reasonably competitive, although performance is not strong.

Both the financial services bought and the way that they are distributed have changed greatly from that just a few years ago, as ING Direct, Citizens Bank, MBNA, Wells Fargo, and others continue to introduce innovative marketing and products. During the preceding two decades, the percentage of household financial assets in banking deposits declined from 31 to 25 percent, while the percentage held in mutual funds increased from 1 to 14 percent. Banking deposits and traditional cash value life insurance sales are stagnant or declining. These shifts have been mirrored by changes in financial institutions.

United States. The U.S. is home to many of the world's largest and most profitable financial institutions. A mature market, the U.S. has witnessed considerable consolidation, with more anticipated because of recent reforms.

The Regulatory and Political Environment. The 1999 enactment of the *Financial Services Modernization Act* (known also as the *Gramm-Leach-Bliley Act*) promises the most fundamental reform in U.S. financial services regulation in more than 60 years. Even with this reform, however, U.S. financial services regulation remains highly fragmented.

Insurance. Insurance companies are authorized and regulated primarily at the level of the individual states. This system evolved from an 1869 U.S. Supreme Court case that held that insurance was not interstate commerce and, therefore, was not the proper subject of federal government oversight. After a 1944 Supreme Court case held otherwise, the U.S. Congress passed in 1945 the *McCarran-Ferguson Act* that reestablished the states as the venue for insurance regulation.

An insurer wishing to do business as an authorized insurer in each of the 50 states must secure a separate license from each state. Unlike in the EU, there is no mutual recognition and no single passport.

Besides general employment and tax laws, insurers may also be subject to other federal regulations. Thus, insurers selling variable life and annuity products are subject to regulations of the Securities and Exchange Commission (SEC). Federal law greatly influences the design and sales of many types of employee benefit plans. Life insurer marketing and product design is influenced greatly by the favorable tax treatment of policy values and definitions of life insurance for tax compliance purposes.

Commercial Banking. U.S. commercial banks are subject to multiple oversight. First, state chartered banks are subject to regulation by state banking authorities. The U.S. has a dual banking system under which banks may be either federally (national banks) or state chartered. Most large banks are national banks.

Second, the Federal Deposit Insurance Corporation (FDIC), established in 1933 through the *National Bank Act* (see below), insures the deposits of and examines member banks. The FDIC also is responsible for ensuring the orderly closure of insolvent banks. National banks are required to be FDIC members, and state banks may be members.

Third, the U.S. Treasury's Office of the Comptroller of the Currency (OCC), established in 1863, charters national banks. It also has authority to examine them, to close them, and to oversee merger applications.

Fourth, the U.S. central bank, the Federal Reserve, is not only responsible for U.S. monetary policy but also establishes reserve requirements for state and national banks. Membership in the Federal Reserve System (FRS) is mandatory for national banks and optional for state banks. The primary advantages of FRS membership are direct access to the federal funds wire transfer network for nationwide lending and borrowing of reserves and access to the discount window. The Fed also has regulatory responsibility for bank holding companies and, as discussed below, will be primarily responsible for newly allowed financial holding companies.

Securities. The regulation of the U.S. securities business has been shaped by three laws. The *Securities Act of 1933* applies to the new issues market, mandating disclosure to prospective purchasers of all material and relevant information about the security. Severe penalties apply for fraud or misrepresentation.

The *Securities Exchange Act of 1934* extends similar requirements to the secondary markets. It also requires registration of national exchanges, brokers, and dealers.

Both Acts are administered by the Securities and Exchange Commission (SEC), established in 1934, which is the primary regulatory body for the U.S. securities markets. The emphasis of U.S. securities regulation has been on consumer protection via disclosure.

The third important law shaping U.S. securities regulation is the *Glass-Steagall Act*. This law is discussed below.

Financial Conglomerates – Pre-reform. Until the recent reform, the formation of financial conglomerates was greatly hindered by two federal statutes: the *Banking Act of 1933* and the *Bank Holding Company Act* (1956). The *Banking Act of 1933* has been a fundamental part of U.S. banking and securities regulation for 66 years. Sections 16, 20, 21, and 22 of the Act collectively are referred to as the *Glass-Steagall Act*.

The Act stemmed from a belief in the early 1930s that banks' errant recommendations for and investments in stocks helped precipitate the Great Depression.[15] To rectify this perceived abuse, the *Glass-Steagall Act* effectively erected a wall between commercial and investment banking.

Over the decades, banks argued futilely for the Act's repeal, contending that such limitations harmed bank competitiveness and profitability and limited consumer choice. The intensity of their reform fervor grew in the 1970s and 1980s, with new arguments that U.S. financial institutions were at a competitive disadvantage internationally because of U.S. restrictiveness.

By the 1990s, banking regulators had done through regulatory interpretation much of that which the banks had been unable to convince the Congress to do. Regulators had interpreted the law to allow banks to trade and underwrite securities through subsidiaries, provided their activities accounted for no more than 10 percent of the group's revenues. This limit was raised to 25 percent in 1996, thus effectively allowing the largest banks to acquire the largest brokerage firms, while *Glass-Steagall* continued to bar brokerage firms from acquiring banks.

The other major impediment to integration has been the *Bank Holding Company Act* (1956) and its 1970 amendments. They limited the ability of bank holding companies to engage in commercial, insurance, and other non-bank financial services activities. Bank holding companies are corporations that own banks and non-bank subsidiaries. They are regulated under the *Bank Holding Company Act* by the Federal Reserve.

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15 Most economists and historians now dispute this view, noting that the more substantial causes were mistakes in Federal Reserve policy, the Smoot-Hawley Tariff, and a tax increase. The Act did, however, restore confidence in the banking system.

