

THE ECONOMICS OF BANKING

**A Target-Instrument Approach
with Special Reference to South Africa**

by
H.B. Falkena and D.T. Llewellyn

SA Financial Sector Forum

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PREFACE

During the last few decades a fundamental change has taken place in the economics of banking. Today, banks are confronted with secular pressures in their markets that were virtually unknown only a decade ago. Some of these pressures are, for instance, far greater contestability of markets and products; sharply increased asymmetric competition; excess capacity in the industry; and the colossal impact of technology and financial innovation (which directly impact on banks' core competencies, in areas such as information technology, processing, risk analysis, and delivery). Last but not least, the competitive position of the consumer has been enhanced significantly. Investor preferences are clearly for better quality financial products and services, safety and convenience, greater choice in the range of products (particularly international products), more transparency and disclosure, integrity, and competence. Banks have to live up to these expectations. In essence banks are rapidly losing some of their historical franchises to new entrants in banking markets – banking markets are becoming less the exclusive preserve of banks.

To sketch the interaction between the global secular pressures in finance, the impact thereof on banks and banking markets, as well as the strategic responses of banks, the analysis is broken up in five chapters. Chapter 1 focuses on the target-instrument approach for the financial services industry. Three ultimate objectives are distinguished, namely ensuring the safety and soundness of the financial system, enhancing client confidence, and promoting efficiencies and the effectiveness of the financial system. Chapters 2, 3, and 4 expand on these three objectives in greater detail and document the alignment of specific business instruments to specific intermediate targets. The last chapter summarises how banks can combine these various business instruments into distinct defensive and offensive business strategies.

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The authors

TABLE OF CONTENTS

Chapter 1: An integrated target-instrument approach for the financial services industry	1
1. Introduction	1
2. The strategy paradigm	3
3. The ultimate objectives of the financial services industry	5
4. Intermediate targets (or indicators)	8
4.1 Intermediate targets ensuring “safety and soundness”	8
4.2 Intermediate targets ensuring “client confidence”	9
4.3 Intermediate targets ensuring “efficiency and effectiveness”	10
5. The alignment of instruments to intermediate targets	11
5.1 “Safety and soundness” enhancing instruments	12
5.2 “Client confidence” enhancing instruments	15
5.3 “Efficiency and effectiveness” enhancing instruments	17
6. Conclusion	21

Chapter 2: Instruments used to enhance the robustness of banks	22
1. Introduction	22
2. Global trends aiming to improve the robustness of banks	22
2.1 Stability in the macroeconomy	26
2.2 A financial system's infrastructure	30
2.3 Market discipline and competition	31
2.4 Incentive structures	33
2.5 Incentives for regulators and supervisors	36
2.6 Ten priorities in restructuring	38
3. Efforts to improve the robustness of the South African financial system	40
3.1 Systemic risk	40
3.2 Market risk	43
3.3 Credit risk	44
3.4 Liquidity risk	45
3.5 Reputation risk	45
3.6 Operational risk	46
3.7 Bankruptcy risk	46
3.8 Summary	47

Chapter 3: Instruments used by banks to enhance the confidence of and fairness to investors	49
1. Introduction	49
2. Conduct of business regulation	50
3. Wholesale <i>versus</i> retail business	57
4. Client compensation schemes	58
5. Business instruments for consumer protection	62
6. Efforts to improve the confidence of and fairness to investors in South Africa	65
6.1 Client information technology and disclosure arrangements	67
6.2 Compliance arrangements, training and competence	68
6.3 Complaints and client compensation arrangements	69
6.4 Single-capacity trading and Chinese walls	70
6.5 Audit arrangements and forensic investigations	71

Chapter 4: Instruments used to enhance the efficiency and effectiveness of banks	73
1. Introduction	73
2. Global trends aiming to improve the efficiency and effectiveness of banks	75
2.1 The organisational structure, information management, and cost-control management	75
2.2 Rationalisation, joint ventures and subcontracting	82
2.3 Consolidation and globalisation	90
2.4 Diversification	99
2.5 Securitisation and monitoring techniques	109
2.6 Segmentation and channels of distribution and access	120
2.7 Cross-subsidisation and other pricing policies	122
2.8 Regulatory capture	123
3. Efforts to improve the efficiency and effectiveness of the South African financial system	124
3.1 Organisational structure, information management, and cost-control management	124
3.2 Rationalisation, joint ventures and subcontracting	126
3.3 Consolidation and globalisation	127
3.4 Diversification, securitisation and monitoring techniques	129
3.5 Segmentation and channels of distribution and access	132
3.6 Cross-subsidising and other pricing policies	133
3.7 Regulatory capture	134

Chapter 5: Defensive and offensive strategies in banking	135
1. Introduction	135
2. The “secular pressure / strategic response” matrix	137
3. Secular pressures facing the banking industry	141
3.1 Business consequences of changes in financial regulation	142
3.2 Business consequences of changes in technology and innovation	157
3.3 Business consequences of changing consumer preferences	160
4. Secular pressures and the defensive counterstrategies of banks	161
4.1 Strategies based on exploiting core competencies	162
4.2 Strategies seeking cost and organisational efficiencies	173
4.3 Strategies based on improving the management and allocation of capital	175
5. Secular pressures and the offensive counterstrategies of banks	177
5.1 Strategies based on operational and geographic expansion	177
5.2 Strategies based on enhancing competitive pricing and trading	183
5.3 Strategies based on internal and external restructuring	184
5.4 The regulatory response to consolidation strategies	186

CHAPTER 1

AN INTEGRATED TARGET-INSTRUMENT APPROACH FOR THE FINANCIAL SERVICES INDUSTRY

1. INTRODUCTION

The financial services industry is a licensed-type business. Accordingly, no bank, securities firm or insurer can sell its services to the general public without a licence. Before such a licence is granted, however, the regulatory authorities have to ensure that the ultimate objectives of financial institutions¹ do not conflict with national and consumer interests.

In South Africa the regulatory authorities have three ultimate objectives, namely: (i) to ensure a *safe* and *sound* financial system in which the general public can trade without fear of losing their savings or investments; (ii) to enhance the *confidence* of and *fairness* to investors by *inter alia* eliminating bad business practices, possible conflicts of interests, facilitating transparency, integrity and good corporate governance; and (iii) to ensure an *efficient* and *effective* financial system in which services are supplied at a competitive price and the majority of the population has access to the various financial services offered.

As a licence is issued to a financial institution only if it can prove that its operations are supporting the three ultimate objectives of the

¹ For instance in the way they behave towards their customers and manage their risks and capital position.

authorities, it is implicit that the ultimate objectives of the regulatory authorities must also be those of the financial services industry. Accordingly, financial institutions must aim ultimately for “safety and soundness”, “client confidence” and “efficiency and effectiveness”.

Thus the strategies adopted by banks have to be consistent with the objectives set by the regulator. Even if the priorities among the ultimate objectives of the bank and those of the regulator may differ, behaviour of the former must be consistent with the objectives of the latter. For instance, the bank may have as its primary ultimate objective the maximisation of shareholder value as, for instance, measured by the rate of return on equity. However, this would be in conflict with regulatory objectives if, for instance, maximising shareholder value was achieved by excessively risky behaviour or hazardous behaviour towards customers.

Within the paradigm outlined in this chapter, the skill in contrasting corporate strategies lies in bringing into alignment the objectives of the bank and regulator. In other words, the *objectives* and *behaviour* of the bank must be consistent with the imposed objectives of the regulator. If they are not, sanctions will follow and, in their extreme form, a licence can be withdrawn.

Although the ultimate objectives of the regulator and financial institutions must be made similar, significant differences occur if these objectives are defined as *intermediate targets* (i.e. the ultimate objectives transformed into quantifiable indicators). Moreover, the alignment of instruments to those intermediate business targets is different for the regulatory authorities and financial institutions respectively. In essence, many (but not all) of the policy instruments of the regulatory authorities become the intermediate targets for financial services firms. For example to ensure confidence of the general public in the financial system, the regulatory authorities stipulate as one of their intermediate targets “acceptable risks within firms”. The authorities use mainly minimum standards (e.g. entry and listing standards) and prudential requirements (e.g. capital and liquidity requirements) to ensure that financial firms do

have “acceptable risks”. However, for such a firm these regulatory policy instruments become, in turn, intermediate business targets.

At the strategic level a firm needs to build regulatory policy instruments into its business planning process in a holistic, integrated manner. For instance, for a financial firm “safety and soundness” implies, in terms of its intermediate targets, that the company should be adequately capitalised, have sufficient liquidity at all times, and show adequate transparency towards its shareholders and clients. To achieve these intermediate targets (i.e. “capital adequacy”, “adequate liquidity” and “transparency”) the following business instruments are aligned by a firm: at the company level (i) risk analysis systems and (ii) management control systems, while at the industry level are added (iii) listing requirements of a stock exchange and (iv) corporate governance rules (see table 1, p.13). In other words, regulatory instruments can also become business instruments.

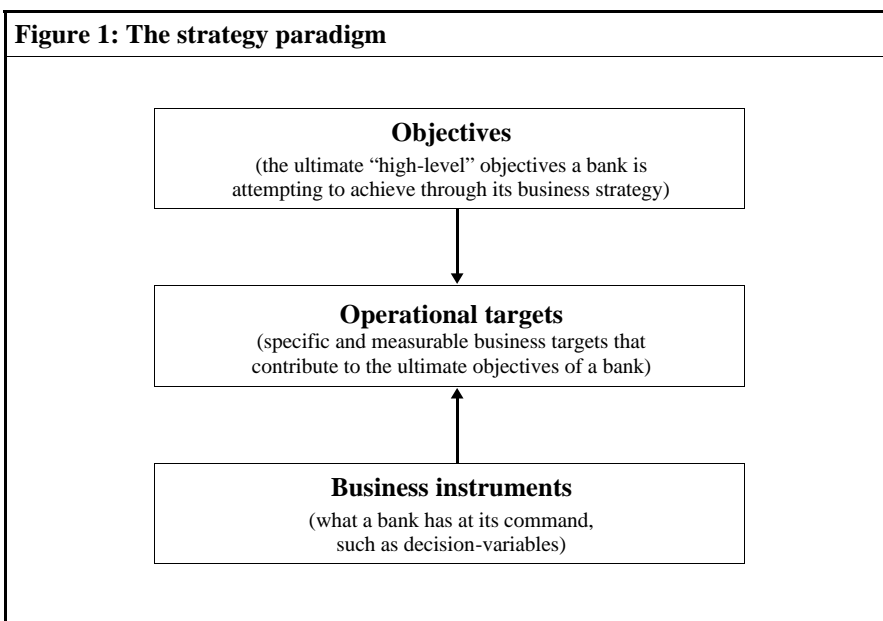
The integrated target-instrument approach, from the viewpoint of the financial industry rather than the regulators, as reflected in tables 1, 2 and 3 (p. 13, p.16 and p.18), will be discussed as follows: section 2 discusses the strategy paradigm; section 3 the three ultimate objectives of a financial firm; section 4 analyses the intermediate targets of the firm; and section 5 addresses the alignment of instruments to these targets.

2. THE STRATEGY PARADIGM

When considering business strategy, an analytical framework needs to be established from the outset. In the context of constructing a strategic business plan, the framework needs to elucidate how regulatory and business objectives can be aligned and potential conflicts between them removed. Four criteria need to be met when constructing such a paradigm if it is to be of value in formulating business strategy:

- be *coherent* to those who need to use it (i.e. easily understood);
- be *robust* (based on sound economic and methodological analysis);
- be *consistent* over time (valued and relevant for different strategy exercises);
- and
- be *manageable* (operational and based on measurable concepts).

The problem arises that some of the high-level objectives a bank may establish are too big, unmeasurable and unmanageable (e.g. deal honestly with customers; be safe and sound at all times). It is therefore necessary to proceed to the next stage of making the objectives operational and manageable. This means that *operational targets* need to be identified. In the absence of direct observation of an *objective*, and in order to make the construction of a business strategy operational, *targets* are identified. While not objectives in themselves (i.e. not necessarily desired in their own right), these are reasonably closely related to an *objective*. Achieving the target is therefore a reasonable proxy of an *objective*.



After applying the four criteria, the paradigm that emerges is summarised in figure 1. It begins with a statement of *objectives*, i.e. what a bank is attempting to achieve through its business strategy. This sets the “high-level” business objectives, and has components within it which need to be identified separately. The objectives are in turn decomposed into *operational targets*. The *instruments* are those

decision-variables under the command of a bank that contribute directly to achieving the targets.

The remainder of this chapter considers the paradigm in greater detail.

3. THE ULTIMATE OBJECTIVES OF THE FINANCIAL SERVICES INDUSTRY

The greater the number of ultimate objectives of a firm, the greater the chance that they will be in mutual conflict. Moreover, too many objectives may result in an unfocused business approach. Ideally, the ultimate objectives should not be more than a handful, and preferably not more than three. As already noted above, there is no implicit conflict between the ultimate objectives of the regulatory authorities and those of private financial institutions. Accordingly, the alignment of regulatory and business objectives (and what that implies for intermediate targets and instruments) needs to be at the centre of a bank's strategy.

Three ultimate objectives are defined. The first objective for any financial firm has to be that it is financially *safe* and *sound*. Without this safety and soundness, a firm constitutes an uncertainty to its clients, business partners as well as the regulatory authorities. Ultimately it will have to close its doors for business or alternatively the prudential requirements will be increased to such a level that shareholders will obtain little or no return on their capital. In such a case the firm will become a takeover target, i.e. a sitting duck. In fact, any financial firm that endangers confidence in the financial system at large or that could potentially become a liability to the public purse (e.g. by means of a bail-out or life-boat assistance) should have its licence withdrawn in good time or be taken over by stronger institutions. Nowadays the regulatory authorities even stipulate (informally) that the senior management/directors of such a failed financial institution should be removed from the industry. Therefore the safety and soundness of a financial firm should be the aim of all its stakeholders.²

² Stakeholders consist of the following groupings: 1. the regulatory authorities who are responsible – and thus accountable – for issuing a licence to a financial firm; ... (cont.)

The second ultimate objective of a financial firm is to obtain the *confidence* of and to show *fairness* to the users of its financial services by providing adequate services and protecting their invested funds against the consequences of default. Clients expect fairness in their dealings with a financial institution and a firm has to live up to that trust. Accordingly, client interests should always take priority over corporate interests. For example, in a declining interest rate cycle retail clients should be advised by a bank to move into flexible-rate mortgages, while a bank's treasury will control, at the wholesale level, the overall mismatch of a bank's book.

However, this may not be in the short-term interest of the bank, as profitability is enhanced if, when market interest rates are on a declining trend, customers are locked into fixed-rate mortgages. This is an example of where, at least in the short run, aligning the immediate objectives of a firm and the regulator may be in conflict. If the two are to be aligned in a situation where conflicts may arise in the short run, it is imperative that there is effective monitoring by the regulatory agency. This is because any one bank will not align regulatory and business objectives unless it has confidence that all other banks will be doing likewise, and that no unmonitored bank will be able to gain an advantage by not making an alignment when all its competitors are doing so. This is the so-called *gridlock* problem.

The third ultimate objective of a financial firm is *efficiency* and *effectiveness*. A firm should be able to face competition from around the corner, from abroad and even from non-financial institutions. The greater the efficiency of a financial firm, the greater the potential returns for shareholders and the greater its robustness to withstand unexpected shocks. However, a firm should not only be *efficient*, but also *effective* in its supply of financial services. In the extreme, a financial system that services *efficiently* one percent of the population is still not an *effective* financial system (in that 99% of the population is excluded from the

... 2. the shareholders who aim for an acceptable return on capital invested in a firm; 3. senior management who will lose their jobs if a firm fails; 4. general staff whose career prospects depend on the financial health of a firm; and last, but not least, 5. clients who may lose all or part or all of their funds if a firm fails.

payments and credit systems). Therefore, a financial firm operating mainly in retail business has to ensure that its services are available to a broad spectrum of clients.

It should be emphasised that the three ultimate objectives stated above may be in mutual conflict. For instance, too great an emphasis placed on efficiency may harm fairness to clients (e.g. by closing branches), too great an emphasis on safety and soundness may harm effectiveness (e.g. by excluding low-income groups from credit) and too great an emphasis on competition strategies may harm safety and soundness by, for instance, inducing banks under competitive pressures (e.g. having their economic rents competed away) into high-risk lending. It is not unusual for periods of deregulation and keen competition to be followed by a period of financial fragility (e.g. the Scandinavian countries in the early 1990s). All of this is the standard “target-instrument dilemma”. When more than one (possibly conflicting) target is established, there needs to be the same number of instruments so that an instrument designed to achieve target A (but which detracts from target B) is compensated by an instrument directed specifically at target B which also negates the adverse effect on target B of the instrument used for target A. The skill in devising strategy is to create the optimum mix of instruments so that all targets are met. In the end the three ultimate objectives can be targeted simultaneously only if the firm has an appropriate number of independent instruments available³.

