Chapter II

Fundamental causes of consolidation

1. Introduction

This chapter is concerned with the fundamental causes of consolidation.[33] To this end, it reviews and builds upon the extensive body of literature academic scholars and other researchers have produced in this field. As generalisations about the main forces driving consolidation are sometimes affected by country-specific circumstances, interviews have been conducted with 45 selected industry participants and experts from the G10 countries, Australia and Spain. These individuals have been asked for their opinions on the basis of a common interview guide, which covers the issues of each section of the chapter.

The analysis distinguishes between motives for consolidation and the environmental factors that influence the form and pace of consolidation. In practice, motives and environmental factors are intertwined, but for the purposes of this chapter it has proven useful to treat them separately. The environmental factors are divided into two categories: those that encourage consolidation and those that discourage consolidation.

The remainder of the chapter is structured as follows. Section 2 analyses the motives for consolidation in the financial sector and examines the main empirical studies. Section 3 deals with the environmental factors encouraging consolidation, which include technological change, deregulation, globalisation, the institutionalisation of savings, and the introduction of the euro. Section 4 discusses the factors that may discourage or impede financial sector consolidation, such as regulations and differences in culture and corporate governance. Section 5 examines three possible future scenarios, based mainly on the outcomes of the interviews. Annex II.1 contains country synopses based on the interviews, where the country-specific causes of consolidation are described. Annex II.2 provides technical information on the structure of the interviews.

2. Framework

Theory

Mergers and acquisitions in the financial sector are undertaken for a wide variety of reasons. In any given case, more than one motive may underlie the decision to merge. Motives may vary with firm characteristics such as size or organisational structure, over time, across countries, across industry segments, or even across lines of business within a segment. In the framework used in this chapter, the motives for mergers and acquisitions are broken down into two basic categories: value-maximising motives and non-value-maximising motives. In a world characterised by perfect capital markets, all activities of financial institutions would be motivated by a desire to maximise shareholder value. In the "real" world, while value

[33] In this chapter, mergers and acquisitions and consolidation are considered as synonyms. The various forms of consolidation are described in more detail in Chapter I.

maximisation is an important factor underlying most decisions, other considerations can, and often do, come into play.

Value-maximising motives

The value of a financial institution, like any other firm, is determined by the present discounted value of expected future profits. Mergers can increase expected future profits either by reducing expected costs or by increasing expected revenues.

Mergers can lead to reductions in costs for several reasons, including:

- economies of scale (reductions in per-unit cost due to increased scale of operations);
- economies of scope (reductions in per-unit cost due to synergies involved in producing multiple products within the same firm);
- replacement of inefficient managers with more efficient managers or management techniques;
- reduction of risk due to geographic or product diversification;
- reduction of tax obligations;
- increased monopsony power allowing firms to purchase inputs at lower prices;
- allowing a firm to become large enough to gain access to capital markets or to receive a credit rating;
- providing a way for financial firms to enter new geographic or product markets at a lower cost than that associated with de novo entry.

Mergers can lead to increased revenues for a variety of reasons, including:

- increased size allowing firms to better serve large customers;
- increased product diversification allowing firms to offer customers “one-stop shopping” for a variety of different products;
- increased product or geographic diversification expanding the pool of potential customers;
- increased size or market share making it easier to attract customers (visibility or reputation effects);
- increased monopoly power allowing firms to raise prices;
- increased size allowing firms to increase the riskiness of their portfolios.

Non-value-maximising motives

Managers’ actions and decisions are not always consistent with the maximisation of firm value. In particular, when the identities of owners and managers differ and capital markets are less than perfect, managers may take actions that further their own personal goals and are not in the interests of the firm’s owners. For example, managers may derive satisfaction from controlling a larger organisation or from increasing their own job security. Thus, they might engage in mergers designed to increase the size of the firm or reduce firm risk, even if such mergers do not enhance firm value. Managers may acquire other firms in order to avoid being acquired themselves (defensive acquisitions), even if being acquired would benefit the firm’s owners. In some cases, managers may care about the size of their firm relative to competitors, leading them to engage in consolidation simply because other firms in the industry are doing so.

The role of government

Government policy can play an important role in either facilitating or hindering consolidation. Governments sometimes facilitate consolidation in an effort to minimise the social costs associated with firm failures. In the United States, for example, government agencies provided financial assistance to healthy banks that acquired failing banks during the banking crises of the 1980s and early 1990s. Financial crises or major problems with large depository institutions also contributed to accelerated changes in the banking landscape in France, Japan, Scandinavia and the United Kingdom. In resolving failed institutions, supervisory authorities have often encouraged mergers or forced the liquidation and sale of the weakest institutions. For example, in Japan during the banking crisis of the 1990s, government funds were deployed to support reconstruction and consolidation of the banking sector. Governments may also promote consolidation in an effort to create a "national champion" that can compete effectively in the global arena. At the same time, laws requiring regulatory approval of mergers and acquisitions or prohibiting certain types of mergers and acquisitions (because of their implications for competition, financial stability, potential conflicts of interest between commercial and investment banking, or other reasons) have the potential to hinder consolidation.

Empirical evidence on the motives for consolidation

Numerous empirical studies have attempted to determine the motives for mergers, both within the financial services sector and more broadly.[34] Unfortunately, the actual motives for mergers are not directly observable and may differ from those stated by management at the time of a merger announcement. Researchers are limited to inferring the motives from observable factors such as the relationship between average cost and firm size, the characteristics of firms that merge, the effects of mergers on stock prices, and the post-merger performance of cost and price measures.

Economies of scale and economies of scope

Many researchers have estimated the relationship between average cost and firm size or product scope for the banking industry, in an attempt to determine the importance of economies of scale and economies of scope in banking. Studies of economies of scale and economies of scope in financial services sectors other than commercial banking are less numerous. Overall, these studies seem to support the view that economies of scale may be a motivating factor for mergers involving small or medium-sized financial services firms, particularly during the 1990s. They do not provide support for the view that economies of scale are an important factor driving mergers involving the very largest firms in the industry. It should be noted, however, that for very large diversified firms, economies of scale may be more difficult to detect because they may be limited to certain product lines and not show up in aggregate, firm-level data. Thus far, there seems to be little or no evidence in support of the importance of economies of scope as a motivator.

Cost efficiency

In some cases, managers do not operate a firm in a manner that minimises the cost of producing given quantities and combinations of products. In this case, the firm is said to suffer from cost inefficiency. Consolidation can help to eliminate cost inefficiency if the acquiring firm's management is more effective at minimising costs than the target's management, and is able to eliminate unnecessary costs after the combination takes place. Studies of the characteristics of the firms involved in financial sector mergers and acquisitions generally support the view that efficiency gains motivate consolidation. These studies tend to find that acquiring firms are more

[34] See Chapter V for a review of this literature.

cost efficient than target firms. However, studies that examine ex post changes in cost efficiency resulting from mergers and acquisitions generally fail to find any evidence that efficiency gains are realised. The consistent failure of research to document efficiency gains from mergers may reflect accounting complexities that make it very difficult to measure changes in cost efficiency or unanticipated difficulties in achieving post-merger efficiency gains. Nonetheless, these studies cast some doubt on the significance of efficiency gains as a motivating factor.

Monopoly power

Mergers and acquisitions can sometimes enhance monopoly power, allowing firms to increase profits by setting prices that are less favourable to customers. This is particularly true when the merging firms are direct competitors and their combination results in a substantial increase in market concentration. Few studies have directly examined the effects of financial sector mergers and acquisitions on prices. Although the findings of these studies are somewhat mixed, those that focus on the types of mergers that are most likely to increase market power do find evidence of significant price effects. Numerous studies have examined the effects of bank mergers on profitability. Some have found increased profitability associated with mergers and acquisitions, while others have not. However, increased profitability does not necessarily imply increased monopoly power, since efficiency gains or cost savings owing to scale or scope economies could also yield improvements in profitability ratios.

Although the evidence is sparse, it seems likely that when direct competitors merge, especially when they already operate in a fairly concentrated market environment, increased monopoly power is one of the factors motivating the consolidation.

Non-value-maximising motives

As indicated above, when capital markets are imperfect and there is separation of ownership from management, managers may undertake consolidations (or other activities) that are not in the interest of the acquiring firm’s owners. A number of mechanisms exist to reduce the probability of managers engaging in activities that are contrary to the interests of the firm’s owners. These include:

- ***Managerial stock ownership***. If managers own a substantial amount of stock in the firms they run, they are likely to have a personal interest in maximising firm value.
- ***Concentrated shareholder ownership***. If shareholder ownership is highly concentrated, shareholders are likely to do a better job of monitoring managerial behaviour than if shareholder ownership is widely dispersed.
- ***Presence of independent outsiders on the board of directors***. Likewise, monitoring of managerial behaviour is likely to be easier or more effective if there are independent outsiders on the firm’s board of directors.

Numerous studies of non-financial firms and a few studies of commercial banks have examined the extent to which these mechanisms reduce the probability of managers entering into non-value-maximising mergers.[35] Although the studies do find evidence that these mechanisms are somewhat effective, their findings provide support for the view that at least some mergers are undertaken for reasons other than value maximisation.

Evidence from the interviews

In the interviews with financial sector participants and industry experts, a number of questions were asked about the motives for consolidation, distinguishing within-country from cross-

[35] See, for example, Allen and Cebenoyan (1991) and Subrahmanyam, Rangan and Rothstein (1997).

border combinations, and within-segment from across-segment combinations. (Responses to questions about the motives for consolidation are summarised in Chart II.1.) Several interviewees indicated that motives differed across industry segments (eg commercial banking versus investment banking versus insurance) and across product lines (notably between wholesale and retail services), as well as with firm size. However, the number of interviews is not large enough to allow meaningful distinctions to be drawn along these various dimensions in analysing the responses.

With respect to within-country, within-segment mergers, the single strongest motivating factor appears to be the desire to achieve economies of scale. Thirty-six out of 45 respondents indicated that economies of scale were “very important” in motivating this type of consolidation (see Chart II.1, panel 1a). This finding contrasts rather sharply with the findings of the academic literature (particularly on the US financial sector), which suggest fairly limited economies of scale in financial services. One should bear in mind, though, that this finding may be less paradoxical than it seems because the econometric studies are backward looking, making it difficult to achieve reliable estimates of scale economies that can explain the current industry consolidation. Several interviewees explained, for example, that the large investments required to take advantage of the latest technological advances or to develop innovative products could only be undertaken by very large organisations. Others noted that mergers provide an opportunity to reduce staffing and eliminate branches, thereby reducing costs.

Other important motivating factors for within-country, within-segment mergers, according to the interviewees, were revenue enhancement due to increased size and increased market power (see Chart II.1, panels 3a and 7a). Note that most interviewees interpreted market power to mean market share, rather than the ability to influence price. The argument presented was that a larger market share makes a firm more visible and therefore more attractive to potential customers. In Europe, a larger market share may also be a defensive motive to become one of the major players in the pan-European market. It was also mentioned that larger banks are better positioned to support large bond issues because they have access to a larger capital base, command a more extensive network to place these issues in the market, and have the advantage of name recognition. Risk reduction due to product diversification and change in organisational focus were considered largely irrelevant for this type of consolidation (see Chart II.1, panels 5a and 6a), while economies of scope, revenue enhancement due to product diversification, and managerial empire building and entrenchment were considered to be slightly important (see Chart II.1, panels 2a, 4a and 8a).

For within-country, across-segment mergers, the most important motive appears to be revenue enhancement due to product diversification, or the ability to offer customers “one-stop shopping” (see Chart II.1, panel 5b). Forty-five per cent of the respondents cited this motive as being “very important”, 7% ranked it somewhere between “moderately important” and “very important”, and 27% judged it to be “moderately important”. The desire to achieve economies of scope was perceived by interviewees to be the second most important motive for this type of merger, with 25% of the respondents ranking it as “very important” and 30% classifying it as “moderately important” (see Chart II.1, panel 2b). Economies of scale, revenue enhancement due to increased size, risk reduction due to product diversification, change in organisation focus, market power, and managerial empire building and entrenchment were all considered to be slightly important factors (see Chart II.1, panels 1b, 3b, 5b, 6b, 7b and 8b).

Many respondents did not provide rankings for the motives for cross-border mergers due to the fairly limited amount of cross-border consolidation that has taken place to date. The responses that were provided to these questions suggest that the strongest motives for within-segment cross-border consolidation were increased market power and revenue enhancement due to both increased size and increased product diversification. With regard to cross-segment, cross-border consolidation, revenue enhancement was also considered to be a strong motivator, but increased market power was viewed as only slightly important.

3. Forces encouraging consolidation

Introduction

This section is concerned with the external forces that have encouraged consolidation in the financial services industry. In some jurisdictions (eg Japan in the 1990s), consolidation has been driven largely by the need to recapitalise distressed institutions after a major crisis. More generally, much of the ongoing restructuring in financial services has been a strategic response on the part of market participants to changes in the competitive environment. Among the major forces creating pressure for change are:

- technological advances;
- deregulation; and
- globalisation of the marketplace.

Just as the motives underlying mergers and acquisitions vary with firm characteristics, etc, the key external forces also appear to vary across multiple dimensions in their influence. In some cases, the basic structural forces are the same, but the impact differs because of different starting points with respect to the number of firms and the range of activities conducted within a given firm. Comments received in the interviews suggest that cross-border mergers are more likely for institutions located in countries that have already experienced considerable domestic consolidation, where the scope for further consolidation based on an exclusively domestic focus has either diminished or bumped up against policy limitations. Various respondents suggested, as well, that different categories of institutions might react to different factors. For example, the need to absorb excess capacity may encourage consolidation among smaller institutions to a greater extent than among larger institutions. Unfortunately, as noted previously, the small number of observations does not permit meaningful distinctions to be drawn along these lines.

Evidence from the interviews does suggest that the influence of the external factors has been supported in some cases by changes in *investor saving patterns* and the *introduction of the euro*, which have served as important catalysts for mergers among institutions in some jurisdictions. In addition, surging stock prices (for acquirers) and low interest rates have provided a supportive environment in which to finance transactions. In sum, technology, deregulation and globalisation have eased or removed entry barriers and paved the way for increased competitive pressures. Shareholders, meanwhile, have become more active. Corporate governance practices still vary across jurisdictions, but the "shareholder value" concept has gained adherents. Thus, as increased competition has squeezed profit margins for many financial institutions, managers have been forced to seek measures to improve performance, including ways to reduce costs, increase revenues, or employ resources more effectively. There are a number of strategic alternatives to achieve these goals, including:

- organic growth;
- de novo entry (especially in niche areas);
- distribution and other strategic alliances; and
- mergers and acquisitions.

All of these strategies have been implemented to varying degrees in most jurisdictions, but mergers and acquisitions have clearly been a big element of the strategic response to date. Going forward, however, the opportunities for online delivery of financial products and services may lead to less emphasis on mergers and acquisitions to achieve entry and increased use of cooperative agreements such as production partnerships, joint ventures and distribution alliances. This will be further discussed in Section 5 on future trends.

Technological changes

Technology has both direct and indirect effects on the restructuring of financial services. Direct effects of technology may include:

- increases in the feasible scale of production of certain products and services (eg credit cards and asset management);
- scale advantages in the production of risk management instruments such as derivative contracts and other off-balance sheet guarantees; and
- economies of scale in the provision of services such as custody, cash management, back office operations and research.

Many wholesale services, in particular, have high technology investment costs but low margins, given customers' demands for increasingly sophisticated services at lower prices. Providers of these services often pursue mergers and acquisitions as a means of spreading the high set-up costs of new technological infrastructure over a larger customer base. The same may be true of providers of retail products like credit cards. A large firm size helps to counterbalance competitive pressures and provides the wherewithal for the continuous technology upgrades necessary to achieve any unit-cost advantage in pricing services that are basically commodity products. Large size may also provide diversification benefits.

Dramatic improvements in the speed and quality of telecommunications, computers and information services have helped to lower information and other costs of transacting (see Table II.1). This development has had a dramatic impact on the financial services industry. A few key examples are:

- ***Changes in distribution capacity***. As a result of increased speed and lower costs of computing and telecommunications equipment, financial service providers can, with the appropriate technology infrastructure, offer a broader array of products and services to larger numbers of clients over wider geographic areas than would have been feasible in the past. This process has facilitated the move towards increasingly global connections among financial markets and made a global reach feasible for service providers.
- ***Creation of new financial services and products***. Technological advances combined with innovations in financial engineering techniques have enabled service providers to unbundle and repackage the risks embedded in existing financial products to tailor new products to meet the risk management and investment needs of specific customers. Modern technology enables financial institutions to make rapid adjustments in the characteristics of their investment portfolios, including the risk profile, and facilitates the efforts of non-financial corporations to develop global operations by providing for the separation of exchange rate fluctuations and other financial risks from their normal business operations.
- ***Blurring of distinctions***. Technology in conjunction with deregulation of product offerings results in competition on a product-by-product basis. Financial institutions of all types now offer products and services that not only compete against those offered by intra-sector competitors, but also against those offered by other categories of service providers. Banks are increasingly engaging in non-traditional activities and securities firms and non-banking institutions have made inroads in traditional banking activities. The same technologies have enabled non-financial entrants to provide a range of banking-type products. In the process, many financial products have been converted into commodities, characterised by a high degree of standardisation and competition focused on price.
- ***Data mining***. Technological advances have also enabled financial service providers to harness information more productively, which means that differentiated or specially tailored products can be created and channelled to targeted customers. Technology

supports the implementation of strategies based on the marketing and mass distribution of commodity-like products. A prime example is the use of direct mail or telemarketing campaigns to offer standardised loan products to retail or small business customers that have a certain risk profile, based on assessments from a credit-scoring model.

- ***New entrants***. At the retail level, electronic delivery channels such as the internet and automated lending technology enable service providers to take advantage of their brand names and customer databases to reach out to targeted customers, without the need for a pre-existing physical presence. Although some physical presence in the market will probably remain a necessary element in the provision of retail banking services, these technologies potentially remove one of the main entry barriers to the retail financial services business. Online delivery channels make it possible for out-of-market institutions to compete for retail (and also small business) customers as well. Moreover, sophisticated search engines enable customers to comparison-shop more easily, so differences in prices are readily exposed and competitors have a relatively low-cost channel through which a competing firm's customers can be reached. How entry by out-of-market institutions might affect concentration in a financial industry is not clear-cut. This would in part depend on the form entry would take (eg de novo entry, mergers and acquisitions, cooperative agreements such as strategic alliances). Furthermore, new entry might stimulate a change in the structure of the industry. For a more comprehensive discussion, see Section 5 on future trends.

In short, technological advances have changed the competitive functioning of the financial sector, at both the production and the distribution level, and have created incentives for new output efficiencies. As noted in the section on motives, such a restructuring process provides many opportunities for mergers and acquisitions. In the interviews, technological advances were considered to be an important force encouraging consolidation, especially with respect to within-country, within-segment combinations. Over 60% of respondents indicated that improvements in information and communications technology were "very important" in encouraging this type of merger, while another 20% said they were "moderately important" (see Chart II.2, panel 1a). Fifty-eight per cent of respondents ranked financial innovation as a "moderately important" or "very important" force encouraging within-country, within-segment consolidation (see Chart II.2, panel 2a). More than half of the interview respondents viewed each of these technology-related forces as at least "moderately important" in encouraging domestic, cross-segment consolidation and cross-border, within-segment consolidation (see Chart II.2, panels 1b, 2b, 1c and 2c). Electronic commerce was viewed as a less important force with regard to encouraging all types of consolidation (see Chart II.2, panel 3).

Deregulation

Governments influence the restructuring process in a number of ways:

- through effects on market competition and entry conditions (eg placing limits on or prohibiting cross-border mergers or mergers between banks and other types of service providers);
- through approval/disapproval decisions for individual merger transactions;
- through limits on the range of permissible activities for service providers;
- through public ownership of institutions; and
- through efforts to minimise the social costs of failures.

Over the past two decades, many official barriers to consolidation have been relaxed as governments have reconsidered the legal and regulatory framework in which financial institutions operate. (See Annex II.3 for a chronological listing of important regulatory changes.) In a number of countries, regulations in the financial services industry, especially as applied to banking organisations, tended in the past to focus almost entirely on safety (eg consumer protection and prevention of failures). However, financial regulatory frameworks in most major countries have shifted from systems based on strict regulatory control to systems based more on enhancing efficiency through competition, with an emphasis on market discipline, supervision and risk-based capital guidelines. In the new operating environment, public policy is less protective of financial service providers (banks), exposing them to the same sorts of market pressures that have long confronted non-financial businesses.

Mergers and acquisitions have been a major component of the restructuring process. This process owes in part to deregulation, but it is difficult to disentangle the effects of regulatory reform in financial services from the effects of advances in technology, innovations in financial engineering and other developments that work in the same direction and may have preceded the changes in regulation. Deregulation in the financial service industry has often been an induced response by policymakers to technological advances and financial crises. At times, regulatory changes have merely ratified changes that had been previously implemented by the market. For example, there is some evidence that technological innovations in deposit taking and lending encouraged deregulation in that area, and technological advances were also a factor enabling financial institutions in the United States to overcome functional and geographic limitations that had been designed into their charters.[36]

The fact that consolidation in some cases has preceded changes in legislation suggests perhaps that deregulation may not be a strictly necessary factor in the textbook sense. The main influence of deregulation appears to be that it enlarges the set of legal tactical manoeuvres, including the types of agreements that can be arranged across sectors and across borders, and thereby gives institutions increased flexibility to respond to competitive impulses.

