



Organisation for Economic Co-operation and Development

Publication sponsored by
the Japanese Government

INSURANCE AND PRIVATE PENSIONS
COMPENDIUM
FOR EMERGING ECONOMIES

Book 1
Part 1:5)c

MERGERS AND ACQUISITIONS IN THE FINANCIAL SERVICES
SECTOR

Stephen Lumpkin

2000

This report is part of the OECD Insurance and Private Pensions Compendium, available on the OECD Web site at www.oecd.org/daf/insurance-pensions/ The Compendium brings together a wide range of policy issues, comparative surveys and reports on insurance and private pensions activities. Book 1 deals with insurance issues and Book 2 is devoted to Private Pensions. The Compendium seeks to facilitate an exchange of experience on market developments and promote "best practices" in the regulation and supervision of insurance and private pensions activities in emerging economies. The views expressed in these documents do not necessarily reflect those of the OECD, or the governments of its Members or non-Member economies.

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

The financial services sector of OECD countries is being transformed by ongoing fundamental change. Mergers and acquisitions (M&As) among financial service providers are continuing at a rapid clip in the United States, have begun to pick up under monetary union in continental Europe, and have emerged as a means of addressing asset quality problems in Asia and elsewhere. In the past year or so, a number of high-profile linkages have been forged among banks, securities dealers, and insurance companies and several other well-publicised mergers are now in the works. These combinations have occurred both within national markets and (less frequently) on a cross-border basis, and have come in a variety of forms, including: (1) acquisitions of smaller institutions by larger domestic acquirers; (2) acquisitions of large institutions by larger, more profitable domestic acquirers; and (3) domestic mergers of equals. Strategic links have been formed at both the wholesale and the retail level, and across different categories of service providers. Increasingly, M&As are being used as part of an overall strategy that entails decisions about the total product mix the institution will offer, the services that are to be provided in-house and those that are to be out-sourced, as well as the geographic area in which the institution wishes to compete.

Regardless of the differences in the current pace of restructuring across countries, the pressure for change has been increasing in virtually all OECD countries. A fairly rapid and, in some cases, accelerating consolidation of the banking sectors in several countries (e.g. the Netherlands, the United Kingdom, and the United States) has been underway for some years, while in other countries (e.g. France, Germany, Italy, Switzerland, and Japan) the pace of restructuring has clearly picked up more recently (Table 1). Although the forces creating pressure for change are similar throughout much of the OECD area, variations in the degree and nature of regulatory and supervisory regimes of the financial sectors in different countries have resulted in some disparities in the responses to this pressure. Nonetheless, it is possible to identify three broad trends that have emerged: (1) consolidation within subgroups of the financial services sector; (2) convergence among different types of service providers (i.e. banks, insurance companies, and securities dealers); and (3) increasing competition across different types of service providers and, with increasing frequency, across institutions serving different national markets.

Economic Rationale for Mergers and Acquisitions in Financial Services

Academic researchers, financial sector analysts, and some regulators have argued that no two mergers or acquisitions are exactly alike. Abstracting from the unique aspects of specific combinations, one finds that most M&As in the financial services area are a response to one or more common motivating factors. Some M&As are defensive in nature (i.e. grow larger/become more profitable or risk being acquired), while others are part of an offensive strategy to enhance revenues, intended to help one or all of the participants to acquire or more fully exploit a perceived competitive advantage.