The *Bank Holding Company Act* generally prohibited bank holding companies and their subsidiaries from marketing insurance. Other legislation allowed bank marketing of insurance but only from a "place of 5,000 or less" or for other "bank related" activities. Under the OCC interpretation, subsidiaries or branches of national banks, located in small towns, did not have to limit their insurance marketing activities to those small towns.

State chartered banks historically had been similarly limited by their states' laws. However, almost all states now grant their banks some insurance sales powers, with more than one-half of the states granting their state banks broad powers to sell virtually any type of insurance.

For decades, the insurance industry, led by insurance agents, had been successful in limiting banks' insurance marketing. Two U.S. Supreme Court cases had a profound effect in the debate.

In *NationsBank v. Variable Annuity Life Insurance Company (1995),*[16] the Court held that the sale of annuities, which had been authorized by the OCC as the sale of investment products, was allowable under the *National Bank Act*. The Court held that annuities were investments and not "insurance." As such, banks would be permitted to both manufacture and sell annuities. Under state insurance law, however, banks can manufacture annuities only if they obtain a Certificate of Authority from the insurance regulator – which seems unlikely as banks are not "life insurance companies." To date, therefore, banks have been unsuccessful in manufacturing annuities but quite successful in marketing annuities underwritten by life insurers.

In the second case, *Barnett Bank v. Nelson, Florida Insurance Commissioner (1996),*[17] the Supreme Court held that a national bank with a branch and insurance agency in a "place of 5,000" may sell insurance as an agent despite state law prohibiting bank and insurance agency affiliations. Further, the court held that preemption of state law applies to any law that "prevents or significantly interferes" with the authority of national banks provided by the *National Bank Act.*

The practical effect of (1) liberal interpretations of federal limitations by bank regulators, (2) states allowing banks to sell insurance, and (3) Supreme Court decisions favorable to banks were that regulators and the courts had greatly diminished the constraints on financial integration inherent in *Glass-Steagall* and the *Bank Holding Company Act*. But diminished constraints are not the same as no constraints.

Financial Conglomerates – Post Reform. After more than two decades of trying to reform U.S. financial services regulation, success was achieved with Congressional passage of the *Financial Services Modernization Act*. The Act effectively eliminates restrictions on financial services integration in the U.S. Highlights of the Act follow.

Title I repeals *Glass-Steagall* and *Bank Holding Company* restrictions on affiliations among banks, securities firms, and insurers. It allows the creation under the *Bank Holding Company Act* of "financial holding companies" and authorizes them to engage in a range of financial activities, including insurance underwriting and distribution, securities underwriting, trading, and merchant banking activities, and banking. The Federal Reserve may not allow the creation of a financial holding company if any of its depository institutions' subsidiaries are not well capitalized and well managed or do not receive a satisfactory community reinvestment rating.

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[16] 115 S.Ct. 810 (1995).

[17] 116 S.Ct. 1103 (1996).

This title provides for state regulation of insurance subject to prohibitions on discriminating against persons affiliated with banks. It also clarifies the role of the Federal Reserve as the umbrella holding company supervisor, with functional state or federal regulation for affiliates and subsidiaries.

Title II provides for functional regulation of banks' securities activities. Title III affirms state regulation of insurance and provides for functional regulation of insurance activities. This title also contains a provision allowing mutual insurance companies to redomesticate to another state and reorganize into a mutual holding company or stock company. This provision applies only to insurers located in states not allowing creation of mutual holding companies.

Title III also preempts state laws prohibiting affiliation between insurers and banks and provides for consultation and sharing of confidential information between the Federal Reserve and state insurance regulators. Finally, this title encourages states to establish uniform or reciprocal agent licensing requirements. If a majority of the states fails to do so within three years, the National Association of Registered Agents and Brokers (NARAB), a private, non-profit entity, would be established and supervised by the NAIC. Agents and brokers could then join NARAB. Certain state laws that discriminate against NARAB members would be preempted.

Title V requires both initial and ongoing disclosure by all financial institutions of their privacy policies and an opportunity for consumers to "opt-out" of sharing of non-public personal information with nonaffiliated third parties. No prohibitions are included or affirmative actions required for the sharing of personal information among affiliated companies. Several consumerists have taken strong exception to this treatment.

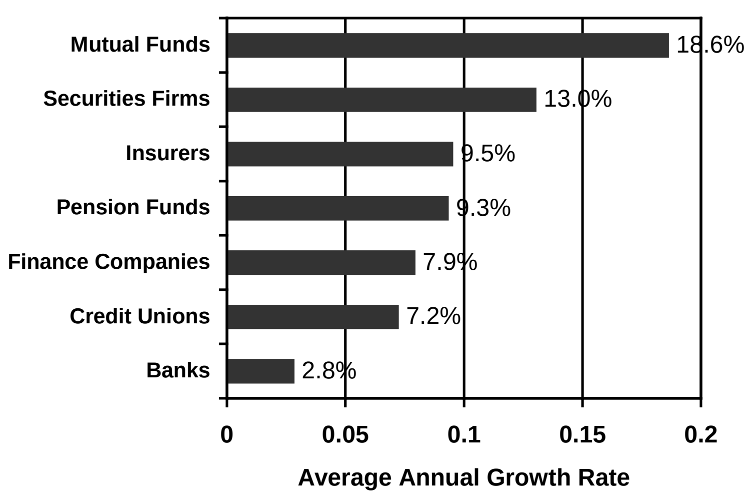
Extent and Nature of Financial Services Integration. On September 23, 1998, the Federal Reserve approved the application by the Travelers Group to acquire Citicorp. By this action, the Federal Reserve for the first time permitted a bank holding company to engage in substantial insurance underwriting activities, notwithstanding the restrictions of the *Bank Holding Company Act*. Citigroup, one of the world's largest financial conglomerates, was thus born. In the process, it arguably signaled a new, elevated stage of financial services integration in the U.S.