In the interviews, over half of the respondents indicated that deregulation was at least "moderately important" as a factor encouraging consolidation for domestic, within-segment institutions, with over one third of the respondents ranking it as a "very important" factor (see Chart II.2, panel 4a). Thirty-eight of the respondents assigned a ranking to this factor for domestic, cross-segment consolidation. As before, about half of the respondents said this factor was at least "moderately important" in encouraging consolidation (see Chart II.2, panel 4b). A similar frequency breakdown occurs in the case of cross-border consolidation, but the total number of respondents is smaller (Chart II.2, panels 4c and 4d).

Globalisation

Globalisation is in many respects a by-product of technology and deregulation. Technological advances have lowered computing costs and telecommunications, while at the same time greatly expanding capacity, making a global reach economically more feasible. Deregulation, meanwhile, has opened up many new markets, both in developed and in transition economies. As a factor encouraging consolidation, globalisation largely affects institutions providing wholesale services. Comments received during the interviews indicate that global corporations expect financial service providers to have the necessary expertise and product mix to meet any investment or risk management need in any location in which the corporations have operations.[37] As non-financial corporations increased the geographic scope of their operations, they created a demand for intermediaries to provide products and services attuned to the international nature of their operations. Maintaining a presence in multiple financial markets and offering a breadth of products and services can entail relatively high fixed costs, creating a

[36] See Kane (1999).

[37] This is one of the basic tenets of client-based universal banking - the service provider chooses the appropriate products, services and geographical presence to service its client base. For a more complete discussion, see Calomiris and Karceski (1998).

need for large size to achieve scale economies. Nonetheless, interviewees did not rate the globalisation of the non-financial sector as an important force encouraging financial consolidation (see Chart II.2, panel 5).

Meanwhile, profit margins in many wholesale business segments have narrowed as a result of increased ease of entry and the commodity-like nature of many wholesale financial products. Low margins, in effect, mean that high volumes are necessary to generate higher returns. This need has prompted some firms to opt for mergers and acquisitions as a means of attaining critical mass. Mergers and acquisitions have also been a frequent option for banks seeking to build a global retail system. By acquiring an existing institution in the target market, the acquirer gains a more rapid foothold than would be possible with an organic growth strategy (see Box II.1).

In addition to increasing the need for wholesale service providers to expand the scale of their operations, globalisation has helped change the competitive dynamics of other market segments. Many financial products are now offered internationally by efficient global competitors, through direct or targeted distribution channels. Some traditional retail banking products and services are still provided on a regional or local level, but a few global providers (eg Spanish banks in Latin America) have begun to make competitive inroads in many markets. National and regional players are forced to respond to the threat posed by new entrants either by emulating their product offerings (which results in commoditisation), or by offering better pricing, which requires increased efficiency, or by offering better services (eg through customisation or personal service).

The globalisation of capital markets also contributes to the shift from a bank-centred system to a market-based one. As capital markets have expanded and become more liquid and efficient, the highest-quality credits have turned increasingly to the commercial paper and bond markets in lieu of certain types of traditional bank and insurance products. Margins on loans to the highest-rated investment grade borrowers have been driven down to the point that only the most efficient institutions are able to provide this form of credit. On the liabilities side of banks' balance sheets, there has been a substantial outflow of deposits to a wide range of competing financial products offered by various institutions in different sectors. For insurers, mutual funds and related products compete against guaranteed investment contracts. In response to the increased competitive pressures, some institutions have opted to expand via the merger route to reach a perceived threshold size for scale economies (see Chart II.2, panel 6a).

A final influence of globalisation is in the area of corporate governance. As businesses have crossed international boundaries and their shares have begun to be held by a wider investor clientele, the demand by investors for a more uniform standard of corporate governance has also increased. Generally, the pressure for change has come from shareholders located outside the home market. A major contributing factor is the ongoing change in investor demographics.

Box II.1

Spanish banks' strategy in Latin America

Acquisitions of large shareholdings in the Latin American financial sector by Spanish institutions are an interesting example of cross-border consolidation. This expansion by the largest Spanish banks was initially focused mainly on emulating the Spanish model of retail banking, but lately has also included the acquisition of private pension funds. The main countries that have been involved in the region are Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

A number of factors have supported these efforts. Most governments in the targeted countries have taken steps to modernise their economies and, in particular, reform their banking and financial systems through deregulation, restructuring and privatisation, while opening their domestic markets to foreign institutions. Other supporting factors include:

- the importance of the common language, historical ties and other cultural factors;
- the strong financial solvency position of the acquiring banks, coupled with the need to implement strategies that increase shareholder value;
- higher potential growth in these countries compared with the EU owing to a faster rate of population increase;
- higher intermediation margins in Latin American banking systems compared with those of more developed countries (compensating for the reduction in margins that has taken place in Spain due to fierce competition in retail banking and the reduction in interest rates);
- the adaptability of readily available products and delivery systems;
- minimal correlation between the economic cycles of Latin America and Spain, which allows some risk diversification.

Although there are high risks associated with these investments, given financial sector instability in the region, the belief is that the immediate introduction of the parents' management processes, systems and improved risk management will enhance profitability quickly. This expansion has resulted in strong franchises, which may prove to be a powerful advantage in coping with expected future consolidation in the European financial sector.

Shareholder pressures

Differences in corporate governance standards still exist among major countries, but use of the "shareholder value" concept has become more widespread and with it has come a focus on the return on assets and the return on equity (ROE) as benchmarks for performance. This emphasis on ROE is most evident in countries where capital markets exert strong competitive pressures, but its importance is spreading rapidly.

One development that has helped to boost the importance of shareholders relative to other stakeholders is the increased institutionalisation of savings stemming from ageing populations in most countries.[38] Financial assets are increasingly being held by large well-informed investors, who base their investment decisions on relative asset returns. Importantly, it has become more common for a large share of the funds institutional investors have under management to be placed with professional fund managers, who develop asset allocation strategies and make investment decisions on behalf of their institutional investor clients. Fund managers actively compete for the opportunity to manage funds from pension plans, foundations, life insurance companies, and so on. Renewal of management contracts and the fund manager's compensation typically have been based on the fund manager's relative investment performance. Consequently, professional fund managers have strong incentives to

[38] In many countries, ageing and the need for retirement income has prompted growth of private pension plans as alternatives to state-sponsored, pay-as-you-go systems. See, for example, OECD (1998).

express their dissatisfaction with low rates of ROE. This increased activism translates into pressure on managers of financial institutions to generate higher levels of profitability. In response, managers have sought ways to increase revenues, create new sources of earnings, generate fee income, reduce cost-to-income ratios, optimally deploy excess capital or, for some institutions, recapitalise after a major crisis. These goals can be achieved through business gains, productivity enhancement or more effective balance sheet management, but mergers and acquisitions appear to be a simpler strategy for many institutions.

In the interviews, the institutionalisation of savings was considered to be a “moderately important” to “very important” factor encouraging consolidation by 50 to 60% of respondents for each type of consolidation considered (see Chart II.2, panel 7).

The introduction of the euro

Another development that has had an impact on the competitive environment for some institutions is the creation of the euro. The general view of the euro is that it acts as a catalyst, reinforcing already existing trends in EU banking systems. However, the surge in consolidation activity in the euro area just prior to and after the euro’s launch leads to some speculation that the euro might have independent effects.[39] Assessing the specific impact of the euro on financial sector consolidation is, however, rather complex for two reasons. First, by the time the euro was introduced, the European financial sector had already undergone several changes dating back to the end of the 1980s, basically as a result of the harmonisation efforts in the context of the single market and the environmental factors outlined in the previous section, supported by a general trend towards liberalisation of capital movements. Second, the relationship between the euro and the consolidation process varies by segment of the financial system (money and capital markets versus retail markets).

Financial markets

Since its inception, the euro has quickly led to an integrated *money market*, thereby affecting the motives for consolidation in two ways. First, the euro has removed the pricing advantage in the “home” interest rate previously enjoyed by domestic banks specialised in dealing in the relevant currency. This change may have put pressure on the profitability of some domestic banks that were large in their domestic system but have a much smaller share of the new integrated money market. Second, given the size of the integrated money market, there is a need for providers of payment services to smaller banks, which favours larger institutions because the required technological equipment entails huge installation costs. For these service providers, the degree of revenue enhancement would be even greater if a synergy were to develop between money market and capital market activities, thus enabling them to provide a wide array of interconnected financial services to other financial institutions.

The euro also affects the treasury activities of the corporate sector in the euro area. Internationally operating corporations used to maintain a correspondent banking connection in several European countries, but under the single currency these relations have been reduced significantly. This development may have encouraged consolidation among banks, because in order to serve these international corporate clients, particularly the larger ones, size may have become more relevant.

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39 According to data obtained from Securities Data Corporation and presented in Chapter I, the value of merger and acquisition transactions involving target firms located in the nine European countries included in our study reached USD 147 billion in 1999, compared with USD 103 billion in 1998 and USD 88 billion in 1997. In 1999, several cross-border mergers took place in the euro area. This process continued in 2000 (eg HSBC-Crédit Commercial de France, MeritaNordbanken-UniDanmark).

The euro also contributes to more integrated *capital markets*, although this process proceeds with a lower intensity than in the money market. In general, the integration of capital markets has three main effects on the motives for bank consolidation:

- it creates the potential for revenue enhancement due to increased size, particularly in the case of institutional investment;
- there is the potential for economies of scale on the cost side; and
- sufficient size may be required to take full advantage of risk diversification within an industry throughout the euro area.

The integration of capital markets represents an opportunity for institutional investors to extend their activity since the size and liquidity of the markets have grown. It may be argued that only large banks are able to develop knowledge throughout the euro area, together with the pool of human resources and the technological capacity needed to suit the needs of large institutional investors, especially in the fields of underwriting, securitisation, investment banking and asset management. Asset allocation in the euro area is increasingly carried out on an industry basis rather than on a country-by-country basis. Accordingly, analysts are being required to follow a larger number of companies, which may entail economies of scale.

Integration has also proceeded in the *government bond markets*. A high degree of liquidity is ensured for benchmark bonds, whose yield to maturity is nearly uniform across the euro area. Spreads between government bond yields and interbank rates have decreased also as a consequence of the restructuring of primary markets carried out by several European governments at the end of the 1990s (eg through the introduction of new competitive auction procedures). This process has penalised particularly those banks that depended on the yield on their government bond portfolio for a significant share of their income. The resultant pressure on margins could induce these banks to pursue cost savings or ways to enhance income, which could lead to merger activity.

In the interviews, roughly 45% of the respondents said the euro was “not a factor” influencing domestic consolidation and approximately 40% said it was “not a factor” encouraging cross-border consolidation. At the same time, approximately 30% of respondents indicated that the euro was a “very important” factor encouraging within-segment mergers, both domestic and cross-border (see Chart II.2, panel 8). Respondents’ views of the importance of the euro varied with their locations. Interviewees from euro area countries tended to rank this factor much higher than those outside the euro area did. Numerous respondents indicated that the euro was likely to become a more significant force in the future than it has been to date.

4. Forces discouraging consolidation

Introduction

There are many other external factors that affect the way financial institutions respond to the changes in their operating environment. This section pays attention to those factors that *discourage* consolidation, such as regulatory regimes, information failures, cultural differences, structures in corporate governance and various other factors. As with the forces encouraging consolidation, the relative importance of the factors addressed may differ across segments and countries.

In addition, some factors discourage certain types of consolidation. In particular, hostile takeovers are impeded much more than friendly mergers, which largely explains the lack of hostile takeovers in the banking industry. For example, government regulation can make permitted hostile takeovers within commercial banking more expensive and time consuming than in non-bank sectors.[40] Also, ownership structures and corporate governance structures (eg the protection of minority shareholder rights) can make it very difficult to acquire a bank through a hostile takeover. Furthermore, as information asymmetries with respect to, for example, the assessment of the loan book of a bank can be substantial, it may be very risky for the bidder to perform an acquisition without the cooperation of the target's management and shareholders. Finally, several interviewees indicated that the lack of hostile takeovers in the banking sector might also be related to the expectations of the bidders that takeover panels and supervisory bodies are likely to turn down this form of corporate control. Bearing these points in mind, the following paragraphs describe the discouraging factors in a more general context.

Regulation

The legal and regulatory environment represents a substantial potential impediment for consolidation, as it affects directly the range of permissible activities undertaken by financial firms and may imply considerable compliance costs. In some countries antitrust laws constitute an important impediment, mainly for domestic consolidation within sectors. Prudential regulation may hinder cross-border consolidation through differences in capital requirements. Product-based supervision, which exists largely in the insurance sector, may reduce cross-border consolidation by limiting potential cost reduction from economies of scale. Potential regulatory impediments to consolidation include:

- ***Protection of "national champions"***. In some countries, the government has an explicit role in approving foreign investment in domestic financial institutions. Governments may protect domestic enterprises by setting high hurdles for foreign buyers attempting to acquire majority stakes. Conditions in some countries have enabled some categories of banks to remain insulated from market forces.
- ***Government ownership of financial institutions***. The scope for consolidation is similarly limited when banks are partially or fully government owned. For these institutions, the consolidation of business activities with others would have to be preceded by privatisation.
- ***Competition policies***. Competition policies are concerned with the negative welfare effects stemming from a lack of competition. Some consolidation projects are refused on the grounds that they would result in market dominance. A further important deterrent related to competition policy rules is the fact that some mergers have to pass the test of competition authorities in different countries, which involves long delays, compliance costs and uncertainty.
- ***Rules on confidentiality***. National regulations with regard to data provision and confidentiality may prevent the consolidation of information platforms on a cross-border and an across-segment basis and, thereby, impede potential cost reductions from technologically induced economies of scale.

Nearly 60% of interviewees viewed legal and regulatory constraints as a "very important" impediment to cross-border mergers, and an additional 15 to 20% viewed them as moderately important. Respondents considered legal and regulatory constraints to be somewhat less important in discouraging domestic consolidation; nonetheless, more than 60% of them rated these factors as at least "moderately important" (see Chart II.3, panel 1). It should be noted that, over time, regulatory differences across countries can be expected diminish, tending to reduce barriers to cross-border consolidation.

[40] See Prowse (1997).

Cultural differences

Cultural differences appear in the consolidation process on the corporate level, between sectors, across regions or countries and between wholesale and retail businesses. The need for cultural integration as part of the consolidation process is a multidimensional issue that touches all stakeholders. Cultural differences increase the complexity, and therefore the costs, of managing size. Post-merger problems have often been ascribed to the underestimation of the difficulties involved in attempts to combine different cultures.

- *Differences between countries*. The importance of cultural differences is especially obvious when a merger crosses national borders or spans geographically distinct regions. Factors that may discourage consolidation include differences in language, communication styles, customer needs and specific established distribution channels. These factors determine the ease, and thus the implicit costs, of a firm's entry into a different country or region.
- *Differences in corporate cultures*. Strong corporate identities are considered to be particularly problematic in mergers between equals. Takeover attempts often turn unfriendly when there are large perceived rifts in business cultures between the acquirer and the target. Such differences may impede the exchange of information, the pursuit of common objectives and the development of a coherent corporate identity. Divergent corporate cultures may exist between corporations within the same business segment, as well as across business lines (eg commercial and investment banking activities that may compete with different products for the same customer base).

Not surprisingly, interviewees indicated that cultural constraints were most important with regard to cross-border consolidation. Approximately two thirds of respondents described cultural constraints as a very important factor discouraging cross-border mergers, whether within or across segments. Cultural constraints were also viewed as an important impediment to domestic mergers involving firms in different industry segments by 40% of interviewees. Nearly half of all respondents considered cultural constraints at least "moderately important" in deterring within-segment, within-country mergers (see Chart II.3, panel 2).

Inadequate information flows

Inadequate information flows are a form of market inefficiency that may increase the uncertainty about the outcome of a merger or acquisition. They may be attributed to incomplete disclosure or large differences in accounting standards across countries and sectors.[41] When faced with such an information asymmetry, stakeholders may disapprove of consolidation.

- ***Lack of comparability of accounting reports***. Large variations in accounting principles and procedures from country to country or even across sectors can impede consolidation, as there may be considerable uncertainty regarding the risk profile and valuation of the assets of the institutions involved in the transactions. The growing complexity of large transactions in recent years has further increased the importance of reliable and transparent accounting standards in order to conduct adequate due diligence procedures in mergers and acquisitions.
- ***Difficulties in asset appraisal***. The existence of information asymmetries is a commonly acknowledged complication in appraising assets particularly in the context of bank's loan books, which include assets for which market liquidity is low. An

[41] Due to developments in information technology and the subsequently more widespread implementation of international accounting standards such as the International Accounting Standards and the US Generally Accepted Accounting Principles, the spread and quality of financial information available in G10 countries in recent years have improved.

assessment of the loan book of an institution implies the difficult task of judging the quality of risk management of the takeover target, which is especially problematic in the context of evaluating single loans.

- ***Lack of transparency***. Ex ante pressure from shareholders to justify a merger decision may be a discouraging factor in the presence of uncertainty and information asymmetries. The potential for hidden costs, as a result of a lack of transparency, may induce acquiring management and shareholders to be more risk averse when considering an acquisition.

Most interviewees did not view market inefficiencies as a particularly important factor inhibiting consolidation, except in the case of cross-border, within-segment mergers (see Chart II.3, panel 3).

Corporate governance

Corporate governance encompasses the organisational structure and the system of checks and balances of an institution. There are significant differences in the legislative and regulatory frameworks across countries as regards the functions of the ("supervisory") board of directors and senior management, which affect the interrelation of the two decision-making bodies within an institution and relations with the firm's owners and other stakeholders, including employees, customers, the community, rating agencies and governments.

- ***Ownership structures***. The organisational form and rules that govern the strategic business decisions of a company have a large bearing on whether consolidation is deemed a valid business option. For example, a strong corporate identity can be an effective defence against surrendering control to outsiders. The "mutual" form of ownership is a special type of ownership structure that may impede consolidation. In some countries mutuals have a large market share in the life insurance and mortgage businesses as well as among depository institutions.
- ***Capital structure***. Corporate governance should not be viewed independently from corporate finance. As the way of raising capital varies, so do the possibilities for influencing or pressuring the supervisory board with regard to decisions on consolidation. Such influence appears to be greatest for firms that rely heavily on equity financing and whose shares are widely held. Where there are a few large shareholders, it is extremely difficult to sway the vote of the governing board without their express approval. Banks that have lent extensively to an enterprise may exercise similar de facto corporate control, although they may not be represented on the supervisory board.
- ***Existence of defensive strategies***. Defences against a takeover are strongest where financing is from private sources and the major share of equities is privately held. Defensive strategies are manifold and include payoff provisions for managers, ie "golden parachutes", or legal and technical obstacles such as complex ownership agreements ("poison pills") or cross-shareholdings with other institutions.

Though not listed separately in the structured interview guide (see Annex II.2), a number of interviewees emphasised that differences in corporate governance may discourage consolidation.

Other discouraging factors

The process of consolidation is a complex phenomenon and includes judgements about interrelationships among many factors. Two other factors that may discourage firms from going forward with a merger or acquisition that were mentioned in the interviews are the costs associated with managing complex institutions and taxation:

- ***Costs of complexity***. An important reason for unsuccessful consolidation is likely to be the underestimation of the costs or the complexity of managing large and heterogeneous institutions and the difficulties of unifying different corporate cultures. For example, a strategy of combining businesses with highly volatile earnings such as investment banking with more stable performers such as life insurance or private banking might lead to a loss in focus as well as undermine the specific strengths of the constituents.
- ***Taxation***. Assessing the impact of the various tax regimes on investment decisions is a complex issue. The tax burden is a cost that is factored into business decisions. As such, it influences the choice of location for the different parts of a business. Although consolidation could also result in a reduction of tax obligations, enterprises often feel in practice that the direct and indirect costs imposed by taxation do not justify a merger, be it with a domestic partner or a foreign one. For example, high capital gains taxes on the sale of corporate holdings may impede the disentanglement of cross-holdings between banks, insurance and industry and, thus, hamper structural adjustment in the financial and corporate sectors. The absence of double taxation agreements between the two countries where the consolidating entities are headquartered would also be an impediment to takeovers. From an efficiency point of view, organisational structures that are optimal from a taxation perspective may be less so from the point of view of production and distribution processes.