In practice any financial firm has dozens of intermediate targets which all

3 In terms of a naval analogy, a battle cruiser primarily has to fight the enemy on the seas, but also has to be equipped to fight a few enemies in the air and under water – clearly the time has passed where it could concentrate solely on enemy ships. Accordingly, any cruiser today has surface-to-surface missiles, anti-aircraft missiles and appropriate anti-submarine devices. In fact, it may be even more efficient and effective to allocate these separate tasks to separate vessels within the same battle fleet: frigates and attack submarines specialising in underwater warfare; aircraft carriers and missile cruisers concentrating on air combat; and battle cruisers themselves specialising in the destruction of enemy naval ships. Obviously, it is a crucial *strategic choice* to decide whether these different functions should be delivered by the same ship or by different (specialised) vessels within the same fleet. This choice is equally difficult in finance. If a financial firm has to fulfil three mutually conflicting objectives, it needs at least three independent instruments to do so.

have to be aligned with appropriate instruments. Therefore it always remains rather difficult to prioritise ultimate objectives and operational targets. For instance, greater emphasis on client confidence should never be at the cost of the “safety and soundness” objective. Instead of prioritising, specific instruments have to be designed and developed for a better client focus if these are not in place already. In the mission statement of a financial firm the three ultimate objectives should carry similar importance and be fully aligned to the objectives of the regulatory authorities.

4. INTERMEDIATE TARGETS (OR INDICATORS)

The intermediate targets of a financial firm flow directly from its ultimate objectives. However, where the ultimate objective is a philosophical concept (i.e. often broad and non-quantifiable), the intermediate target is a quantifiable indicator that fulfils a specific aspect of the broad objective. Therefore an intermediate target can be hit or missed!

For example, the firm’s ultimate objective of “safety and soundness” can be transformed into a quantifiable intermediate target of “capital adequacy”, which in turn depends on a value-at-risk model. Accordingly, the *instrument* used to calculate the firm’s value-at-risk is a risk analysis system, the *intermediate target* is a specified amount of (primary and secondary) capital, while the *ultimate objective* of the whole analysis is to ensure the “safety and soundness” of the financial institution. Table 1 (p.13) shows how these three concepts (i.e. objectives, targets and instruments) can be combined into a conceptual framework. Of course, the intermediate targets can be broken down in much more detail (e.g. capital adequacy can be split into the various risk categories such as capital adequacy for market and credit risks), but the aim of table 1 is mainly conceptual.

The intermediate targets mentioned in table 1 can be made operational by transforming them into quantifiable yardsticks.

4.1 Intermediate targets ensuring “safety and soundness”

What table 1 does (also tables 2, p.16 and 3, p.18) is to consider each of the three objectives, and then identify specific operational targets or

business measures that make these objectives operational. Thus, an objective may be to ensure the “safety and soundness of a bank”. In itself this is not operational, as it does not indicate to the bank’s management what its behaviour should be and specifically what is needed to achieve “safety and soundness”. The objective is made operational by establishing specific and measurable targets. These include:

- *Capital adequacy*: A specific target is set by the regulatory authorities, but the board of directors may well top up a little (e.g. aim for a 12% capital ratio against risk-weighted assets compared with a statutory requirement of 8%).
- *Adequate liquidity*: A specific target for cash and liquid assets is set by the regulatory authorities or the board of directors (e.g. 3% cash and liquid assets against short-term liabilities).
- *Acceptable profitability profile*: Usually the return on equity (ROE) is used as a profitability measure (a 15% ROE for banking is now the widely accepted global target, although most of the European banks operate below a 10% ROE). Obviously a high ROE also supports confidence in an institution. However, as already noted, a too high ratio may be in conflict with other objectives.
- *Acceptable ownership relationships*: A target could be the spread rule of the stock exchange, but could also embrace specific shareholder agreements on, for example, maximum shareholding, voting rights and freedom to sell equity. A certain percentage of total shares can also be predetermined for an executive share incentive scheme.

4.2 Intermediate targets ensuring “client confidence”

A similar approach is adopted in the case of the “client confidence” objective. How can this high-level objective (shared by the regulator and a bank) be made operational by the selection of specific and measurable targets? The targets identified are summarised as follows:

- *Client satisfaction*: Marketing surveys of various kinds are used to measure the degree of client satisfaction.
- *Maximum integrity*: The compliance officer has to ensure that only people with integrity are employed by a firm (i.e. his so-called “gate keeper” responsibility).

- *Adequate competence*: Through appropriate entrance requirements, ongoing staff training and spot inspections (e.g. by the compliance officer) the degree of competence in a firm is measured against the background of client needs.
- *Minimum conflict of interest*: Potential problems of conflicts of interest are addressed foremost by establishing Chinese walls in a firm.
- *Minimum fraud, insider trading and money laundering*: Forensic investigations have to determine the degree of fraud and illegal transactions taking place in firms.
- *Transparency*: The fulfilment of transparency requirements is often determined by the listing requirements of the stock exchange and corporate governance rules.

4.3 Intermediate targets ensuring “efficiency and effectiveness”

The third objective that needs to be made operational by the establishment of measurable targets relates to “efficiency and effectiveness”. The specific targets identified are:

- *Economies of scale, scope and x-efficiency*⁴: Any firm should know whether it is operating, with its existing labour and capital resources, at optimum efficiency in terms of quantity of production as well as the variety of its products. These efficiency standards as well as the optimum mix of labour and capital inputs in production are measured continuously by specific research units.
- *Financial innovation*: The standard of measurement for innovation is usually the time period required for new products to be designed and brought to market – alternatively how much time is required to copy and improve on the products of competitors.
- *Market share and market penetration*: Even in tough business

4 The distinction between *economies of scale* and *x-efficiency* is important. Economies of scale are achieved when a firm is producing a level of output at which the minimum point on the long-run average cost curve is achieved. X-efficiency is attained when, whatever level of output is achieved, a firm is operating with the lowest possible average costs *for that level of output*. The actual level of output may be below that which produces the lowest possible long-run average costs.

conditions, a firm prefers to maintain its market share, which is usually expressed as a percentage per product line. The degree of market penetration can also be measured objectively from sales figures.

- *Competitive pricing*: The degree of competitive pricing is measured by the absolute difference in the finest quoted price in the market and a firm's price for such a product.
- *Competitive cost structure*: This is usually expressed as operating expenditure as a percentage operating income (cost-to-income ratio).
- *Access to credit by small firms and individuals*: The effectiveness of supplying financial services is usually measured by the percentage of total credit granted to small firms and individuals.

5. THE ALIGNMENT OF INSTRUMENTS TO INTERMEDIATE TARGETS

Having decomposed the objectives into operational targets, it is necessary to identify specific business instruments to attain these targets. Business instruments are what a bank has at its command and can be regarded as decision-variables. In order to cope with the problem of internal conflicts between intermediate targets, a firm should have at least the same number of instruments as targets. With sufficient instruments it is possible to address each target in isolation without worrying too much about side-effects.

The instruments of a firm can be grouped under three main headings depending on whether such instruments are primarily used to enhance: (i) *safety and soundness*; (ii) *client confidence*; and (iii) *efficiency and effectiveness*. Long-term strategy and short-term operational tactics are dependent on how these instruments are used in mutual combination or on the emphasis placed on certain specific instruments at specific times.

As is evident from table 1, one specific instrument can have a positive impact on more than one intermediate target, which in turn will increase the power of such an instrument. By contrast, some instruments (e.g. Chinese wall structures) are aligned to only one specific target – such

instruments are then less powerful on a broad spectrum, but can still be very efficient in a specific area. The ultimate aim of the analysis is to ensure an integrated approach to both long-term strategic changes and short-term tactical operations in one overall conceptual framework.

The instruments mentioned in tables 1, 2 and 3 are discussed below. A more detailed analysis of the current state of thinking in respect of these instruments is discussed in chapters 2, 3 and 4.

It should be noted that the conceptual relationships indicated in the tables may be specific to one specific banking firm and may even change over time – in essence the tables summarise one specific approach, and other combinations are possible.

5.1 “Safety and soundness” enhancing instruments

This class of instruments (see table 1) is primarily aligned to address issues of a firm’s financial robustness.

- *Risk analysis system:* The risk management function of a financial institution not only calculates the market-risk exposures with corresponding capital and liquidity requirements, but is also heavily involved in hedging strategies and rate sensitivity analysis. Accordingly, it makes a major contribution in the area of competitive pricing, market penetration and a firm’s cost structure. Being in the forefront of financial engineering, the risk management function powerfully supports developments in the field of financial innovation, and ultimately the profitability of a firm.
- *Management control and supervision systems:* The safety and soundness of a firm is dependent not only on sound risk management rules, equally important is compliance with such rules, e.g. capital and liquidity rules. In this supervisory role the management control systems play a key role. Management control systems have to ensure that a firm maintains maximum transparency, controls operating expenses and fights insider trading, fraud and money laundering.
- *Share buyback policies:* Overcapitalisation of a firm usually results in a low ROE. In order to improve its ROE, a financial firm could divest

itself of subsidiaries with too low a ROE and use the proceeds of such sales to repurchase its shares⁵.

- *Management incentive structures*: A direct link between the economic value added by a firm and the management incentive scheme ensures that management is dedicated to profit performance. Client satisfaction, financial innovation and cost efficiency can all be influenced by appropriate incentives.
- *Consultation with regulatory authorities and shareholders*: Both listed and unlisted financial institutions are subjected to inspections and supervision by their regulatory authorities (i.e. the SA Reserve Bank and/or Financial Services Board). The regulatory authorities may even require additional capital or liquidity should they be dissatisfied with a risk profile in relation to a capital base. The authorities can also share information on specific corporate executives and in so doing improve the integrity of a firm. Moreover, negotiating with large shareholders may result in a strengthened capital base, either through specific shareholder agreements or simply through additional capital invested in the enterprise.
- *Listing requirements of a stock exchange*: In terms of the Banks Act, a bank has to be a company. The stock exchange listing requirements are powerful requirements to ensure the safety and soundness of listed financial institutions. For instance, disclosure, accounting requirements and timing or the spread rule for corporate shareholding are stipulated by the Johannesburg Stock Exchange (JSE) listing rules.
- *Corporate governance rules*: A key issue is whether a bank has corporate governance mechanisms which are conducive to the management of risk and which enhance client confidence in a firm. These include the role of executive and non-executive directors,

5 Nomura (in its 1999 published report *South African Banks: Strategy Games*) argued as follows: “The absence of a truly competitive market has permitted the banks to pursue an ‘all things to all men’ strategy... In the new environment all banks, we believe, will be forced to focus on their strengths and streamline or even cut altogether lesser performing divisions”.

whether a bank's internal control mechanisms are effective, and whether the board and senior management have established clear guidelines regarding acceptable risk. The mechanisms also involve the question of whether a named board member is responsible for risk management and control.

5.2 “Client confidence” enhancing instruments

Instruments in this class are aligned specifically to improve a firm's reputation (see table 2). It is of great importance that the users of financial services are treated fairly and that their funds invested are appropriately protected.

- *Client information technology*: A better informed client is usually a more satisfied client. Information can be obtained from branches, ATMs, through the mail (e.g. economic reports), the Internet or in the press (e.g. advertisements). Internationally there is a tendency to move progressively away from (feel-good) advertising to supplying (informative) educational “demand pull” information.
- *Compliance arrangements*: The task of the compliance office is primarily to ensure that a firm fulfils all the requirements in respect of its code of business conduct as well as all the requirements flowing from the avoidance of reputation risks. In the relationship between a client and a financial firm the compliance officer plays a crucial role.
- *Disclosure arrangements*: With the increasing complexity of finance, more and more disclosure is required to ensure fairness towards the client (and shareholders).
- *Training and competence*: The main aim of training and education programmes within a company is to enhance the competence of staff (as well as integrity in so far as this can be brought about by study).
- *Complaints procedures*: Dissatisfied clients should have appropriate channels of redress, which assume the form of a complaint to the compliance officer or the industry's ombudsman. Ultimately the legal department of a firm may also become involved, should the complaint be heard in the courts.

Table 2: Strategic target-instrument approach for the financial services industry: client confidence																						
Ultimate objectives		Safety & soundness				Client confidence				Efficiency & effectiveness												
Intermediate targets/indicators for a bank		Capital adequacy	Adequate liquidity	Acceptable profitability profile	Acceptable ownership relationships	Client satisfaction	Maximum integrity	Adequate competence arrangements	Minimum conflict of interest	Minimum fraud and insider trading	Transparency	Optimum economies of scale	Optimum economies of scope	Optimum x-efficiency	Financial innovation	Market share and market penetration	Competitive pricing	Competitive cost structure	Access to credit by small firms and individuals			
Client-confidence-enhancing instruments of a bank		Client information technology				*	*	*	*	*	*											
		Compliance arrangements	*				*	*	*	*	*							*				
		Disclosure arrangements				*	*															
		Training and competence					*	*	*	*	*											
		Complaints procedures					*	*	*	*	*	*							*			
		Compensation schemes		*			*			*	*	*										
		Single-capacity trading								*	*	*										
		Chinese walls								*	*	*										
		Audit arrangements						*		*	*	*										
		Forensic investigations						*		*	*	*										

- *Compensation schemes*: Various types of compensation schemes can be used to fulfil this client demand (e.g. deposit insurance or fidelity funds).
- *Single-capacity trading and Chinese walls*: Both these arrangements are designed solely to address potential conflicts of interest within a firm.
- *Audit arrangements*: Auditors play a key role in the distribution of adequate financial information. They are also involved in investor protection arrangements such as ensuring that the buyback of equity is not to the disadvantage of investors.
- *Forensic investigations*: This instrument is used virtually exclusively to combat financial fraud, insider trading and money laundering.

5.3 “Efficiency and effectiveness” enhancing instruments

The efficiency and effectiveness of a financial firm is crucially dependent on how and where it operates, under what organisational structure it wants to operate, how clients are segmented and have access to financial services, and what products are sold or securitised for the securities markets. All these business operations are embraced by the information management function and, depending on that function’s quality and efficiency, the firm has an ability to implement its far-reaching strategies. Any improvement in the efficiency of a firm is bound to increase its profitability as well. The business instruments are outlined in table 3.

- *Organisational structure*: To improve *inter alia* efficiency, cost structure and market penetration, the organisational structure of a financial firm (or financial conglomerate) is of the utmost importance. Typically, the key questions in this area are the advantages and disadvantages of unbundling or the separate capitalisation (or not) of strategic business units or to what degree a business can be integrated in a universal banking structure. Another key question is to what extent certain inhouse services should be outsourced, and thus purchased at arm’s length from independent suppliers. Increasingly, processes can be supplied from outside a bank. Better business focus can be obtained by unbundling a complex financial structure, and creating clearly defined “profit centres”.

- *Information management*: Studies on economies of scale, scope and x-efficiency are crucially dependent on data from the information management function. Moreover, risk management and control systems – and everything that goes with them – are also fully dependent on information technology support. In essence business information management is the lifeblood of a firm.
- *Cost-control management*: Unnecessary expenses have to be eliminated as far as possible to ensure that a firm can price its products competitively, which in turn facilitates market penetration.
- *Monitoring techniques*: Once credit has been granted, a client has to be closely monitored to avoid unexpected bad debt exposures.
- *Rationalisation*: The pruning of below-average performing units will not only improve the cost efficiency of a firm, but may also contribute to better economies of scale and scope should the firm have grown too large in certain of its activities.
- *Joint ventures*: Where a firm lacks the required skills or critical mass to make a success in a particular sphere of business, an outside partner can be of great help.
- *Subcontracting*: The outsourcing of non-core business can greatly contribute to better economies of scale, and thus a more competitive cost structure.
- *Consolidation*: Mergers and acquisitions are aimed mainly at improving economies of scale and scope, reducing the cost structures, and obtaining a better market penetration. They may even improve competitive pricing if a merger (takeover) succeeds in silencing a major competitor⁶.
- *Globalisation*: In essence this instrument is part of an organisational structure, but is usually separately considered, as its emphasis is solely on geographic diversification and resulting international competitiveness. Globalisation may also improve the risk

6 Nomura has recently offered the opinion that “there is also the opportunity of realising significant economies of scale by merging major banking units. Many observers believe that a country the size of South Africa does not need five major banks engaged in all major business segments and managing nation-wide branch networks”.

profile of a firm, in that it is no longer solely dependent on its home country for its income stream.