As a mature market with an aging population, but in the face of a surprisingly strong and stable economy and booming stock market, the U.S. financial services market is competitive and becoming more so. Consumers are increasingly comfortable with equity investments. Almost one-half of U.S. households own common stocks or mutual funds, up from 19 percent in 1983.

Consumers expect to deal with financial institutions in ways most convenient with them and not necessarily through those means dictated by the institution. As they become more sophisticated and have more money to save and invest, they expect greater financial institution efficiency and better product performance. Thus, the high costs associated with typical insurance distribution make insurance an attractive prize for banks and other depository institutions. The experience in European countries suggests that banks may be able to distribute insurance at lower costs than traditional insurance distribution channels. If true, this would be great news for depository institutions, especially as their share of total financial assets continues it decline – from about 60 percent in 1977 to less one-fourth in 1999.

With anemic bank asset growth, others enjoyed strong rates of growth. Figure 6, which shows growth rates for major U.S. financial intermediaries over the period 1986 through 1996, illustrates this point. Many of the problems for U.S. banks stemmed from regulatory restrictions and their relatively small size, limited geographical orientation, and poor management practices.

Figure 6: U.S. Asset Growth: 1986-1996



The situation has changed. Substantial consolidation has ensued, with U.S. banks again occupying the top tiers among the world's largest and most profitable financial institutions. Recent important mergers include Chemical Bank, Manufacturers Hanover, and Chase Manhattan to create Chase Manhattan; NationsBank and BankAmerica to form BankAmerica; and Bank One and First Chicago to form Bank One. The number of banks in the U.S. has declined from approximately 14,500 in the mid-1980s to less than 9,000 today. Similar consolidation is occurring in insurance. More consolidation both within sector and across sectors is expected.

Financial services integration in the U.S. is surprisingly advanced given the obstacles that many financial institutions had to address. Banks have been important marketers of individual annuities, typically for unaffiliated insurers. They write perhaps 15 percent of new annuity considerations. They have long been able to sell insurance products judged closely related to banking, including credit life and health insurance, although aggregate premiums written have been small. Their writings of nonlife insurance remain comparatively small. Banks are not prominent in securities activities, although this too is changing.

Securities firms write relatively large shares of the variable annuity business and small but increasing shares of life insurance. Schabb, Merrill Lynch, and Morgan Stanley Dean Witter are important distribution channels. Mutual funds, such as Vanguard and Fidelity, increasingly offer insurance to their customers. The Prudential, John Hancock, USAA, and several other insurers already offer banking, securities, and insurance services. Numerous insurers are establishing or have acquired thrift charters recently. Potentially among the most important is State Farm, which plans to offer comprehensive consumer banking services. Several insurers have either created their own mutual funds or have formed alliances to offer nonproprietary mutual funds through their own distribution channels.

Simultaneously, many financial institutions have become more specialized. This trend is not necessarily incompatible with the integration trends in the U.S. For example, First Union bank, with about 3 percent of U.S. bank deposits, is concentrating on the individual and small business market, Bank One (with 3 percent also) on credit cards, and J. P. Morgan on wholesale business. Each, however, offers its target market an array of financial products and services. USAA Insurance Group's target market is former military officers, but it offers them a full array of financial services.

The insurance demutualization trend in the U.S. promises to enhance consolidation and integration, as it is in Canada. Already, the Prudential, Metropolitan, MONY, UNUM, the Equitable, and several other large insurers have demutualized or are in the process.

The integration trend is being fostered by the activities of non-financial institutions. Certainly, Microsoft, Quicken, AOL, and other internet-focussed businesses have the potential for fundamentally altering financial service distribution and servicing. Diversified firms such as Ford, General Electric, and American Express already offer a full array of financial products, including banking services, credit cards, securities, and insurance.

PUBLIC POLICY CONCERNS IN INTEGRATION

Many individuals and government policy makers express concern about certain aspects of the financial services integration trends observed above. The question is whether new or additional regulation is needed to protect consumers or the financial system.

Categories of Market Imperfections

In considering this question, we should first be clear about the generic types of market imperfections of concerns to financial services regulators. These market imperfections fall into three broad categories: information problems, market power, and negative externalities. *Information problems* exist when the information that buyers or sellers have is deficient in some way, such as being incomplete or inaccurate. Thus, insurance buyers typically have incomplete information about the policies that they purchase and the insurer's financial solidity. This information asymmetry – the "lemons" problem – means that customers are at an information imbalance vis-à-vis the insurer and its agents, which could lead them unknowingly to purchase poor-value insurance or purchase it from financially unsound insurers. Hence, government intervention is justified to minimize the chances of consumers being harmed because of insurer insolvency or misleading or incomplete marketing information.

As noted earlier, *market power* exists when the seller (or buyer) can exercise meaningful control over prices. If a market were reasonably competitive, all sellers would be forced by competition to charge more or less the same prices. Firms seek to create market power and thus enhance profitability through market segmentation and product differentiation strategies.

Market power can result also from increasing returns to scale and from concerted practices among competitors that restrain competition, such as market sharing arrangements, pricing collusion, or exclusive dealings. In many instances, regulation is the source of market power for companies, as when government creates unreasonable barriers to entry for new competitors or mandates price controls (as in mandating interest rates on demand deposits or premiums for insurance policies).