5. Future trends

Introduction

The interview results suggest strongly that the consolidation process in the future will vary from country to country and from segment to segment, depending on different starting points regarding the number of firms and the range of activities conducted within a given firm. The pace of consolidation could accelerate in Europe, given that the encouraging impact of the euro has not yet run its course, while impediments may be reduced as convergence progresses in areas such as regulation and taxation. There is the possibility that a tiered structure might develop in the interbank market in the euro area, whereby a few large banks act as “money centre” banks. Under these circumstances, the physical location of banks becomes less important and the necessary size could be achieved through domestic consolidation. In retail markets, once physical distribution of the euro currency occurs, there is likely to be greater mobility of depositors and borrowers, which is expected to affect competition in the sector on a cross-border basis and reinforce the structural decline in traditional interest margins. The euro favours integration of the retail sector also in an indirect way by exerting pressure on the competent Community and national authorities to remove the residual barriers to cross-border activity. This would lead to a more competitive environment in which the maintenance of excess banking capacity in some European countries is set to become less sustainable. The integration of the corporate bond markets may also affect motives for consolidation, if the issuance of bonds or commercial paper becomes a significant alternative for corporations to traditional bank loans. Interest margins could decrease, inducing banks to pursue cost savings or increased market share through consolidation. It is also noteworthy that, in Europe, concentration in the financial sector is currently much higher in smaller countries such as the Nordic countries and the Netherlands than in the rest of continental Europe, particularly Germany and Italy. Thus, while institutions in the former countries have already engaged in cross-border consolidation, consolidation in the other countries is expected to continue at the national level for a while. In the United States and Japan, where concentration remains low despite recent consolidation, we can expect to see increasing concentration in the financial services sector in the future.

In all countries, environmental factors (eg technology, deregulation and investor demographics) will still influence the pace and form of consolidation. A stock market crash – if such were to occur – might temporarily slow the pace of financial sector consolidation, but would be unlikely to completely derail it, given the strength of the other underlying forces. The key question, therefore, is not so much whether consolidation will continue in the future, but rather how. In order to explore this issue, the remainder of this section considers a number of alternative future scenarios. It should be noted that these scenarios are not mutually exclusive and could apply simultaneously to different segments of the financial services industry.

Scenarios

Scenario 1: Universal institutions

The first scenario is a continuation of the current trend towards globally active universal service providers that dominate the wholesale business segment along with other service categories. The "gaps" might be filled in by niche players or regional institutions specialised, for example, in lending to households or to small and medium-sized firms in industries such as agriculture. According to this view of the financial services sector, there would be further consolidation (where legal) between financial and non-financial entities such as internet and communications firms, enabling the financial institutions to secure the advantages of diversification and scale embodied in new technologies. There are, however, reasons to believe that there are upper limits to the advantages of creating ever larger, all-encompassing financial institutions. For example, as the size and complexity of institutions increase, so do the difficulties in managing them. As managerial capacity becomes stretched too far, profits suffer, which often leads to deconstruction or other forms of retrenchment.

Scenario 2: Specialised institutions

In the second scenario, the deconstruction process is avoided. Consolidation continues apace, but instead of growth in the number of universal banks, firms specialise as they grow. Differences in the optimal scale pertaining to various activities or limited economies of scope also appear to justify at least some degree of product specialisation, for example, in either wholesale or retail activities. Many wholesale institutions already take a global perspective, but in retail segments a regional presence might suffice as the benefits of scale are limited by great differences in the local cultures served. A number of interviewees suggested, moreover, that the optimal size and structure of institutions might depend, in part, on the size of the market in which the institutions operate. In smaller markets such as Scandinavia, medium-sized institutions of a universal nature might be optimal as the benefits of one-stop shopping in such a situation could outweigh any costs of complexity. In large markets such as the United States, specialisation or looser forms of consolidation (eg strategic alliances or joint ventures) may be more appropriate as the costs of merging to become "large" start to dominate.

Scenario 3: Contract banking

The third scenario takes the specialisation process in the preceding scenario one step further. In addition to specialisation along functional lines, financial institutions in the future may also choose to specialise in certain production technologies. This would entail a radical departure from current practices, which generally consist of the joint production of a broad line of products and services, including the production of all sub-components (vertical integration). In this respect, a distinction can be made between the *manufacture* of (components of) financial services and the *delivery* of these services to the final customer. The key question is whether financial institutions must manage the entire manufacturing process themselves in order to secure scale benefits or whether the same benefits may be realised if (part of) the production process is outsourced.

In the so-called paradigm of contract banking[42] (which applies equally to other segments of the financial services industry) the answer to the first part of this question is negative. Depending on the comparative advantages of a certain bank, it need manufacture only some of the (components of) services it has on offer, obtaining the rest from other specialised producers (whether in or outside the financial sector proper). Competition would take place on the basis of brand name, the quality of products and services, and pricing. In the extreme case, relying solely on its information advantage, a bank would function as a gateway supplying customers with all the products and advice they need, but doing little more than managing contracts with external suppliers (hence the term contract banking). A good example might be internet banking. Bridges between personal financial software and the websites of financial institutions – combined with advances in reliability, security, digital signatures, etc – could make it possible for the internet to support a full range of financial services. Third parties may actually originate the various services or advise customers on where to obtain the cheapest offerings. Thus, supply chains could be "deconstructed", as different institutions would specialise in certain aspects of the financial intermediation process. Other industries, such as the telecom industry, the automobile sector and the airline industry, are leading the way in this respect. All of these industries have generally disintegrated into a constellation of sub-industries, while the individual firms at the end of the production chain maintain a single marketing channel to the customer.

While consolidation among providers of financial services will almost certainly continue in the short-term, it is possible that in the longer run some of this consolidation will be undone. Experience in other economic sectors suggests that merger waves are sometimes (partially) reversed. Usually, though, a merger wave will have inexorably changed the industry, so that the starting point will never be regained.

Impact on the consolidation process

Although the prospects for the contract banking paradigm may appear somewhat remote for the near future, a few respondents in the interviews indicated that, in some countries, more moderate forms of specialisation in combination with outsourcing are indeed expected to take place ("back to core business"). One policy issue related to this theme is how competition in the financial sector might develop if indeed the future has more specialisation in store, as within certain specialised areas monopoly power might increase.

Specialisation to such an extent would certainly change the pattern of consolidation in the financial sector. Consolidation would still occur as firms strove to diversify in terms of both products and markets served, but this process would be accompanied by divestments as the underlying production chain was (partly) broken. At the same time, the various specialised producers, for example in the area of payment processing, might also consolidate. Thus, the structure of the financial sector would become more layered than it is nowadays.

Between the extremes of a highly concentrated financial sector consisting of predominantly universal institutions and a more specialised financial sector as described above, there is a whole spectrum of possible outcomes. For example, rather than a complete deconstruction of the production chain, forms of cooperation may be established between the various suppliers, including strategic alliances and joint ventures. In fact, in the interviews a number of financial sector experts suggested that these forms of collaboration might become more common in the future as cross-border and cross-industry cooperation increases, because in those instances more intense forms of consolidation are relatively difficult to realise or justify. What balance will be struck will depend, in particular, on the economies of scope that exist between the various production processes as well as the intensity of competition in the financial sector. The fewer the economies of scope and the higher the level of competition, the greater the pressures

[42] The term "contract banking" derives from Llewellyn (1999). However, similar ideas have been expressed in Deloitte Touche Tohmatsu International (1995) and Evans and Wurster (2000).

towards deconstruction of the production chain will be. In this respect, financial sector regulation may also have a role to play by influencing the degree of financial sector competition from both within and outside the financial services industry.

All told, the consolidation trend in the financial sector is likely to continue, given the sustained pressures on the environment in which financial institutions operate. Simultaneously, there are also forces at work that may change the organisation of the financial sector. Of course, exactly how these myriad forces will balance out in the future remains to be seen.

Tables and charts (Chapter II)

Table II.1

Insurance fees – life and property/casualty

Traditional agent	USD 400 - 700
Internet	USD 200 - 350

Banking costs per transaction

Branch	USD 1.07
Telephone	USD 0.52
ATM	USD 0.27
Proprietary online system	USD 0.105
Internet	USD 0.01

Costs per bill

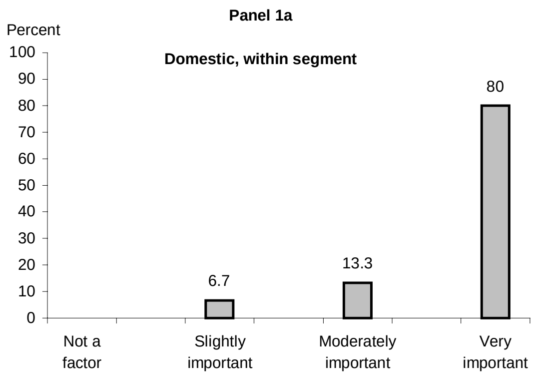
Paper	
Biller cost	USD 1.65 - 2.70
Cost to customer	USD 0.42
Bank cost	USD 0.15 - 0.20
Internet	
Biller cost	USD 0.60 - 1.00
Cost to customer	USD 0
Bank cost	USD 0.05 - 0.10

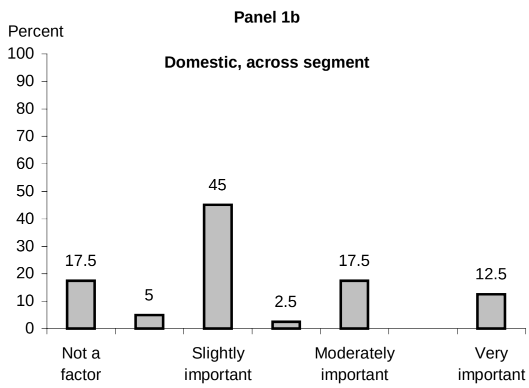
Source: *Emerging Digital Economy*, US Department of Commerce, 1998.

Chart II.1

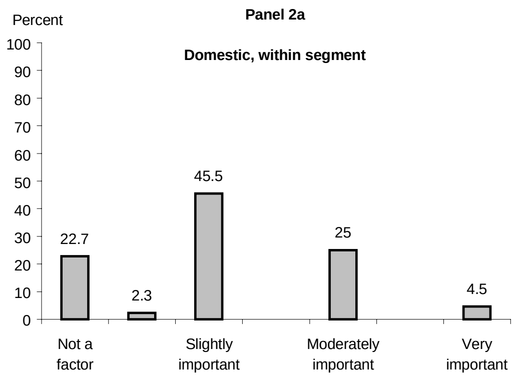
Motives for consolidation

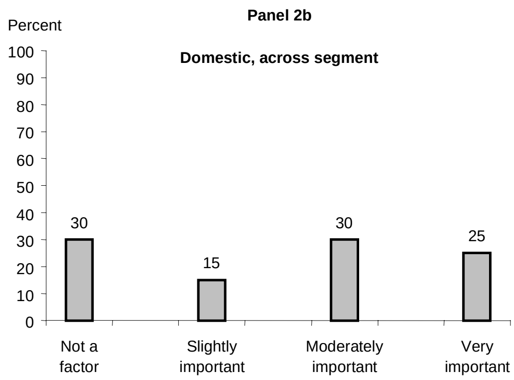
Panel 1: Economies of scale



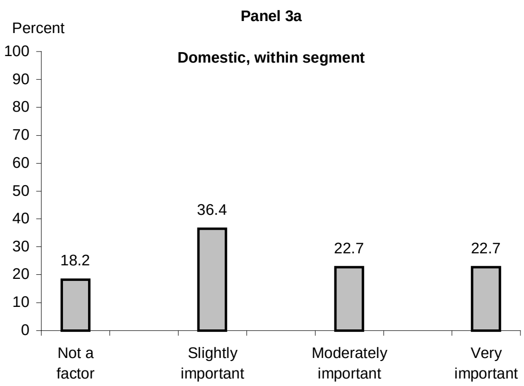


Panel 2: Economies of scope





Panel 3: Revenue enhancement – increased size



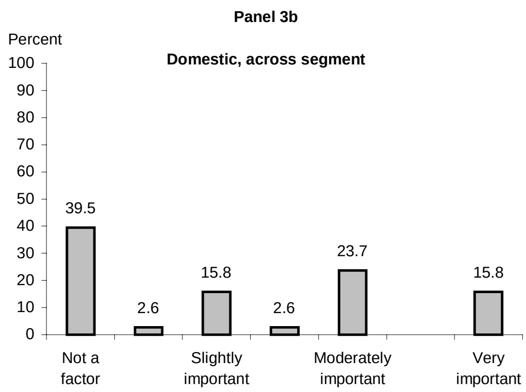
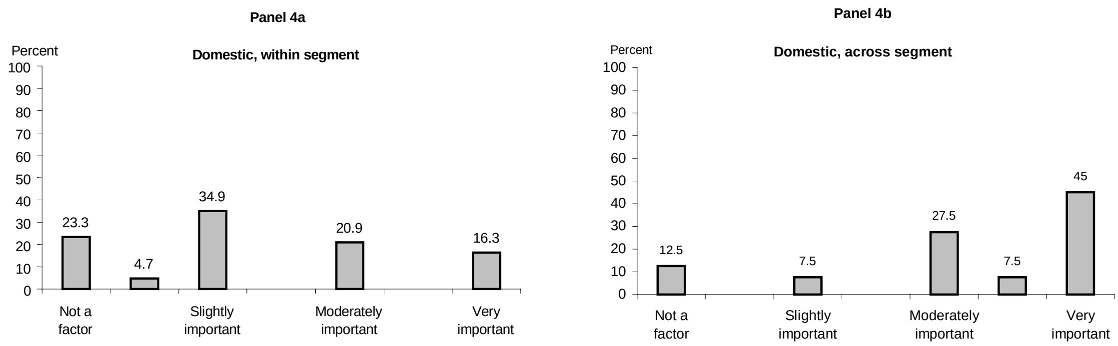
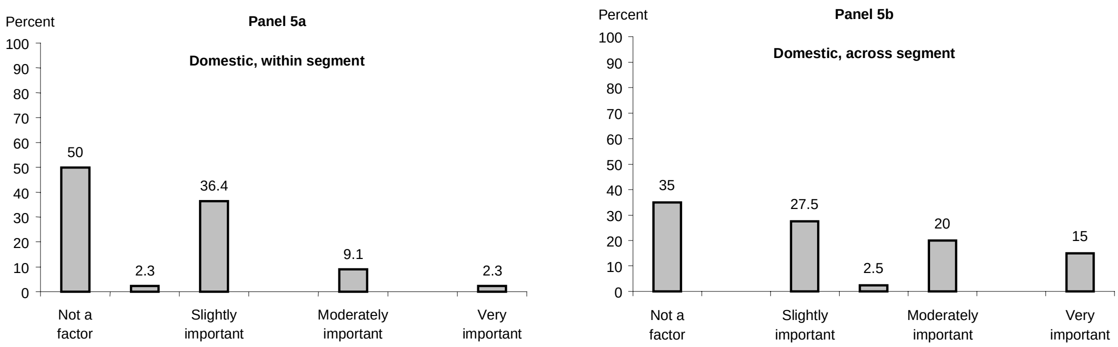


Chart II.1 (continued)

Panel 4: Revenue enhancement – one-stop shopping



Panel 5: Risk reduction: product diversification



Panel 6: Change in organisational focus

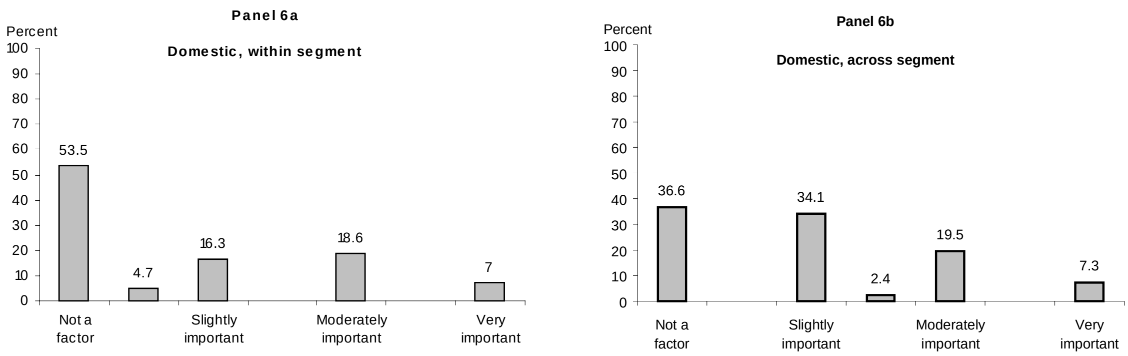
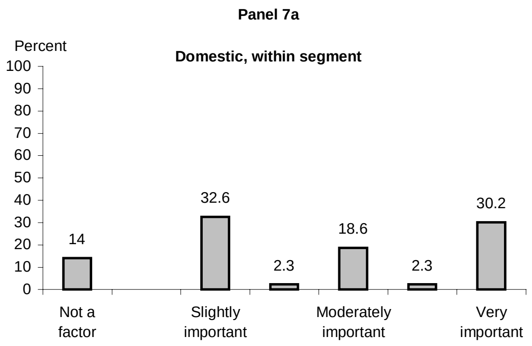
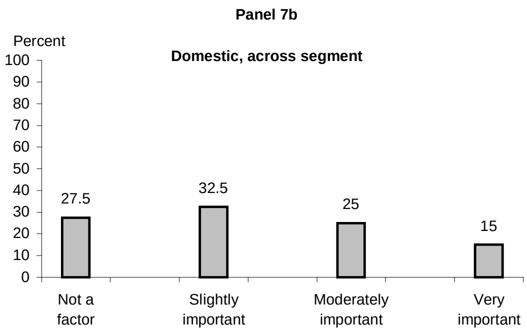


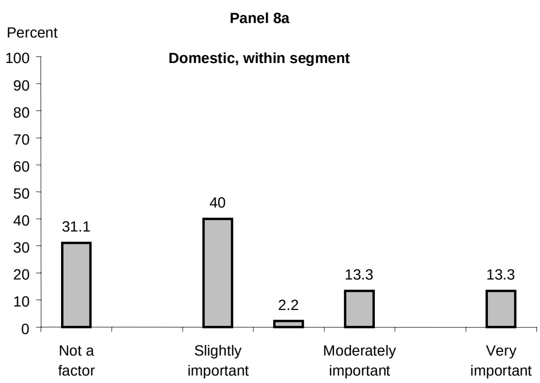
Chart II.1 (continued)

Panel 7: Increased market power





Panel 8: Managerial empire building



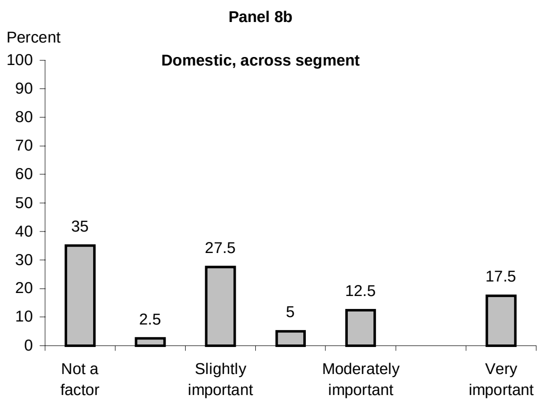
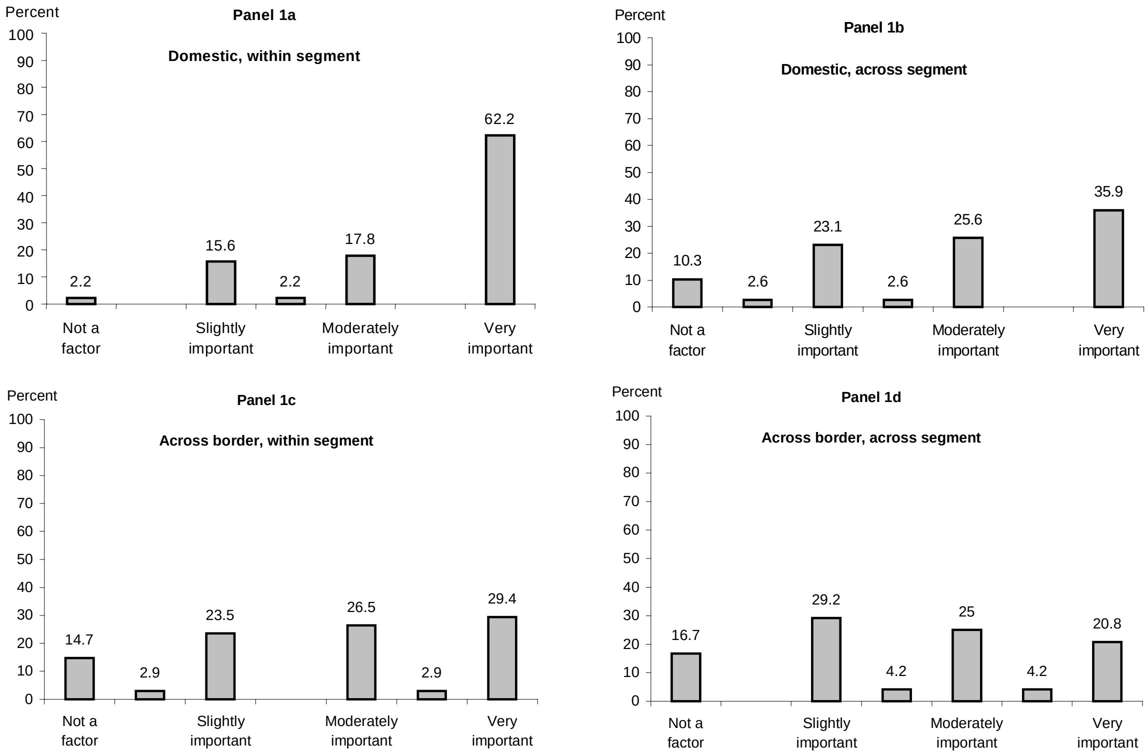