Table 1. Merger and acquisition activity in the banking sector¹

	Number of transactions				Value of transactions							
					In billions of US dollars				As a % of all sectors ²			
	1991-92	1993-94	1995-96	1997-98 ³	1991-92	1993-94	1995-96	1997-98 ³	1991-92	1993-94	1995-96	1997-98 ³
United States	1 354	1 477	1 803	1 052	56.8	55.3	114.9	362.4	18.7	9.0	10.6	18.2
Japan	22	8	14	28	0.0	2.2	34.0	1.1	0.3	18.8	21.6	4.1
Euro area ⁴	495	350	241	203	17.5	14.6	19.1	100.4	8.3	9.3	11.2	27.1
Belgium	22	18	20	21	1.0	0.6	0.5	32.5	14.1	7.0	4.9	34.8
Finland	51	16	7	7	0.9	1.0	1.2	4.3	22.3	21.7	7.4	77.5
France	133	71	50	36	2.4	0.5	6.5	4.0	4.3	1.0	9.8	4.1
Germany	71	83	36	45	3.5	1.9	1.0	23.2	6.5	7.6	3.7	45.5
Italy	122	105	93	55	5.3	6.1	5.3	30.1	15.6	17.7	24.9	63.3
Netherlands	20	13	8	9	0.1	0.1	2.2	0.4	0.2	0.5	17.5	0.8
Spain	76	44	27	30	4.3	4.5	2.3	5.9	13.5	21.5	14.1	26.6
Norway	23	24	9	5	0.1	0.2	1.0	1.5	1.2	5.7	8.0	20.0
Sweden	38	23	8	8	1.1	0.4	0.1	2.1	3.8	2.0	0.3	7.1
Switzerland	47	59	28	22	0.4	3.9	1.0	24.3	9.5	43.4	2.4	78.3
United Kingdom	71	40	25	17	7.5	3.3	22.6	11.0	6.5	3.4	10.4	4.0
Australia	19	20	18	14	0.9	1.5	7.3	2.3	3.6	5.7	14.3	4.9
Canada	29	31	16	11	0.5	1.8	0.1	29.1	1.9	4.1	1.6	34.4
Total banks	2 098	2 032	2 162	1 360	84.7	83.2	200.8	534.2	11.7	8.5	11.0	18.9
<i>Memo item:</i>												
<i>Total non-bank financial</i>	<i>2 723</i>	<i>3 267</i>	<i>3 973</i>	<i>5 156</i>	<i>63.7</i>	<i>122.2</i>	<i>189.9</i>	<i>534.2</i>	<i>8.8</i>	<i>12.5</i>	<i>10.4</i>	<i>19.4</i>

Notes: 1) Classified by the industry of the target; only completed or pending deals; announcement date volumes. 2) Of mergers and acquisitions in all industries. 3) As at 30 October 1998. 4) Excluding Austria, Ireland, Luxembourg and Portugal. Source: BIS, Securities Data Company.

At first glance it is not easy to distinguish M&As that are defensive in nature from those based on offensive strategies. For example, an institution might move to increase the scale of its operations through a merger to ward off would-be acquirers, but the same strategy could be adopted by an institution seeking to make itself a more attractive merger candidate. Both defensive mergers and offensive combinations result in an entity that is larger in absolute size than any of its participants, and that may have greater geographic reach, if the merger is between institutions that primarily operate in different markets. However, increased size alone is not a guarantor of profitability. Empirical evidence suggests that to the extent that scale economies exist in certain financial services and products (e.g. lending to investment-grade corporate customers, global custody, and investment banking) they certainly do not exist in all areas. Thus, a decision to increase scale without regard to the mix of products and services offered may not result in improved performance, which, in the longer run, maximises shareholder value and acts as a much more effective deterrent to hostile takeovers.

Managers of financial institutions have increasingly become more cognisant of the market value of their shares. Maximising shareholder value has long been an objective of managers in English speaking countries, as reflected in share repurchase programs, cost-cutting efforts (even under favourable economic conditions), spin-offs of selected business lines and, more recently, de-mutualisation in reaction to increased price competition. Differences in governance standards still remain among OECD countries, but use of “shareholder value” is becoming more widespread, and with it has come a focus on return on assets (ROA) and return on equity (ROE) as benchmarks for performance. One important factor that has contributed to the focus by managers on earnings per share is the increased institutionalisation of savings, and the associated growing role of professional fund managers. A large share of the funds controlled by institutional investors (e.g. pension funds, life insurance companies, mutual funds, and hedge funds) is

managed by professional fund managers, whose retention is based on an assessment of their own investment performance relative to some benchmark index. These professional fund managers are more inclined than most retail investors to express their dissatisfaction with low rates of ROE. Managers of financial services firms have begun to respond to investor concerns. Perhaps the obvious solution is to widen margins, but competition in many business segments is intense and this is not easily done. Instead, as part of their efforts to improve the investment performance of their institutions, managers of banks and other financial service institutions are placing much greater emphasis on lowering costs and increasing the efficiency of their operations. This search for increased efficiency has become one of the principal motivations for M&As.