Negative externalities exist when a firm's activities impose uncompensated costs on others. Ordinarily, costs of production reflect the prices of inputs. If they do not, as when a firm pollutes and "gets away with it," costs of production are understated and, therefore, the price of the good or service produced is lower than it should be. In turn, consumers buy more of the good or service than otherwise.

The most important negative externality in financial services stems from the possibility of systemic risks. *Systemic risks* exist because the difficulties of financial intermediaries can cause harm elsewhere within an economy. We can identify two types of systemic risks. The first – dubbed *cascading failures* – exists when the failure of one financial institution is the proximate cause of the failure of others. This can occur, for example, if a bank's default on its short-term credit obligations to other banks precipitates other bank failures – ultimately causing harm to the real economy.

The second type of systemic risk is a *run* in which many depositors (or other creditors) demand their money at once. Runs are caused by a loss of confidence in the financial institution, often precipitated by a real or imagined fear of insolvency. The failure of one or more banks can then precipitate runs on otherwise solvent banks, causing their failure. Similar runs in securities markets can lead to crashes.

Categories of Regulation

Government regulation of financial intermediaries is justified when market imperfections could cause substantial economic harm to consumers or the economy and, importantly, government intervention can ameliorate the harm. Governments are not always capable of ameliorating harm. (Just as there are *market* imperfections, so too are there *government* imperfections.) Generally, regulatory intervention falls into three categories: prudential, market conduct, and competition policy.

Prudential regulation is concerned with the financial condition of the financial intermediary. Market conduct regulation addresses the marketing behavior of the intermediary and its agents. Competition policy (antitrust) regulation is concerned with actions of the intermediary that have the effect of substantially lessening competition. Prudential regulation evolved primarily because of information problems and negative externalities (especially for banking). Market conduct regulation evolved primarily because of information problems. Competition policy regulation evolved because of market power concerns. Historically, prudential regulation has been the most critical element in government oversight of financial intermediaries.

Multinational Public Policy Initiatives

Financial services integration raises questions whether it introduces additional or more complex market imperfections and, therefore, whether different or additional regulation is needed. These questions are not limited by national boundaries. With the continued internationalization of financial services, it was recognized that an international approach was desirable.

Thus, at the initiative of the Basle Committee on Banking Supervision (the Basle Committee), an informal group of banking, securities, and insurance regulators was formed in 1993 to examine issues relating to supervision of financial conglomerates. The report (The Tripartite Group, 1995) was the first to address cross-sectoral issues associated with integration on an international level.

A more formal approach emerged in 1996 with the creation of the Joint Forum on Financial Conglomerates (Joint Forum), which was charged with taking forward the work of the Tripartite Group. The Joint Forum is comprised of an equal number of senior bank, securities, and insurance supervisors representing the Basle Committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors (IAIS). Thirteen countries are represented in the Joint Forum, with the EU attending in an observer capacity.

The Joint Forum's 1999 report contains papers addressing the following topics:

- capital adequacy – these papers outline measurement techniques and principles to facilitate the assessment of capital adequacy on a group-wide basis

- fit and proper requirements – this paper provides guidance to ensure that supervisors of entities within financial conglomerates are able to exercise their responsibilities to assess whether those entities are soundly and prudently managed

- sharing of information by supervisors – these papers set out general principles and a framework for facilitating information sharing between sector supervisors

- coordination of activities by supervisors – this paper provides supervisors guidance on cooperation and selection of a coordinator (lead) regulator in emergency and non-emergency situation.

Recently, papers setting our proposed principles on risk concentration and intra-group transactions and exposures have been released for comment, with further work continuing on transparency issues. Consideration is being made to renaming the Joint Forum and to an expanded mandate.

Additional but, to date, limited work on issues related to financial integration is also being carried out by the G-7 Stability Forum in the area of encouraging implementation of core regulatory principles. Finally, the Multidisciplinary Working Group on Enhanced Disclosure, created in mid-1999, has begun to study enhanced disclosure by financial institutions and how to promote market discipline in financial risk management.

Public Policy Issues in Integration

The discussion below draws from the above and other sources. Our focus is on only those public policy issues that arise from integration, not on issues of the type ordinarily dealt with by sectoral regulation alone.[18] The discussion is framed around the three classes of market imperfections and associated typical regulatory responses.

Information Problems. This area addresses potential information problems that could accompany integration. The problems are clustered around prudential and market conduct regulation. As will be seen, prudential issues dominate.

- Prudential Issues. At least six prudential issues have been mentioned as flowing from financial integration. These issues are presented and discussed below as if they were distinct from each other, for ease of exposition. Of course, they relate to each other, often intimately so. They include the following:

- Transparency

- Contagion

- Double and multiple gearing

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[18] Thus, we ignore the important issue of whether financial institutions should be permitted extensive equity investments in or other control of commercial businesses and vice versa, as this issue applies equally to isolated financial institutions.

- Unregulated group entities
- Fit and proper requirements
- Regulatory arbitrage

Transparency. Overarching all public policy concerns about financial services integration is the issue of group transparency. As it relates mainly, but not exclusively, to prudential concerns, we cover it here. Transparency concerns the extent to which accurate, complete, timely, and relevant information about the financial group is readily available to regulators. Transparency also is sometimes considered as encompassing the availability of such information to other interested parties, such as customers (especially corporate customers), citizens, rating agencies, and marketing intermediaries. This form of transparency often is classified as disclosure.

Using the narrower definition, regulators are concerned about the possibility of opaque management, ownership, and legal structures. If supervisors do not fully understand these structures, they may be unable to assess properly either the totality of the risks faced by the group or the risk that non-regulated members of the group may pose to the regulated members.