Chart II.2

Forces encouraging consolidation

Panel 1: Technology – IT and communications



Panel 2: Technology – financial innovation

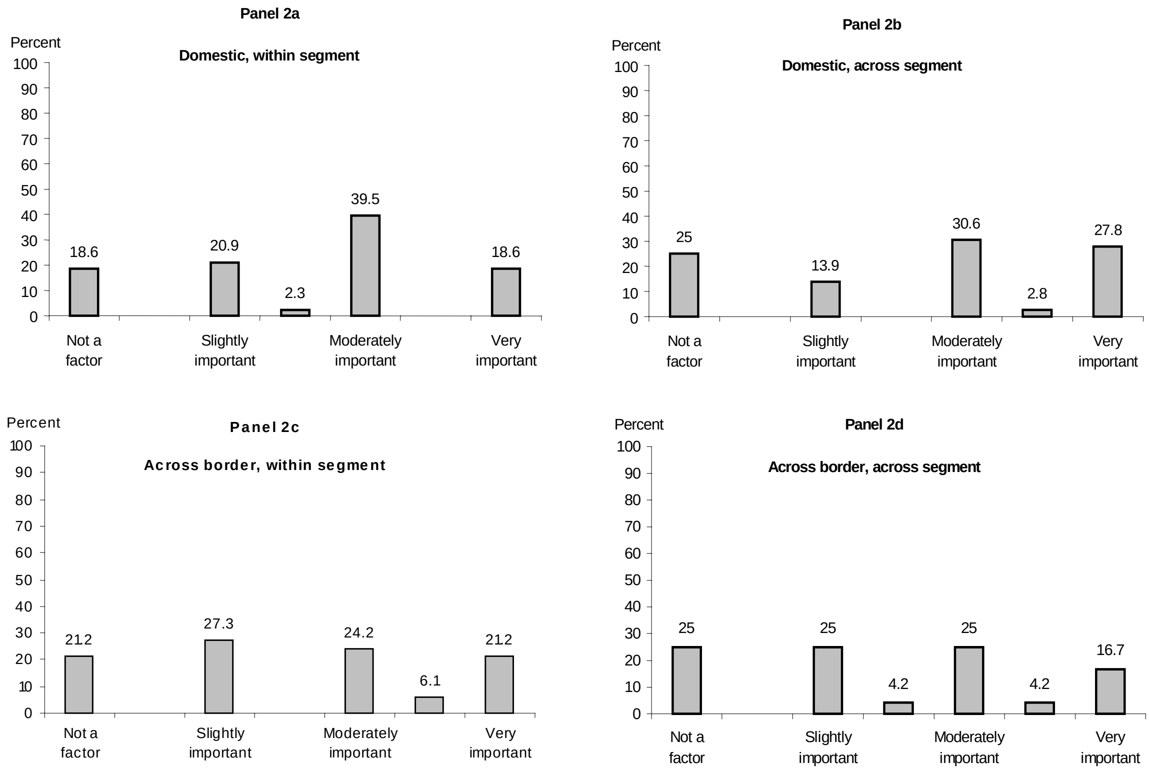
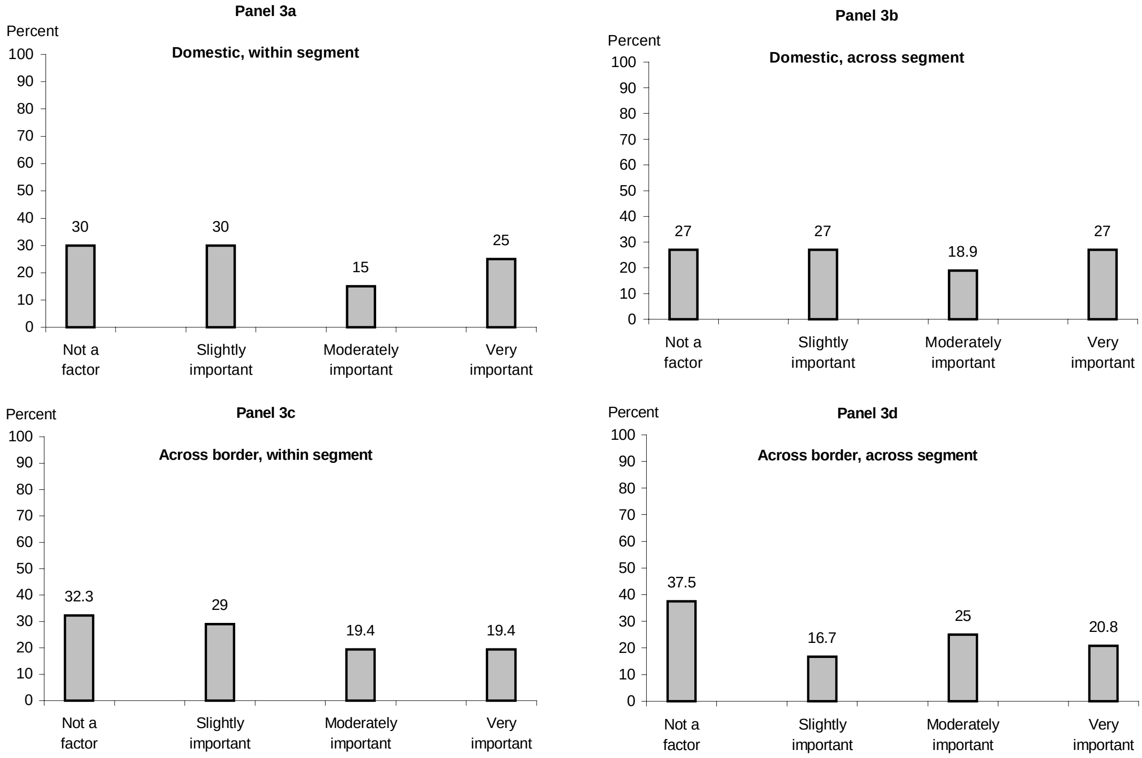


Chart II.2 (continued)

Panel 3: Technology – electronic commerce



Panel 4: Deregulation

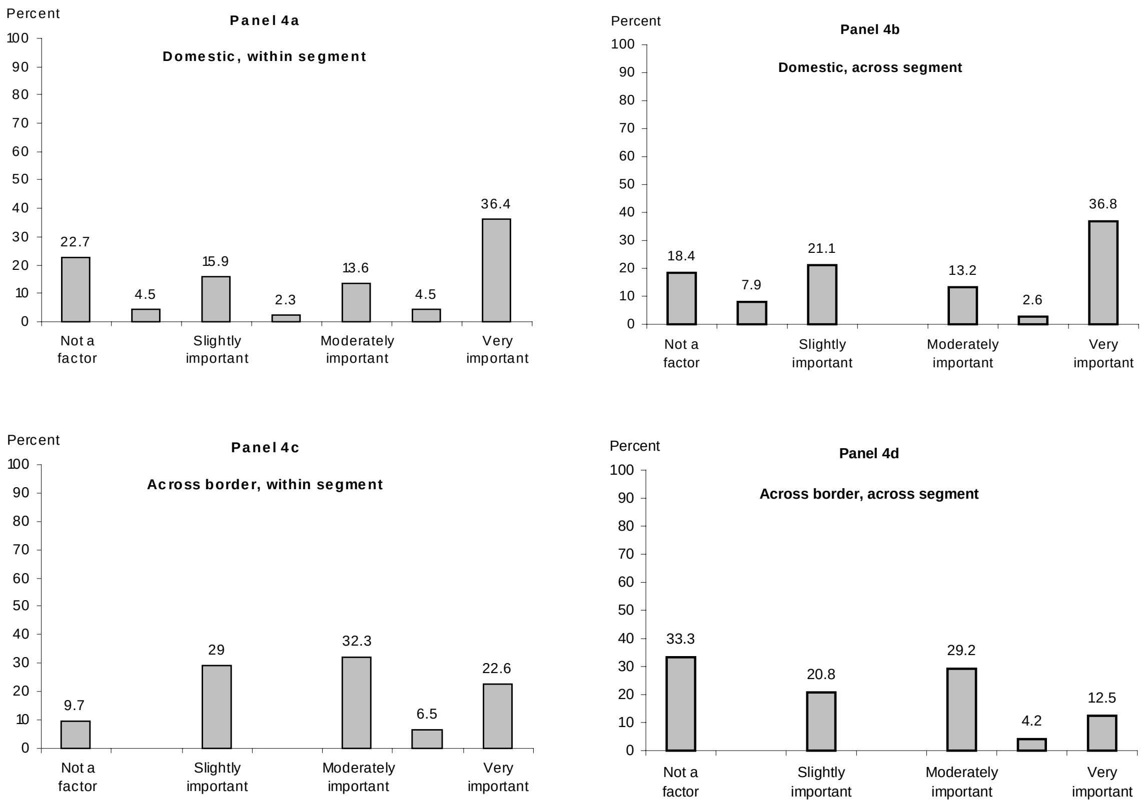
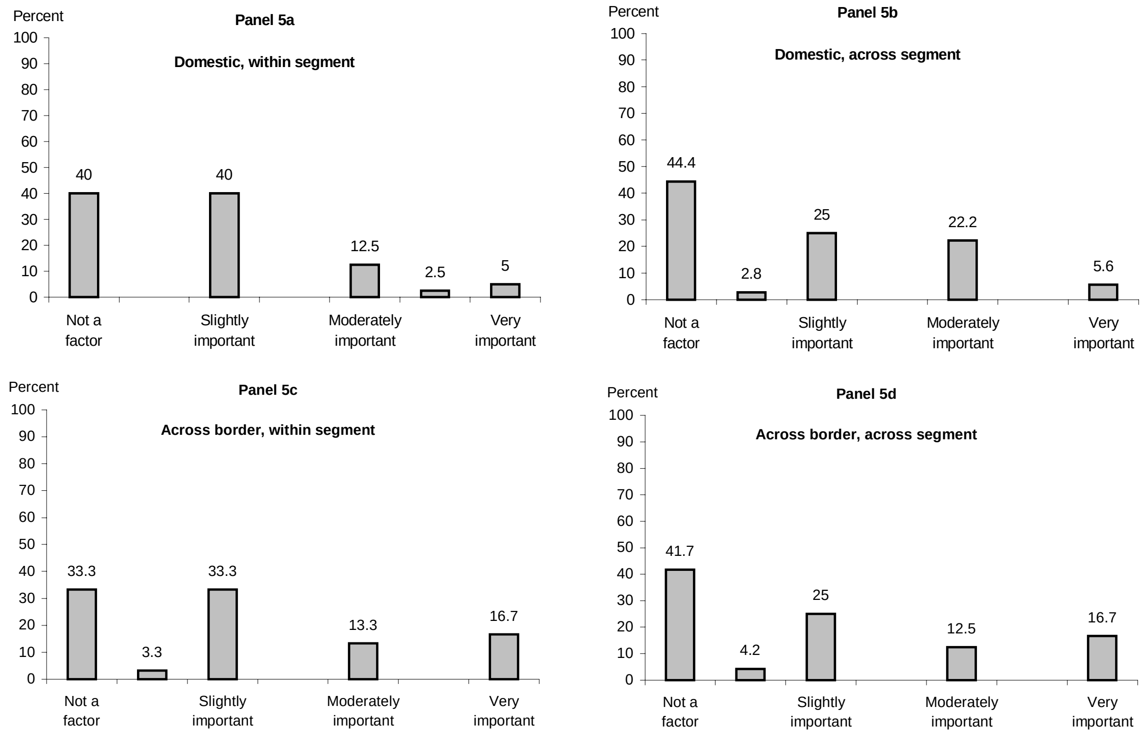


Chart II.2 (continued)

Panel 5: Globalisation – non-financial trade



Panel 6: Globalisation – expansion of capital markets

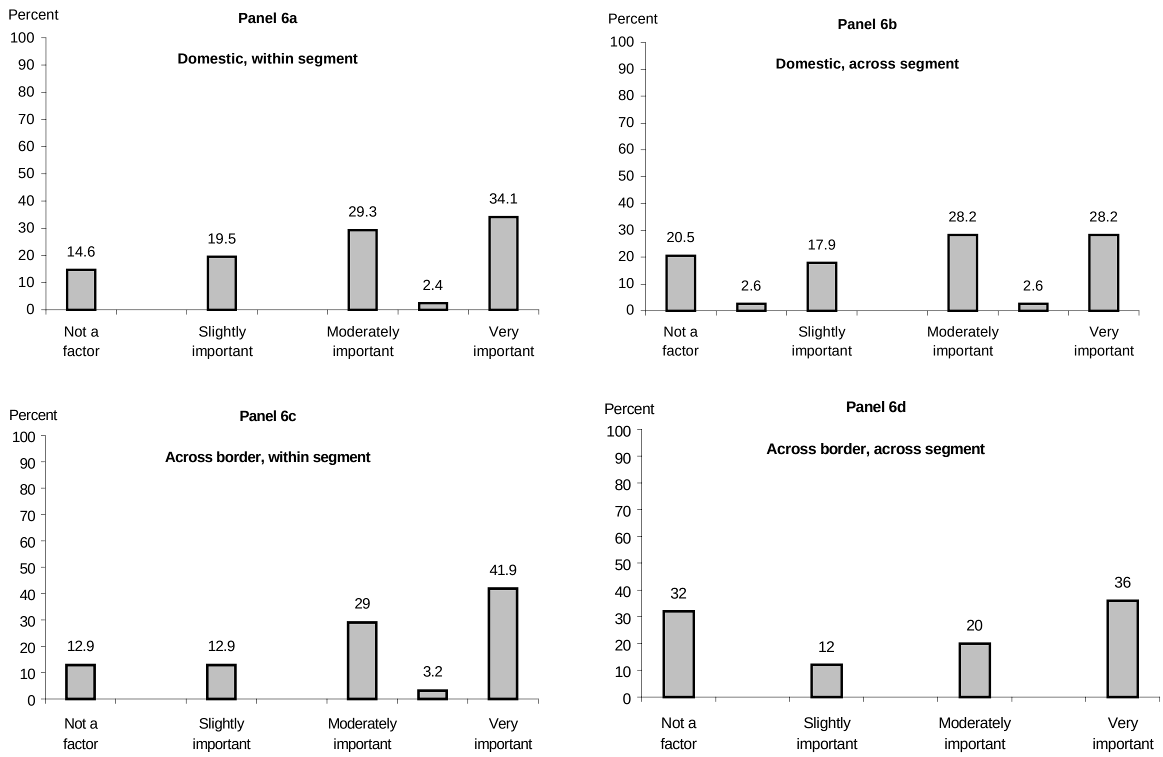
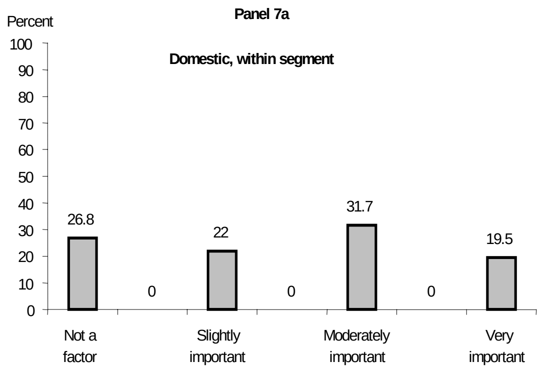
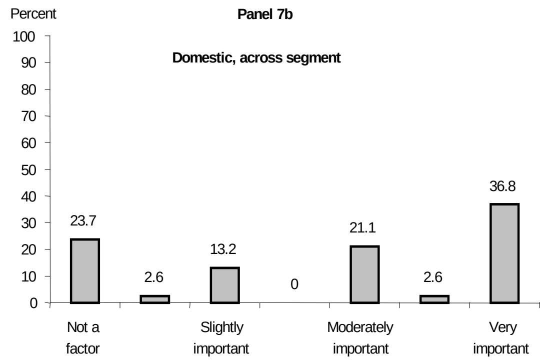
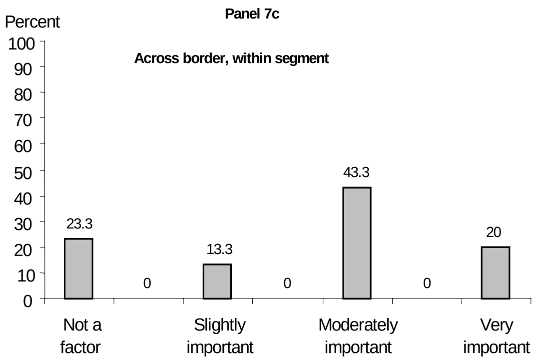


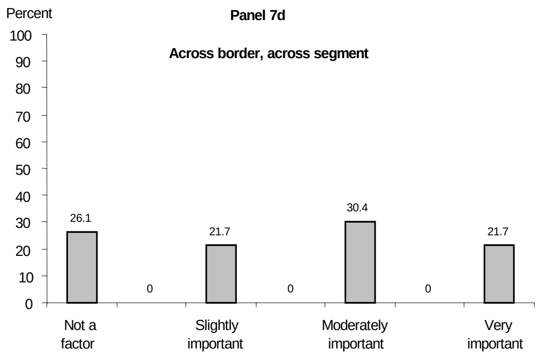
Chart II.2 (continued)

Panel 7: Globalisation – institutional savings

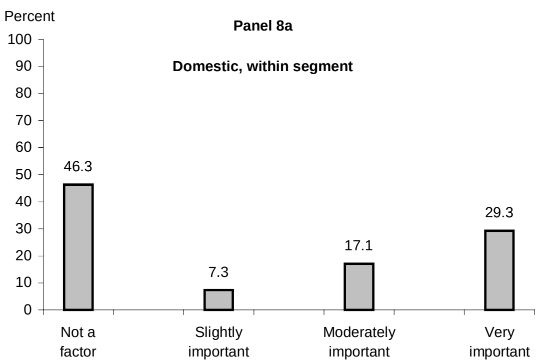


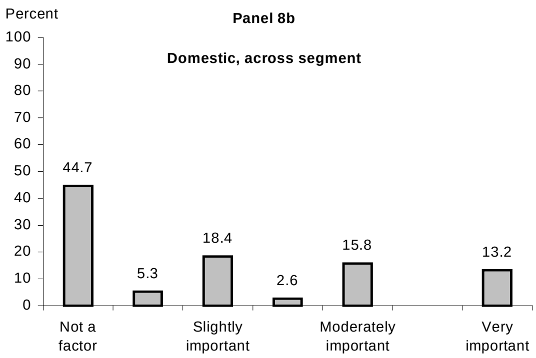


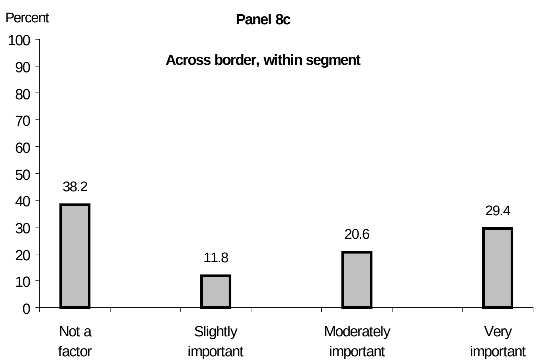




Panel 8: Globalisation – euro







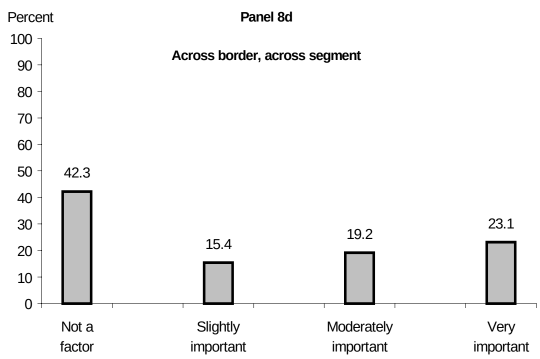
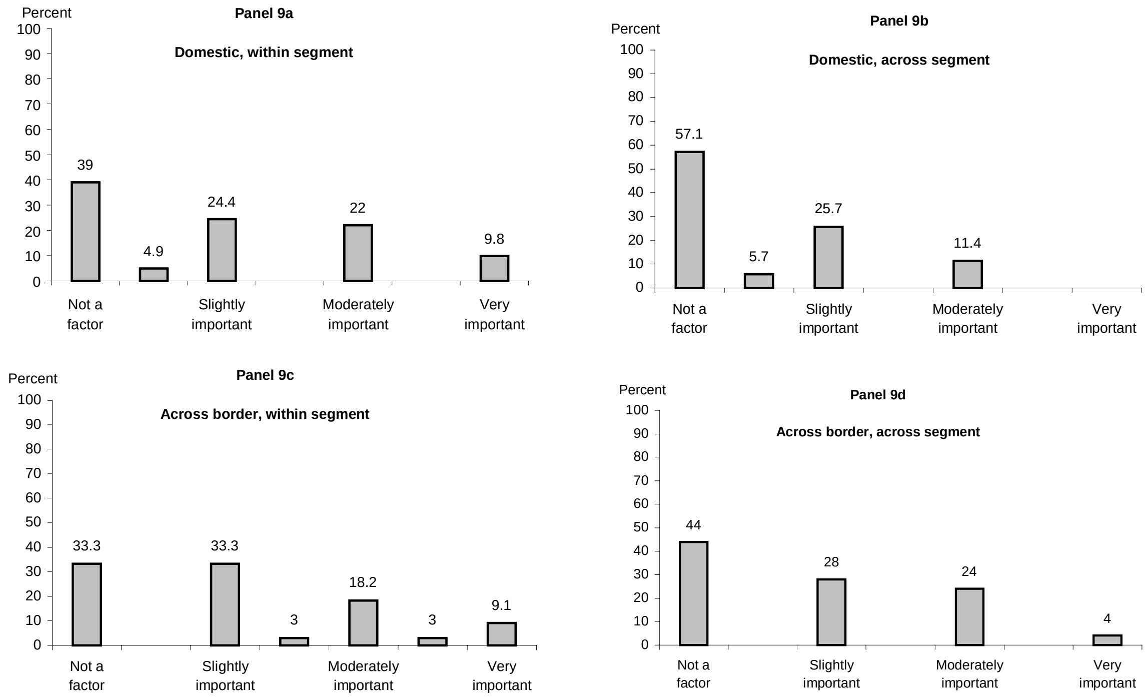