- *Diversification*: Here the aim is primarily to improve economies of scope: i.e. how many different products can be produced from one production plant. In finance the key question is whether banking, securities and insurance products can be sold and serviced sensibly through one major institution (i.e. a universal bank) or whether it is more efficient to do so through various specialised outlets (i.e. a financial conglomerate structure).
- *Securitisation*: Off-balance-sheet financing can significantly enhance efficiency if corporate growth is limited by a lack of capital. With the development of capital markets and technological support, an increasing number of financial instruments can be supplied and serviced through the securities markets rather than through financial intermediation. Securitisation, and the resulting diversification, can powerfully support economies of scale, profitability, lower cost structures and the penetration of new market segments.
- *Segmentation*: Efficiency can be improved not only by diversification strategies, but also by segmenting clients in various (profitability) classes, with each class being serviced differently at different costs. Each class may also be offered different access channels, which is bound to improve client satisfaction.
- *Distribution and access channels*: Distribution channels ensure that a firm can deliver its various services to various market segments. Access channels work the other way round by ensuring that one specific market segment can make use of a range of specific financial products on offer. Good distribution channels improve efficiency and client satisfaction, while good access channels improve effectiveness. Typical distribution channels are branches, ATMs, telephone banking and the like, while access channels embrace, in addition, specialised financial institutions such as the Postbank.
- *Pricing policies and cross-subsidising*: In a perfectly efficient market there is only one price for one product. The cross-subsidisation of

certain products or the marketing of “lost leaders” are signs of imperfect markets. There are cross-subsidies between different customers, products and businesses. This necessarily implies “subsidising” and “subsidised” products, which also presupposes an ability to segment markets. With subsidising products, prices are set high relative to costs and risks; while prices are set too low with those products that are subsidised. This is possible only if there are entry barriers to these subsidising products as, without such barriers, new entrants would compete away the subsidising price differentials. As competition increases, the room to manoeuvre on price is usually reduced. Cross-subsidisation of financial services (as well as the granting of credit to small firms and individuals) is often done for political reasons. Again, as the efficiency of the financial system increases, the room to use these instruments to improve the effectiveness of the financial system is reduced.

- *Regulatory capture*: The regulated and the regulator operating on the same wavelength is not only profitable, but may also contribute to an attractive entry barrier, which in turn enhances a firm’s competitive pricing strategies.

6. CONCLUSION

An integrated target-instrument approach to corporate strategy allows for the simultaneous pursuit of potentially conflicting objectives. Senior management can use the analysis for either strategic positioning or tactical manoeuvres. It supports a holistic view of a firm’s strategies and pinpoints the likely consequences of underperformance in specific business areas.

CHAPTER 2

INSTRUMENTS USED TO ENHANCE THE ROBUSTNESS OF BANKS

1. INTRODUCTION

No bank can flourish unless its financial footing is both strong and stable. Banks, as professional risk managers *par excellence*, have to ensure that they are sufficiently rewarded for the commercial risks they take. Unfortunately, international experience shows that the world's financial system is far from strong and stable. In recent years about three-quarters of International Monetary Fund (IMF) member countries have had significant problems in their banking systems. Banks in many countries still have very high levels of non-performing loans, there has been a major destruction of bank capital, banks have failed in great numbers and massive support operations with tax payers' money have been necessary. The bailout of banks (in various forms) has involved substantial costs: in around 25 per cent of cases the costs have exceeded 10 per cent of GNP.

This chapter focuses on how to improve the robustness of banks, which implies a focus on global trends in the international banking system (see section 2) and what the consequences of these trends will be for the South African financial system (see section 3).

2. GLOBAL TRENDS AIMING TO IMPROVE THE ROBUSTNESS OF BANKS

Banks remain unique in that they can create potential systemic risks because of the nature of their contracts: it is particularly the *combination* of contracts that is crucial. Debt contracts are written on both sides of the

balance sheet: on the liabilities side contracts are for money-certain or “guaranteed” deposits, but on the assets side debt contracts are non-marketable and of uncertain value.

In contrast, investment firms write contracts with their clients resulting in *uncertain* liabilities, as the value of these liabilities is determined by the value of their asset portfolios (e.g. money-market funds). Insurance undertakings also write *uncertain* liability contracts but, in contrast to that of investment firms, the value of their liabilities is independent of the return on their assets, being instead based on the occurrence of an observable event unrelated to their financial statements (e.g. theft, fire and murder).

Therefore, owing to the nature of their business contracts, banks create major systemic risks (i.e. a balance sheet containing highly liquid and certain liability contracts combined with illiquid and uncertain assets). In contrast, investment firms hardly create any systemic risks, as the values of their assets and liabilities should move more or less in tandem (nonetheless necessitating stringent prudential requirements such as capital adequacy, large exposure limits, connected lending limits and foreign exchange limits). Likewise, insurance undertakings do not pose systemic risks, because they have the opposite type of situation to that of banks, i.e. long-term liabilities matched by readily marketable assets (therefore there cannot be a run on insurance companies’ liabilities).

As a result of these fundamental balance sheet characteristics, a crisis in insurance (e.g. a sharp deterioration in asset values) implies that policy holders will lose out, whereas trading conditions in a securities firm implies that shareholders may lose their capital investments, but only in the case of banking do ordinary depositors run the risk of losing their savings should a bank’s loans become non-performing. Moreover, a banking crisis may quickly translate into a crisis in the payments system if the authorities are not standing by with bailout facilities.

The asset and liability contracts issued by banks hold two systemic dangers: (i) bank runs can occur; and (ii) a solvent bank can be made insolvent by a run on deposits. The first arises because, in the absence of one hundred per cent deposit insurance, depositors know that a bank is

illiquid and will pay out on the basis of first-come-first served. If any doubt arises about the security of a bank (perhaps because of the negative confidence effect associated with the failure of another bank), depositors will attempt to withdraw their deposits immediately.

The second (a solvent bank can be made insolvent) arises because, due to asymmetric information problems (i.e. a bank knows more about the quality of its assets and loans than do other banks), the bank can only sell illiquid loans at values below par. A simple application of arithmetic indicates that a bank with a capital ratio of x per cent becomes insolvent if a fire-sale of assets occurs at more than x per cent below par.

Investment firms and insurance companies are primarily involved in the management of market and underwriting risks respectively. Although securities prices may fluctuate by as much as 20% in a single month (e.g. the New York Stock Exchange in October 1989), the systemic risk flowing from securities markets is limited, provided investment firms are appropriately capitalised (for instance, using internal value-at-risk models). Likewise, underwriting risks may expose insurance companies to major risks, but through appropriate diversification of assets and purchasing reinsurance these risks can be reduced to an acceptable level.

The purely systemic dimension of an insurer is considerably less of an issue than in the case of a bank, because: (i) insurance companies' liabilities are long-term in nature and hence their liabilities are not prone to runs; (ii) insurance companies do not have the same linkages with one another as do banks through market trading and the payments system; (iii) the assets of insurance companies are readily marketable; (iv) the contracts of insurance companies are often entered into on the basis that their commitment to their liabilities is determined by the performance of their assets; and (v) insurance companies are not involved directly with the payments system. Overall, insurance companies are not engaged in the type of asset transformation that banks are engaged in, which gives banks a particular systemic dimension. In fact, an insurance company is involved in precisely the opposite type of asset transformation: it effectively transforms illiquid liabilities into liquid assets, as compared with banks,

which transform liquid liabilities into illiquid assets. While there is a case for prudential regulation of insurance companies, this is not because they raise potential systemic issues.

Generally speaking, systemic risk is relatively low (or even non-existent) in non-bank financial institutions, provided the regulatory authorities ensure: (i) appropriate prudential requirements (“solo plus” supervision and the elimination of the double gearing of capital); (ii) place stringent limits on large credit exposures and connected lending; and (iii) curtail large currency exposures.

Accordingly, if the authorities try to improve the robustness of the financial system, they look firstly to the banking sector. Moreover, as bank bailouts have to be financed with taxpayers’ money, there is a very close interaction between bank owners (and their appointed managers) on the one side, and the regulatory authorities on the other. The objectives of a robust financial system in general and the management of banking risks in particular are tasks for both the private sector and regulatory authorities, and hence close cooperation between them is required for success. The regulator will write rules and create incentives for banks to reduce the probability of insolvency.

Given recent experience and the huge costs involved, it is instructive to consider the basic characteristics of a robust financial system in greater detail. Robustness refers to the ability of the financial system to remain stable and efficient under a wide range of market conditions and shocks.

Three particular elements are important in this:

- *flexibility* – the ability of the financial system to operate in all circumstances and to change the way it operates as market conditions alter;
- *resilience* – the ability to continue to function in the face of external shocks, including instability in the macroeconomy; and
- *internal stability* – the financial system should not itself generate its own shocks or magnify shocks in the macroeconomy.

For purposes of analysis, the basic characteristics and requirements of a robust financial system can be considered under four headings: (i) stability in the macroeconomy; (ii) the financial system’s infrastructure;

(iii) market discipline and competition; and (iv) the quality of regulation and supervision of the financial system. In essence, this all amounts to two basic requirements: firstly, the requirement for the authorities to reduce the extent of macro shocks and macro instability and secondly for them to strengthen the ability of the financial system to cope with those macro-economic shocks that do occur.

2.1 Stability in the macroeconomy

Almost invariably, crises in the financial system (i.e. involving more than one bank) are preceded by major macroeconomic adjustment and especially a restrictive monetary and fiscal policy stance to reduce inflationary pressures. This often leads to an economy moving into recession. Most financial crises have been preceded by sharp fluctuations in the macroeconomy, and often in asset prices.

However, it would be a mistake to ascribe banking crises and financial instability entirely, or even mainly, to macroeconomic instability. While macro instability may be the proximate cause of a banking crisis, such a crisis usually emerges because the instability in the macroeconomy reveals weaknesses within the financial system itself. A shock (such as a recession) often leads to a banking crisis because it reveals inherent weaknesses within a financial system. Such weaknesses include: poor, weak, or inappropriate incentives in the management system; weak internal risk analysis; inefficient management control systems within financial firms; and poor regulation and supervision of financial institutions.

Financial crises are often preceded by a sharp fall in asset prices and a move into recession as a government adopts stabilisation measures to control inflation. Sharp movements in relative prices (sometimes owing to the removal of subsidies) can also induce banking sector problems. They cause unexpected changes in the economic conditions of particular industries to a degree that falsifies the assumptions on which bank lending to these industries were based. However, it is also usually the case that the seeds of the problem (e.g. overlending, weak risk analysis and poor management control) were sown in the earlier upswing of the business

cycle. The downswing phase reveals previous errors and over-optimism. The mistakes made in the upswing emerge in the downswing. In South East Asia, for instance, a decade of substantial economic growth up to 1997 concealed the effects of what was, in fact, questionable bank lending policies.

A robust financial system should be able to cope with a reasonable degree of economic instability. The problem is to define what is “reasonable” and what degree of shock a financial system should be able and prepared to cope with. This must necessarily vary from one country to another. *It is for this reason that prudential standards need to be higher in developing countries, reflecting the inherent higher degree of macro-economic instability due to the structure of the economy.*

There are many routes through which instability in the economy can lead to problems in the financial system, including: changes in the creditworthiness of bank customers; changes in the underlying assumptions of previous lending decisions; changes in business conditions both for banks and their customers; false expectations and excessive optimism and euphoria about economic conditions; increased interest rate volatility; and volatile international capital flows. In all of these instances, economic instability can feed through as problems for the financial system and, in extreme cases, induce banking crises.

There are many examples of this throughout the world both in the industrialised countries and in emerging and developing economies. Several elements can cause a volatile macroeconomy:

- unstable and unpredictable conduct of fiscal and monetary policy;
- high and volatile rates of inflation which create confusing signals for decisionmakers;
- weak public finances and budget financing through financial repression techniques;
- excessive reliance on external foreign currency debt which becomes hazardous if, for any reason, the exchange rate is devalued;
- volatile or sharp movements in a country’s terms of trade; and

- unstable capital flows which, among other considerations, induce sharp fluctuations in domestic monetary conditions.

Instability in an economy can in some cases be associated with volatile capital flows into and out of a country. The main problem centres on liquid capital flows. In some countries there has been official encouragement for banks to secure short-term external funding. This can prove to be very volatile. Reliance on short-term bank financing has proven to be an inefficient and volatile means of financing international capital transfers. The “feast-to-famine” phenomenon is often experienced as a result. *The active development of a capital market as an alternative to banks is a constructive step to lessen the financial fragility of a financial system.* Overall, there should be less reliance on short-term borrowing through a banking system.

A common experience in countries which have experienced serious banking problems is that expectations have been volatile and asset prices (including property) have been subject to wild fluctuations. A sharp (sometimes speculative) rise in asset prices has been followed by an equally dramatic collapse. An initial rise in asset prices induces over-optimism and sometimes euphoria, which in turn leads to increased demand for borrowed funds and an increased willingness by banks to lend.

There are several reasons for the demand for borrowed funds to rise when asset prices are rising: optimism is created; speculative purchases of assets are financed by borrowing; and borrowers (firms and individuals) become relaxed about the rise in their debt-income ratio (even though it makes them potentially more vulnerable). Similarly, banks are willing to extend credit in a period of sharp asset price inflation: perceptions of credit-worthiness are enhanced, and the value of collateral is increased. The rise in financial asset values induces borrowers to incur more debt (on the assumption that their debt-servicing capacity has increased) and banks to increase their lending and acquiesce to their customers’ higher gearing ratios. The rise in asset prices tends to make banks less risk-averse, generally more optimistic, more confident of borrowers’ ability to service debt, and more confident about the value of collateral.

Problems subsequently arise when asset prices fall as each of the considerations relevant in the upswing is reversed. Borrowers become especially vulnerable as they suffer falls in asset prices at a time when their gearing ratios are exceptionally high. Thus, while the proximate cause of a banking crisis might be a recession and fall in asset prices, the seeds of the problem are usually sown in the previous upswing when there is insufficient discipline on lendings.

For these reasons, there is some advantage in minimising fluctuations in the macroeconomy or, at least, keeping their magnitude within reasonable bounds. This raises the question of the speed and sequencing of liberalisation measures in the financial sector. Many banking crises have followed programmes of liberalisation in the financial sector. Substantial changes in a regulatory regime are likely to induce sharp, and possibly uncertain, changes in behaviour.

In general, liberalisation programmes have the effect of raising the efficiency of a financial system, because they usually enhance competition, often facilitate the entry of foreign banks, and remove financial repression (distorted interest rates, credit rationing, etc.). For instance, since 1994 some 70 foreign banks have entered the South African market, increasing competition most especially (if not exclusively) in the corporate banking sector. Sophisticated and heavily capitalised foreign banks, which had exited the country during the apartheid era, have returned *en masse*. Foreign banks typically target the top 100 corporates and parastatals with project finance, treasury, derivatives and cash management services. A major competitive advantage is their global network capability. The net result has been a significant diminution of South African banks' corporate profit potential.

In addition, *capital account liberalisation usually leads to a narrowing of interest rate spreads*. This in turn is bound to increase fragility in the short run.

Therefore, steps should be taken to mitigate the risks. Authorisation and monitoring of financial institutions (notably banks) need to be particularly strict in the early years of liberalisation programmes. In

general, the more deregulated a financial system, the greater the need for monitoring and supervision. The more deregulated a banking system, the greater the need for the business operations of banks to be monitored because the environment is potentially more risky.

In essence, macroeconomic instability causes financial system instability only if there are underlying weaknesses within such a system already. Accordingly some of the internal characteristics of a financial system are likely to make it robust and stable, even in the face of macroeconomic fluctuations. These characteristics can be considered under the headings of: (i) infrastructure; (ii) market discipline and competition; (iii) incentive structures; and (iv) incentives for regulators and supervisors.

2.2 A financial system's infrastructure

The objective here is to create an institutional setting and financial infrastructure for a sound credit culture and effective market functioning. This includes aspects such as: legal arrangements; information disclosure and availability; and the basic tools of sound accountancy and auditing. Many developing and emerging markets do not fulfil these basic requirements, which in turn increases their cost of foreign capital. Several elements in particular may be identified:

- A strong legal framework to ensure that property rights are well defined (and easily and reasonably exercisable at reasonable cost) and to promote a sound credit culture within financial institutions. This implies creating a legal environment in which the terms and conditions of contracts are observed and the rights and obligations of all agents involved in loans or transactions in financial assets are well-defined, understood and enforceable without undue delay or cost.
- A legal framework for the pledging of collateral and the ability to take possession of collateral.
- Clearly defined bankruptcy laws and codes, along with effective enforcement.
- Priority should be given to improving the quality, timeliness and relevance of information used by all market participants (users and

suppliers) and regulators to assess asset quality, creditworthiness and the condition of financial institutions. This includes timely publication of relevant financial data on the soundness of financial institutions.

- Adequate systems within financial firms for assessing risks *ex ante* and asset values *ex post*.
- Systems and incentives for timely and accurate provisioning against bad or doubtful debts.
- Comprehensive and well-defined accounting principles which conform to agreed international standards and provide accurate and relevant information on financial performance. This includes international standards for classifying loans as non-performing.
- Mechanisms to ensure that loan valuation, asset classification, loan concentrations, inter-connected lending, and risk assessment practices reflect sound and accurate assessments of claims and counterparties. This also requires mechanisms for the independent verification of financial statements and compliance with the principles of sound practice through professional external auditing and on-site inspection by supervisory agencies.
- Effective rating agencies operating independently of government authorities.
- A wide variety of financial instruments (including derivatives) and markets which can assist financial institutions in the management of risks.

These considerations relate to the basic infrastructure of a financial system and many require public policy initiatives by public agencies with responsibility for systemic stability.

2.3 Market discipline and competition

Analysis of financial crises throughout the world indicates very powerfully that two common characteristics are: weak internal risk analysis as well as management and control *systems*; and/or weak (or even perverse) *incentives* within a financial system generally and within financial institutions in particular. These need to be addressed if a robust and stable financial system is to be created.