In the past, the financial services sector was segmented along distinct service lines — banking, securities, and insurance — which were the result of official regulation (in some jurisdictions) and industry practice. However, in nearly all OECD countries, governments have implemented various structural reforms that have liberalised many of the previous restraints. As a consequence, the provision of financial services has become far less compartmentalised and financial institutions of all types now offer products and services that compete not only against those offered by similar institutions but also against those offered by other categories of service providers (e.g. leveraged loans from banks compete against high-yield bonds). Moreover, dynamic offshore markets have begun to provide a strong competitive impulse, as exchange controls and other barriers to cross-border capital flows and service operations have been dismantled. As a result, many financial products are now offered globally, where institutions tend to emulate products offered in the global market, regardless of domestic restrictions.¹ Some traditional retail banking services are still provided on a regional or local level, but in many markets global providers have begun to make competitive inroads. In this environment, most service providers have been forced to re-think their strategies and re-arrange their product mix to expand in profitable new sectors, while retrenching in declining ones. M&As have played a key role in facilitating this process.

In some cases, institutions in mature product areas have used M&As to achieve growth. Managers of financial institutions have also used M&As to acquire complementary skills or gain access to market segments where the strength of one partner has offset the deficiencies of the other. Examples of these types of combinations include transactions designed to acquire an established presence in a particular geographic region or market sector, to acquire risk management skills, or technical skills. For example, many continental European banks have acquired smaller United Kingdom and United States-based investment firms with a view toward becoming global investment banks. Other institutions have pursued a strategy of expanding into a number of foreign markets, most commonly emerging economies, to provide banking services at the local level.

In addition to outright takeovers, some financial services firms have purchased significant stakes in other institutions [e.g. ING (Netherlands) stake in BHF (Germany) and KBC's (Belgium) stake in Cr dit Commerciale de France], while others have formed international alliances accomplished by way of small equity swaps. Many of these transactions have cut across traditional barriers, involving banking organisations, insurance firms, and securities dealers. The securities industry has been consolidating for decades. In the 1980s and early-1990s, many ownership linkages were established between insurance companies and investment banks/ broker dealers. Somewhat later, mergers took place between investment banks that operated mostly in the wholesale markets and those with sizeable retail networks. In the past year or so, banking organisations have begun to acquire or forge linkages with investment banks to gain entrance to or enhance their capabilities in providing “one-stop shopping”, whereby a bank or investment bank offers both leveraged loans and high-yield bonds in one transaction to a single borrower (Table 2).

¹ Corporate lending has been a global product for more than a decade and middle-market lending appears to be moving in that direction as well.

Table 2. Notable bank/investment bank mergers

(1997)

<u>Transaction</u>	<u>Millions of US dollars</u>
Union Bank of Switzerland with Swiss Bank	\$25,000
First Union with CoreStates	16,000
NationsBank with Barnett Banks	13,800
Morgan Stanley with Dean Witter Discover	10,500
First Bank System with U.S. Bancorp	8,900
Salomon Brothers with Smith Barney	8,800
First Union with Signet Banking	3,300
Bankers Trust with Alex. Brown	1,700
Fleet Financial with Quick & Reilly	1,530
NationsBank with Montgomery Securities	1,200
U.S. Bancorp with Piper Jaffrey	730
Swiss Bank with Dillon Read	600
Bank of America with Robertson Stephens	540
Canadian Imperial Bank of Commerce with Oppenheimer	525
ING with Furman Selz	500
First Union with Wheat First Butcher Singer	484

Source : Loan Pricing Corp./Gold Sheets

Faced with narrowing margins in some business segments and stiff competition in others, a number of firms in the banking, securities, and insurance sectors have turned to asset management as a potential source of expansion. Ageing populations, worsening dependency ratios and inadequate state funded pension systems have led many countries to promote the development of private, defined contribution pension plans. Institutions have been positioning themselves to benefit from the expected increase in the volume of saving for retirement purposes by offering a mix of portfolio management services for institutional investors as well as collective investment products for individuals (e.g. mutual funds, unit investment trusts, etc.). M&As have continued to transform the asset management business with the largest managers growing even larger. The number of asset managers running global portfolios has also increased and many of the largest non-US asset managers (e.g. Barclays Global Investors, UBS, and AXA) derive a large portion of their assets under management from outside the home market. Nonetheless, there are no undisputed leaders in the global funds management area, and in some markets, notably the United States, the asset management business remains highly fragmented and hence a candidate for consolidation down the road.