Chart II.2 (continued)

Panel 9: Privatisation



Panel 10: Climate of capital markets

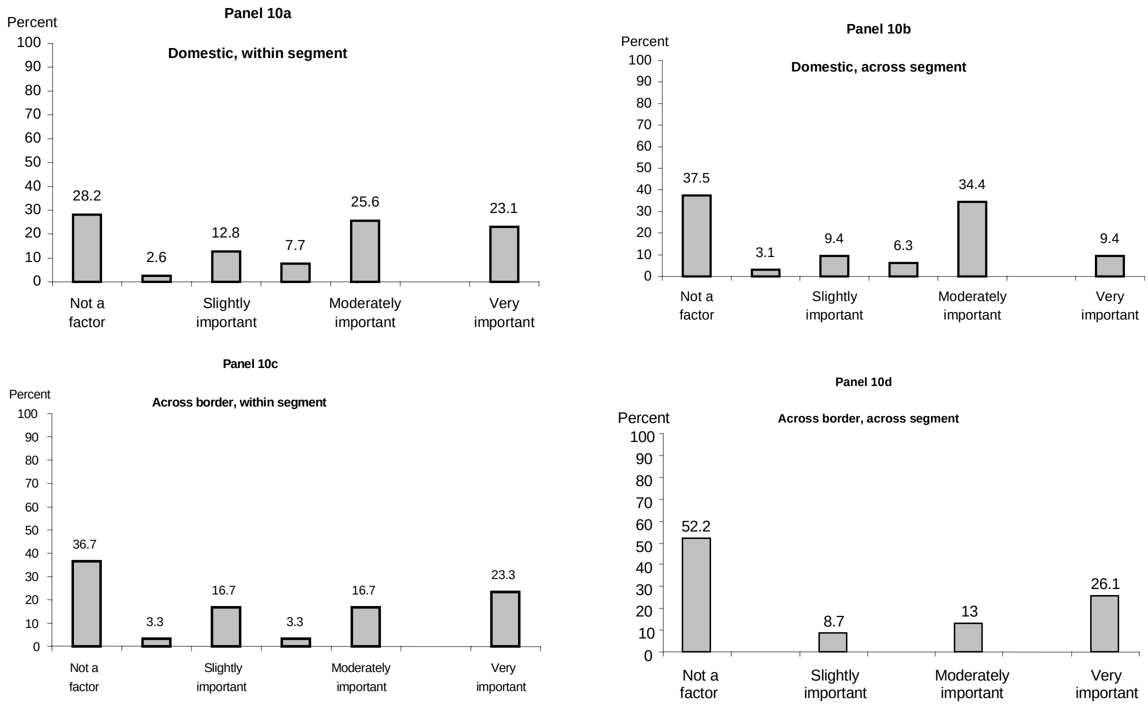


Chart 2 (continued)

Panel 11: Bail out and financial conditions

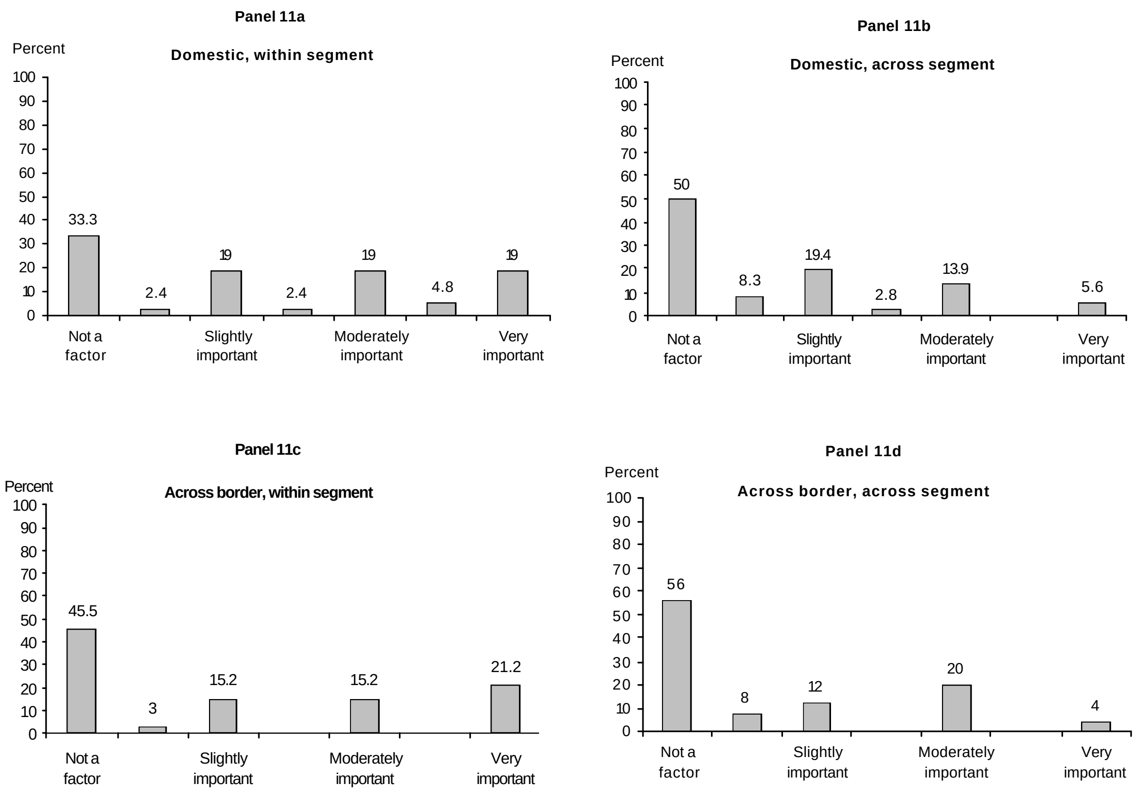
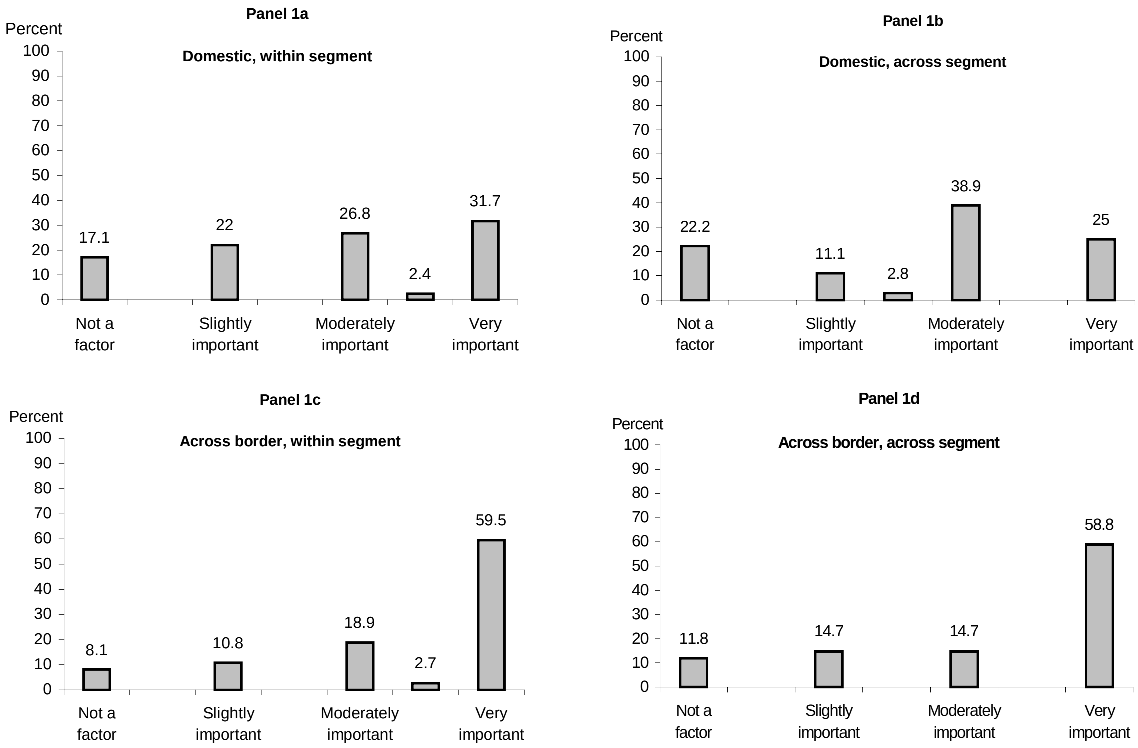


Chart II.3

Forces discouraging consolidation

Panel 1: Legal and regulatory impediments



Panel 2: Cultural constraints

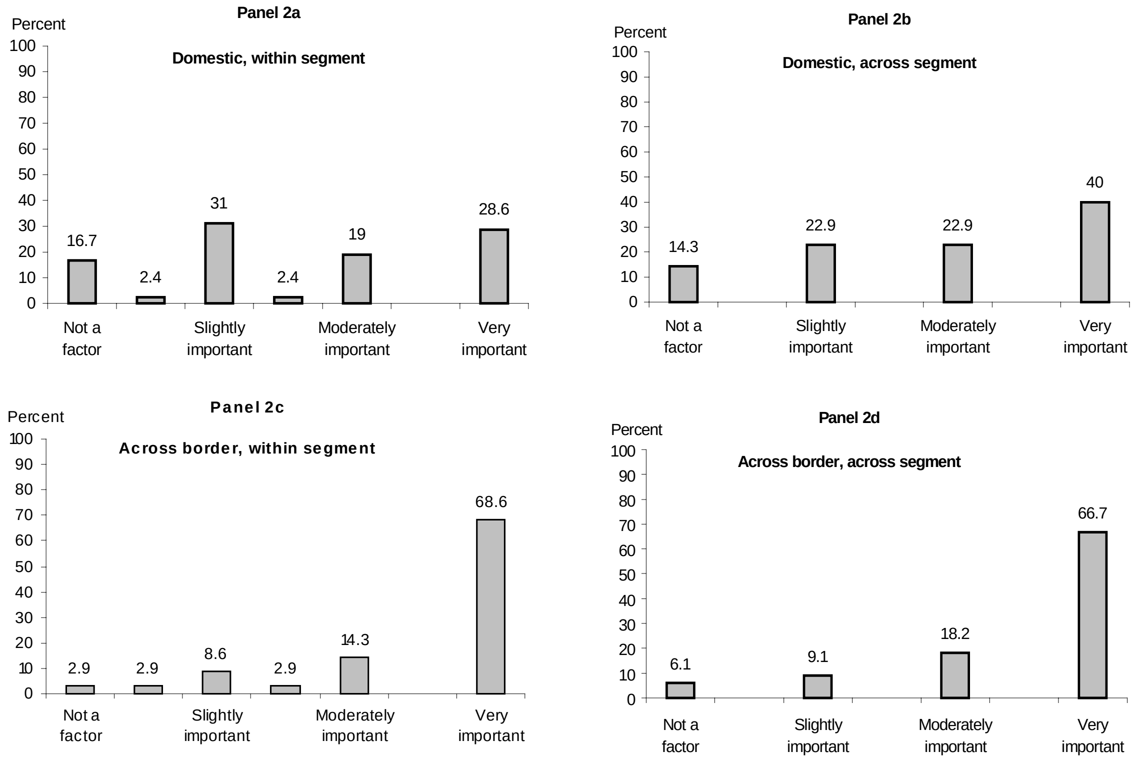
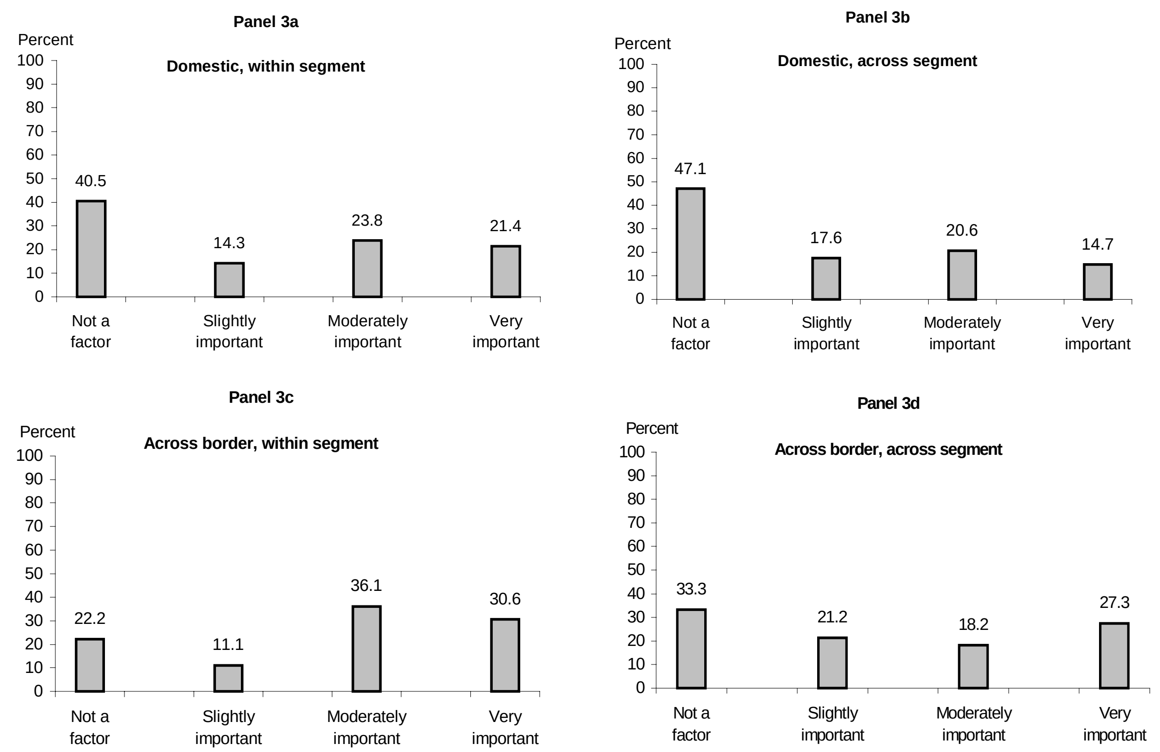


Chart II.3 (continued)

Panel 3: Market inefficiencies



Panel 4: Deconstruction

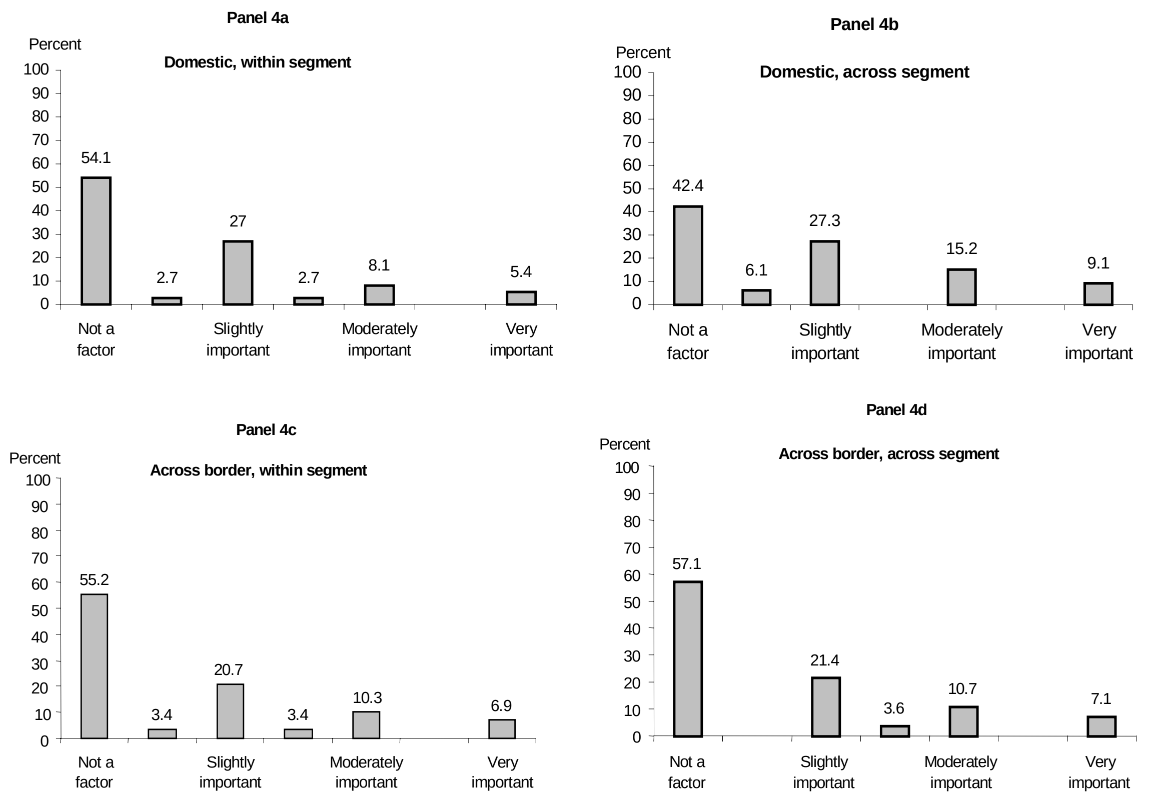
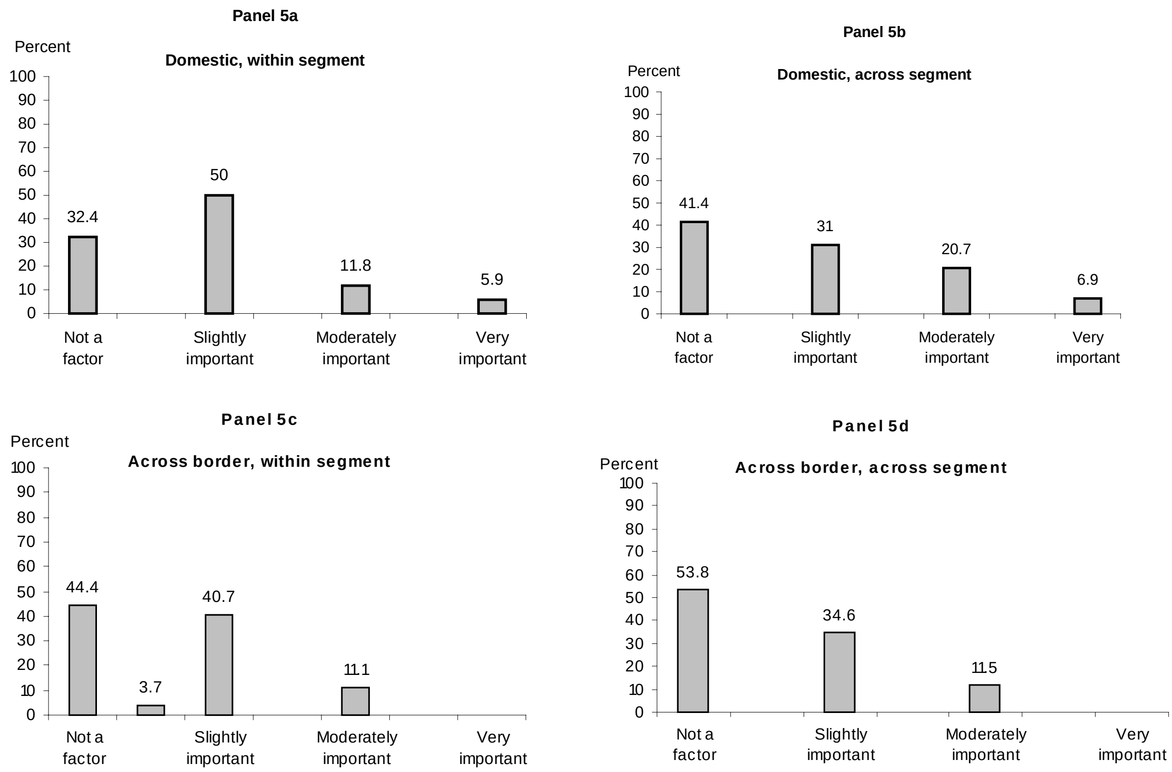
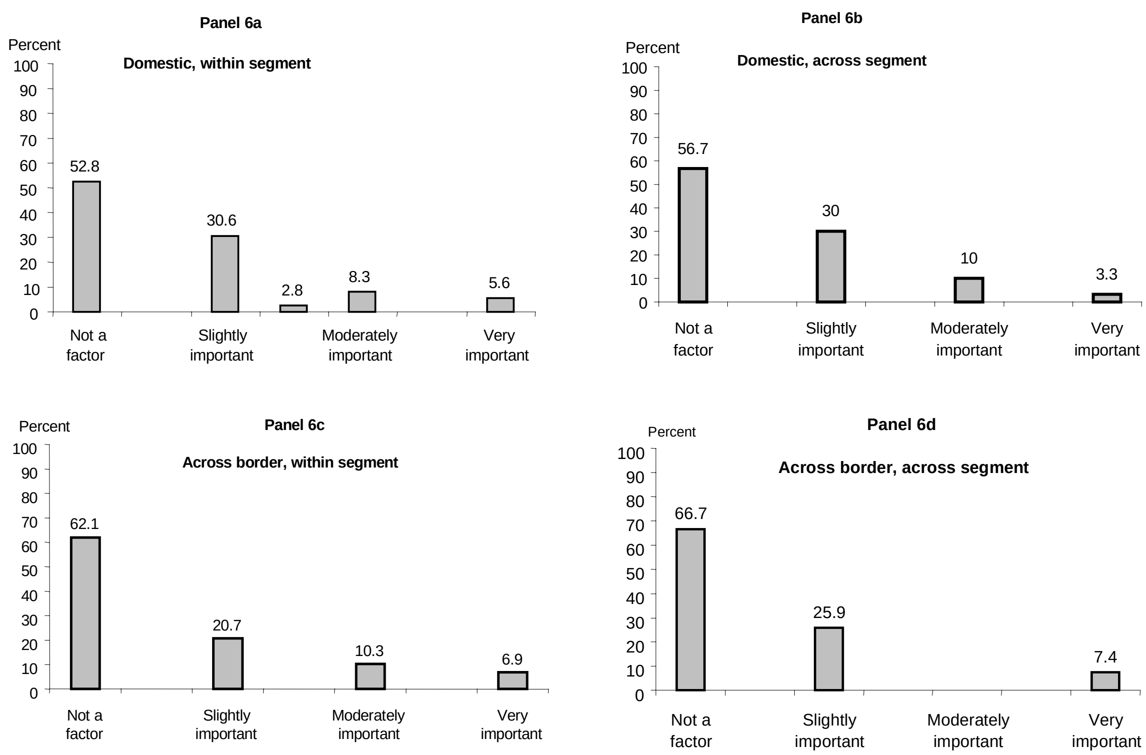