While banking crises do have unique and country-specific features, they also have a lot in common. Several conditions tend to precede most banking crises both at individual and systemic levels:

- rapid growth in bank lending within a relatively short period;
- unrealistic expectations and euphoria about economic prospects in an economy;
- a sharp and unsustainable rise in asset prices (part of euphoria speculation) leading to unrealistic demands for credit and a willingness of banks and other lenders to supply loans;
- concentrated bank portfolios often with a high property content, i.e. while project risks may be properly assessed, portfolio risk often is not;
- excessive inter-connected lending within banking groups;
- government involvement in loans and loan decisions which may have the effect of weakening incentive structures, eroding discipline on lenders (an implicit guarantor), and may also involve undue political influence or insider relationships;
- inappropriate risk premiums being charged in lending interest rates; and
- insufficient attention being given to the value of collateral most especially if rapid balance sheet growth occurs in a period of asset price inflation.

In the final analysis, weak internal risk analysis, management and control systems are at the root of all banking crises. Instability elsewhere should not conceal or be used to excuse weaknesses in this area of bank management. Further, when these weaknesses are present, they frequently manifest themselves in excessive lending on property projects. This is partly because in periods of rapid asset price inflation property appears to be an attractive lending proposition. However, it is in essence speculative lending and the bubble bursts when overcapacity in the property sector becomes evident.

Banking crises often follow major regulatory regime changes which create unfamiliar market conditions. Periods of rapid balance sheet growth, especially if this occurs after a regime shift and in a period of

intense competition when market share considerations dominate, almost inevitably involve banks incurring more risk. There are several reasons for this: banks begin to compete for market share by lowering their risk thresholds; risks are underpriced in order to gain market share; control systems tend to weaken in periods of rapid balance sheet growth; growth itself generates unwarranted optimism and a growth-momentum develops; and portfolios become unbalanced if new lending opportunities are concentrated in a narrow range of business sectors. When, as is often the case, fast growth strategies are pursued by all banks simultaneously, borrowers become overindebted and more risky, which in turn increases the vulnerability of the banks from whom they are borrowing.

2.4 Incentive structures

In many ways financial regulation should be viewed as a set of contracts – i.e. laws, regulations and supervisory actions – to create incentives for regulated firms to adjust their actions and behaviour, and to control their own risks. They can usefully be viewed as incentive-compatible contracts. Within this framework, financial regulation involves a process of creating incentive-compatible contracts, so that regulated firms have an incentive to behave in a way consistent with the regulatory objectives of systemic stability and investor protection.

The central issue, therefore, is whether all parties have the right incentives to act in a way that satisfies the objectives of regulation. As banking crises frequently occur when there are weak incentives to act prudently, a necessary ingredient of a robust and stable financial system is the creation of appropriate and efficient incentives and disciplining mechanisms for all market participants and most especially bank *owners* and bank *managers*. These are briefly considered in turn.

2.4.1 Incentives for bank owners

The owners of banks (or their elected directors) have to take some responsibility for ensuring a bank is managed in a prudent manner. Various incentives can be created for this:

- Ensure that banks have appropriate levels of equity capital. In many of

the countries that have experienced banking crises the capital position of the banking sector has been weak, and capital ratios have been significantly below Bank for International Settlements (BIS) standards. Capital serves three main roles as far as incentive structures are concerned: a commitment of the owners to supply risk resources to the business and which they can lose in the event that the bank makes bad loans; an internal insurance fund; and the avoidance of the bank becoming the captive of its bad debtors. In general, the higher the equity capital ratio of a bank, the more the owners have to lose and hence the greater the incentive for them to monitor the behaviour of managers. Low capital creates a moral hazard in that, given the small amount owners have to lose, they are more likely to condone a bank taking excessive risks. This may sometimes be in a “gamble-for-resurrection” strategy (as was evidently the case during the savings and loan crisis in the United States). Regulators should require banks to hold capital commensurate with the risks they take.

- Corporate governance arrangements should be such that equity holders (i.e. the owners of the bank) actively supervise managers. This in turn requires transparency and the publication of relevant, timely and accurate information.
- Supervisors and safety-net agencies should ensure that owners (shareholders) lose out in any restructuring operations in the event of failure. Failure to penalise shareholders in the restructuring of unsuccessful banks has been a major shortcoming in rescue operations in Latin America.
- Encouragement should be given to ownership structures that foster shareholder monitoring and oversight. This includes private ownership of banks to strengthen the monitoring of management performance and to reduce distortions in incentives for managers.

2.4.2 Incentives for bank managers

Nearly all aspects of a firm’s behaviour are corporate governance issues. Several procedures, processes and structures can reinforce internal risk

control mechanisms. These include internal audits; internal audit committees; procedures for reporting to senior management and supervisors; and making a board member responsible for compliance and risk analysis and management systems.

Supervisors can strengthen the incentives for these by, for instance, relating the frequency and intensity of inspection visits to the adequacy of internal control procedures. They can also calibrate the external burden of regulation to the quality of management and the efficiency of internal incentives.

The key is that there needs to be internal incentives for management of financial institutions to behave in appropriate ways, and a regulator has a role in ensuring that internal incentives are compatible with the objectives of regulation. Creating the right incentive structures for bank managers is equally as important as those for the owners. In fact, the two should be viewed in combination:

- In all financial institutions there should be strong and effective risk analysis, as well as appropriate management and control systems. In some countries this is made difficult by the close links between banks and large industrial groups. Quite a few bank failures are ultimately due to weaknesses in this area. Regulatory agencies have a powerful role in promoting, and insisting upon, effective systems of internal management and risk control in financial institutions by setting standards of strict accountability of owners, directors and senior management. This includes: prevention of insider abuses and financial crime; control of connected lending and promotion of accurate loan valuation; asset classification; and risk assessment.
- Managers should also lose through failure. This requires a high degree of professionalism in bank managers and decisionmakers and penalties (including dismissal) for incompetence among bank managers.
- Subject to prudential standards being maintained, proper incentives can be created by the fostering of competition in the financial sector. This can be achieved, for instance, by: removing restrictions on business activity; allowing the entry of foreign banks and other

financial institutions; and forcing the abandoning of restrictive practices, cartels and other anti-competitive mechanisms.

- Strict control of concentrated lending and inter-connected lending.

Combining appropriate incentives for owners and managers contributes to a robust financial system and, in principle, the market would evolve such incentives. However, experience indicates that, in many areas, especially when the competitive environment is changing and the regulatory regime is being adjusted, it is hazardous to rely on the market evolving appropriate incentives. There is, therefore, a significant role for regulatory and supervisory authorities.

2.5 Incentives for regulators and supervisors

Some of the specific measures already outlined can be encouraged, sponsored or required by regulatory and supervisory authorities charged with maintaining systemic stability and the safety and soundness of financial institutions. Regulation and supervision sometimes fail, and at times to a degree that requires official intervention to maintain systemic stability. The way such intervention is effected has signalling and incentive effects for the future behaviour of financial institutions. Maintaining the integrity of a banking system requires that some bank liability holders be protected from the consequences of bank failure. But this should be limited, as the application of public funds can create adverse incentives that aggravate the crisis. Care is evidently needed when devising bank restructuring policies, and this applies most especially to future potential moral hazard implications.

A key issue for regulators is to maintain consistency and to send consistent signals. One way of doing this is to adopt a precommitment policy along with preannounced graduated responses, albeit with the possibility of overrides in exceptional circumstances. A graduated response is preferred simply because, for example, there is no magical capital ratio below which an institution is in danger and above which it is safe. In general, the potential danger increases as the capital ratio declines. No single dividing line should trigger action, but there should be a series

of trigger points so that the cumulative effect of intervention rises as the seriousness of a predicament increases.

The latest international tendency is to develop appropriate incentives for regulators and supervisors: i.e. to set appropriate objectives; to adopt well-designed rules not to over-regulate; and to act in a timely fashion. When considering incentive structures for regulators, several perspectives are suggested:

- Given the highly geared nature of banks, capital is able to cover only a limited range of risks. If risks move outside this range, capital cannot protect a bank. For this reason, reliance on capital adequacy regulation alone is insufficient. Regulators and supervisors need to put explicit emphasis on monitoring banks' risk analysis and monitoring systems so that risks do not move outside the range which can effectively be covered by banks' internal insurance funds.
- The design and application of safety-net arrangements (lender-of-last-resort and deposit insurance) should create incentives for stakeholders to exercise oversight and to act prudently so as to reduce the probability of recourse being made to public funds.
- The creation of a well-defined strategy for responding to the possible insolvency of financial institutions. This includes: taking prompt corrective action to address financial problems before they reach critical proportions; closing nonviable institutions promptly; vigorously monitoring weak and/or restructured institutions; undertaking a timely assessment of the full scope of financial insolvency and the fiscal cost of resolving the problem; and creating limited *explicit* rather than *implicit* deposit insurance (with an element of coinsurance) paid for by banks and targeted especially towards protecting small depositors.
- There should be a clear bias (though not a bar) against forbearance when a bank is in difficulty. Regulatory authorities need to build up a reputation for tough supervision and, when necessary, decisive action in cases of financial problems. Supervisory authorities may, from time to time, face substantial political pressure to delay action in closing hazardous financial institutions. But the need to maintain credibility

creates a strong bias against forbearance, and there are a large number of cases of unsuccessful forbearance which reinforces this conclusion.

- Intervention authorities need to ensure that parties who have benefited from risk taking bear a large proportion of the cost of restructuring the banking system. This implies, for example, that shareholders should be the first to lose their investment along with large holders of long-term liabilities such as subordinated debt. Also, delinquent borrowers should not be given favourable treatment at public expense.
- Prompt action should be taken to prevent problem institutions from extending credit to high-risk borrowers or capitalising unpaid interest on delinquent loans into new credit. Execution of this principle is designed to reduce the moral hazard risk in bank restructurings which arises when institutions with low and declining net worth continue to operate under the protection of public policies designed to maintain the integrity of the banking system. This implies that, when practicable, insolvent institutions should be removed from the hands of current owners, whether through sale, nationalisation, or closure.
- Some (though not all) bank liability holders need to be protected, and this will involve the use of public funds. But any such financial transfer should be limited to those liability holders whose protection from bankruptcy is necessary to preserve the banking system.
- Use of public funds in rescue operations should be kept to a minimum and, whenever used, be subject to strict conditionality.

2.6 Ten priorities in restructuring

As already noted, many countries have experienced serious banking problems over the past decade. Lessons can be learned by both banks and their regulators about how to respond to crises when they emerge. In the process of restructuring following a financial crisis, ten priorities need to be established as the focus of any public policy responses:

1. Financial market functioning needs to be restored as quickly as possible while minimising market disruption. The central bank may have to intervene abruptly and drastically.

2. Every attempt should be made to minimise the possibility that difficulties encountered by individual financial firms escalate to a systemic crisis. The central bank and the banking sector has to work in close cooperation to control systemic risk during a crisis.
3. Balance sheet assets of weak institutions need to be restructured and placed on a sound footing. This should be designed to ameliorate the moral hazard that weak banks become the captive of their bad customers and, in the process, the danger that bad loans drive out good projects which need financing.
4. In most cases the ownership of failed institutions should change.
5. The capital of banks needs to be restored.
6. Where necessary or appropriate, excess capacity (such as an excessive number of banks) needs to be rationalised as part of the public policy response to a financial crisis.
7. The use of public funds should be kept to a minimum.
8. Any use of public funds should be subject to strict conditionality.
9. The management and recovery of loans should be separated from the ongoing activity of banks so that proper emphasis can be put on the efficient management of the continuing activity of banks.
10. The operations, systems and management approaches in restored banks should change to minimise the danger of problems recurring.

When all of these are put together, creating appropriate incentive structures become a central feature of establishing and maintaining a stable and robust financial system. If the incentive structures are wrong, or weak, the chances of a banking crisis emerging at some time are high. Incentive structures are, therefore, at the centre of creating conditions for a robust financial system.

The experience of Latin America is instructive as an object lesson in how, if appropriate measures are taken, a banking crisis can be transformed. Following the banking crises in several Latin American countries, several policy measures were adopted both to restore a banking system and to prevent (or lessen the probability of) similar crises occurring again:

- Foreign competition in banking was encouraged.
- Consolidation of the banking system was supported and encouraged.
- Regulation and supervision was tightened and made more explicit.
- Accountancy and disclosure standards and requirements were tightened.
- Links between banking and politics were broken.

When a banking crisis emerges, policy strategy must be aimed at reconstituting the banking system (including recapitalising banks) and should apply measures designed to significantly lower the probability of a crisis re-emerging.

3. EFFORTS TO IMPROVE THE ROBUSTNESS OF THE SOUTH AFRICAN FINANCIAL SYSTEM

In the broader context of global developments South Africa's financial system is confronted with a number of specific challenges to ensure its "safety and soundness". These challenges can be categorised into various risk classes, such as systemic risks, market risks or operational risks.

3.1 Systemic risk

As no country can print foreign exchange, the balance of payments has to be managed ultimately by appropriate macroeconomic policies. This in turn implies appropriate levels for the rate of interest, the exchange rate, the tax rate and the wage rate. Since 1994 macroeconomic policy has been fundamentally improved in South Africa. The inflation rate has more or less halved, while the increase in real public debt has been halted. The danger of moving into a public debt trap has passed for now. Nonetheless the real wage rate is still far in excess of labour productivity improvements which *ceteris paribus* requires a very high real interest rate to protect the balance of payments position. Compared with developed countries the overall tax burden is not excessive in South Africa (i.e. about a quarter of GDP) although most developing countries boast much lower tax burdens. The rand exchange rate is slightly undervalued in terms of purchasing power parity.

Ultimately, macroeconomic growth (GDP) can only be stimulated – and thus unemployment reduced and crime combated – if real interest

rates move lower, which in turn depends on a moderation in wage demands and a sharp increase in the supply of skilled labour.

Every nation needs a high degree of self-discipline if it wants to improve its education system structurally, increase its national savings and be content with realistic wage levels. In essence, South Africa's level of consumption is too high in relation to its national production. As a result its investment in human and fixed capital and its multi-factor productivity are too low. These macroeconomic challenges are aggravated by the expected impact of AIDS in about five years from now. It is estimated that by 2005 more than half a million workers will die from this disease annually, i.e. during the most productive period of their life cycle.

From a systemic point of view South African banks have to consider the following aspects more specifically:

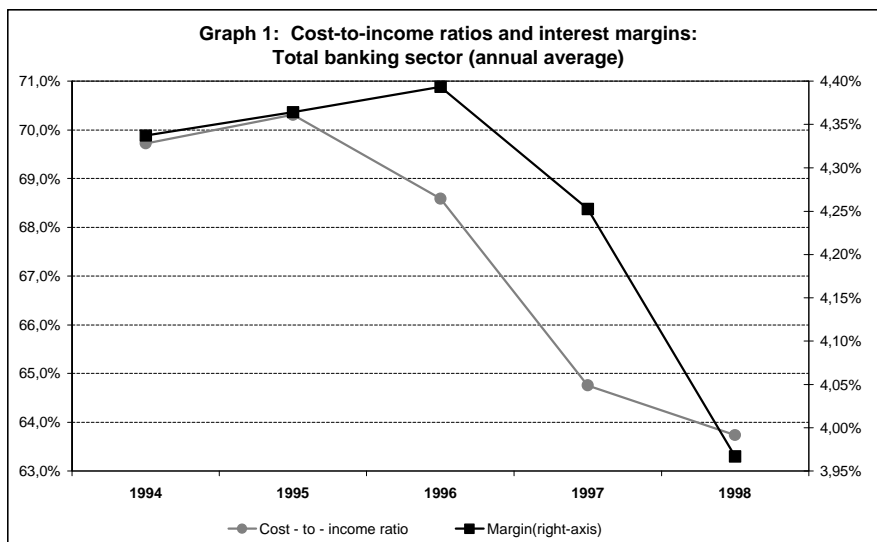
- Structurally the inflation rate may fall to even lower levels in years to come (say, to a level comparable with that of the G30 countries).
- The real interest rate may remain relatively high (enforced by international capital markets).
- Foreign competition (particularly through the securities markets) may increase even more, enforcing greater efficiency and lower interest margins of banks (see graph 1).
- Margins of banks may come under pressure as the inflation rate falls (if only in terms of inflationary accounting rules).
- AIDS may result in sharply higher bad debt exposures.
- Credit demand may be subdued owing to the high debt exposure of the household sector.

Considering that the key socio-economic challenges will remain daunting during the coming decades (i.e. too little domestic savings, a too small educated labour force, too much crime, AIDS and high unemployment), while international competition will increase to even higher levels, South African banks face a high degree of inherent risk – at least compared with the macroeconomic stability of the industrial countries.

Moreover, banks should also take into account new and emerging trends in capital regulation which are currently being prepared by the

Bank for International Settlements (BIS). These were recently announced in a discussion paper issued by the Basle Committee on Banking Supervision and the BIS has set a consultation period extending to March 2000. The main features of the new approach include:

- more risk categories and risk weights to be applied;
- more emphasis on incentives for prudent behaviour;
- greater reliance to be placed on market indicators of bank strength;
- greater capacity for banks to issue debt capital;
- enhanced emphasis on risk analysis, and management and control systems; and
- a greater role for rating agencies in the assessment of banking risk.