In the insurance sector, life companies have encountered sluggish demand for traditional insurance products in recent years, while facing increased competition from entities such as banks and mutual funds in the market for asset accumulation products such as annuities. The result has been a narrowing of profit margins, which has forced many firms to seek ways to reduce costs. As in other segments of the financial services sector, the result has been considerable restructuring, with both an expansion in consolidation within the industry and an increase in linkages with other service providers. Mergers with banking organisations (often referred to as “bancassurance”) have been an important component of this restructuring process, especially in continental Europe. These combinations enable the participants to

consolidate their asset management businesses. Bank acquirers get an extension of their retail banking product lines, while insurers get an established distribution network — the bank’s branches. However, the ability to cross-sell products and services is not a guarantee of profitability. It is still necessary to blend the two cultures (banking and insurance) and experience suggests that this has not always been done successfully.

A large academic literature has examined the various motivations for mergers.² In the empirical literature, the motives for consolidation of financial institutions can be placed in two basic groups — value maximising and non-value maximising (e.g. empire building). The participants in any given M&A transaction might have more than one motive for combining their operations and, in the absence of specific internal information, it is difficult to determine what these motives might be. The usual approach taken in practice has been to identify the outcome of the consummated transaction and then infer from that result what the intent of the participants must have been. For example, evidence that M&As result in increased market power or increased efficiency is consistent with the presumption that the expected pricing power or efficiency improvements were (at least) part of the motivation for consummating the arrangements. The same factors — increases in the participating firms’ market power in setting prices and improvements in their efficiency — also help to maximise shareholder value, which a number of analysts consider to be the ultimate goal of M&As, while acknowledging that other stakeholders (e.g. managers and governments) may have non-value maximising motives. For example, in situations where corporate governance controls are relatively weak, managers might be able to pursue objectives such as empire-building, profiting from the usual positive link between firm size and executive compensation. However, few would argue that all, or even most, M&A combinations result from non-value maximising objectives.

In general, the empirical evidence supports the view that some M&As are motivated by expected increases in market power, expected improvements in profit efficiency and expected diversification benefits, but there appears to be little or no improvement in cost efficiency, on average, at least for some types of consolidation. In particular, results from a number of studies show that in a substantial proportion of M&As a larger, more efficient institution has taken over a smaller, less efficient institution, perhaps to spread the expertise or the operating policies and procedures of the more efficient institution across additional resources. In the case of banks, evidence from the United States and Europe suggests that M&As may be motivated at least in part by expected efficiency gains. There is also evidence in support of the proposition that the potential for efficiency gains may motivate consolidation in the other segments of the financial services sector. In the United States life insurance industry, for example, acquiring firms have tended to be more efficient than average, while target firms have tended to be financially impaired.³ Similarly, studies have shown that acquirers in the United States credit union industry tend to be larger than average, while targets tend to be smaller in size and in weaker financial condition than credit unions that are not targets of M&A activity.⁴

M&As may also be motivated by the potential for improvement in the risk-expected return profile of the combined entity. Diversification gains can be achieved by expanding the skill set of managers, offering a broader range of products, spreading credit risk across industries or regions, or servicing a wider clientele.

² For an excellent review of this literature, see Allen N. Berger, Rebecca S. Demsetz, and Philip E. Strahan “The consolidation of the financial services industry: Causes, consequences, and implications for the future”, *Journal of Banking and Finance* 23 (1999), pp. 135-194.

³ See J.D. Cummins, S.L. Tennyson, and M.A. Weiss, “Consolidation and efficiency in the US life insurance industry”, *Journal of Banking and Finance* 23 (1999), pp. 325-357.

⁴ H.O. Fried, C.A.K. Lovell, and S. Yaisawarng “The impact of mergers on credit union service provision”, *Journal of Banking and Finance* 23 (1999), pp. 367-386.