Chart II.3 (continued)

Panel 5: Outsourcing



Panel 6: Internet



Annex II.1
Interviews – country synopses

For each G10 country, Australia and Spain a synopsis has been drawn up based on the qualitative assessments of the interviews. These synopses contain information on the motives for consolidation, external factors and expectations for the future. The sequence is as follows:

United States

In order to develop a picture of financial sector consolidation in the United States, seven interviews were conducted with various industry experts. The interviewees included a lawyer who has advised banks on mergers and acquisitions, a senior official with a leading US bank, two banking industry consultants, a senior analyst with an investment bank, and representatives of a thrift industry trade association and an insurance industry trade association.

Motives for consolidation

All but one of the seven US interviewees indicated that cost savings due to economies of scale were moderately or very important as a driver of within-segment, within-country mergers, although it was noted that anticipated cost savings often were not realised. Cost savings due to economies of scale were viewed as slightly important or not a factor in the case of cross-segment mergers and cross-border mergers. Revenue enhancement due to product diversification was viewed as moderately to very important in motivating cross-segment mergers, both within and across borders. Five out of seven interviewees considered change in organisational focus to be unimportant, while one viewed it as very important for cross-segment mergers and one viewed it as very important for within-segment mergers for small savings institutions. The interviewees varied considerably in their views regarding the importance of increased market power and managerial empire building as motives for consolidation.

External factors

For commercial banks, the most important forces encouraging domestic consolidation (both within and across segments) were improvements in information and communications technology, deregulation (especially interstate banking), bailouts (particularly in the late 1980s and early 1990s) and the climate of capital markets. For cross-border consolidation involving commercial banks, expansion of domestic and international capital markets was viewed as an important factor. Cultural constraints were viewed as a very important factor discouraging cross-border mergers and a moderately important factor discouraging domestic cross-sector mergers. One interviewee indicated that cultural constraints have not played as big a role as they should, since firms often have trouble dealing with cultural differences after a merger. One interviewee perceived market inefficiencies to be a very important factor discouraging cross-border consolidation.

For investment banking and asset management companies, the most important factors encouraging mergers of all types were improvements in information and communications technology, trade in non-financial products, expansion of domestic and international capital markets and the climate of capital markets. Market inefficiencies were viewed as a moderately important factor encouraging cross-border consolidation, rather than a deterrent to consolidation. Cultural differences were deemed a very important deterrent to domestic cross-segment mergers and to cross-border mergers. Legal and regulatory constraints were viewed as important factors discouraging cross-border mergers.

For insurance firms, the most important factors encouraging within-country mergers were the institutionalisation of savings (within segments) and deregulation. Electronic commerce, privatisation, bailouts and the climate of capital markets were viewed as moderately important. For cross-border mergers involving insurance companies, trade in non-financial products and the creation of the euro were viewed as important factors as well. Legal and regulatory constraints were viewed as moderately important factors discouraging consolidation, both within and across borders, and cultural constraints were viewed as very important in discouraging cross-border mergers.

Expectations for the future

Consolidation is expected to continue in the future, with essentially the same economic factors driving deals. The pace of bank-bank consolidation is expected to slow down, especially if the anticipated elimination of pooling-of-interest accounting for mergers is implemented. There is likely to be a substantial increase in insurance company mergers if the economy slows down. The Financial Services Modernisation Act is expected to have a minor impact on consolidation. It is unlikely that there will be many bank-insurance deals. None of the interviewees expect to see a great deal of cross-border consolidation involving US firms in the near future. Strategic alliances may play a more important role in the future than in the past. There may also be more disaggregation as firms shed non-core lines of business.

Canada

This synopsis is based on interviews with a Canadian lawyer who has advised Canadian banks about their merger objectives, an academic well versed in financial services sector issues, and representatives of two major Canadian banks.

Motives for consolidation

The most important motive for within-country, within-segment consolidation is cost savings attributable to increased size. Other factors that ranked important or moderately important include revenue enhancement due to increased size, cost savings attributable to product diversification, and revenue enhancement due to product diversification. Increased market power and managerial empire building were said to be not important. In cross-segment mergers, cost savings attributable to increased size were again deemed fairly important, but revenue enhancement due to product diversification was considered the most important motive. Cost savings attributable to product diversification and revenue enhancement due to increased size were viewed as moderately important.

Rankings of the motives for cross-border and within-segment consolidation varied across the interviewees, but it is fair to say that the same general ranking prevailed as above for in-country consolidation. Overall, the motives for cross-border and cross-segment consolidation were weak relative to the motives for within-country mergers and relative to the motives for cross-border within-segment mergers.

Interviewees all agreed that motives for consolidation are affected by the size of the financial institutions involved. They believed that in the current Canadian regulatory environment, mergers between smaller institutions are more likely to win government approval than mergers involving large institutions. Another observation made by the interviewees was that consolidation for smaller institutions can lead to an increase in market power, while larger institutions see consolidation as providing opportunities to get rid of excess capacity or increase efficiency.

External factors

As for forces encouraging consolidation within segments, each of the three technology forces were ranked as moderately important or very important. Under globalisation, trade in non-financial products and expansion of domestic and international capital markets were ranked as moderately to very important, and institutionalisation of savings was ranked as moderately important. The climate of capital markets was also viewed as a moderately important factor. Rankings of forces for consolidation across segments and within the country were quite similar.

Turning to cross-border consolidation within segments, interviewees did not agree on the relative importance of the three technology forces. One thought that they were not at all important, while another thought they were very important. Under globalisation, expansion of domestic and international capital markets was ranked very important. The institutionalisation of savings was not ranked as a significant force encouraging cross-border consolidation. Creation of the euro and privatisation were viewed as not at all important. Under other forces, the climate of capital markets was regarded as moderately important.

Legal and regulatory constraints were frequently cited as most important among the forces discouraging consolidation in Canada. There was less agreement on the importance of cultural constraints and market inefficiencies. Outsourcing was mentioned as slightly important by two of the interviewees. Forces discouraging consolidation across segments within Canada were said to be the same as the forces discouraging consolidation within segments. In terms of cross-border transactions, the undervalued Canadian dollar was viewed as a market inefficiency acting as a force discouraging consolidation, as was the high equity price of many US financial institutions. As for inbound mergers and acquisitions, Canadian regulation and ownership policy considerations were seen as forces discouraging consolidation.

Expectations for the future

Turning to future expectations, interviewees said that a great deal hinges on a change in Canadian government policy. This will come about in time, they believed. Consolidation within segments and across segments was seen as a way to enhance the efficiency of Canada’s financial sector, and would be in Canada’s national interest. Interviewees agreed that the largest Canadian financial institutions are small players on the world scene and felt they need to be bigger in order to compete more effectively with large foreign counterparts. The interviewees believed that a merger between large Canadian banks may be one or two years away from happening, while a merger between a large insurance company and a bank may not occur for possibly three years. With a change in Canadian government policy, cross-border consolidation between US and Canadian firms, in both directions, would be quite probable. Whilst the interviewees expressed a preference for further consolidation, it should be acknowledged that the optimal level of concentration in the Canadian financial sector is a contentious issue. In 1998 public authorities denied two merger requests by four of the largest Canadian banks on the basis of prudential concerns and concerns regarding the level of domestic competition (for a comprehensive discussion of the decision see Annex III.1 of Chapter III).

Japan

Interviews in Japan were conducted with four representatives of large investment banking firms.

Motives for consolidation

During the 1980s, most of the large Japanese banks (like other G10 financial institutions) sought a more active international presence, and expanded their branch networks and business operations overseas in an attempt to gain market share. The bursting of Japan's asset bubble in 1990-91, however, and the rapid deterioration of loan portfolios radically changed the operating environment. There were some cases of bank consolidation in the early to mid-1990s, the purpose of which was to achieve greater market power, to adapt to a changed regulatory environment, or to effect a "rescue merger" of a smaller, weaker bank with a larger bank. Since the late 1990s, the most important aim of financial consolidation has been to cut costs, combine revenue streams, and achieve economies of scale in order to survive in a new and more competitive environment. Although mergers and tie-ups seen thus far may not have an obvious strategic goal, the general consensus is that "bigger is better". Through mergers, acquisitions and shared business operations, Japanese financial institutions are seeking to streamline operations, reduce operational redundancies and use the resources from combined revenue streams to increase spending on information technology (IT) and other crucial infrastructure. The focus of this drive to regain competitiveness is clearly the domestic market. Japanese banks have been retrenching for several years from their overseas operations. At the same time, foreign banks in Japan are niche players, do not show significant interest in increasing their emphasis on loan intermediation, and appear unlikely to challenge domestic banks in their most important markets.

External factors

Interviewees all cited bailouts or the financial condition of firms as being a very important force encouraging consolidation. One of the interviewees said that price deregulation was a very important force encouraging consolidation, while others ranked that factor as either moderately or slightly important. Privatisation was rated as slightly important. Information technology was believed to be very important as a force for consolidation by two interviewees and moderately important by two others. (Japanese financial institutions are behind in IT and consolidation is one way to make the extremely high costs of catch-up more manageable.) Interviewees said that expansion of domestic and international capital markets has been slightly important as a force for consolidation, while creation of the euro was not a factor in Japanese consolidation. Turning to forces discouraging consolidation, all interviewees rated cultural forces as very important. (In particular, the keiretsu model of business group organisation has had a chilling effect on consolidation, although there is some basis for believing this counterforce has been weakening recently.) Market inefficiencies were seen as somewhat important in discouraging consolidation, and legal and regulatory constraints were slightly important. Interviewees ranked other forces discouraging consolidation as not a factor for Japan.

Expectations for the future

Looking to the future, there is anticipation of more consolidation. Lending capacity in Japan continues to be high relative to GDP. It will probably take years for Japanese banks to regain their competitiveness by raising their return on equity and become world-class players with up-to-date, efficient IT systems. With greater market acceptance and greater use of e-banking and e-commerce in Japan, more mergers as well as other types of consolidation (joint ventures, strategic alliances) may develop. Regulatory changes, which allow cross-industry entry through holding companies, may stimulate cross-segment consolidation. However, the market pressure that prompted the dramatic waves of structural reform and consolidation of the past two years is waning, and the pace of change may be slow.

France

Two large commercial banks, one large mutual bank and the association representing the insurance firms were interviewed.

Motives for consolidation

The commercial banks had a broad vision for financial sector consolidation (though somewhat centred on traditional banking and less so on investment banking) and shared a relatively common view, while the views of the mutual banks and the representatives of the insurance firms emphasised within-sector developments. The dominant motive for consolidation was thought to be cost cutting. In particular, the greatest scope for cost savings arising from consolidation was at the level of "production"; ie the production of instruments, such as mortgages, other specific loans and insurance, as well as back-office functions. Few cost savings were envisaged at the level of distribution, where the development of "brands" was considered to be critical. Moreover, cost savings were considered to be greater among banks within the same geographic region. Overall, much less emphasis was placed on revenue enhancement as an important factor, with one bank arguing that consolidation provided no such advantage while the other was rather more circumspect. It thought that size (using market capitalisation as a proxy) was related to return on equity and therefore the maximisation of shareholder value.

External factors

Turning to the forces encouraging consolidation, there was general agreement that information technology would produce cost savings but, as it was an expensive purchase, would also play an important strategic role. In Europe, deregulation and privatisation were considered to be another major force as they provided opportunities for consolidation.

As for factors discouraging consolidation, the most important impediment to cross-border consolidation between commercial banks had been moral suasion at the political level, though there is some evidence that this may have been lessening more recently. Another important impediment to consolidation through a merger (both cross-border and within-country) is tax considerations, especially large capital gains taxes in an asset-heavy industry. As for within-country consolidation, the large share of the banking and insurance sectors controlled by mutuals was said to be another important impediment to consolidation. Mutuals have many advantages, including some tax advantages (though these have been diminished in the case of banks), dominant local presence in certain rural areas, and, of course, the fact that they cannot be bought (unless they are demutualised). Mutuals have used these advantages and relatively healthy balance sheet positions to purchase listed firms. Most notably, this has occurred in the case of the two large mutual banks in France.

Expectations for the future

Looking forward, the concept of a universal bank is thought to be out of date, and it is anticipated that financial institutions will specialise, eg in investment banking or in the retail business. Furthermore, the traditional retail bank will need to have access to customers through a multi-channel network, rather than just through its branches. New channels may include the internet and television.

Cross-border consolidation of retail banks in Europe could circumvent political obstacles both through the creation of cross-border alliances and through cross-border mergers of upstream production (as described above) – for which the concentration was expected to be much greater than in retail distribution. In many ways this is similar to what has happened in the automobile industry, where cars of a different brand use similar parts (even engines). The more consolidated (upstream) sectors would probably be controlled by the larger retail banks.

The demutualisation of savings and loan banks, which will bring them onto the market as candidates for takeovers, would be another source for major changes in the financial landscape in Europe. It will have an effect similar to D'Amato's bank reform in Italy, which transformed the banking sector there. However, demutualisation is not currently under consideration in France. For a mutual to become a large player in it own right, it will need to improve the centralisation of management decisions, as the structure currently in place assigns many decision-making functions to regional cooperatives, which can retard the process. In terms of cross-border consolidation between mutuals, there currently does not exist a pan-European directive concerning the establishment of cross-border mutual subsidiaries.

Germany

Interviews in Germany were conducted with three commercial banks and an investment bank.

Motives for consolidation

With regard to consolidation within segments at the domestic level, cost savings attributable to increased size (economies of scale) were singled out by all interviewees as the primary motive. This factor is important mainly because of the growing diffusion of technologies. Revenue enhancement due to increased size is frequently underlined as well, thus further confirming the significance of scale economies. Besides IT departments, scale economies are deemed particularly significant with respect to other activities, including research, legal services, risk management, advertising, back-office operations and investment banking.

Increased market power was the second most cited motive. The attainment of a greater volume via a larger customer base would enable banks to alleviate the impact of declining interest margins. Another advantage of increased market power is better name recognition, which would be particularly significant for investment banking activities.

The situation is less clear as regards operations across segments, because consolidation has hardly stretched beyond sectoral boundaries in recent years. As a result, the only consistent pattern is the greater importance attributed to economies of scope (cost savings attributable to product diversification and revenue enhancement due to product diversification). Consolidation of banks with insurance companies is usually regarded as essential for the improvement of risk management. Moreover, existing alliances (achieved by cross-shareholdings) between these two sectors reduce the scope for full-blown mergers and acquisitions. By contrast, there are some examples of the acquisition of investment banks by large commercial banks. These are generally justified on the ground that they enable the latter to acquire better expertise in securities activities.

With regard to cross-border consolidation, the interviewees generally indicate that the ranking of motives is not fundamentally different from the case of consolidation at the domestic level. As regards the size of firms, economies of scale could be especially important for smaller banks, especially in retail banking (network of branches, development of common platforms) or in investment banking.

External factors

As for forces encouraging consolidation, all interviewees underlined the importance of technology for operations within segments at the domestic level. This driving force has a direct impact on economies of scale due to the huge set-up costs and to the importance of spreading the costs of technology over a large customer base. Furthermore, technology induces a greater mobility of consumers and enables them, especially corporations, to gain direct access to capital markets. Finally, technology enhances competition because it favours the emergence of new competitors targeting new market niches (for instance in the field of remote banking).

The euro was often cited as an important factor as well. The euro mainly acts as a catalyst for changes through its impact on the integration of capital markets and on price transparency and, therefore, on the degree of competition. Expansion of domestic and international capital markets was mentioned by all participants. One interviewee referred specifically to the securitisation trend and the accompanying use of ratings. Other commonly cited forces, albeit to a lesser extent, include the institutionalisation of savings and deregulation.

According to two interviewees, consolidation across segments is characterised by a far lesser role of technology due to technological discrepancies. Likewise, the euro loses much of its significance. As far as cross-border consolidation is concerned, the euro was widely cited as an essential encouraging factor. Deregulation is more important as well in this context. By contrast, the role of technology decreases due to technical incompatibilities from one country to another. Size is an important factor in a country where small banks are very commonplace. Unless they have a specialised niche, they are bound to be negatively affected by technology through strengthened competition and greater economies of scale.

With respect to the forces discouraging consolidation within segments at the national level, all interviewees referred to the role played by the segmentation of the German banking market and more specifically by the cooperative and publicly owned savings banks. In particular, it was indicated that these banks cannot be acquired by other institutions and are insulated from competitive forces. As regards consolidation across segments, cultural constraints and the fact that informal alliances are already in place reduce the impetus towards the acquisition of insurance companies. Cultural and regulatory impediments are especially significant for cross-border consolidation.

Expectations for the future

The interviewees anticipate an increase in the number of mergers, especially on a cross-border basis (one interviewee is sceptical in this respect). This evolution could be enhanced by two other anticipated developments, namely the lifting of remaining regulatory constraints (one interviewee is less optimistic in this respect), which is an effect of the introduction of the euro, and a greater openness of the cooperative and savings banks sector. The specialisation and the polarisation of the German banking sector are liable to increase in a context characterised by the diffusion of technology. Some banks anticipate a re-specialisation of financial institutions and a growing tendency towards outsourcing.

Italy

Three interviews were conducted with banks, which covered the main segments of the banking sector in terms of size, and one with a university professor, which covered the insurance sector.

Motives for consolidation

The main motive for consolidation within the banking sector at the domestic level concerns the need for banks to pursue cost savings attributable to increased size (economies of scale). A number of areas were referred to in which economies of scale can be pursued, including information technology, back offices, payment services, general directorates, etc. The objectives of revenue enhancement due to product diversification and, to a lesser extent, to increased size were mentioned as other relevant motives for consolidation. In particular, the need to be able to provide the whole range of services to customers was regarded as a very important motive. Another relevant motive was the need of banks to increase their market share with the objective of enlarging the customer base and diffusing products and services. Among other factors, geographical diversification was mentioned as an important factor for risk diversification and increased market share.

Regarding operations across segments (bancassurance), the main motive for consolidation is the pursuit of product diversification. This is intended, in the first instance, to provide “one-stop shopping capabilities” and, secondly, an opportunity for risk diversification. For cross-border operations within the banking and the insurance sectors, the motive of revenue enhancement due to increased size tends to become more important, whereas the cost saving argument loses some of its relevance. Moreover, the motives based on revenue enhancement through increased size and increased market power tend to be more important for large banks, whereas the motives based on cost savings through increased size and revenue enhancement through product diversification appear more relevant for small/medium-sized banks. By contrast, the pursuit of economies of scale is relevant throughout the whole banking sector.