The objective of the new proposals is threefold: (i) to create more powerful and refined *incentives* for prudent behaviour and management; (ii) to increase the efficiency of pricing of risks; and (iii) to minimise moral hazards. The capital regulatory environment is likely to be very different in a few years time, compared with the current regime. Banks need to consider the implications of this.

3.2 Market risk

For years the South African capital markets have been making inroads into the banking industry (mainly through securitisation). Powerfully supported by technology and globalisation, this trend is likely to accelerate in years to come. For example, the Bond Exchange of South Africa is keen to see a change in the definition of a deposit (in terms of the Banks Act of 1980) in order to establish a proper commercial paper market in South Africa. If this is successful, it will have a massive impact on corporate bank lending. Clearly the banking sector may well participate in this structural change by increased trading through banks' securities firms, but ultimately this process of securitisation will, nonetheless, result in a lower profit margin in favour of corporate clients.

Moreover, globalisation may well result in the physical transfer of large blocks of share trading from the Johannesburg Stock Exchange (JSE) to London. The starting signal could be the permission for foreign brokers to engage in remote trading. In fact, it is hard to see why the regulatory authorities should prohibit remote trading on the JSE, particularly in the light of increased globalisation and the harmonisation of international regulatory requirements. For South African banks this trend would imply that a large slice of the money and capital markets will be moving to the centre of financial power (i.e. to London as the dominant market for this time zone). Accordingly, the London branch of a South African bank will become far more than just a foreign branch, as a significant volume of treasury business may also take place there.

Market risk also has an impact on the possible diversification policies of South African banks into other emerging markets. Major capital investments by South African banks in, for instance, Africa entail two important prerequisites: firstly, as the risk profile of South African banks will increase rather than decrease, banks need more regulatory capital; and secondly, the securities markets in Africa are rather illiquid, which in turn requires specific safety measures to avoid massive fraud, insider trading, etc. Seen from the point of view of a balanced-portfolio approach, South African banks should rather add low risk business to their books and leave

the high risk (African) business to the industrial countries whose banks have a lower overall risk exposure (i.e. a bank in an emerging market should not add unnecessary additional emerging market exposure to its portfolio). Moreover, should South African banks move into Africa on an agency basis (rather than a principal basis), their risk management systems as well as their information and control systems have to be of the highest standard. The opportunity costs of such a move should be carefully considered.

3.3 Credit risk

The proposed changes in banks' capital requirements by March 2000 as proposed by the BIS (whose proposals are always implemented by the Bank Supervision Department at the South African Reserve Bank) will entail a sharper split between wholesale and retail business in times to come. The rating of top-class corporates (i.e. by rating agencies and the banks themselves) will ultimately imply a reduction in the cost of debt for such corporates. A positive impact of the proposed capital requirements is a better competitive position of the banks *vis-à-vis* the capital markets, but nonetheless the corporate sector will profit most by the proposed regulatory changes.

In terms of proposed new regulations for the Banks Act in South Africa, credit risk flowing from large exposures and connected lending will have to be covered by additional capital, while the provisions for non-performing debt become progressively harsh after 90 days, with full provision and the writing back of any interest earned indicated on the income statement after twelve months. Again, depending on the credit quality of a bank's book, additional regulatory capital may be required. In an increasingly competitive environment the effective use of bank capital becomes a crucial issue. Therefore, investments, particularly in initially low-profitability businesses with high risk but long-term potential (say, business in Africa), have to be very well considered (i.e. in respect of the large opportunity costs in terms of capital requirements and the immediate impact of such projects on a bank's ROE).

Since mid-1999 listed companies have been allowed to repurchase

their own shares on the stock market. It is expected that many financial institutions (particularly insurers) will use this facility to improve their ROE's. But even banks with relatively little surplus capital may consider repurchasing their own equity, namely by first shedding those investments in respect of which the ROE is relatively low or to rebalance the ratio between primary and secondary capital. Share buybacks are likely to have a major impact on the structure of financial institutions, as they enforce *inter alia* a reconsideration of all marginally profitable business. Moreover, share buybacks reinforce the global trend from a universal banking structure towards a financial conglomerate structure, as underperforming subsidiaries are either improved or sold. In short, the ability of banks to buyback their own equity is likely to result in a push towards quality, unbundling, rationalisation and overall improved efficiency, strongly supported by management incentive schemes.

A specific credit risk in the retail markets of South African banks and insurers is the impact of AIDS in about five years from now. Many mortgagors in the lower-market segment will be unable to service their mortgage bonds as they lose their jobs (no repayments) and ultimately die (claims on insurance companies). Most likely, the impact of AIDS on private banking (market segment A+) will be negligible, but in market segments D and E it can no longer be ignored in respect of strategic planning.

3.4 Liquidity risk

The "repo" accommodation policy of the monetary authorities (implemented in March 1998) is ideally suited to cope with unexpected liquidity demands by banks (e.g. as a result of more volatile capital flows after the full abolishment of exchange controls for foreign investors). No immediate changes are foreseen in the liquidity management of banks.

3.5 Reputation risk

Currently corporate governance rules are enforced *de facto* through the listing requirements of the JSE. These rules will be upgraded to international standards in 2001 after the appropriate changes have been made to the Companies Act. In a nutshell, South African banks will have

to adjust to an industry code of business conduct, rulings by ombudsmen, compliance procedures, client education and even greater disclosure. On balance, these changes are for the better – for both financial institutions and their clients – but careful management is required nonetheless. Whatever the benefits, the operational expenses may increase significantly in this area, which in turn may adversely affect the cost-to-income ratio of the banking industry initially.

3.6 Operational risk

Lack of sufficient employment opportunities for unskilled labour, together with a serious lack of skilled labour (management), make South Africa an ideal breeding ground for criminals. Accordingly, South African financial institutions have to invest in relatively large audit departments and forensic investigation units to fight *inter alia* white collar crimes such as fraud and insider trading. In addition, running expenses of branch security and money transportation will remain relatively high. On balance, running a bank in South Africa entails high operational costs which will become increasingly difficult to finance considering the expected pressures on interest margins. Perhaps e-money has to play an increasingly important role, but the changeover will require massive investment in information technology and staff training.

3.7 Bankruptcy risk

Considering the major changes in the regulatory approach to bailout procedures, financial institutions running into solvency problems in future will be dealt with very differently than in the past. Any bailout now implies that the owners and long-term subordinated debt holders will lose their full investments before formal assistance (taxpayers' money) will become available. Moreover, senior managers may well lose their jobs should the insolvency be a result of a lack of managerial controls and supervision. Retail clients will be protected by deposit insurance in times to come, implying that the political impact of a failed bank will be less severe. Of course, the large "clearing" banks (i.e. the big four or five in South Africa) will not be dissolved quickly, but the authorities may

actively support a foreign takeover. Moreover, the proposed BIS capital regime requires the involvement of rating agencies in capital adequacy requirements, which may trigger an earlier takeover than would otherwise be the case.

In essence, the regulatory authorities are working hard to harmonise the liquidation rules for financial institutions with international standards. The general aim is to lower entry barriers to the financial industry and simultaneously lower exit barriers as well, by stipulating detailed liquidation procedures in advance. This change in the regulatory regime implies that financial institutions will be more exposed to the competitive forces of the global capital markets. Full disclosure and internationally standardised accounting rules ultimately imply that banks' secret reserves are phenomena of the past and that bad news has to be taken on the chin.

3.8 Summary

From a "safety and soundness" point of view South African banks will have to adjust to international standards during the next five years. In terms of capital and liquidity requirements South African banks are currently well managed, although the country's "emerging market" status may still imply that the risk-weighted capital requirement will have to be higher than the 8% currently applicable to G30 countries.

Macroeconomic developments during the next few years may imply only a moderate demand for credit and margins in corporate banking may remain squeezed (competition from the securities markets), while retail banking may struggle with bad debt exposures for longer, owing to cyclical and structural developments (e.g. low GDP growth, lower inflation, high real interest rates and the impact of AIDS).

International competition and the globalisation of the financial sector may have a significant impact on the margins of local banks and even enhance foreign money and capital markets at the cost of local business. The trend to trade South African securities from abroad will also be enhanced by the high crime rate and the corresponding difficulty in attracting skilled treasury staff to the country.

Most of the expected changes will be brought about gradually over a period of, say, five years and therefore banks will have sufficient time to adjust to these new market forces. From a stability and safety point of view, South African financial institutions are generally well managed and supervised. However, the big challenge is for retail banks to adjust to the expected negative impact of AIDS. Various specific instruments are available to cope with this problem, such as: higher equity interest of bondholders in residential property; higher risk premiums for higher risk market segments (i.e. higher mortgage rates); greater asset diversification by banks (not into Africa of course, but into countries not greatly affected by AIDS); specific insurance contracts; and improved securitisation of mortgage bonds, with credit risk more evenly spread across institutional investors. In the extreme, some thought could even be given to government guarantees (which are unlikely to be implemented, though).

All in all, banks are advised to lower their gearing and thus strengthen their capital base in the face of these macroeconomic uncertainties. In order to meet investors' demands of a ROE of 15%, banks are likely to strive for quality business by selling off their less profitable operations and using the proceeds to buyback their own shares.

Therefore banks will seek to disengage from operations which do not earn this required rate of return on equity. If such assets cannot be replaced by high-return assets, the excess capital will be returned to shareholders in order to raise the rate of return on the remaining equity.

CHAPTER 3

INSTRUMENTS USED BY BANKS TO ENHANCE THE CONFIDENCE OF AND FAIRNESS TO INVESTORS

1. INTRODUCTION

In many countries consumer protection matters have become of major importance to consumer groups, regulatory agencies and companies. The consumer movement has developed into a powerful force in many countries and consumers have become more demanding. At the same time the climate of opinion has clearly changed towards regarding fairness to consumers as a significant part of business strategy. In any case, government intervention strongly supports fairness towards consumers.

Consumer protection is an important issue for the financial services industry because the nature of some financial products requires more immediate, explicit consumer protection measures. Consumers – especially the less sophisticated section – frequently feel vulnerable when purchasing complex financial products. In many countries conduct of business regulation in finance (sometimes based on a comprehensive and highly prescriptive rule book) has been strengthened and made more extensive. In some countries (e.g. Australia) dedicated conduct of business regulatory agencies have been established to specifically focus on consumer protection.

In an increasing number of countries banks and other financial institutions have strengthened their own compliance departments and have created their own detailed rule books to guide advisers and salespeople on how to conduct business with customers. Many banks have published customer charters which set out good customer relations and business practice.

Apart from extending regulation into conduct of business areas and making existing regulations more powerful, resources have also been devoted by regulatory and supervisory agencies to strengthening the monitoring and supervision of financial firms to ensure that regulations are complied with. This is especially the case in the United Kingdom. Also, in some countries (again the UK is a prime example) the supervisory agency has extensive powers to impose sanctions on firms which have transgressed conduct of business regulation.

One particular trend in this area is for training and competence requirements within financial firms to be strengthened and extended. The consumer is put at risk not only by fraudulent and blatantly dishonest dealings, but also by incompetence when financial institutions' representatives do not fully understand the nature of financial products being sold or recommended or the appropriateness of particular products to the specific needs of the customer. Increasingly, the regulator prescribes that specified examinations have to be passed by staff before advice can be offered to consumers.

This chapter is structured along the following lines: section 2 addresses the importance of proper business conduct in general; section 3 emphasises why the retail market demands higher standards of business conduct than the wholesale market; section 4 looks into the pros and cons of client compensation schemes; section 5 analyses the available business instruments to ensure an appropriate level of consumer protection; while the last section summarises progress made with regard to consumer protection within the context of the South African banking industry.

2. CONDUCT OF BUSINESS REGULATION

Conduct of business regulation and supervision and similar mechanisms within financial firms focus on how these firms conduct business with their customers, especially on issues such as

- mandatory information disclosure;
- the honesty and integrity of firms and their employees;

- the level of competence of firms supplying financial services and products;
- fair business practices;
- the way financial products are marketed;
- the requirement to “know the customer”;
- applying “suitability” requirements when advising and selling a product to a customer other than on an execution-only basis;
- requirement to disclose status to clients (e.g. tied agent versus independent financial adviser); and
- efficient record keeping.

Conduct of business regulation can also establish guidelines for the objectivity of advice with the aim of minimising principal-agent problems which can arise when principals (those seeking advice) and agents either do not have equal access to information, or expertise to assess information. Overall, conduct of business regulation is designed to establish rules and guidelines about appropriate behaviour and business practices when dealing with customers.

With respect to consumer protection in retail financial services, a useful starting point is to determine why a contract may fail from the consumer’s perspective and to focus regulation and internal instruments on these aspects. There are five alternative dimensions to a failed contract:

- (i) the consumer receives bad advice – perhaps because an agency conflict is exploited;
- (ii) the supplying institution becomes insolvent before the contract matures;
- (iii) the contract turns out to be different from what the consumer was anticipating;
- (iv) fraud and misrepresentation; and
- (v) the financial institution has been incompetent.

The key issue is the extent to which regulation and internal mechanisms within financial firms can effectively and efficiently address these issues and reduce the probability of them occurring. *The same considerations underlying the case for regulation also create a case for*

banks adopting internal mechanisms to give confidence to customers that they will be treated competently and fairly.

There are many market imperfections and failures in retail financial services which create a rationale for regulation:

- problems of inadequate information on the part of the consumer;
- problems of asymmetric information (consumers are less informed than are suppliers of financial services);
- agency costs (asymmetric information can be used to exploit the consumer);
- potential principal-agent problems and issues related to conflicts of interest;
- problems of ascertaining quality at the time of purchase;
- imprecise definitions of products and contracts;
- inability of retail consumers to assess the safety and soundness of financial institutions except at inordinate cost;
- consumer underinvestment in information and resultant “free-rider” problems (whereby consumers assume that others have investigated the safety and integrity of suppliers of financial services); and
- all consumers not being equally equipped to assess quality, etc, because of the technicalities of some financial products.

Many of the problems in retail investment services and products arise because of the fiduciary role of financial institutions and because of the fact that their contracts (such as life assurance, pensions, etc.) are long-term in nature. This has three implications: (i) the consumer is unable to ascertain the quality of a contract at the time of purchase; (ii) potential moral hazards emerge because the behaviour of the firm after the sale affects the value of the contract and firms may, under some circumstances, have incentives to behave opportunistically; and (iii) no amount of information available at the time of purchase can solve this problem.

In the final analysis, treating customers with integrity and competence is part of good business practice. An informed judgement about the

purchase of financial products and services cannot be made unless consumers know the true costs of products, the precise nature and terms of products or contracts, the basis on which financial products are offered (e.g. whether the firm is a tied agent or an independent adviser) or the benefit to an agent (e.g. commission). These are real information costs to the consumer. All of this requires a high degree of information disclosure in order to make consumers effective in the market place.

Because of the nature of financial contracts between financial firms and their customers there is a need for continuous internal and external monitoring of the behaviour of financial firms. There are several reasons for this: often long-term contracts are involved; principal-agent problems can arise; the quality of a financial product cannot be ascertained at the time of purchase; there is often a fiduciary role for the financial institution; etc. Above all, the value of a product is determined by the behaviour of the supplier *after* products have been purchased and contracts signed. This is particularly significant for long-term contracts , since the consumer is unable to exit at low cost.

A major issue in financial services relates to questions of consumer confidence. The known existence of asymmetric information can, under some circumstances, reduce consumer demand for services and contracts. In a situation where consumers know there are good and bad products or firms but, due to a lack of sufficient and credible information, are unable to determine the quality at the time of purchase, because it is revealed only after the lapse of time, the demand for some products may decline. In some instances where known asymmetric information exists, risk-averse consumers may exit the market altogether. This is because the perceived costs of purchasing a low-quality product are taken seriously, and consumers may forego the opportunity of purchasing what may be a high-quality product because of the high risk and high cost of unwittingly purchasing a poor product. In such a situation consumers do not purchase products they believe may be beneficial because they are unable to distinguish between high- and low-quality products. Saving and investment may be discouraged without assurance about the terms on

which contracts are offered, the safety of assets which underpin them and the quality of advice received.

This has a clear cost, as consumer welfare is as much compromised by reluctance (because of lack of confidence in the industry) to purchase appropriate products as it is through being sold inappropriate products.

When consumers know there are low-quality products in the market, even good products and firms may become tarnished by the generalised reputation of poor products and firms. One role of regulation, therefore, is to set *minimum* standards and thereby remove “lemons” from the market. In this sense suppliers may also have an interest in regulation which sets minimum standards and enhances confidence in the market. It is not unknown for producers in an industry to welcome regulation if it keeps low-quality producers out of the market.

Consumers may demand a degree of comfort that can be provided only by regulation. There are several reasons why it can be rational for the consumer to demand regulation:

- lower transaction costs for the consumer (e.g. cost savings in investigating the position of financial firms, analysis, etc.);
- lack of information and inability of consumers to utilise information;
- demand for a reasonable degree of assurance in transacting with financial firms;
- past experience of bad behaviour of financial firms;
- the value of a contract can be determined by the behaviour and solvency of a financial firm only *after* the contract is signed and the product is purchased;
- the consumer may be making a substantial financial commitment in the transactions;
- a preference for regulation to prevent hazardous behaviour by financial institutions as an alternative to claiming compensation after bad behaviour has occurred;
- to secure economies of scale in monitoring; and
- depositors at banks may believe, correctly, that at least part of the

costs of regulation is an addition to the fixed costs of regulated firms and absorbed as such by banks' shareholders.