The structures of financial groups vary greatly because of tax, legal, cultural, regulatory, and historical considerations. Complexity is multiplied with such groups. Regulators are concerned that they be able to understand fully the lines of accountability relevant to their tasks. Large international financial conglomerates can be particularly complex, making effective regulation more difficult, especially with multiple national and international sectoral regulators. There is concern that some groups may choose complex structures to make their operations opaque in order to avoid or impede effective regulation (The Tripartite Group, 1995, p. 29). To avoid these problems, regulators must have the power to secure needed information from the group itself or from other regulators.

Contagion. Contagion entails the risk that financial difficulties encountered by one unit in a financial conglomerate could have adverse effects on the financial stability of the group as a whole or possibly on the entire market in which the constituent parts operate (i.e., negative externalities). Close monitoring of the relationships among entities in the group is of paramount importance. Adequate transparency minimizes the risk of contagion.

The Tripartite Group (1995, p. 19) identified two types of contagion. The first is psychological in that the market effectively transfers problems associated with one part of a conglomerate to other parts. The financial difficulties of an insurer within the group may be perceived as threatening financial performance of the bank, for example, irrespective of whether the perception comports with reality.

The second type relates to intra-group exposures. Intra-group exposures are direct or indirect claims of units within a conglomerate that are held by other conglomerate units. Some such exposures include the following:

- Credit extentions or lines of credit between affiliates
- Cross-shareholdings
- Intra-group trading in securities
- Insurance or other risk management services provided by one unit for another
- Intra-group guarantees and commitments

Intra-group exposures can have implications for both liquidity and group solvency. An example is a life insurer placing its premiums on deposit with its parent bank, a practice that might not be obvious to regulators. The Tripartite Group (1995, pp. 20 and 23) said that it was important for regulators to be made aware of all intra-group exposures and their specific purposes. Each sectoral regulator should then ensure that the pattern of activity and aggregate exposure between the regulated entity for which it is responsible and other group companies are not such that the failure of another company will undermine the regulated entity. Close coordination among regulators is essential, especially when uncertainties arise. The Tripartite Group admonished regulators that they must ensure that capital is increased or activities limited if the risk that other companies pose to the regulated entity appear to be unacceptable.

Double and Multiple Gearing.[19] Double gearing, also called double leverage, occurs whenever one entity holds regulatory capital issued by another entity within the same group and the issuer is allowed to count the capital in its own balance sheet. Multiple gearing (leverage) occurs when the subsidiary firm in the previous instance itself sends regulatory capital downstream to a third-tier affiliate. Double and multiple gearing are special classes of intra-group exposures and ordinarily are associated with parents downstreaming capital to subsidiaries. The flow can be reversed or can be by a sister affiliate.

The principal issue raised with double and multiple gearing is less the ownership structure flowing from it and more the proper assessment of a financial conglomerate's consolidated capital. With double and multiple gearing, group capital derived directly from each entity's solo capital is likely overstated. For the most part, capital derived only from external sources provides support for the group. Consequently, assessments of group capital should exclude intra-group holdings of regulatory capital.

The Joint Forum (1999, Annexes 1 and 2) noted three methodologies used for adjusting financial data for double and multiple gearing. These methodologies also accommodate the important issue of capital adequacy assessment for groups containing subsidiaries that are not 100 percent owned by the group.

Unregulated Group Entities. Additional information problems stemming from financial services integration can occur when the group contains an unregulated entity; that is, one not subject to oversight by any sectoral regulator. One such issue is excessive leveraging.[20] Excessive leveraging, another class of intra-group exposure, can occur when an unregulated parent issues debt or other instruments not acceptable as regulatory capital in a downstream entity and downstreams the proceeds to a subsidiary firm in the form of equity or other regulatory capital. The subsidiary's effective leverage may be greater than appears on a solo basis. Such leverage is not inherently unsafe but can become so if undue stress is placed on the regulated subsidiary because of the parent's obligation to service the debt.

With an unregulated holding company, an assessment of group-wide capital adequacy should encompass the effect of the holding company's structure. Regulators will, therefore, need to be able to obtain information about the holding company's ability to service all external debt.

Excessive leveraging as well as double and multiple gearing can also occur when the unregulated entity is an intermediate holding company. The group-wide capital assessment should eliminate the effect of such holding companies. Such intermediate holding companies typically are non-trading entities whose only assets are their investments in subsidiaries or that provide services to other companies.

Finally, some unregulated group entities conduct activities similar to those of regulated companies; for example, leasing, factoring, and reinsurance. In such instances, a comparable or notional capital proxy may be estimated by applying to the unregulated entity the capital requirements of the most analogous

19 This discussion draws from The Joint Forum (1999), pp. 8-9.

20 This discussion draws from The Joint Forum (1999), pp. 9-10.

regulated industry. Unregulated non-financial entities normally would be excluded from the assessment of the group.

Fit and Proper Requirements.[21] The probity and competence of the top management of banks, securities firms, and insurers are critical to the achievement of regulatory objectives, particularly as relates to prudential aspects. An effective and comprehensive supervisory regime should include controls designed to encourage the continued satisfaction of the fitness, propriety, or other qualification tests of supervisors and to allow supervisory intervention where necessary. The application of such tests for managers, directors, and key shareholders is a common regulatory mechanism for supervisors to ensure that the institutions for which they have supervisory responsibility are operated in a sound and prudent manner.

The organizational and managerial structure of financial conglomerates adds complexity for supervisors seeking to ensure the fitness, propriety, and other qualifications of the top management of regulated entities. The management of such entities can be influenced by individuals who may not be managers or directors of the regulated entities themselves. Thus, managers and directors of unregulated entities, such as those within an unregulated upstream holding company, can exercise a material influence over many aspects of the regulated entities' business and can also play a key role in controlling risks in the various entities of the group.