External factors

Information technology was regarded almost unanimously as a primary encouraging factor. The introduction of the euro was a second important factor. The euro was perceived in the strategic planning of banks as the main driving force to complete the single market and, thus, to achieve the full integration of financial markets. Third, deregulation has also played an important role over the past years, though it has in current times exhausted its effects. Fourth, privatisation was regarded as an additional important factor, given the large number of publicly owned banks. Finally, consolidation as a tool for the resolution of banking crises has played an important role for both small and large banks.

For operations across segments, the aspect of institutionalisation of savings in particular tends to become more important, whereas with regard to cross-border operations some factors become more important (eg globalisation), others less (eg privatisation and resolution of crises). Furthermore, technology and financial innovation may represent a threat for small and medium-sized banks that are not dynamic and thus create an incentive for consolidation. By contrast, these two factors may represent an opportunity for those banks that are dynamic to follow niche strategies and to develop new distribution channels.

Regarding the forces discouraging consolidation in the banking sector at the domestic level, the emphasis was put on legal and cultural constraints. However, this refers mainly to the first part of the reference period (1990s) rather than to more recent years since most of the constraints have been removed. In this respect, one aspect frequently mentioned was that the publicly owned banks lacked the necessary managerial mentality and that this tended to discourage the process of consolidation. Legal and cultural constraints were regarded as having even more relevance with regard to operations across segments at the domestic level and on a cross-border basis.

Expectations for the future

In the banking sector, the process of consolidation was expected to continue at the national level but mainly for small and medium-sized banks. For the largest six or seven banking groups, the increase in size in the domestic market no longer appears to be a strategic priority, largely because it could raise antitrust concerns. The new strategic focus is likely to be the development of complementary activities to the traditional banking business, such as asset management and investment banking, which generate non-interest income. In these areas, it is possible to set up international platforms also through partnerships or strategic alliances with specialised institutions.

As far as the factors affecting consolidation in the banking sector are concerned, the importance of information technology (internet) was expected to grow. Second, the importance of the euro as a factor encouraging consolidation was also expected to grow through its effects on the integration of financial markets. Third, further regulatory convergence was expected mainly on a cross-border basis, also partly as a consequence of the pressure exerted by the euro on the competent Community and national authorities. Fourth, competition from non-banks was expected to increase not only from non-bank financial institutions but also through the provision of banking services by industrial firms. Fifth, cultural constraints were thought likely to decrease in terms of importance for operations across segments. Finally, outsourcing is expected to spread further by providing an opportunity to save costs, especially for small banks. However, this was not expected to have a direct effect on consolidation.

United Kingdom

Five interviews were conducted in the United Kingdom. Interviewees included a representative of a large British bank, representatives of a rating agency, a representative of a bank consulting firm especially knowledgeable about the UK banking sector, a representative of a large securities firm, and representatives of a boutique investment bank with expertise in both the banking and insurance sectors.

Motives for consolidation

The most important motive for consolidation within sectors (banks, investment banks and insurance firms) has been cost savings attributed to increased size. There has to be a credible cost savings story about a proposed merger or acquisition in the United Kingdom or the market will not ratify the deal. Interviewees also reported revenue enhancement due to increased size as important, but secondary to cost savings as a motive for consolidation. Other motives deemed important were increased market power and managerial empire building. Motives for consolidation across sectors yielded a different set of rankings. Revenue enhancement due to size and due to product diversification were most important; managerial empire building continued to rate as an important motive. However, cost savings attributable to increased size dropped to "slightly important". In investment banking, a few of the biggest players have a global strategic focus. Firms in this category believe they can do any kind of deal anywhere in the world that a customer desires. The market gives special rewards to firms in this "bulge bracket" in terms of much higher trading volumes. (Investment banking capabilities that were formerly housed in major UK-owned banks have been divested in some cases in order to concentrate on retail banking services.)

Cross-border consolidation in the banking sector requires a certain leap of faith, as one interviewee put it, and those interviewed tended to downgrade the importance of the various motives when compared to within-country consolidation. Motives for cross-border consolidation in investment banking were deemed stronger than within-country because of a desire by the bulge-bracket firms to offer any service to any firm. Interviewees reported that motives for cross-border consolidation within segments in order of importance were revenue enhancement due to increased size and managerial empire building. Interviewees generally indicated that size matters. For banks, the largest ones have the greatest acquisition opportunities. For investment banks, smaller firms seeking shelter look for the best deal they can get; large firms want to be in the bulge bracket.

External factors

Turning to forces encouraging consolidation within segments, information and communications technology and e-commerce, along with expansion of domestic and international capital markets were ranked highest, while deregulation and privatisation were insignificant. The creation of the euro has not been a significant force for consolidation up until now. Across segments, forces for consolidation were rated the same or lower. Across borders, the creation of the euro and institutionalisation of savings were ranked highest by all but one interviewee among forces for consolidation (particularly looking ahead and looking towards Europe), followed by e-commerce, deregulation and privatisation. For banks, size is a factor in determining the number of potential buyers and sellers. For investment banks, small firms are vulnerable; medium-sized firms are attractive to foreign buyers looking for footholds elsewhere.

The most important forces discouraging consolidation within segments were market inefficiencies and legal and regulatory constraints. Across segments, and across borders, cultural constraints and legal/regulatory constraints were most important. Two interviewees rated the internet as a moderately important or very important force discouraging cross-border consolidation, while others rated it only "slightly important". Outsourcing was seen as only slightly important. Furthermore, larger firms can more easily fight off within-country or cross-border acquisition attempts. Regulators were perceived as having a home court bias.

Expectations for the future

Mergers within segments will continue at a moderate pace in the UK market, particularly in banking. In investment banking, the few remaining UK-owned firms will continue to diminish as a result of foreign acquisition. In the insurance sector, interviewees believe there is relatively little opportunity remaining for consolidation among non-life firms owing to the consolidation that has already taken place. Further consolidation will result in the comparatively weak UK firms being acquired by US and/or European firms. Consolidation in the less-concentrated life insurance sector will continue, and European life insurance companies may acquire some of these entities. Key variables affecting the pace and nature of consolidation include: investor attitudes; regulatory constraints, where the key concern will be the effects of further consolidation on competition; and the public's perception of merger problems. Outsourcing, mentioned as a force against consolidation, is still active and could mitigate against consolidation in the future. If the United Kingdom decides to join the euro area in the future, and if increasing harmonisation ensues for tax regimes, financial regulation and financial products, then there could be much more pan-European financial sector consolidation over time.

Australia

Interviews were conducted with three of the four major banks in Australia about their approach to consolidation.

Motives for consolidation

In the first phase of consolidation – until the mid-1990s – an important motive was risk reduction through geographic (cross-border) diversification, to reduce dependence on economic conditions in Australia. However, the experience of two of the banks in moving offshore provides an interesting contrast. One bank began to build up its offshore network, with a focus on the Asian-Pacific region, in the mid 1980s, but withdrew a few years later in response to substantial domestic losses and integration difficulties; cultural differences were cited as a major obstacle. In contrast, the second bank concentrated successfully on retail bank acquisitions in Anglo-Saxon countries and was cautious not to alienate local customers by re-branding banking products.

More recently, consolidation has increasingly been driven by the desire of the banks for revenue enhancement by becoming retailers of a full range of financial services to customers. This is recognition that, within a relatively mature banking market, funds management and other financial products offer greater potential for earnings than traditional banking. Accordingly, two of the banks have acquired or are pursuing acquisitions in the funds management area and in other specialised services, such as mortgage processing, as a means of filling gaps in their product ranges. For one bank, the goal is to become a "best of breeds" retail supermarket.

Although not a factor in every acquisition, the banks acknowledged the potential for significant cost savings from economies of scale, particularly in technology. Research and development of newer technologies involve substantial fixed costs and risks, which are more easily borne by larger institutions. Mergers were viewed as a rapid and cost-effective way of increasing size both at home and abroad; organic growth was expensive because of the need to compete aggressively on price to attract customers from other banks.

External factors

Globalisation was acknowledged as an important factor encouraging consolidation, in at least two respects. The expansion of international capital markets has allowed the banks to fund their balance sheet growth well beyond what could be sustained by domestic deposit growth and the Australian capital market alone. Their size, diversification and strong credit ratings have also given the banks a funding advantage over smaller institutions. Secondly, greater global competition has spurred the banks to shore up their positions by increasing their size and product range through consolidation. Financial innovation, technological change and the commoditisation of products have fostered the emergence of a competitive fringe of non-bank financial institutions in Australia, and made it easier for customers to shop around, placing further pressure on profit margins.

Government policy on competition has been a key influence shaping the direction of consolidation in Australia. Under the current “four pillars” policy, mergers between the four major banks will not be approved until the Commonwealth Government is satisfied there has been a sufficient strengthening of competition in the Australian banking market. In the absence of this policy, each of the banks interviewed would be looking to merge with another of the majors in expectation of substantial cost savings through a rationalisation of branch networks as well as technology and back-office synergies. A further element in competition policy is the application of a regional rather than a national definition of the banking market in assessments of merger proposals by the Australian competition regulator. This has created some difficulties for major banks seeking to merge with smaller banks, which have, nevertheless, sizeable positions in a regional market.

Aside from competition policy, regulatory and taxation arrangements were not seen as an impediment to consolidation. Nor was outsourcing, because this process was already occurring in the non-core areas of the banks themselves and because outsourcing contracts could always be paid out or renegotiated. On the other hand, cultural differences have been a barrier, especially across segments. Experience suggests that successful acquisitions have been based on a marriage of similar management philosophies and have been friendly in approach, thus reducing the risk of loss of customers and management. Across borders, the banks believed that risk increased with distance from customers – in physical, cultural and language terms.

Expectations for the future

The banks interviewed expected that the four major banks would continue to dominate financial intermediation in Australia because of their broad-based relationships with customers. These banks will all be seeking to develop the financial services supermarket concept – including a strong move into the management of retirement savings – and will be competing in an increasingly global market. Looking further ahead, consolidation may also involve mergers or alliances with non-financial institutions specialising in distribution technologies. In this environment, small banks may be able to survive if they can develop expertise in niche markets and products, buying in technology and other services to benefit from any scale economies of suppliers. The banks interviewed thought that the group most at risk from competition is medium-sized financial institutions, which, in the absence of strategic alliances, face burgeoning technology costs and may lack the scale to compete successfully in global markets.

Belgium

Three interviews were conducted in Belgium, two with large financial services groups (including a cross-border financial conglomerate) and one with a medium-sized financial group.

Motives for consolidation

Despite the differences that exist between the three financial institutions that were interviewed, it is possible to distinguish several common motives that explain why consolidation has occurred. The leading motive was a combination of cost savings and revenue enhancement. Cost savings, particularly in the case of the largest groups, were envisaged through downsizing the number of branches and staff restructuring. It was mentioned that a merger makes it somewhat easier from a practical or political perspective to actually realise these cost reductions compared to a standalone situation. Since much consolidation in Belgium is across segments, it is no surprise that groups expect to enhance their revenues through exploiting the bank-insurance concept. The possibilities of cross-selling (access to distribution channels) and the diversification of products (one-stop shopping and the need to be able to provide the whole range of products to customers) are key in this respect. Revenue enhancement through increased market size and market power tended to be important for the larger groups. Other motives, such as risk reduction and managerial empire building, were not found to be very relevant in the Belgian case.

External factors

The introduction of the euro along with the globalisation of capital markets was considered as a factor encouraging consolidation. The euro will integrate European financial markets, making them much larger than the markets that existed previously in EMU member states. In order to be a player of some significance – particularly in the wholesale segment – one needs to grow. In the case of asset management, consolidation will even accelerate, as this type of business will receive a stimulus from the demographic changes (ageing) that are taking place. The favourable climate of capital markets was also seen as a stimulating force, as this facilitates the financing of mergers and acquisitions. The developments in information technology were mentioned as well, as small and medium-sized firms cannot afford the large investments that are needed, although one felt that its impact on mergers and acquisitions should not be overstated. Disintermediation (more than deregulation) was also identified as a factor, since it increases competitive pressures to which banks must respond.

Differences in culture and corporate governance have been complicating and impeding consolidation in Belgium to a considerable extent. In fact, these factors largely explain why consolidation among large banks took off relatively late. Culture and corporate governance play an even more discouraging role in the cross-border context.

Expectations for the future

All interviewees anticipate more consolidation, including cross-border consolidation in Europe brought about by the euro and the process of globalisation. Furthermore, one expects that there will remain room for three or four retail banks in Belgium (domestic players), while there may emerge a few very large European retail banks, serving Europe and beyond. In order to meet competitive pressures from the global wholesale players of the United States, the large universal banks in Europe may specialise in the future. There will continue to be many niche players and regional players in the wholesale field. Finally, it was recognised that the developments in the financial sector are surrounded by a large degree of uncertainty, and that competition will probably also come from outside the financial sector (eg telecommunications). That may be behind the strategy of the Belgian banks as they try to diversify their activities across banking and insurance. Outsourcing may also increase, as it provides opportunities for cost savings. Deconstruction of the financial sector, although not very likely in the short run, may be a threat in some form in the longer run. This will partly depend on the progress in information technology, which is difficult to predict.

Netherlands

The interviews in the Netherlands were held with four major banks.

Motives for consolidation

Increasing scale appears to be one of the main motives for consolidation in the Dutch financial sector, with an eye on both cost savings and revenue enhancement. Cost savings were related, for example, to overlaps in branch networks and staffing as well as to high investments needed in technology, product innovation and (in the wholesale sector) human capital. Generally, cost savings were thought to be most important in cases of consolidation within industry segments (both domestic and cross-border). With regard to the motive of revenue enhancement through increasing scale, a distinction was made between wholesale and retail. In the wholesale segment, increasing scale was thought to motivate consolidation because a larger equity base and greater name recognition allow larger customers to be served. In the retail sector, increasing scale was linked to the need to speed up the innovation process and widen distribution channels in view of the fact that competitors can copy product innovations ever faster due to technological developments. The desire to extend the retail customer base has stimulated cross-border consolidation, given a mature home market.

Product diversification was cited as another important motive for consolidation, particularly for consolidation across segments (both domestic and cross-border), though it was connected to revenue enhancement ("one-stop shopping") rather than to cost savings (economies of scope) or risk reduction. A key factor in this process has been that customers view financial products more and more as substitutes. The interviews indicate that psychological motives have been moderately important, particularly the fear of becoming a takeover target oneself. Another moderately important motive was said to be shareholder pressures to create value. This also indirectly influences institutions that are not publicly held, as it affects the behaviour of their competitors. There were different views as to how the size of the firms involved might affect the relative importance of the various motives. Tentatively, it may be concluded that cost considerations have been particularly relevant to smaller institutions, whereas larger players may have had a broader set of objectives, including, for example, change in organisational focus.

External factors

All interviewees viewed the development of technology, particularly information and communications technology, as one of the main factors encouraging consolidation. It enables substantial economies of scale to be achieved (for example concentration of the back office) as well as efficiency gains (such as a more efficient use of customer data, or data mining), while it is itself also subject to considerable economies of scale. Deregulation was also commonly mentioned as a cause of consolidation both within the Netherlands and across borders. Of the factors related to globalisation, the introduction of the euro was mentioned by some as an independent force, particularly for its psychological effect and because the concomitant loss of revenue may have stimulated consolidation as a way of achieving cost savings. More value was attached to the process of European integration in general. Finally, one interviewee mentioned high stock prices as a factor in the recent merger and acquisition wave: if an institution's own stock price appears overvalued it will be more willing to pay a high price for the target (in case of an exchange of stock).

The existence of factors discouraging consolidation was emphasised particularly in the context of cross-border and cross-segment consolidation. The most important ones were legal, regulatory and cultural constraints, including differences with regard to tax systems and corporate governance and policies promoting national champions. It was noted that the impact of the above-mentioned impediments is more severe in the case of full-fledged mergers compared to more decentralised types of cooperation such as strategic alliances.

Expectations for the future

It was generally expected that merger and acquisition activity will continue in the coming years. In the retail segment, cross-border consolidation may well increase because of the need to buy brand names and customer bases. One scenario put forth is that in five or 10 years there will be only a handful of retail banks left in Europe. Some identified certain potential counterforces for the future. Technological progress and increasing transparency (partly because of the euro) may undermine the traditional advantages of financial institutions with regard to customer information and financial techniques, while at the same time reducing customer loyalty. In this view, increased competition, especially from outside the financial sector itself, may lead to a partial dissolution of production and distribution chains. Such a scenario was seen as a potential threat because institutions might lose control over product development. Others, however, believed that these counterforces would not prove strong enough to significantly weaken the practice of universal banking.

Spain

Four interviews were conducted in Spain: two with commercial banks and two with bankers' associations.

Motives for consolidation

There was agreement that the most important factor in the Spanish domestic process of consolidation has been cost savings due to economies of scale. Interviewees considered that cost reduction is easier to achieve when mergers and acquisitions take place between institutions of the same country. It was also mentioned that it is less painful to undertake these types of measures during an upward economic cycle. Another factor pointed out as very relevant is the attainment of critical mass for three main reasons: to face the upcoming European consolidation that is expected to take place, to increase market share, notably for certain activities, and to defend against possible hostile acquisitions. The first two reasons were considered to be more important for larger firms and the third for smaller ones.

With regard to cross-border consolidation (the acquisition of Latin American institutions), the main motive cited was revenue enhancement owing to the reduction of margins that has taken place in Spain. Another factor cited was cost savings (economies of scope) as Spanish banks emulate in Latin America their Spanish model of retail banking. When it comes to risk reduction there were mixed opinions. Some of the interviewees cited the risks involved, while another mentioned that the negative correlation between the economic cycles in some Latin American countries and Spain allows some risk reduction.

External factors

Bailouts were mentioned as one of the main forces encouraging domestic consolidation. Deregulation and the creation of the euro were also reported as catalysts for consolidation. Expansion of domestic and international capital markets was also cited, stressing that it is a force for big banks that want to be players in these markets. The climate of capital markets was also mentioned as important because the current situation makes it easier to finance an acquisition. Nevertheless, it could also act as a discouraging factor because the quoted price of the target institution could be at a very high level. There were mixed opinions regarding technology issues. Technological developments are obliging financial institutions to invest large amounts and to think about new strategies, especially in the case of small institutions. But it was noted that technology is often mentioned for reasons of image, and that it is not encouraging consolidation.

Regarding cross-border consolidation (the acquisition of Latin American institutions), deregulation, privatisation and bailouts were mentioned as the most important forces. The institutionalisation of savings was included as relevant because it explains why Spanish banks have acquired sizeable Latin American private pension funds. Regarding technology issues, there were the same mixed opinions that have been noted previously. It was also underlined that the only actors in this process were the large institutions. The most important factor discouraging domestic consolidation mentioned was legal and regulatory constraints. This is because Spanish savings banks have a special legal status that makes it difficult for them to be acquired by commercial banks.

Legal and regulatory constraints were cited as a very important factor in the cross-border context – even at the European level – because regulation is still very fragmented and there are also some political issues. Nevertheless, it was pointed out that these constraints are less important when the target institution is not very big. Market inefficiencies and cultural constraints were also mentioned as meaningful issues, especially when they referred to the situation of some Latin American capital markets.

Expectations for the future

Every interviewee said that the Spanish banking system is currently consolidated and they did not expect more mergers and acquisitions between big institutions. Further consolidation will take place among the medium and small banks and within the savings bank sector. They agreed that cross-border consolidation in the European Union is expected to be very important in the next decade. Factors of growing importance will be the impact of the euro, increased globalisation and greater use of new technology. Market inefficiencies and regulatory constraints will become less important.

Some said that there will be more hostile mergers and acquisitions, and that the role of insurance companies will increase. It was also noted that the current cross-border alliances are likely to be the first place for future mergers, although alliances are difficult to manage and do not add value for shareholders. It was also mentioned that e-business will be crucial in the near future. Financial business will be done more and more by non-financial firms and vice versa. The first step has already taken place with alliances between banks and telecommunications companies. Those investments will only be profitable with a large customer base.

Sweden

The interviews in Sweden were held with two major banks and one investment bank.

Motives for consolidation

Insiders in the industry commonly identified economies of scale as one of the main motives for consolidation. These have been realised through reductions in personnel, a flat organisation structure, decentralisation and the use of technology. Scaling up was also thought to be stimulated by shareholder pressures and by the shift to offering retail customers more comprehensive service and integrated asset and liability management. One relative outsider noted, though, that there would be limits to the benefits of sizing up further. If Scandinavian institutions were to grow much beyond their current medium size, diseconomies of scale might set in due to a dilution of control as well as cultural differences. Instead of economies of scale, empire building and psychological factors might be the main motives behind the current consolidation process.

No clear-cut distinction could be made between consolidation within segments and across segments because of the overriding presence of universal banking. However, it was noted that, if anything, wholesale operations are being scaled down as global enterprises have been lost to larger, non-Nordic institutions and the capital markets. The concomitant shift in activities from traditional lending to advice implied that the need to enhance the capital basis is no longer felt in the wholesale segment. In the context of cross-border consolidation, mention was made of revenue enhancement due to geographic expansion.