Consistent with this notion, one study of United States banks found that acquirers tended to submit higher bids for targets when the merger or acquisition would result in significant diversification gains.⁵

Factors Driving Mergers and Acquisitions in Financial Services

There is fairly widespread agreement among market participants and academic researchers as to the factors that have been driving the ongoing restructuring of the financial services sector. Among the key drivers of the recent fast pace of M&A activity are **deregulation, international consolidation of markets, excess capacity/financial distress, and technological advances**. Together these forces have been rapidly transforming the global financial landscape and the resulting increase in and, in some areas, acceleration of competitive pressures has encouraged the expansion in M&A activity. These factors are not mutually exclusive. For example, technological change has encouraged financial globalisation and there is some evidence that technological innovations in deposit taking and lending may have encouraged deregulation. Advances in telecommunications and computing equipment have dramatically lowered transaction costs for financial services. In the process, many products have been converted into commodities, barriers between service segments have been bypassed, and search costs have declined as well. In addition, consumer attitudes to technology have changed. Individuals have greater access to and greater familiarity with electronic delivery mechanisms, and are showing greater willingness to use them. For instance, electronic platforms are increasingly being used for trading purposes by retail customers. Accordingly, many innovations in the design and delivery of financial services are making use of the internet as a means of reaching customers. This change in consumer attitudes has enabled providers to take advantage of technological advances to service a larger number of customers at lower cost and achieve a scale that previously would not have been manageable.

In conjunction with technological innovations and the resultant lowering in transaction costs, factors such as monetary union in Europe and the adoption of international accounting standards in other regions are resulting in increased transparency in the pricing of financial services.⁶ These developments, in turn, are helping to expose inefficiencies that institutions in these regions are beginning to identify and address. One major inefficiency that gets exposed is the difference in productivity levels across service providers. Weaker performers are being forced to either seek merger partners or shrink their operations in some way. Going forward, the ongoing restructuring is expected to result in three major categories of financial service providers: (1) institutions that operate within a specific, well-defined regional area; (2) institutions that specialise in the provision of specific products and services such as mutual funds or banks that specialise in niche areas such as private banking, retail operations or other services; and (3) wholesale commercial and investment banks that provide products and services that are subject to scale economies and require a global reach, such as cash management, custody and trade services, and investment banking.

Regional Variations in Merger Activity

This restructuring of the financial services sector is accelerating throughout the OECD area, with a spate of new M&As arranged recently within the banking sector and between large banking organisations and other categories of financial service providers. In the **United States**, while the pace of consolidation has been torrid of late, large scale mergers among financial have been occurring for the past two decades as that nation continues moving from the fragmented system of many separate state banking structures brought about by legal restraints toward a more nation-wide banking structure. The United States banking system

⁵ G.J. Benston, W.C. Hunter, and L.D. Wall “Motivations for bank mergers and acquisitions: Enhancing the deposit insurance put option versus earnings diversification”, *Journal of Money, Credit, and Banking* 271 (1995), pp. 777-788.

⁶ For a discussion of the impact of the monetary union on the Euro area, see “Special Focus: Challenges for the Euro Area”, *Financial Market Trends*, 72 (February 1999), pp. 19-81.

was historically subject to tight restrictions on geographic expansion, both within and across states, while federal laws mandated the separation of the banking, securities, and insurance businesses. Both types of restrictions have diminished significantly.

The removal of legal restrictions on geographic expansion began in earnest in the mid-1980s, when most states passed laws allowing the acquisition of in-state banks by out-of-state banks. The Riegle-Neal Act of 1994, which took effect on 30 June 1997, subsequently provided for interstate banking and branching at the national level but by that time, Hawaii was the only state that had not already enacted some form of interstate banking legislation. In large part, the consolidation of the United States banking system reflects the response by larger banking organisations to the change in the statutory environment and the increased opportunities for geographic diversification. The beginning of the erosion of Glass-Steagall happened in 1987 when the Federal Reserve granted three banking organisations permission to underwrite and deal in certain securities. Further impetus came in December 1996, when the Federal Reserve lifted the amount of investment banking income a bank could earn from its Section 20 subsidiary to 25 per cent from 10 per cent.

As in other jurisdictions, however, the increased consolidation of financial service providers in the United States cannot be attributed solely to the adjustment by institutions to a new operating environment. As noted previously, banks and other financial institutions are also responding to increased competitive pressures brought about by rapid advances in computing and telecommunications, and the resultant blurring of distinctions among the various types of financial institutions, lower barriers to entry owing to deregulation, and increased globalisation. The latter influence appears to be especially important to institutions that specialise in lending to large corporate customers and other wholesale services. Of course, consolidation has also been occurring among retail service providers and among specialist institutions such as credit card companies. Another recent phenomenon is the consolidation of banking subsidiaries into single banks by multibank holding companies. The result of the ongoing M&A activity is a continued decline in the number of banks (Table 1).