Additionally, for multinational financial conglomerates, issues of supervisory jurisdiction arise. A supervisor's reach may not extend beyond national boundaries. This raises the issue of the sharing of information among supervisors with respect to individuals (and companies, see below).

To address these concerns, the Joint Forum (1999, p. 43) recommended that fitness, propriety, or other qualification tests should be applied to managers and directors of other entities in a conglomerate if they exercise a material or controlling influence on the operation of regulated entities. Tests should apply as well to individuals holding substantial ownership or who can exercise material influence on regulated entities within the conglomerate.

Regulatory Arbitrage. Financial conglomerates should be expected to undertake their activities in ways that minimize their regulatory burdens and taxes. Of course, tax treatment, accounting standards, investment restrictions, capital adequacy requirements, and other elements of regulation differ between types of financial intermediaries and across countries. To the extent that sectoral regulations and taxation differ, arbitrage possibilities are created.

For example, regulations typically limit the maximum exposure that credit institutions may undertake with respect to a single client or group of related clients. Thus, in the EU, loans or other exposures to a single client may not exceed 25 percent of a bank's free capital. In contrast, limitations on insurers' counterparty exposures generally are unrelated to their capital. It is possible for an insurer's exposure to a single client to exceed 100 percent of its capital. Even in countries that subject all major types of financial intermediaries to capital-related limitations (e.g., the U.S.), they are rarely the same across different types of intermediaries. Similar examples are found with capital requirements in connection with other investments and products.

Arbitrage possibilities influence decisions about the structure of the group. If the parent firm is a regulated financial institution, as is common with banks in the U.K., the group itself could be subject to regulations applicable to that institution. The parent is fully subject to regulatory oversight. If the parent firm is an unregulated entity, as is common in the U.S., many of its activities may pass outside regulatory scrutiny.

With continued internationalization and convergence of financial services, the material differences in sectoral and cross-national regulation will gradually disappear, as governments individually and

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[21] This discussion draws from The Joint Forum (1999), pp. 41-44.

collectively converge toward more common approaches.[22] In the interim, however, arbitrage is possible. In some instances, it may result in no meaningful weakening of regulation; in others, the opposite. The Tripartitie Group (1995, p. 35) believed that regulatory arbitrage in relation to core activities in most jurisdictions was rare. That there is scope for arbitrage, however, suggests that it must be considered carefully. The suggested solutions to this issue are to move toward consolidated financial regulation where such differences are eliminated or to ensure that sectoral regulators cooperate fully with each other to identify and, if necessary, address such instances collectively.

Market Conduct Issues. Market conduct regulation is the other major regulatory category intended primarily to address information problems. The information asymmetry problems here are conflicts of interest (agency problems). Concern has been expressed that conflicts of interest within integrated financial services groups might lead to deficiencies in market conduct. These conflicts of interest were discussed above in connection with management issues in financial conglomeration. Additionally, there may be greater scope for churning of a customer's investments within a conglomerate structure.

As between commercial and investment banking activities, most authorities seem to doubt its importance, with many noting that financial firms have strong reputational incentives to address these potential problems internally. As between insurance and banking activities, the same reputational incentives should apply, plus there have been comparatively few instances of bank/insurance tie-in sales (Kelley, 1985; Diamond, 1989; *Bank Powers*, 1990; Benston, 1990 and 1994).

To the extent that proper private incentives and appropriate management control are insufficient to address conflicts of interest, a regulatory response may be called for. Already, most potential conflicts are illegal.

Market Power. The second major classification of market imperfections addressed by regulation is market power. Market power could arise through economies of scale or scope, but available evidence, as noted earlier, suggests that such economies are unlikely. Market power could, in theory, arise from size alone if barriers to entry are great. It also could evolve through predatory pricing.

An established, large conglomerate could sell at less than the cost of production if it wished to drive out smaller competitors or to discourage new entrants. As a practical matter, this option seems remote, provided there are not substantial barriers to entry (Skipper, 1997). For every large national or multinational financial conglomerate that might attempt such practices, there are several others with the financial capacity to weather the storm. Existing competition law would seem to be sufficient, if enforced reasonably, to prohibit or punish concerted anti-competitive behavior by conglomerates. An exception could occur if the collusion occurred outside of a national market but with respect to that national market, such as by large international financial conglomerates.

Negative Externalities. The third major classification of market imperfection addressed by financial services regulation is negative externalities. The principal negative externality is systemic risk, most commonly associated with commercial banking. The public policy question is whether financial service conglomerates pose a greater risk to system-wide financial stability than do solo institutions. If they do, their failure could both create greater harm to the real economy and impose greater costs on taxpayers.

Are Financial Conglomerates Riskier? In an examination of the studies on the effects on risk and return of combining banking and non-bank financial activities, Kwan and Laderman (1999) conclude that the studies generally show that both securities activities and insurance (agency and underwriting) are riskier

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22 For a discussion of these issues, see Barfield (1996).

and more profitable than banking. The literature also suggests, however, that such activities provide diversification benefits, with the result that they offer the potential to reduce bankruptcy risk.[23]

Hence, it appears that financial services integration could lead to a reduction in systemic risk. This hoped-for benefit, however, might not materialize if the smaller likelihood of failure (because of diversification) is accompanied by a much higher severity associated with those failures that do occur. That is, if financial firms are larger because of integration (a likely result), their now-less-frequent failure might cause greater harm to the financial system. In turn, government authorities presumably would be more likely to take a "too-big-to-fail" (TBTF) position.