One of the characteristics of many financial transactions is that they involve *incomplete contracts* because their value is determined largely by the behaviour of the supplier after purchase. Two obvious examples are where an investment manager (e.g. a pension fund) turns out to be incompetent or even corrupt, and where a financial institution becomes insolvent while having fiduciary commitments to its customers. This leads to the possibility of opportunistic behaviour on the part of the financial firm, i.e. behaviour that is in the institution's interest and clearly against the interest of the investor.

In practice, there are significant differences between (some) financial and non-financial services to such a degree that makes a case for regulation in finance which does not apply to other goods and services. These special characteristics include the following:

- They are often purchased infrequently and hence the consumer has little experience or ability to learn from experience.
- There is no guarantee or warranty attached.
- Faults cannot be rectified.
- If a firm becomes insolvent after purchase and during the term of the contract, value may be lost.
- Information on reliability is difficult to obtain.
- Value is not immediately visible at the time of purchase: the consumer does not know if a bad product is being purchased.
- There is a lack of transparency – it is difficult to verify the claims being made by the seller.
- Value is often critically determined by the personal circumstances of the purchaser.
- The value of contracts is determined by the behaviour of suppliers after purchases have been made. This creates the potential for opportunistic behaviour and gives rise to a need for monitoring. No amount of information available at the time of purchase can guard against this potential hazard.

- The consumer's future welfare is often dependent on the performance of the contract: a faulty product can be replaced, while a bad financial contract cannot be surrendered other than at (sometimes substantial) cost.
- The value of a financial contract rises over time whereas the value of other products decline. This lowers the net replacement cost of the latter in the event that, at some time in the future, they need to be replaced due to a fault or total breakdown.
- The consumer frequently requires advice when purchasing financial products which gives rise to principal-agent problems.
- The consumer often lacks confidence in purchasing financial contracts.
- It is often easy for a financial salesperson to conceal relevant information and/or mislead the consumer.
- It is usually difficult to detect misrepresentation at the time of purchase.
- The product cannot be tested before purchasing.
- The full cost of the product may not be known at the time of purchase and it can sometimes be concealed from the consumer.
- The purchase often creates a fiduciary relationship with the company which takes on the responsibility of managing the client's investment or savings.
- It may be a long time (if at all) before the consumer becomes aware of the value and mistakes of a financial contract. This limits the power of reputation as an assurance of good products. Even if, in the long run, reputation is damaged by bad behaviour, consumer wealth is impaired in the meantime.

These characteristics mean that, in practice, the transaction costs for the consumer in verifying the value of contracts (even when this can be done at all) are high. Because of the nature of the products and contracts, producers can easily mislead the consumer and this may not be detected for many years, and sometimes not until the contract matures, by which time irreparable damage may have been done. In these circumstances, it may not be sufficient to rely on the reputation of the supplier only.

3. WHOLESALE *VERSUS* RETAIL BUSINESS

Consumers of financial services are not a homogeneous group, and their requirements for conduct of business regulation (and willingness to pay the costs of regulation) are also likely to be heterogeneous. It is therefore appropriate to have a different regulatory regime for the conduct of business in the retail sector than in the wholesale sector (see table 1). In particular, the case for regulating retail business (involving the purchase of financial products, services and contracts by individuals) is considerably stronger than the case for wholesale business. On the other hand, the distinction between wholesale and retail business is less clear-cut in the realm of prudential regulation.

The distinction between wholesale and retail business is not straightforward, and the Financial Services Authority in the UK has suggested an alternative split between counterparties who are market professionals, expert end-users and retail investors. Nevertheless, in general a distinction needs to be made between retail and wholesale finance. The case for regulation and supervision of retail financial services is more firmly based than for wholesale business:

- There is the standard problem associated with the absence of repeat orders, i.e. the small-volume retail customer does not have frequent repeat orders for financial contracts. Two problems arise from this: the consumer has little opportunity to learn from experience, and there may be less incentive for firms to offer quality products.
- Problems regarding asymmetric information are greater at the retail level than in professional wholesale markets. More generally, the suppliers and users of financial contracts are considerably less equal in the retail sector than in professional wholesale markets.
- Because of the nature of the contracts involved it is necessary for financial firms to be monitored continuously. However, individuals are not in a position to monitor the behaviour of the suppliers of financial contracts.
- A retail consumer may be less able to ascertain the value of a contract at the time of purchase.

- The individual consumer has limited ability and opportunity to acquire the necessary skills to enter into complex financial contracts.
- The purchase of financial contracts is often based on advice given by professional advisers, which may raise potential principal-agent problems.
- Retail consumers are rarely in a position to judge the safety and soundness of financial institutions.

In effect, market imperfections are more pervasive in the retail than in the wholesale sector and, as the ultimate rationale of regulation centres on questions of market imperfections, it is appropriate for retail financial services to be regulated more explicitly than wholesale business.

Issue	Wholesale	Retail
Internal competition	Intense	Weaker but newcomers important as: (i) they behave differently; (ii) exit barriers are low
Entry barriers	Disappearing	Barriers remain in some areas
Exit barriers	Low	High for incumbents but low for newcomers
Official regulation	Declining	Increasing
Technology	Advancing rapidly	Advancing rapidly
Competition from non-banks: financial	Increasing rapidly	Rising but limited to selected business areas
Competition from non-banks: non-financial	Increasing rapidly	Rising but limited to selected business areas
Competition from markets	High	Low but rising
Cross-border competition	Intense	Very low
Diversification	Increasing rapidly	Increasing rapidly
Securitisation	High	Low
Contract banking	Will occur	Will occur
Excess capacity	High	Rationalisation but more obstacles
Deconstruction	Developing	Developing
Payments	Challenged by others	Challenged by others
Customer loyalty	Low	High because of switching costs

4. CLIENT COMPENSATION SCHEMES

Whether clients in general should be compensated for losses incurred if a financial institution goes bankrupt is a difficult issue to decide, as strong

pros and cons are at stake (see tables 2 and 3). In this context much depends on how a compensation scheme is funded and particularly whether it is funded within the industry or by the taxpayer¹. The former may cause a problem due to the different sizes of banks. If a small bank fails, the rest of the industry can easily cope with paying the depositors. But if a large bank fails, all the other banks may not be able to pay out the depositors without themselves getting into difficulties.

Ultimately deposit insurance is designed to do achieve two goals: (i) compensate depositors for losses incurred; and (ii) reduce the probability of bank runs (i.e. the failure of a bank should not cause depositors to withdraw funds from *other* banks if they are fully insured). Initially the regulatory authorities were generally in favour of bank deposit-insurance schemes, but during the 1980s some serious reservations developed in this regard (see again table 2). If 100% cover is offered, a moral hazard is created in two respects. Firstly, the insured institution may be induced to take excessive risks, especially when its capital position is weak. If no risk materialises, the bank realises a profit but, if a risk does materialise, the cost is passed on to the insurance fund. This creates a one-way option for high-risk strategies. In essence, a bank does not need to pay a higher rate of interest in this instance to fund high-risk assets. Secondly, a depositor has less incentive to take the necessary care in selecting institutions for deposit purposes.

In contrast, if coverage is less than total, a scheme can be ineffective. For instance, depositors will withdraw all their funds even if they stand to lose only a small proportion of their deposits in the event of an institution's

1 Government can be involved in a compensation scheme either by being party to the scheme or by regulating the scheme (i.e. laying down the regulations and supervising the scheme). In addition, compensation schemes of a sufficient size are usually required for financial exchanges to protect the interests of the small investor. Moreover, in situations where netting arrangements are not legally enforceable, the authorities can still allow offset on a regulated exchange if the overall exposure risk is covered by an approved compensation scheme. Compensation schemes contribute significantly to market liquidity since without them, financial gearing would be significantly lowered.

Favourable	Unfavourable
<ul style="list-style-type: none"> • Lowers exit costs in banking and therefore may help to reduce excess capacity. • Affords at least some protection to retail investors. • Enhances stability of banking systems by reducing the probability of runs on healthy banks. • Cash-reserve and liquid-asset requirements have been significantly reduced internationally, which necessitates replacing this type of liquidity buffer with the “safety-net” of deposit insurance. • Takes role of taxpayer into consideration (assuming that the funding of the insurance scheme is done by government). The oligopolistic structure in banking may become monopolistic if bank failure is not avoided (assuming that international competition is weak – as it was in South Africa for a long time). • Simplifies the lender of last resort facility of the central bank. • Explicitly sets out the rules and extent of protection rather than leaving it to political decisions. 	<ul style="list-style-type: none"> • Overall risk in the banking industry could increase (e.g. a 100% cover always creates a moral hazard problem). • Banks’ internal control and risk management systems (the first line of defence) may be neglected, while depositors may become indifferent to the credibility of individual banking concerns. • Large banks are in effect subsidising small banks. • The cost/benefit can be unfavourable (e.g. the US experience). As a result of the higher cost structure of banking in general, healthy banks are bound to lose business to securities firms in the capital markets. • A bank which is part of a large financial conglomerate needs no insurance, as financial assistance would be forthcoming from within the group. • Running deposit insurance on sound actuarial principles is difficult in a country like SA where a few big banks control more than 80% of the retail banking business. • Financial engineering makes it difficult to draw the line at which stage deposits are to be protected. • The limit of the deposit insured may be too high for the poor, but nevertheless too low to prevent a run on a bank • Deposit insurance is a cure after a crisis – better to prevent the crisis by proper bank supervision. • The insurance capacity of the local banking and insurance sectors may be too small to cover this risk (e.g. the Norwegian experience). • Creates a political dilemma of how to determine the premium (i.e. based on the size of the bank, the actuarially calculated risk value or fixed-price insurance). • “Creative destruction”, in the sense of efficient institutions superseding obsolete ones, may be restricted. • Reduces the power of government as a role player in a lifeboat situation.

collapse. The view is widely held among bankers that, on balance and as a group, retail investors² are better off (i.e. at less cost to them) under proper bank supervision than under bank deposit-insurance arrangements³.

Favourable	Unfavourable
<ul style="list-style-type: none"> • The structural and procedural aspects of investor protection are formalised, and arbitrary actions are not necessary – given that the relevant aspects have been properly and adequately considered • Enforces a proper risk assessment, as the compensation fund cannot accept a limitless responsibility for investor protection • Affords the government the scope for providing more or less concisely defined guarantees – given that the rules of the game are well-publicised – and does not expose it (and taxpayers) to assumed or imagined unconditional guarantees • Greater stability can be created for the financial system if investors who do not have the capability of performing adequate risk assessments are provided with greater certainty or at least some assurance on the safety of their investment 	<ul style="list-style-type: none"> • Provides the scope for a firm to take on higher-risk business (in the case of failure the claims against it can be devolved on to the compensation fund) • Can induce moral hazards among investors (it removes the incentive to consider the risks involved with a certain type of investment or a specific institution) • Leads to cross-subsidisation where financially stronger institutions are continually paying for weaker institutions with respect to the guarantees (or the support) provided by the compensation scheme (i.e. the free-rider problem) • Although an upper limit is often provided, it is still an open question as to whether there is an implicit undertaking over and above that limit for government to provide investor protection • Legal challenges can be issued to compensation schemes arising from the fact that not all projected risks are covered

By contrast, regulators usually prefer bank-deposit insurance⁴ for the following reasons:

-
- 2 Wholesale investors should receive no specific protection, as asymmetric information is a less important issue in their case.
 - 3 According to the Governor of the Reserve Bank of New Zealand all that is required is a sound monetary policy to temper fluctuations in asset prices (enforced by positive real interest rates), adequately capitalised banks (Basle Agreement), tough quarterly disclosure rules, six-monthly audits, and a rating certificate of a recognised rating agency on the front door of the bank (*The Economist*, 26 June 1993).
 - 4 In South Africa there is as yet no compensation contract between the financial industry and investors. By contrast, in the UK banks contribute annually to the *Deposit Protection Fund* and other firms contribute annually to the *Investor Compensation Scheme*. This does not represent a claim on the UK government, though. Currently the UK deposit protection of banks is equal to a maximum of 90% of deposits up to a maximum deposit of , 20 000 (or a maximum payout of , 18 000). This is not index-linked. With investments the sum is: 100% of the first , 30 000 and then 90% of the next , 20 000 (or a maximum payout of , 48 000).

- The lender of last resort facility is an important regulatory subsidy. As a *quid pro quo* banks should pay at least for the additional liquidity buffer in the form of deposit insurance.
- Over the years the cash and liquid-asset requirements have been lowered to encourage a more level playing field between banks and non-bank financial institutions. Deposit insurance, which is more focused than liquid-asset requirements, may restore the liquidity positions of banks to an acceptable level (i.e. based on actuarial values).
- Bank depositors unaware of how exactly their money is diversified within a banking group may require additional safety measures and are willing to pay for such services⁵.

The issues related to investor compensation schemes (e.g. those related to life assurance business) are somewhat different, compared with bank deposit insurance. Compensation may be paid when investors lose money directly, owing to the insolvency of a firm, but also when consumers have been badly treated (e.g. dishonestly sold a product) and the firm has subsequently become insolvent and hence cannot pay compensation. The arguments about investor compensation are outlined in table 3.

5. BUSINESS INSTRUMENTS FOR CONSUMER PROTECTION

While regulation may require a certain conduct of business standards to be enforced by financial firms, it is also desirable for banks and other institutions to set their own standards of fairness to customers. As well as being required by regulation, it is good business practice which, in the long run, should yield benefits to the company. Some of the instruments a

5 The key issues are what investors in aggregate demand and how much they are prepared to pay for “safety” features. It is possible to draw an analogy with car safety regulations. Suppose that, prior to regulations, many cars were unsafe and consumers were unable to tell which cars were unsafe at the time of purchase. Safety regulations (demanded by consumers) will increase the cost of production and, if taken to extremes, decrease the competitiveness of the motor industry. However, as long as consumers are willing to pay for safety features, the cost of safety forms as much an integral part of the total costs of car production as the cost of metal.

bank has available in this area are briefly discussed below (see also table 3 in chapter 2).

- *Consumer information technology*: Finance has become an increasingly technology-based industry. This includes technology to handle information about customers and also to monitor compliance standards. Technology, and appropriate software, may also be needed to enable bank staff to understand the risk and other characteristics of the financial products being sold, and be able to give customers full information about the characteristics of prices and, where appropriate, projections of future values.
- *Compliance standards*: In the final analysis, all aspects of a company's business are corporate governance issues and this includes compliance. A bank needs to ensure that it has a clearly structured compliance manual focused on consumer protection and fairness to customers. The compliance department needs to be adequately funded and it needs to have a sufficient status within a bank to be able to impose its authority on the relevant part of the bank. It needs to have effective and efficient monitoring mechanisms to ensure that staff are following the bank's requirements with respect to conduct of business. Overall, the task of compliance arrangements within a bank is to ensure that high standards of consumer protection and fairness are followed throughout as part of its business strategy, but also to satisfy externally imposed regulatory standards.
- *Disclosure arrangements*: The major advantages flowing from disclosure are better informed clients and the lowering of potential conflicts of interests and asymmetric information flows. Currently the focus of the regulatory authorities is on the retail market, but even in the wholesale market (particularly the over-the-counter market) more disclosure is stipulated to ensure fairness in trading.
- *Training and competence*: A bank needs to give priority, and allocate appropriate resources, to the training and competence of its staff. A negative image is created if customers become aware that bank staff is

not sufficiently trained and fully competent regarding the business they are transacting with customers. This requires explicit and clearly structured training programmes. It also requires regular updates and a programme of continuing professional development. As part of this, mechanisms need to be in place to ensure that all relevant staff understand a bank's compliance requirements.

- *Complaint procedures*: An important part of being fair to consumers is adequate complaint procedures of which customers are made aware of. The customer should be able to complain to a bank if service has been inadequate in any way and such a complaint should be carefully monitored and followed through. Where appropriate, compensation should be offered.
- *Compensation schemes*: These not only enhance the position of clients, but also lower entry barriers and thus increase competitive pricing. For instance, the entry of microlenders, as a type of banking institution, will require some form of deposit insurance to level the competitive playing field.
- *Single-capacity trading*: One instance in which consumers may be treated unfairly, and may even be placed in jeopardy, is a conflict of interest within a bank. This arises when a bank employee may be recommending a particular service, not because it is in the interest of the client, but because it is in the interest of some other business in the bank. A good example is where a bank has a securities market-making arm and a particular investment is recommended because the market-maker is long on the security. One way of dealing with this is to have single-capacity trading under which such potential conflicts of interest do not arise. In the UK there is a particular variant of this issue in retail investment business known as the Polarisation Rule. This requires an adviser or salesperson to be either an appointed representative of only one company or alternatively an independent financial adviser in respect of the products of all firms. But he/she cannot be both, and the consumer has to be made aware of the person's status.