Table 3. Number of Banks in the U.S.

(Year-End 1990-98)

<u>Year</u>	<u>Number of Banks</u>
1990	12,230
1991	11,814
1992	11,362
1993	10,870
1994	10,351
1995	9,842
1996	9,426
1997	9,054
1998	8,688

Source : Federal Reserve Bank of Philadelphia

In **Europe**, the pace of M&A activity has also quickened considerably, although the overall volume of M&As has not reached the proportions registered in the United States. In the Euro zone, liabilities are no longer in the domestic currencies, and benchmarks have become euro-based as well. European banks have not faced legal restrictions on geographic expansion within national borders or on product lines, restraints that historically constrained banks in the United States. Partly reflecting this freedom, the European financial system has in many respects been a bank-dominated culture. For example, banks in continental Europe have typically had a much larger share of total intermediated credit than those in United States. Similarly, the distribution of investment products in continental Europe has largely been handled by the banking system, while in the United States in particular, but in Anglo countries in general, the direct sale of securities to ultimate lenders is much more widespread. Owing to linguistic and cultural differences and

perhaps also exchange rate considerations, most banks and other financial institutions in continental Europe tended to focus on their own “national” markets. The directives resulting in the post-1992 European financial market removed most legal barriers to offering services throughout the European Union, but retail banking and the distribution of primary market issues remained largely national, rather than continental, services and products. For institutions participating in the European Monetary Union (EMU), this is likely to change.

EMU is expected ultimately to result in the development of a fully integrated European financial market, with increased use of the capital markets by corporate customers and less reliance on relationship-based lending. EMU potentially creates opportunities for a wider distribution of other financial services, including wholesale underwriting, pan-European asset management, operating services, and consumer/private banking. This is expected to result in increased competition for banks in the EMU area, both from other domestic and foreign banking organisations and from other providers of financial services. Earnings growth in traditional banking businesses such as foreign-exchange trading, corporate lending, and government bond trading will likely be substantially reduced as markets develop under EMU. Many banks in the EMU area are relatively overstaffed and over-branched (Table 3). Moreover, based on common