The moral hazard problems of a TBTF policy are well known. If customers (depositors, insureds, creditors, etc.) believe that they will be made whole financially were the financial institution to fail, they have much less incentive to monitor the institution and to cease doing business with it if it takes on more risk. In turn, managers (with shareholder approval) might take on greater risk than they would otherwise (Boyd and Gertler, 1993). Thus, it is possible that large financial conglomerates, contrary to the findings of the literature, could be riskier even in the face of diversification benefits. This increased riskiness would have stemmed, however, from an increase in the risk appetite of managers and shareholders, brought about because of a TBTF policy or other reasons.

Safety Net Issues. Governments build so-called safety nets into financial systems to minimize systemic risks. The safety net includes deposit insurance or other guarantee arrangements, the discount window, and payment system guarantees.[24] Does financial service integration pose additional burdens on the safety net, with resultant taxpayer exposure?

As with a TBTF policy, safety nets create moral hazard problems. Customer incentives to monitor the condition of financial institutions with which they do business is diminished, so managers are prone to take on more risk than they otherwise would. An expansion of banking activities through integration, thus, could lead to excessive risk taking that could weaken the fabric of the financial system (Mishkin, 1999).

Neither the TBTF nor the safety net issue is new. Suggested reform proposals include the following:

- eliminate deposit insurance (Edwards, 1996)
- price deposit insurance premiums to reflect institutional risk[25]
- limit deposit insurance protection to narrow banking[26]
- increase capital requirements and enact stricter closure rules (Benston and Kaufman, 1988)
- more vigilant supervision
- impose a program of "constructive ambiguity" onto the safety net (Mishkin, 1999)

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23 Exceptions occur in certain securities activities. According to Kwan and Laderman (1999), the literature suggests that, while securities trading tends to be more profitable and riskier than banking, it may not provide diversification benefits because of its high stand-alone risk.

24 For an examination of the elements of the U.S. and other countries' safety nets and of the need for reform associated with universal banking, see Saunders and Walter (1994), chap. 7.

25 For a discussion of this proposal, see Saunders (1997), chap. 18.

26 For a discussion of this proposal, see Mishkin (1999).

These and other proposals to address the moral hazard issue seem as applicable in an integrated financial services world as in a segregated one. Supervision admittedly will be more complex as will problems of regulatory arbitrage such as moving the underwriting of products from units not within the safety net to units enjoying safety net protection. To the extent that these problems prove valid, however, they are not caused by integration but by government failure. As such, the solution is governmental reform, not limitations on integration.

The Relationship between Integration and Regulatory Structure

A final public policy concern is whether existing regulatory structures are appropriate in an integrated financial world. If financial sectors are integrating, shouldn't supervisors do the same? The underlying issue is what regulatory structure minimizes the chances of government failure in ameliorating market imperfections and does so most efficiently.

The case for consolidated regulation is both compelling and obvious. To have true consolidated regulation, it would seem that the single regulator should:

- have oversight responsibilities for all or most types of financial intermediaries, especially banks and insurers

- work under laws that are not inconsistent across types of intermediaties

- apply comparable (although not necessarily identical) regulation to all intermediaries and cross-sectoral competing products, ensuring equality of competitive opportunity between types of intermediaries

Having a single supervisory body could minimize the problems of information sharing and coordination associated with sectoral supervisors, at least at the national level. In concept, it would permit a less complex approach for addressing issues such as transparency, multiple and excessive gearing, fit and proper requirements, and contagion. Needed harmonization of accounting and capital adequacy requirements across financial intermediaries would, in theory, be facilitated. Opportunities for regulatory arbitrage should be lessened.

On the other hand, it is argued that existing solo regulatory approaches, augmented by information sharing and agreement on coordination issues, are adequate and involve less disruption. There is something to be said for building on existing structures.

Moreover, the objectives of regulation vary by sector. Banking supervision is oriented more toward stability of the financial system as a whole, rather than the solidity of individual banks or efficiency, and relies on consolidated regulation. Systemic risks are not as important in insurance as they are in banking or even securities (Skipper, 1996). Securities regulation is oriented more toward consumer protection through disclosure and market efficiency than toward system stability. Insurance regulation is oriented more toward financial soundness of individual insurers and fairness, with less focus on systemic risks and efficiency.

Additionally, arguments have been made that product differences justify solo regulatory approaches. Insurance products tend to be more complex and often involve much longer guarantees than banking and securities products. As a consequence, risk and risk management practices differ by sector and regulatory specialization offers greater efficiency.

This debate might be moot to some extent. Already many banking regulators have captured the "high ground" of consolidated regulation because of their charge to protect the financial system against systemic risks and because they already focus their regulatory efforts at the group level. Thus, so the argument goes, if a financial conglomerate contains a commercial bank, the banking supervisor should have an important voice in the supervision of the group.

No international consensus has yet emerged on this issue. Some countries already have consolidated supervision, including the U.K., Australia, Denmark, Sweden, Singapore, Japan, and Korea. Most countries retain sectoral regulation for banking, securities, and insurance, although some include investment banking within the overall banking function; for example, Germany and Switzerland.

According to Thompson (1999), Deputy Superintendent of Canada's consolidated regulator, the case for consolidated regulation is strongest in a market that exhibits the following characteristics:

- similar products and services are offered by different types of intermediaries in the same market segments
- institutions in competing sectors have similar strategies for growth and development in home and/or international markets
- institutions in one sector create systemic risk exposure for another sector
- competing sectors are at a similar and advanced stage of development
- institutions are combining in ways that make it difficult to distinguish a bank and an insurance company
- the financial services industry is pushing for reform to meet competitive pressures

Clearly, the larger the financial services market of a country, the greater the complexity and difficulty in moving to consolidated regulation. Thus, for example, substantial regulatory change in the U.S. financial regulatory system would seem problematical, even though, according to *The Economist* (October 30, 1999, p. 19), "[U.S. regulation] is hopelessly fragmented and costly." In contrast, the more modest in size is a country's financial sector, the easier it should be to move to consolidated approaches.