- *Chinese walls*: If potential conflicts are possible, a bank needs to establish clear and credible Chinese walls to ensure that information about one section of a business is not made available to other sections. Consumers need to have confidence that these measures are in place and are enforced vigorously.
- *Audit arrangements*: A bank needs to establish internal audit arrangements to ensure that compliance requirements are fulfilled. In addition, an audit committee should provide transparency for investors. For instance, Warren Buffet propounds three questions for auditors: First, if an auditor was solely responsible for the preparation of the company's financial statements, would the audited accounts have been different in either material or non-material ways? If different, the auditor should explain both management's argument and his own. Second, if the auditor was an investor, would he have received all the information essential to understanding the company's financial performance during the reporting period? Third, is the firm following the same internal audit procedure the auditor would if he himself were chief executive officer? If not, what were the differences and why? In essence, auditors should be serving investors, and not become subservient to management.
- *Forensic investigation*: The reputation of a bank, and therefore its clients' investments, may be at stake if bank staff are involved in insider trading, money laundering and financial fraud. To combat such practices, spot forensic investigations have to be conducted throughout the firm.

6. EFFORTS TO IMPROVE THE CONFIDENCE OF AND FAIRNESS TO INVESTORS IN SOUTH AFRICA

For South African financial institutions investor protection issues traditionally had a relatively low priority. Up to the 1990s the emphasis for most firms was very much on business efficiency. At times it even seemed that clients of financial institutions had to be "tough" to qualify.

Only after some spectacular and embarrassing scams and frauds in the late eighties did the sentiment change in the industry⁶. Clearly the continuous misselling that was going on was not only an embarrassment to government, but also to those financial institutions having client interests as a priority.

A major contributing factor which enforced a new look at investor protection was keener competition. Alternative financial products, often very competitive, were offered by banks, insurance companies and the securities markets in the 1990s, which enhanced the position of investors. Increasingly client satisfaction was seen as a major competitive force. In short, political as well as economic pressures developed in both the public and private sectors during the 1990s in order to improve the degree of investor protection.

In the early 1990s the authorities, mainly through the Financial Services Board, made it known to the financial sector that investor protection issues were being critically reconsidered and that the financial sector had to put “its house in order”. In fact the authorities made it informally known that fairness issues were considered to be of more importance than efficiency issues.

As a reference standard of fairness to investors, the South African regulatory authorities looked primarily to the standards of the European Union and more specifically the Personal Investment Authority in the UK. During the mid-1990s disclosure arrangements, cooling-off periods and complaint arrangements were significantly improved. In the late-1990s the emphasis shifted to compliance and compensation arrangements and currently the emphasis is very much on quality of financial advice and the role financial advisers play in that respect. All in all it is expected that in

6 For instance some retail clients lost heavily in acting on the advice of their brokers to invest in firms such as Masterbond or the Supreme Group. In essence these scams operated as associate firms under the guise of mortgage participation bond schemes, without any meaningful disclosure of their activities. Another worrying fact was the great number of life assurance policies which lapsed or were surrendered only a few years after being issued.

the early-2000s South African financial firms will comply with international standards in respect of retail investor protection issues.

This section summarises the progress made in the area of investor protection by highlighting the major issues at stake for South African financial firms.

6.1 Client information technology and disclosure arrangements

Asymmetrical flows of information are one of the main reasons for market failure in South Africa. Particularly in the financial services industry, suppliers of financial products and/or financial advisers have more information than the buyers of financial products. To adjust to this state of affairs, financial institutions have implemented (or are in the process of doing so) the following measures:

- Improved information on the financial products made available to clients. In respect of disclosure and reporting procedures South Africa is slowly starting to comply with nearly all international standards. For instance, in terms of the Financial Advisers Bill (1999) the commissions of insurance agents are to be disclosed in future.
- Extended cooling-off periods in which clients can reconsider purchases. The undesirable practice of high-pressure selling is now counter-balanced with an opportunity to reconsider and cancel a transaction.
- Better education of the investing public by consumer bodies, financial firms and the regulatory authorities. Although standards in this area have improved somewhat, a lot more still needs to be done in South Africa over the next few years.
- Adherence to minimum quality standards by suppliers of financial products.
- Adherence to a code of conduct. For instance, financial advisers are required to act ethically and to furnish clients with sufficient information to enable purchasers to make informed decisions.
- Disclosure of the status and role of the financial adviser and the institution that is being represented.

Of course, the “buyer beware” principle remains a fundamental pillar

of business in South Africa because, if the authorities were to relieve the individual of taking responsibility for decisions, this may undermine the functioning of a free-market system.

6.2 Compliance arrangements, training and competence

Compliance officers have been required for all securities firms since 1995, while they are proposed for banking institutions in terms of the new regulations under the Banks Act. The compliance function has always been a major responsibility of the chief actuary in insurance companies. It is expected that in the next few years all financial institutions in South Africa will formally have to appoint a compliance officer, which will greatly enhance fair dealing with investors. In 1999 the Compliance Institute of South Africa was established, with the specific aim of promoting professional standards, best practices and coordination among compliance functions in different types of financial institutions.

In essence the compliance officer of a financial institution takes responsibility for the firm's reputation risk, which in turn implies the following:

- Risk of giving bad advice – with possible public reprimands.
- Risk of appointing wrong staff – i.e. unfit and improper staff.
- Risk of incompetence of existing staff – i.e. badly trained staff.
- Risk of misleading marketing and advertisements.
- Risk of not complying with corporate governance principles, in particular in respect of insider trading and money laundering – i.e. market abuse and financial fraud.

In order to address these risks the compliance arrangements of a financial institution are critically evaluated against the following key aspects:

- Entry standards – e.g. no advisers with a criminal record.
- Fit and proper standards – e.g. the requirement for particular skills.
- Authorisation and/or registration standards – note that any agreement facilitated by a person acting without a licence is not enforceable.
- Monitoring of advisers and the advice given by them – e.g. the financial adviser has to demonstrate exactly how a selected financial product meets a client's needs.

It is ultimately the compliance officer's responsibility to ensure that all staff are appropriately trained and competent in a broader sense. Accordingly any sales staff who are unfit and improper have to be removed from the client interface with immediate effect.

In order to assist the client to make the right choice, South African financial firms are now gearing up for their client education processes. In the years ahead closer cooperation is likely between suppliers, clients (or the consumer bodies who represent them) and the authorities to ensure appropriate educational standards in respect of financial products and services. Already there is a distinct shift in the advertising of financial firms away from "feel good" adverts to informative adverts, but much more is likely to be done in coming years. The strengthening of market conduct rules is not only in the interest of clients, but will also enhance the reputation of financial firms. Because of self-interest most firms are keen to protect their reputation and thus accept responsibility for their products and their advisers.

6.3 Complaints and client compensation arrangements

High-pressure selling, dishonesty, fraud or any other unethical business practices are likely to result in complaints and eventually compensation. Complaints highlight possible shortcomings and should therefore be taken seriously by firms. In principle consumer complaints should be lodged first with the product supplier or intermediaries through their compliance officers. If not satisfactorily addressed by a firm, clients can contact the industry's ombudsman or adjudicator for a resolution.

The ombudsman gives speedy, cost-effective solutions through a relatively informal process. It will be a condition of licensing that all financial advisers submit themselves to the jurisdiction of an ombudsman. Currently the South African financial industry has four ombudsmen: one each for banking, short- and long-term insurance and pension funds. In terms of their statutory powers ombudsmen can demand considerable compensation from firms. For instance, the banking adjudicator's rulings are binding on banks and claim payouts up to R500 000 can be ordered,

plus incidental costs incurred by the complainant, plus up to R2 500 for distress. Of course the possibility to take any complaint to the courts of law always remains open to all parties, but this route of dispute solving should be considered the last available option and should be used only for important issues of principle.

Wronged investors can be compensated from various sources. In cases where the product supplier is at fault, compensation will flow from that firm. Should the firm become bankrupt as a result, compensation may flow from an industry fidelity fund. Currently the three financial exchanges in South Africa each have their own fidelity funds. Moreover, negotiations are in progress to establish a deposit-insurance fund for the banking industry. In terms of the proposals, deposits of up to R50 000 will be insured for up to 90% of the deposit value in the event of a bank failure. This would be funded by banks according to an actuarial calculation, but ultimately a depositor would pay for the insurance by way of a discounted interest rate.

6.4 Single-capacity trading and Chinese walls

Any conflict of interest between a firm and its clients is ultimately a compliance issue. Ideally such conflicts should be avoided through procedures such as single-capacity trading and Chinese wall structures. The requirement of single-capacity trading is enforced through the Financial Services Board, while the imposition of Chinese walls is a primary issue for compliance officers and ultimately boards of directors.

In line with international practice, financial exchanges in South Africa allow both single- and dual-capacity trading. Up to the “Big Bang” on the JSE in 1995 trading was done strictly on a single-capacity basis, but efficiency arguments enforced a change. Currently both dual- and single-capacity trading are permitted on exchanges, and it is now up to the investors to select brokers to their liking. Therefore, should clients fear front-running practices by their brokers, they can choose to change to single-capacity brokers.

Generally, most financial firms in South Africa have put in place Chinese walls where this is an obvious requirement. In respect of Chinese

walls the rule of thumb is that only those managers who are involved for at most a quarter of their work time on either side of a Chinese wall may manage both sides of the wall. However, the imposition of adequate Chinese wall structures within financial firms is still waiting on compliance officers finding their feet over the next few years.

6.5 Audit arrangements and forensic investigations

In combating insider trading, money laundering and financial fraud in general – all practices which ultimately have adverse effects on the reputation of firms – audit and forensic investigations play a key role. As South African companies will have to comply fully with the standards of The International Accounting Standards Committee by the end of 2000, their audit standards will also be internationally acceptable in the near future.

In terms of the envisaged Financial Advisers Act a financial adviser's external auditor is required to report, biannually, to the regulator on the adequacy of the financial adviser's compliance manual as well as on the extent to which the financial adviser has not complied with certain provisions of the Act.

Money laundering and insider trading became criminal offences in South Africa in 1997 and 1998 respectively. However, it is still early days to assess the effectiveness of implementation. The Insider Trading Directorate was set up only in January 1999 and is in the process of sharpening its teeth, while the SA Reserve Bank has instructed all banks to be on the lookout for any money laundering practices. Banks have to report any suspect trades in this area to the police. However, few banks have reported any money laundering practices, and no prosecutions have taken place to date.

Since the lifting of trade and financial boycotts in 1994, South Africa reputedly became much more involved in international money laundering, but hard evidence and successful prosecution are still lacking. In this area it is difficult to make any projections. The will clearly exists to stop these criminal practices, but capacity remains a major constraint. Financial firms as well as the authorities are already battling with a lack of skilled

labour in their normal daily activities, and it is unlikely that these constraints will be lifted in the medium term. Accordingly many of the offenders may still slip through the net unless, of course, international assistance is forthcoming.

CHAPTER 4

INSTRUMENTS USED TO ENHANCE THE EFFICIENCY AND EFFECTIVENESS OF BANKS

1. INTRODUCTION

Ultimately only efficient financial institutions will survive in a competitive global market. However, efficiency considerations in themselves are clearly not enough – particularly in a broader context. In aggregate a financial system also has to be effective in the sense that it fulfils the financial requirements of the majority of market participants. For instance, an efficient and effective national payments system requires not only low costs and efficient execution of transactions, but also requires that this system is open (indirectly) for use by most citizens.

Efficiency and effectiveness issues in finance have become complex challenges for the financial services industry particularly since the early 1980s. In contrast to the objectives of stability and fairness, improvements in efficiency and effectiveness ultimately rest on the shoulders of business alone. Although the authorities can, and do, contribute to efficiency (e.g. by supporting disclosure and by encouraging competition between market participants) and effectiveness (e.g. by encouraging the provision of services to the wider community through, for example, the post office), it is the business sector itself that has to bring about efficiency improvements.

In essence, efficiency issues centre on the three main components of any financial system, namely clients, products and suppliers and, most importantly, the dynamic interaction between them, for example: (i) the interaction between client and supplier results in issues such as pricing policies (e.g. cross-subsidising), market segmentation (e.g. private

banking or banking for the mass market), distribution channels (e.g. bank branches or ATMs) and access channels (e.g. cheque or savings book transactions); (ii) the interaction between client and product centres around questions of diversification (e.g. the selling of banking and insurance products under one roof) and securitisation (i.e. satisfying client demands either through financial intermediation or by way of the securities market); while (iii) the interaction between suppliers and products gives rise to efficiency issues such as consolidation (e.g. mergers and acquisitions), globalisation (e.g. geographic consolidation) and regulatory capture. Moreover, these processes themselves are interactive. For instance, globalisation and consolidation can be driven by diversification goals.

The overall organisational structure of a financial institution will largely reflect its approaches to the abovementioned core issues. Take for example the organisational differences between universal banking versus financial conglomerates. Which of these two organisational structures is able to cut operational costs most and what will be the consequence of these structures on information management? Ultimately, the efficiency in cost cutting, the possibilities of joint ventures, and the quality of information management all hinge critically on the overall organisational structure of a financial institution, which in turn is based on how successful it operates at the interfaces of client, product and supplier.

The approach in this chapter will be along the following lines. Section 2 starts with the broad issues of organisational structure, information management and cost-control management. Thereafter global trends will be analysed by focussing on respectively the interaction between supplier and product (i.e. consolidation and globalisation) client and product (i.e. diversification, securitisation and monitoring techniques) and client and supplier (i.e. segmentation, and distribution and access channels). The possible impact of these international trends on the South African financial system will be discussed in section 3.

2. GLOBAL TRENDS AIMING TO IMPROVE THE EFFICIENCY AND EFFECTIVENESS OF BANKS

2.1 The organisational structure, information management and cost-control management

2.1.1 The organisational structure and the demarcation problem

Traditionally, emphasis has always been placed on a strict *functional* classification between banking, investment business¹ and insurance. In the terminology of risk management, banks were seen primarily as credit risk managers, investment firms as market risk managers and insurance companies as underwriters of observable risks.

However, since the breakdown of the Bretton Woods system – which went hand-in-hand with the development of financial engineering – the functional differentiation between banking, investment business and insurance has increasingly faded. Today banks are major participants in the bond and currency markets (i.e. securities business), investment firms compete for bank deposits and corporate loans by way of money market funds and the securitisation of commercial paper, and insurance companies sell single-premium endowment policies that are in essence managed capital market funds. Although banking is still predominantly about credit risk management, significant parts of banking business may now overlap with securities business. In addition, banking business and insurance business are increasingly being intertwined in financial groups (i.e. in the so-called bancassurance groups).

The demarcation lines between the different types of financial institutions have faded even more since the Big Bang on the London Stock Exchange in 1986. Since then there has been increased functional integration between banking, investment and insurance. The market forces driving the formation of financial conglomerates are also propelling greater cross-border provision of financial services. This increased competition flowing from the globalisation of financial markets, has made

¹ Investment firms embody both securities companies and investment management firms.

it increasingly difficult for the regulatory authorities to enforce a stringent functional separation between banking, investment and insurance. With the globalisation of financial markets, increased competition, improved information systems and better computer technology, the integration of all financial services under “one roof” soon became the new trend.

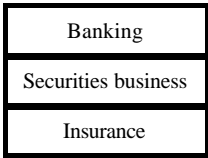
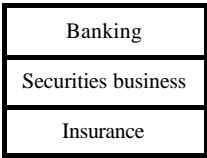
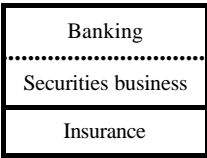
However, true *Allfinanz* – i.e. where a financial institution sells from one balance sheet the full spectrum of financial products (i.e. banking, securities and insurance products) through its various distribution channels – exists nowhere in the world. In practice, the closest to *Allfinanz* is a *universal bank* in which banking and securities business are fully consolidated on one balance sheet, but insurance businesses are located in a separately capitalised subsidiary (see Model C in figure 1). Of course, a universal bank can sell to its clients the full range of banking, securities and insurance products, but the production of the insurance product, and therefore the underwriting risk thereof, has to be managed separately. To date no regulatory authority has allowed the full accounting consolidation of banking and insurance, as the differences in the underlying accounting philosophies and the characteristics of the respective balance sheets are considered too great. Even in countries such as the Netherlands, Germany and Switzerland – i.e. the home countries of the largest bancassurance groups in the world – insurance undertakings are always separately capitalised subsidiaries within a financial conglomerate structure. The major reasons for separating banking from insurance are the following:

- There is a fundamental difference in the nature of banking and insurance assets and liabilities. For instance, banks tend to have assets which are difficult to value, whereas insurance companies have uncertain liabilities.
- Banks and insurance companies use very different valuation principles.
- The correlation between asset and liability risks is fundamentally different between banking and insurance. For instance, contracts written by a bank (its liabilities) tend to be far shorter in duration than those of insurers.

- The definition of regulatory capital differs greatly between banking and insurance undertakings. Their solvency and liquidity requirements are also different.

In short, accounting-based consolidation is not an appropriate technique for heterogeneous financial groups including banks, insurers, and investment firms. Accordingly, it is an international standard to treat investments in insurance companies as investments in unconsolidated subsidiaries and associates.