Table 4. Bank restructuring: number of branches¹

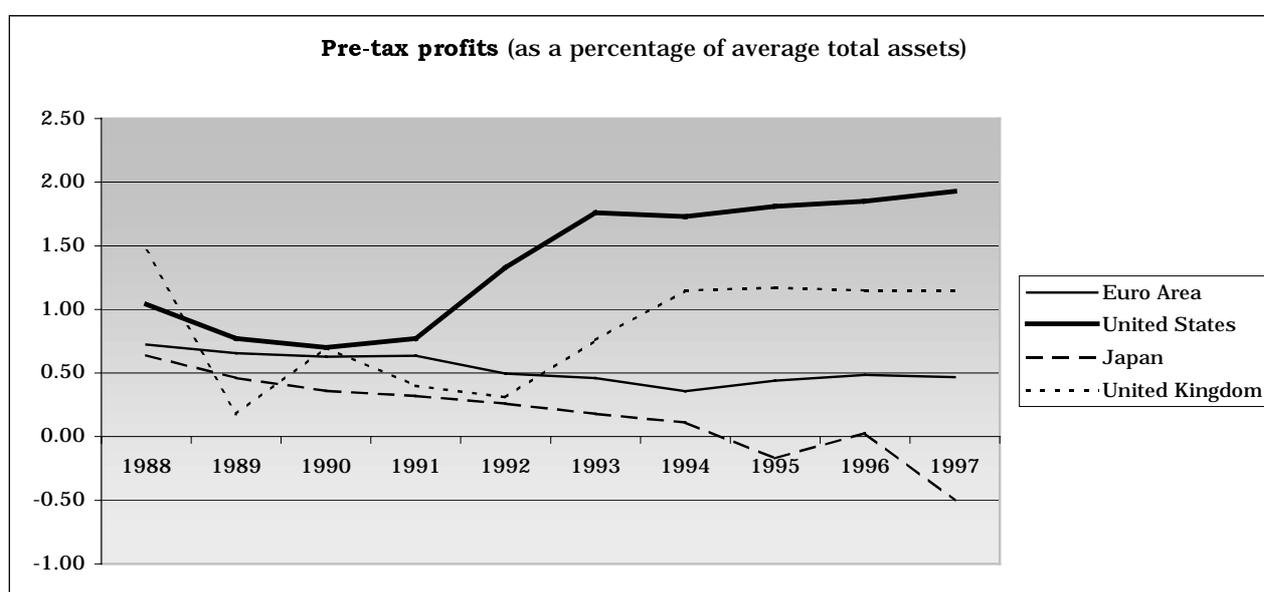
	1980 ²	1990	1997	Peak		
	Number (in thousands)				year	% change ³
United States	58.6	70.0	76.9	76.9	1997	–
Japan	13.9	22.6	23.3	23.5	1995	– 0.7
Euro area ⁴	130.4	148.4	159.9	159.9	1997	–
Austria	3.4	4.5	4.7	4.7	1997	–
Belgium	7.8	8.3	7.4	8.5	1989	– 13.2
Finland	3.4	3.3	1.2	3.5	1988	– 64.9
France	24.3	25.7	25.5	25.9	1987	– 1.7
Germany ⁵	39.3	43.6	47.1	49.2	1992	– 4.3
Italy	12.2	17.7	25.6	25.6	1997	–
Netherlands	6.6	8.0	7.0	8.5	1986	– 17.0
Portugal	1.4	2.0	3.8	3.8	1997	–
Spain	25.8	35.2	37.6	37.6	1997	–
Norway	1.9	1.8	1.6	2.2	1987	– 27.2
Sweden	3.7	3.2	2.5	3.7	1980	– 31.1
Switzerland	3.7	4.2	3.3	4.2	1990	– 19.9
United Kingdom	20.4	19.0	14.3	21.2	1985	– 32.5
Australia	6.3	6.9	6.1	7.1	1993	– 13.4
Canada	8.8	8.7	9.4	9.4	1997	–

Notes: 1. Deposit-taking institutions; for the United States, excluding various types of credit co-operative. 2. For the Euro area, France, the Netherlands and Portugal, 1981; for Australia, 1987. 3. From peak to most recent observation where applicable. 4. Excluding Ireland and Luxembourg. 5. For 1980, western Germany only.

Sources: British Bankers’ Association; Building Societies Association; national data.

accounting measures of performance, banks in the EMU area have been at the lower end of profitability in recent years (Chart 1). Thus, the added boost to competition expected in the EMU area intensifies the pressures on banks in the region to remove the excess capacity and improve their performance.

The necessary restructuring can take a number of forms: (1) institutions can reduce the scale of their operations by cutting back, or exiting completely, unprofitable lines of business; (2) larger or more profitable institutions can absorb smaller or less profitable ones; or (3) poorer performers can be driven from the market. In practice, the first two forms of adjustment have accounted for the bulk of the consolidation in the sector. In most European countries, the strategic response thus far has been consolidation **within** domestic borders, with larger institutions acquiring smaller ones and eliminating overlapping branch networks in the same locality. Direct provision of cross-border retail services still has a few hurdles to overcome, and explicit or implicit forms of protection have hampered cross-border acquisitions of large banks in the region. Nevertheless, mergers involving larger players are becoming more frequent, and while the few cross-border mergers that have been completed (mostly bank/insurance linkages) have not (yet) produced large gains in profitability, most experts consider cross-border consolidation in the region to be inevitable. Toward that end, market participants are expected to watch carefully for the coming cross-border mergers of banks in the region for clues on how to overcome regulatory or other hurdles and the difficulties arising from different historical traditions and cultures.



In Asian OECD countries (**Korea** and **Japan**), consolidation of the financial services sector has proceeded more slowly than in the United States and Europe, and generally has been motivated more by the need to re-capitalise distressed financial institutions rather than the search for efficiency. Bank supervisory authorities in the region have encouraged mergers or forced acquisitions as a means of resolving failed institutions. This is especially the case in Japan, where the process of consolidation is likely to continue for some time. As illustrated in Chart 1, Japanese banks have reported low or declining profits for a number of years. This weak performance has sharply diminished the number of Japanese banks in the ranks of global players. The planned merger of Industrial Bank of Japan, Fuji Bank, and Dai-Ichi Kangyo Bank likely has been motivated in part by a desire to establish a Japanese financial group that can compete in the global financial market. However, as with other restructuring efforts, success will depend on the ability of the merged entity to cut costs and improve efficiency.