THE FUTURE OF FINANCIAL SERVICES INTEGRATION

Services in general and financial services in particular lie at the center of all developed economies. Financial services innovation and production efficiency are essential to continued economic development. The question is how integrated financial services fits into this evolution and whether it poses unacceptable risks to consumers and the financial system.

Whether integration leads to economies of scale or scope or greater efficiencies cannot be answered with confidence at this time. In one sense, however, the answers are irrelevant. The pressures for integration seem both unrelenting and irreversible. Financial firms are battling for customers and understand that they must allow potential and present customers to conduct their financial affairs in ways most convenient to them. This translates into figuring out how to make available a range of financial products and services through multiple distribution channels and how to offer multiple service points. Our poor understanding of the possibilities for technology to assist in making integration work hinders the making of sound forecasts.

With time being the currency of the future, the opportunities for economies of scope in consumption seem to loom large. Securing these economies does not require financial conglomeration, however. It requires integration only at the interface of the customer and the distributor (advisor), and that distributor can as easily be Microsoft as Citigroup representatives.

The market will determine whether financial conglomeration makes good business sense and, if so, the optimum operational structure. One can imagine different outcomes in different markets, depending on cultural, historical, and economic factors, such as stage of development. Additionally, even for markets in which some financial firms move aggressively to integrate, we will find many that decide that specialization offers greater opportunities. These trends seem contradictory, but they need not be. Important market segments will prefer specialized service providers, in part because their needs will themselves be highly specialized (e.g., large businesses and wealthy individuals). Additionally, we should not be surprised to find that specialized financial institutions are able to develop a better understanding of their narrower target markets and corresponding core competencies, allowing them to compete effectively with conglomerates.

The globalization of business in particular and financial services specifically fosters integration. One has but to consider whether the recent U.S. reforms would have been enacted or as sweeping without the compelling arguments from U.S. financial institutions that they were at a competitive disadvantage internationally under former U.S. law.

A byproduct of globalization and liberalization, especially for mature markets, is consolidation aided by demutualization, both of which seem destined to continue. Look particularly for greater consolidation activity in Japan, Germany, the U.S. in the commercial banking and insurance sectors, and in France. Demutualization in Japan has yet to bloom, but it will. In all instances, important transparency and fairness issues must be addressed.

Integration seems to be further advanced in Australia and the Netherlands than other countries, with France and the U.K. not far removed. Each of these and other countries with reasonably advanced integration offer a wealth of experiences for countries, such as the U.S. and especially Japan, that are not as far along. At the same time, however, care must be taken to recognize those situations or elements that do not travel well. As noted in this paper, for example, some unique circumstances aiding integration in Australia, France, the Netherlands, Spain, and the U.K. may not exist in the U.S. or Japan.

The public policy concerns accompanying financial services integration are rational but manageable with reasonable and timely governmental responses. The question is whether governments will adjust fast enough to minimize possibilities of systemic and substantial consumer harm and whether their adjustments will be no more burdensome on business than necessary. Both the management and regulation of conflicts of interest might pose the greatest challenges.

Within the U.S. and between the U.S. and the EU, however, the privacy issue stands out. Lowering the costs of gathering, storing, and using (including sharing) information lies at the heart of integration. Network externalities might also accompany integration. An unresolved issue is how to achieve the appropriate balance between an individual's right to control the flow of personally identifiable information about him- or herself and a business's (and ultimately, customers') desire for information efficiencies. A reasonable approach would seem to be to allow explicit consumer consent to share sensitive personal information between affiliated companies. Providing consent to disclose information and being notified of prospective disclosures do not provide comparable confidentially safeguards (Skipper, 1979, 1980a, 1980b).

The integration trend will push regulatory convergence in two dimensions. First, with integration and product convergence, those aspects of national regulation and taxation that are specific to one financial sector or its products can be expected to cause increasing distortion. Firms will offer products and structure themselves in ways that minimize their regulatory burdens and taxes; i.e., regulatory and tax arbitrage will ensue. This will continue to drive governments to seek greater horizontal equity in financial institution and product regulation and in taxation. In turn, this will lead to national regulatory and tax convergence. This could facilitate the move by more nations toward consolidated regulation.

Second, international differences in regulation and taxation of financial institutions and products increasingly will afford opportunities for international regulatory and tax arbitrage. This is especially true as markets continue to liberalize and as the cross-border provision of financial services grows, facilitated by the internet. Again, it is logical that firms will take advantage of these differences. Pressure will mount for governments to harmonize key elements of tax and regulation. A danger is that governments will succumb to the sirens' song of *de jure* harmonization and harmonize the wrong things or harmonize at the wrong level, thereby stifling innovation and efficiency. The superior approach is gradual convergence through mutual recognition and establishment of regulatory principles (Skipper, 1998). In this process, the importance of some meaningful degree of accounting harmonization internationally cannot be overemphasized.

Many knowledgeable observers believe that the financial world of the future will be dominated by a dozen or so financial conglomerates. Even if accurate, oligopolistic markets can remain competitive and innovative if barriers to entry remain low, especially to foreign financial service suppliers. And certainly, specialist suppliers, even if small, will provoke continuous improvement by the giants. Irrespective of the "correct" view, changing demographics and economic prosperity ensure a growing role for financial service providers and distributors.

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