External factors

All interviewees mentioned technology as a relevant factor changing the financial landscape, though they judged its importance somewhat differently. One expert downplayed the general impact of technology on the financial sector, particularly the retail segment, because the scope to save costs is limited, for example, by the fact that customers attach value to having access to both the branch network and electronic distribution channels. In this view, technology did not much stimulate consolidation through increasing competition from niche players, since high customer loyalty, low margins and high cost efficiency among the incumbents make entry difficult. The other experts put more weight on technology because of the inherent scale economies. In this context, it was noted that since technology has become a competitive factor in its own right, looser forms of consolidation, such as joint ventures and strategic alliances, may no longer suffice as a foundation for collaboration between smaller or medium-sized financial institutions, thereby stimulating mergers.

Globalisation was thought to be a minor factor encouraging consolidation, mainly in asset management due to the institutionalisation of investment. Deregulation and privatisation were not regarded as important forces encouraging consolidation in the 1990s. Deregulation was completed mostly in the 1980s, while state ownership has been of a fairly passive nature. Legal constraints were identified as important forces discouraging consolidation. One example of a legal constraint was that mergers and acquisitions require the consent of a large majority of shareholders, far larger than needed to actually exercise control. Generally, cultural differences between firms were also thought to discourage consolidation. With regard to cross-border consolidation, the Norwegian policy of promoting national champions was seen as an obstacle to consolidation involving Norwegian institutions, while consolidation with Danish institutions has been made more difficult by the scattered and opaque structure of share ownership.

Expectations for the future

For the time being, consolidation is expected to continue on a regional scale. However, it was expected that once consolidation at the domestic level has advanced in the rest of Europe, Scandinavian institutions could become takeover targets by institutions from the European continent. The validity of the universal banking concept was generally upheld in the case of Scandinavia. It was thought that in medium-sized markets, such as Scandinavia, the benefits of one-stop shopping outweigh the commercial benefits of specialisation. One interviewee stressed the need to control distribution channels and maintain direct contact with customers. In any case, the high cost efficiency of the incumbents would continue to thwart entry, including entry by non-financial companies offering competing distribution channels.

Switzerland

Four interviews were conducted in Switzerland. The interviewees were from two large globally operating financial services groups, a regional partially government-owned bank and an industry association.

Motives for consolidation

Cost savings attributable to increased size were strongest in retail market consolidation or when a smaller institution within the same segment was involved. Revenue enhancement due to increased size was not perceived to be a consolidation motive for small banks and reinsurance businesses, but was very important across segments among insurance, banking and asset management in view of the requirements of institutional investors. The ability to provide “one-stop shopping” was seen as a very important motive for across-segment consolidation between non-life insurance and banking and insurance and asset management. Increased product diversification and subsequent risk reduction was seen as an important factor for across-segment consolidation for the banks but not for large insurance companies. Reaping the benefits of a strong rating was seen as an important motive for acquirers in the banking sector, where traditionally solidity and trustworthiness were seen as valuable intangible assets to gain market share. Another motive for consolidation may be the ability to gain better ratings due to “too big to fail” considerations.

External factors

Technological developments were seen as a very important factor for consolidation. The interviewees of the large institutions considered the institutionalisation of savings as an important factor (ability to serve larger customers, ie institutional investors). Deregulation was deemed to be a very important factor but has its limits as a one-off effect. Privatisation was seen as moderately important and includes not only the privatisation of financial institutions but the emergence of new large customers as well. The climate of capital markets (eg low interest rates, low volatility in share prices, etc) was considered as a moderately important factor but mostly from the shareholder perspective.

Market inefficiencies in terms of information asymmetries were seen as a growing factor impeding consolidation, as high expectations about the gains from consolidation have often not been realised. Legal and regulatory constraints are considered important factors in cross-sector consolidation and were seen as even more important in cross-border than domestic cases. Cultural constraints were perceived by the representatives of the larger players to be manageable on a domestic level and therefore only a slightly important factor. For smaller banks, cultural impediments were important, especially across segments. Cross-border cultural constraints were seen as important when European companies were involved. Other important impediments included data protection issues and different stock exchange rules.

Expectations for the future

Economies of scale in information technology have been an important factor for consolidation in the past. Lower production costs lessen the importance of this factor. Changing customer needs towards convenience and returns, the emergence of large institutional investors due to the institutionalisation of savings and new large corporate customers due to privatisation may further revenue enhancement effects. Consolidation in Europe has so far mainly taken place within countries. After consolidation opportunities become scarce on a national level, more cross-border consolidation can be expected. Pressure from shareholders is expected to gain even more importance in the future. Although the effects due to market inefficiencies are not always straightforward, on balance this may result in a continuation of consolidation. The segmentation process in the industry may gain further momentum, whereas middle-sized companies are considered to be prone to consolidation. Deconstruction of institutions along production and distribution lines was seen as an important potential counterforce, especially in minimising costs of managing large and complex entities. In the Swiss domestic market a continuation of the privatisation process of the state-owned banks can be expected. This may further the potential for domestic consolidation.

Annex II.2
Interviews – technical appendix

To help gain a better understanding of the motives underlying and factors influencing the form and pace of consolidation in the financial services sector, members of the G10 Task Force on Causes of Financial Sector Consolidation conducted interviews with various market participants and experts in the G10 countries, Australia and Spain. Among the interviewees were representatives from the banking, insurance and investment banking sectors, as well as legal experts, consultants, trade associations and academics. The numbers and types of interviewees varied across countries.

For purposes of the interviews, consolidation was defined broadly to include all forms of cooperation, whether through formal mergers and acquisitions or looser arrangements such as distribution alliances and joint ventures. The interviewees were asked to focus on consolidation that has occurred since 1990 among major finance industry segments, which were defined as depository institutions, insurance companies, asset management companies, investment companies and other financial institutions.

In addition to providing a qualitative assessment of the consolidation process (including future expectations), participants were asked to rank a number of motives for consolidation, as well as forces encouraging and discouraging consolidation, using the scale shown below.

Rank	Assessment
0	Not a factor
1	Slightly important
2	Moderately important
3	Very important

In a number of cases respondents indicated that the value for a particular factor lay between two rank categories (eg 0-1). For purposes of quantitative comparisons, responses given as ranges were coded at the midpoint of the range (eg 0.5).

For each of the three major categories of questions (motives for consolidation, forces encouraging consolidation and forces discouraging consolidation), interviewees were asked to consider consolidation both within and across industry segments as defined above. The same questions were asked for both domestic and cross-border consolidation. Thus, for each factor the following grid was obtained:

	Within segments	Across segments
Domestic consolidation		
Cross-border consolidation		

There were a total of 45 respondents to the written questionnaires. Generally speaking, a smaller number of responses were given for consolidation across industry segments compared with rankings assigned for consolidation within industry segments. In a number of cases, respondents assigned the same rankings to factors motivating or encouraging consolidation across industry segments as they did to the same factors regarding within-industry consolidation; thus, comparisons along these lines would not be meaningful. The sample size also is too small to permit meaningful comparisons based on the type of institution or firm size. Nonetheless, the bulk of the interview results provide very illustrative and consistent information on the consolidation process in the financial sector.

As for the rows of the response grid for each factor, a larger number of respondents provided rankings for domestic consolidation than for cross-border consolidation. In most instances, those respondents declining to provide rankings for cross-border factors cited the limited amount of cross-border consolidation that has taken place thus far. In many cases, however, the rankings given for cross-border consolidation result in fairly similar frequency distributions as for domestic consolidation, but are based on a smaller numerical count.

Note that missing values are not included in any of the calculations. Thus, for example, if only 41 of the 45 respondents provided rankings for a given factor, frequency tabulations for that factor are based on a numerical count of 41. Details shown in the charts may not sum to 100% due to rounding.

The interviews were conducted on the basis of a common interview guide, which listed the following factors.

List of factors

Motives for consolidation	Forces encouraging consolidation	Forces discouraging consolidation
Cost savings attributable to – increased size (economies of scale) – product diversification (economies of scope)	Technology: – information and communications – financial innovation – electronic commerce	Market inefficiencies
Revenue enhancement – due to increased size (ability to serve larger customers) – due to product diversification (ability to provide "one-stop shopping")	Globalisation: – expansion of domestic and international capital markets – trade in non-financial products – institutionalisation of savings – creation of the euro	Legal and regulatory constraints
Risk reduction due to product diversification	Deregulation	Cultural constraints (cross-firm and cross-segment)
Change in organisational focus	Privatisation	Deconstruction (breaking up of institutions into more specialised units)
Increased market power	Bailouts or financial conditions of firms	Outsourcing
Managerial empire building and retrenchment	Climate of capital markets	Internet

Annex II.3
Chronological list of key regulatory changes

Australia

- **1979**. An open tender system allowing the market to determine the prices of Commonwealth Government securities was introduced.
- **1980**. Interest rate ceilings on all bank deposits were removed.
- September **1981**. The practice of issuing credit directives governing the growth of banks' lending ceased.
- December **1983**. The Australian dollar was floated and exchange controls were lifted.
- **1984**. The Reserve Bank established a banking supervision unit.
- September **1984**. Access to the Australian banking market was opened to foreign banks.
- May **1985**. The Liquid and Government Securities Convention (which had required banks to hold around one-fifth of their assets in government securities) was replaced with a prudentially focused Prime Assets Ratio.
- April **1986**. The last interest rate control, a cap on the rate for owner-occupied housing loans, was lifted.
- **1986**. Employer-provided superannuation contributions began to be incorporated into the employment contracts covering a range of private sector industries.
- **1987**. The Insurance and Superannuation Commission was established.
- May **1990**. The Commonwealth Government stated that mergers would not be permitted among any of the four major banks or two or three major life insurance institutions (the so-called "six pillars" policy).
- **1991**. The Commonwealth Government introduced a mandatory system for employer contributions.
- February **1992**. The Government removed the restriction on the number of foreign banks and allowed such banks to operate as a branch and/or a subsidiary.
- **1992**. The state-based regime of supervision of building societies and credit unions was unified under the Australian Financial Institutions Commission.
- **1995**. The Commonwealth Government enhanced incentives for employee contributions to superannuation.
- March **1997**. The Financial System Inquiry (known as the Wallis Committee) released its Final Report.
- April **1997**. The "six pillars" policy was ended. At the same time, the Commonwealth Government indicated that it will not approve mergers between the four major banks until it is satisfied there has been a sufficient strengthening of competition in the Australian banking market (the "four pillars" policy).
- July **1998**. An integrated prudential regulator, the Australian Prudential Regulation Authority (APRA), was established.

Canada

- The **1954** Bank Act amendments allowed banks to enter and compete for household loans.
- The **1967** amendments further enhanced competitive pressures. A ceiling (6%) on interest rates was eliminated; banks were permitted to finance residential mortgages; and deposit insurance for banks and trust and mortgage loan companies was introduced. However, banks were prohibited from owning trust companies and a 10% ownership limit was imposed on shares of banks.
- The **1980** amendments allowed foreign banks to establish subsidiaries in Canada. (The aggregate size restrictions were removed in 1989 for US banks as part of the Canada-US Free Trade Agreement, in 1994 for Mexican banks of part of NAFTA and in 1995 for the rest of the foreign bank subsidiaries). The Canadian Payments Association (CPA) Act was passed and the CPA took over cheque clearing from banks.
- In **1987,** restrictions which kept banks out of the securities industry (the Canadian equivalent to the Glass-Steagall Act) were eliminated. From June 1987, there were no limits on investments in securities firms by Canadian financial institutions; and non-residents were permitted to own up to 50% of a securities firm (100% from 1988).
- In **1992**, cross-ownership restrictions on financial institutions were eased and business powers were broadened. Corporate governance and rules associated with self-dealing and conflict of interest were strengthened. Federal financial institutions were allowed to diversify into new financial businesses and into limited non-financial services; reserve requirements on banks were phased out to offer a level playing field.
- In **1997**, the government announced its intention to allow foreign banks to branch directly into Canada.
- In **1998**, legislation and regulations were introduced to allow all federally regulated mutually owned life insurance companies to convert to public stock companies.
- In **1999**, the legislation and regulations required to allow foreign banks to establish specialised, commercially oriented branches in Canada were introduced and passed.
- In **2000**, the government introduced legislation to create financial holding companies, to relax the widely held ownership rule for large financial institutions, and to allow close holding of small- and medium-sized financial institutions, including banks. The initiative included non-legislative guidelines for the review of merger proposals among major banks.

Continental Europe

France

- **1980**. Implementation of the first banking directive.
- **1982**. All major banks are nationalised.
- The **1984** Bank Act allows the emergence of universal banks.
- In **1987** and **1993**, privatisation of several banks including Banque Nationale de Paris.
- **1989**. Implementation in French law of the second banking directive (89/646).
- **1990**. The liberalisation of capital movements is completed (Article 67 of the EEC Treaty).
- **1995**. Implementation of the deposit insurance directive (94/19).

Germany

- **1973**. Most capital controls are dismantled.
- **1978**. Implementation of the first banking directive. The first banking directive adopted in 1977 established the minimum requirements for licensing and supervising banks (the so-called credit institutions) and was a first step towards the principle of home country supervision. The requirements for licensing relied on two major criteria, namely a minimum capital requirement and reputable and experienced management ("fit and proper").
- **1992**. Implementation of the second banking directive (89/646). This directive, adopted by the Council of Ministers in June 1989, introduces the so-called single banking licence ("European passport"). The latter issued by the home country enables any bank to establish branches or subsidiaries or to offer a wide range of services in another EU country.
- **1994**. Money market funds are permitted.

Italy

- **1983**. Elimination of credit ceilings.
- **1985**. Implementation of the first banking directive.
- **1990**. Liberalisation of banks' branching.
- **1990**. Foreign exchange and capital controls are eliminated by May 1990.
- **1992**. Elimination of floor prices on government bonds.
- **1993**. Implementation of the second banking directive. Foreign banks are permitted, the demarcation line between short-term and long-term lending banks is abolished.
- **1993-94**. Privatisation of Credito Italiano and some other publicly owned banks.

Japan

- **1979**, May. The deposit interest rate is deregulated for negotiable certificates of deposit (CDs) of JPY 500 million and above and with a maturity of three to six months.
- **1983**, April. Banks started to retail public bonds.
- **1984**, January. The minimum CD size with deregulated interest rates was set at JPY 300 million. (Between January 1984 and 1994, gradual liberalisation on deposit interest rates on various deposit instruments proceeded.)
- **1984**, May. "Real Demand Principle" in foreign exchanges was abolished. Current and capital accounts are completely liberalised.
- **1984**, June. Banks started to deal public bonds.
- **1986**, February. Treasury Bills were introduced.
- **1986**, December. Tokyo Offshore Markets opened.
- **1986**. Asset (pension fund) management companies were allowed to be established by banks as subsidiaries.
- **1987**, November. Banks and securities firms started to deal in CDs.
- **1987**, November. Auctions were introduced in 10-year bond issues.

- **1988**, May. Banks started to deal securities futures and securities firms started to deal financial futures.
- **1992**, June. A law was passed (to be enacted in 1993): banks would be allowed to establish a subsidiary for securities business with limited scope of business; banks and securities firms would be allowed to establish trust banking subsidiaries with limited scope of business. Between 1993 and 1996, 19 securities subsidiaries were established by banks. Between 1993 and 1995, 17 trust banking subsidiaries were established by banks and securities firms. Banks would be allowed to set up investment trust management companies.
- **1995,** May. A law was passed (to be enacted in 1996): life insurance companies would be able to establish non-life subsidiaries, and non-life insurance companies would be able to establish life subsidiaries.
- **1998**. Insurance premiums for non-life insurance policies, such as auto, fire and casualty, were deregulated.

United Kingdom

- The **1979** Banking Act gave formal responsibility for supervision to the Bank of England. Prior to that the Bank had traditionally exercised informal banking supervision powers.
- The **1979** Credit Unions Act provided a statutory framework for the incorporation and regulation of credit unions – small mutual banks serving members.
- The **1982** Insurance Companies Act provides the regulatory framework for authorisation and prudential supervision of companies carrying on insurance business. An important subsequent amendment was to change the framework so as to comply with requirements of EU Directives on life and non-life insurance business. Some requirements under the Act affect Lloyd's of London – though that is largely self-regulated with underpinning from successive Lloyd's Acts.
- The **1986** Building Societies Act gave societies a legal framework and established the Building Societies Commission with regulatory responsibility. It also provided a legal means for societies to convert from mutual to plc status. The 1986 Act was prescriptive about societies' powers, but these restrictions have largely been removed by the 1997 Act, so societies now have (almost) as much freedom as banks.
- The **1986** Financial Services Act created a two-tier system that split regulatory responsibility between the Securities and Investments Board (SIB) and the Self Regulatory Organisations (SROs), together with the Recognised Professional Bodies (RPBs). The SIB and SROs had the primary responsibility to deliver the standards of regulation, supervision and investor protection required by the Financial Services Act. This structure was intended to be sufficiently flexible to respond to the regulatory needs of the various financial market sectors.
- The **1986** "Big Bang" reforms saw extensive deregulation of the City. Anticompetitive practices that had restricted the entry of new participants into London's markets were abolished.
- The **1987** Banking Act enhanced the supervision of banks, including the establishment of a Board of Banking Supervision. The Act also reflected the establishment of a single European market in banking, with recognition of home state responsibility for supervision.
- The **1992** Friendly Societies Act established the Friendly Societies Commission with regulatory responsibility.

- In **1997** the SIB became the FSA. The functions of the SROs and RPBs will be exercised by the FSA. The objectives were to reform the institutional architecture to bring regulation and supervision closer to the changing structure of the financial industry, to introduce clearer responsibilities and accountability, and to reduce complexity whilst reducing compliance costs. The FSA regulates and authorises all financial business including unit trusts and OEICs, and recognises and supervises all investment exchanges and clearing houses.
- In **1997** a memorandum of understanding between HM Treasury, the Bank of England and the FSA set out their respective roles in the area of financial stability and established a framework for accountability, transparency and information exchange, including for support operations. The Bank of England is responsible for the overall stability of the financial system.
- The **1998** Bank of England Act passed responsibility for banking regulation from the Bank of England to the FSA on 1 June 1998.
- The **2000** Financial Services and Markets Act will give the FSA a series of enabling powers to allow it to act as it considers appropriate in particular cases. The Act also places a number of obligations on the FSA eg to consult on proposed rules and to publish cost-benefit analyses to ensure proportionality.

Other relevant pieces of UK legislation not specifically targeted at the financial services sector include the Companies Act 1989. The European Union is another source of regulation through various directives such as the Investment Services Directive and the Capital Adequacy Directive.

United States[43]

Banking

- **1980**. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) phased out deposit interest rate ceilings, expanded the powers of thrift institutions, and increased the limit of deposit insurance from USD 40,000 to USD 100,000.
- **1982**. The Garn-St. Germain Depository Institutions Act of 1982 authorised money market deposit accounts and net worth certificates for thrifts. It also relaxed restrictions on commercial lending by thrifts. The law loosened other lending restrictions as well.
- **1987**. The Competitive Equality Banking Act of 1987 (CEBA) recapitalised the thrift insurance fund and made other provisions to protect certain depository institutions.
- **1987-96**. In 1987, The Federal Reserve Board permitted bank holding companies to exercise limited underwriting and dealing powers with four types of debt in "Section 20" subsidiaries. The revenue generated by these activities could not exceed 5% of the organisation's total revenues. The powers granted to bank holding companies were increased over the years to include more types of debt securities and equity securities. Moreover, the revenue limit was raised to 10% in 1989 and further to 25% in 1996.

[43] The primary source for changes in banking legislation is the *FDIC Banking Review*, Volume II, No 1, 1998. Securities information comes from several sources including "Securities Underwriting" by Samuel L Hayes, III; Andrew D Regan, in *Financial Services* edited by Samuel L Hayes, III, 1993; and a conversation with Mike Schoenfeld of the Federal Reserve Board.

- **1989**. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) authorised the use of taxpayer funds to resolve failed thrifts. The act also eliminated the existing thrift regulatory structure, gave FDIC control of thrift deposit insurance, and set deposit insurance reserve levels.
- **1991**. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was designed in large part to restrict discretion in monitoring and resolving problems in the thrift industry.
- **1990s**. Most, if not all, individual state legislatures loosened restrictions on intrastate branching. States also passed legislation allowing increasing levels of interstate banking. In other words, bank holding companies had an increasing number of options regarding potential acquisition targets.
- **1994**. The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 permitted banks to engage in interstate banking and interstate branching.
- **1999**. The Gramm-Leach-Bliley Act of 1999 substantially expanded powers for qualifying bank holding companies by repealing existing restrictions on affiliations with insurance companies and securities firms. Also, firms that met certain criteria could engage in a broad array of other financially related activities.

Securities

- **1975**. The Securities and Exchange Commission (SEC) abolished fixed rate brokerage commissions, whereby brokers had charged a fixed rate per share traded. After this change, brokers were free to set the level of their commissions and negotiate with customers regarding fees.
- **1982**. Securities and Exchange Commission (SEC) Rule 415 of the Securities Act of 1933 was introduced in 1982 to enable firms to use shelf registration, which permits certain firms to register predetermined amounts with the SEC for sale to investors at some undetermined time in the future.
- **1987-96**. Section 20 subsidiaries of bank holding companies (see above).
- **1990**. Rule 144A of the Securities Act of 1933 was adopted by the SEC in 1990 to liberalise and enhance the liquidity of the private placement market.
- **1999**. Gramm-Leach-Bliley Act (see above).

Insurance

- **1999**. Gramm-Leach-Bliley Act (see above).

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