The liquidation of bad loans has not fully run its course, and further consolidation in the Japanese banking industry will almost certainly be required either through additional mergers or the forced liquidation or sale of the weakest institutions. Greater attention to efficiency will be needed as the authorities work to ensure that a sufficient number of domestic institutions remain viable to compete in servicing the financial needs of the country. Thus far, cross-border linkages have played only a small role in the restructuring process, and foreign hostile takeovers of Japanese financial institutions are virtually non-existent. However, there

may be scope going forward for increased participation by foreign institutions in the more liberalised financial services sector that is expected to evolve as deregulation of brokerage commissions and other remaining “big bang” reforms progress.

Financial crises or major problems with large banks also contributed to accelerated changes in the banking landscape in countries such as Finland, France, Mexico, Norway, Sweden and the United States. The evidence suggests that consolidation has proceeded fastest and in some respects furthest in Sweden, Finland and Norway. Korea provides another example in which high barriers to foreign bank entry have been eroded by a systemic crisis of such magnitude and scope that it required a massive capital infusion and could not be resolved solely by consolidation of domestic institutions. As in some other episodes of systemic banking crises, the Korean banking authorities have found foreign institutions to be the only group of strategic investors with the financial resources, risk management skills, and managerial expertise needed to re-capitalise and restructure failed institutions. Thus, as part of policy response to the crisis, the banking authorities moved to strengthen governance of banks and to allow foreign interests to acquire strategic stakes in domestic institutions of up to 100 per cent. Further, foreign banks and securities firms, which previously were restricted to branches, were permitted to establish branches or subsidiaries.

Cross-border linkages are also likely to play a key role in other jurisdictions where the authorities still face the task of rehabilitating weak institutions. Banking systems in **Mexico**, elsewhere in Latin America, and in most of the developing countries in South East Asia have experienced systemic crises in the past five years or so that have left many institutions under-capitalised relative to international standards. Resolving the lingering asset quality problems and raising the necessary capital will likely entail a considerable expenditure of public funds, as well as securitisation, direct sales of assets, and mergers of weak institutions with stronger domestic or foreign partners. As part of the process of rehabilitating weak institutions, new opportunities for foreign institutions should emerge. In fact, financial institutions based in the OECD area have already begun to acquire banks in Latin American and Asia.

Mergers, Strategic Acquisitions and Public Policy

Governments play a role in the restructuring process by restricting the types of M&As permitted (e.g. placing limits on or prohibiting cross-border mergers or mergers between banks and other types of service providers) and through approval/disapproval decisions for individual M&As. In some jurisdictions, public ownership of banks, with direct control by the State or by banking foundations, is another means by which government affects the process of restructuring.⁷ In some cases, analysts have argued that the existence of large numbers of state-owned regional and savings banks has acted as an impediment to the consolidation of the domestic banking sector. Governments also affect the process indirectly. For example, rigid labour laws in a number of jurisdictions have been cited as factors limiting the ability of acquirers or merger participants to achieve necessary cost savings by reducing the number of employees or cutting lines of business.

Corporate governance practices, especially the position of shareholders relative to other stakeholders, are also relevant. Managers of financial institutions have been paying greater attention to the interests of shareholders in recent years, and this has encouraged the restructuring process by increasing the focus on profitability and the return on assets, rather than on the size of the balance sheet.

In all OECD regions, the authorities are reconsidering the legal and regulatory framework in which financial institutions operate. Deregulation of the banking sector has not fully run its course, and in many jurisdictions, deregulation of the insurance sector has trailed behind that of the banking sector. In this environment, the ongoing changes in the financial services sector, whereby institutions compete across a number of dimensions, raise a number of policy concerns for officials. Among the policy issues that arise

⁷ Large public-owned banks are numerous and of some importance in France, Germany and Spain.

from the current wave of consolidation are the size of financial institutions and their impact on markets, including the implications for competition policy and financial stability; the growing complexity of financial conglomerates brought about by the convergence among banks, managed funds, securities firms, and insurance companies; and the problems encountered in supervision of globally operating institutions.