Figure 1: The integration of financial services towards universal banking

Model A	Model B	Model C
Total segregation of functions (no cross-holdings of any nature)	Separately capitalised <i>subsidiaries</i> within a financial conglomerate structure (firewall structure)	Separate <i>divisions</i> for banking and securities business (Chinese walls) Underwriting business separately capitalised (firewalls)
		

Until recently the financial services industry was organised either along the lines of a universal banking structure or as a financial conglomerate (with a small percentage of highly specialised niche players at the fringes). A *financial conglomerate* differs from a universal bank in that its banking and securities business are separately capitalised subsidiaries and therefore not divisions captured on the same balance sheet as would be the case in a universal bank (see Model B in figure 1). Examples of universal banks (in the past) were the continental European banks such as Deutsche Bank, Credit Suisse, ABN Amro and Bank Société Générale, while the British preferred financial conglomerate structures (e.g. Barclays, Midlands and Lloyds-TSB). For the Americans, organisational structure was not really an issue until 1997, as their Glass-

Steagal Act enforced total separation of banking, investment banking (i.e. securities business) and insurance² (see Model A in figure 1).

The major advantage of a universal banking structure is tax efficiency and the efficient use of capital in the sense that no capital lies idle in overcapitalised subsidiaries. At times a universal bank can also be more flexible and responsive than a financial conglomerate in which coordination may be more difficult in the short term. However, a financial conglomerate has the advantage that the major strategic business units have a clear business focus, their own balance sheets, better cost control and superior information management. Moreover, underperforming subsidiaries can be sold off, which in the context of a universal bank is virtually impossible.

Today nearly all major universal banks have reorganised themselves into financial conglomerate structures where a financial holding company (usually a bank holding company) has controlling interests in a range of financial and non-financial subsidiaries.³ The organisational structure of a universal bank creates specific risks and problems:

- Business structures and operations are often too complex and this raises the issue of whether they are fully understood by all relevant parties (including regulatory agencies).

2 The Glass-Steagall Act that prevents US banks from underwriting and dealing in securities has *de facto* been “reinterpreted” away by the Federal Reserve. Section 20 of the 1934 Act prohibits banks from affiliation with a company “engaged principally” in trading in securities. In 1987 the Fed refined this concept: banks were not “engaged principally” in dealing and underwriting securities as long as they derived less than 5% of their gross revenue from their Section 20 (securities dealing) subsidiaries. In 1997 this was raised to 25%. This means that even the largest investment banks are now open to takeover, provided a commercial bank that does so is large enough.

3 In respect of working definitions the following preliminary concepts can be noted: A *financial conglomerate* is a group of undertakings whose activities largely, though not necessarily entirely, consists of providing financial services in different sectors. Such a conglomerate must include at least two of the following three types of supervised financial institutions: (i) banks; (ii) investment firms; and (iii) insurance undertakings. A *homogeneous financial conglomerate* consists of legal financial entities engaged in either banking and/or investment business. A *heterogeneous financial conglomerate* consists of legal financial entities engaged in insurance business and banking and/or investment business. *Mixed-activity groups* are conglomerates which are predominantly industrially or commercially oriented but contain at least one regulated financial entity.

- The complex mix of different risks may increase the overall risk profile of an institution. The main concern is that of *contagion* (risks in one division contaminating other parts of the business).
- This also creates a potential for the transfer of capital at non-market related prices, as may occur when an attempt is made to start a new business division or when financial assistance is provided to another division in the group. Such transfers may be explicit and readily identifiable (as with interest-free loans) or may be obscure (as with devices such as off-market pricing of intra-group transactions).
- Transparency may be a problem in that it is not clear what is happening within a universal banking structure in such areas as inter-connected lending, the allocation of capital, the full identification of risks, the integrity and autonomy of management in different parts of the firm, etc.
- The autonomy of divisional managers within different parts of the group can be a major issue of concern, as an unclear corporate or managerial structure can raise concerns regarding connected parties, lines of authority, and financial and managerial responsibility.
- Connected lending (to insiders) creates potential risks and conflicts of interest in that loans are made to those who are in a position to influence policy and lending decisions in the firm. At best this may involve cross-subsidies and at worst hazardous and excessively risky lending that would not be made if the relationship were at “arm’s length”.

During the last decade the advantages of a conglomerate financial structure have come more powerfully to the fore. Even Deutsche Bank, a classical example of universal banking, is now unbundling into proper banking, securities business and insurance entities. The complexity of managing a universal bank seems simply too great in today’s financial markets. Increasingly *the directors want to view the financial conglomerate as a type of asset portfolio, which is managed as a portfolio in the sense that each subsidiary is judged as an independent asset with a specific risk/return profile*. To ensure that a financial conglomerate as a whole remains at the “efficiency frontier” such

subsidiaries should be marketable – i.e. through mergers and acquisitions successful subsidiaries should be enlarged, while unsuccessful ones could be disposed of. Even if the local market for such companies is illiquid, directors should at least try to ensure that the management of those subsidiaries can be easily replaced in times of underperformance. For instance, Credit Suisse, a large Swiss universal bank, replaced the Chinese walls between its banking and investment business with firewalls in 1996 in order to improve: (i) cost control; (ii) cost transparency; (iii) client focus (Credit Suisse bundled three retail businesses into one to obtain critical mass); (iv) taxation procedures (particularly in an international context); (v) corporate cultures (especially between countries); and (vi) capitalisation procedures. In South Africa, FirstRand sees itself now primarily as a “strategic enabler and facilitator”.

A strategic business unit (SBU) could be seen as an independent operational variable⁴. SBUs should have their own focus, risk/return profile and management incentive structures. Generally, the incentive structure for management is superior if the rewards are directly linked to the specific risk/return profile of an SBU. Incentives should primarily promote a focused business approach, which can be quickly lost if remuneration packages of top management are solely based on a group’s performance.

The success of universal banks in continental Europe was in the past

4 To use the naval analogy again: yesterday’s battleships are today merely floating museums. Naval warfare has become too complex to be coordinated from one ship only. The enemy is in the air (missile attacks by enemy aeroplanes) or beyond the horizon (enemy missile cruisers) or underwater (nuclear submarines). This requires that information management and the control of costs have to be delegated to the lowest fighting units to be efficient (e.g. individual aircraft). Accordingly, the aircraft carrier replaced the battleship as flagship in modern times. Now the aircraft carrier itself plus all its planes and supporting vessels are strategic fighting units (SFUs). A bad performance by an aeroplane can imply the replacement of the pilot or the replacement of his plane. A better type of aircraft may even demand an adjustment to, or the total replacement of, the aircraft carrier. In short, a modern war fleet has to be far more flexible than in the past. The danger of “overcapitalisation” in a few ships or aircraft is considered small change by the admiralty, compared with the advantages obtained from better information management techniques and primarily from better focus for each strategic fighting unit.

closely linked to the underdevelopment of their capital markets. However, financial innovation and improved technology lent the securities markets a sharp competitive edge, and soon the universal banks experienced the painful realisation that they could not really control costs efficiently in an ineffective organisational structure. Hence, the changes to financial conglomerate structures which are now evident across the globe.

2.1.2 Management control systems and autonomy

Good internal management control systems depend crucially on the autonomy of the various business units in a financial conglomerate. To ensure this autonomy and to improve accountability, supervisors are increasingly making individual directors responsible for specific regulatory issues. For example, besides the fact that the board of directors takes collective responsibility for the wellbeing of a company, supervisors may appoint individual directors with explicit responsibility for:

- systemic regulation (mainly in banking);
- prudential regulation (mainly in investment firms and insurance companies);
- retail “conduct of business” regulation;
- wholesale “conduct of business” regulation; and
- self-regulation (mainly financial exchange members).

Last, but not least, autonomy implies Chinese walls of a certain minimum height. Front office (i.e. chief dealer) and back office (chief operational officer) have to be separated. Likewise the credit departments (with insider-information about companies’ balance sheets) and fund management departments have to be separated. In principle, all units with privileged information need to be separated by a Chinese wall, and the height of the wall should be up to the level of a senior manager that spends only, say, a quarter of his total working time on activities on either side of these walls.

The Barings Bank failure produced a standard reaction among (less informed) observers that *official* supervision needed to be increased and improved. However, more discerning commentators observed that the

external regulation required to prevent such cases of fraud (when they had escaped internal management) would have had to be so pervasive, intrusive and expensive as to be practically impossible. The failure arose from poor *internal* monitoring and supervision, *not* from a lack of regulation and *official* supervision. What went wrong was the lack of internal control systems, failure of management to monitor its staff, failure of the bank to enforce its own rules and insufficient effective mechanisms for this to be done. Indeed, it could be argued that most of the so-called regulatory failures were actually failures of monitoring and supervision rather than of the absence of rules.

In such cases there is really no alternative to placing the primary responsibility for risk control on the shoulders of internal management and auditors. There are various procedures, processes and structures that can help to reinforce internal risk control mechanisms. Compliance officers, internal auditors, internal audit committees, procedures for reporting to senior management and perhaps to supervisors can and should be introduced. Supervisors can help to strengthen such internal procedures by relating the frequency and scale of their external supervision to the perceived adequacy of internal control mechanisms.

A key issue remains how to persuade sufficiently qualified and motivated people to take on the auditing/compliance role either among the regulated or among the regulators. This is, perhaps, one of the major challenges in this area.

2.2 Rationalisation, joint ventures and subcontracting

The banking industry is committed to a return on equity (ROE) of some 15% in industrial countries. This profitability objective enforces a new look at joint ventures and the subcontracting of (mainly) non-core activities.

The rationalisation and selling-off of non-core banking business, or those businesses of banks dragging down average profit performance, has the advantage that it not only immediately improves the ROE of a bank, but in addition its cash flow, creating the opportunity to buyback a bank's

own shares on the stock market, which in turn may improve the bank's ROE even more.

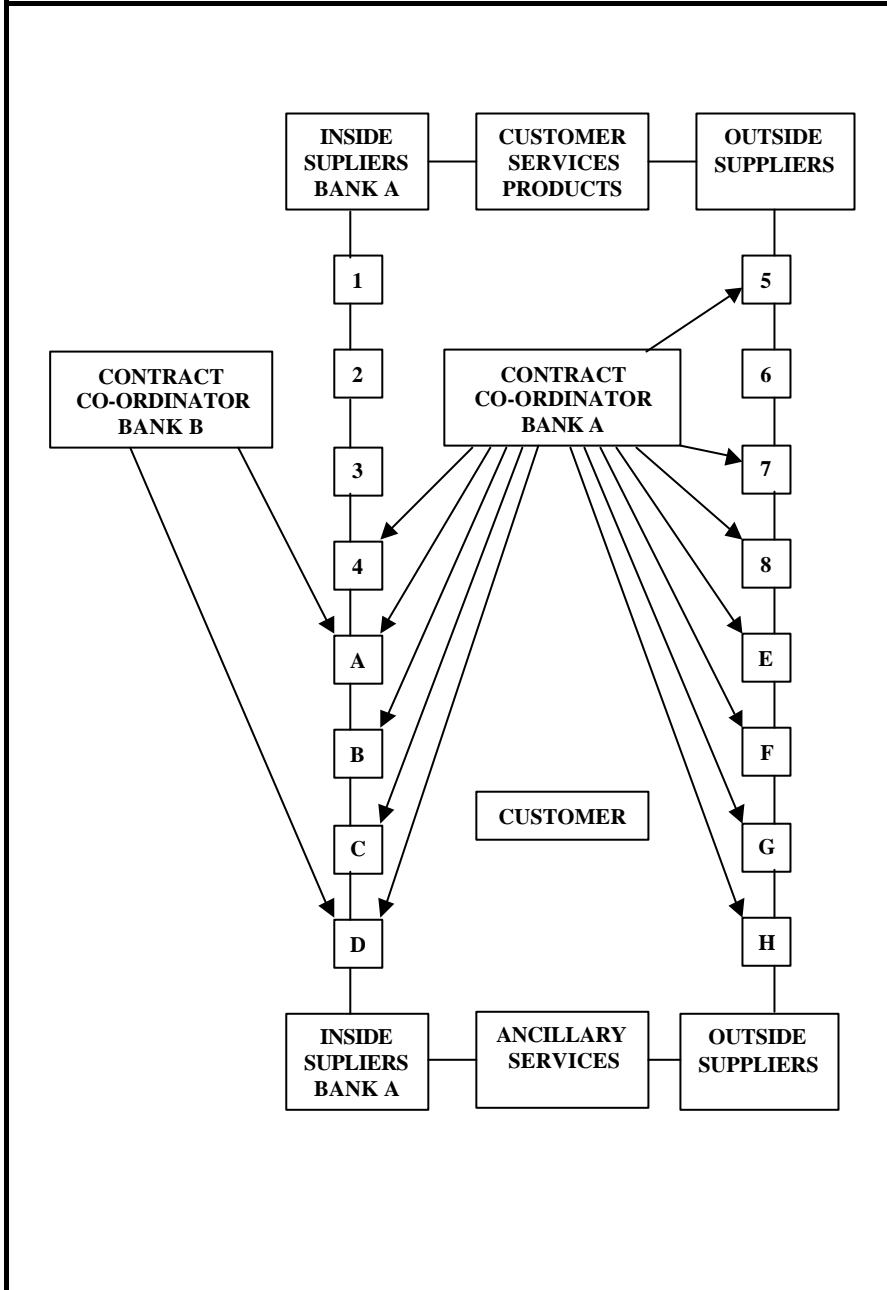
Joint ventures and outsourcing (i.e. conceptually both subcategories of "contract banking" as discussed below) have the advantage that specialised services are obtained at market-related prices (often these services cost significantly more if they are developed inhouse) or that fixed costs are transformed into variable costs.

Joint ventures constitute a big strategic issue in the banking industry today, particularly where the other party is involved in high technology or retailing. In "contract banking" a bank defines the components and decides which are to be supplied internally and which subcontracted. In effect, a series of contracts are established by a contracting bank with internal and external suppliers. This is illustrated in figure 2. For example, the customer has a demand for a series of products and services (1, 2, 3, etc.) and has a contract with a bank (Bank A, the contract coordinator) to supply those services. The bank in turn has a series of contracts with internal and external suppliers of those services and products (the arrows show the supply of contracts). The subcomponents of these products and services (i.e. A, B, C etc.) may also be supplied either internally or externally. Thus Bank A has contracts with internal suppliers of components A, B, C and D, but subcontracts in respect of components E, F, G and H. Bank A may also contract internally or externally for its inhouse service needs, e.g. cheque clearing. Similarly, a third-party bank, Bank B, may buy in products 1 and 2 and components A and D from Bank A.

The basic economics of the banking firm have already begun to change, and the process is likely to accelerate in the years to come. A twofold distinction needs to be made: (i) between delivery and manufacture of banking services; and (ii) between the services and products a customer ultimately demands (e.g. loans) and the components and processes making up those products and services.

It is instructive to consider industries other than banks because, to some extent, banks are moving towards the model adopted by firms in other industries. When a customer buys a car, for instance, it appears as if

Figure 2: Example of a contract banking structure



the company presents an integrated service to the customer. In fact, of the many thousands of parts which make up a car, the company itself produces virtually none. Most of what is presented to the customer is a repackaging of products manufactured by other companies to the motor company's specification, design requirements and standards. The reasons for this are obvious. The economies of scale are different in the various manufacturing processes of the component parts, and different suppliers have different comparative advantages and expertise. In other words, for the motor company the transaction costs of combining contracts for the external supply of components are less than the economies of scale to be derived from manufacturing all of the component parts internally. What the motor company does (the value it adds) is essentially threefold: it maintains a customer interface; it efficiently manages a complex set of external contracts; and it has a particular expertise (or core competency) in design and assembly.

This process, common in the manufacturing of goods, has not been the norm in banking where traditionally the banking firm has offered an integrated service by itself providing the service and its constituent components. However, the process of *deconstruction* (components of products and services are identified separately) changes this picture. It enables particular subcomponents of products or services to be subcontracted (outsourced) and supplied by other firms on a contract basis. In this process one complex business system is unbundled and reformed into several relatively simple ones, with each stage in the production function now performed by a cost-effective participant. In the restructuring process redundant capacity is eliminated. Similarly, deconstruction enables a bank to provide a particular subcomponent of a service to competitors. As an example, a bank may subcontract the administration of its credit card operation while at the same time exporting to other banks its risk analysis capacity. The potential exists because the economies of scale in bank processes vary. By subcontracting a particular process a small bank may be able to buy into economies of scale it could not achieve itself.

A bank is a complex firm and within it four key roles are distinguished:

- a customer interface and the management of customer relationships;
- a supplier of a range of products and services;
- a provider of a range of ancillary services (services which are not explicitly demanded by the customer but which are an integral part of what is demanded – e.g. risk analysis and administration); and
- a supplier of alternative delivery mechanisms.

Thus the banking firm can be viewed as a firm which has an interface with a customer base (supplying a range of apparently integrated products and services) and demanding a series of support services in order to supply the products and services. A distinction is made between the final products and services the customer demands and the bank supplies (e.g. loans), and the various components of each product or service (e.g. risk analysis, administration, etc.).

In contract banking a bank coordinates inputs from a wide range of different companies. The core is the contract a bank has with its customers to supply a set of services or products of a particular standard and at a specified price. In turn, the bank contractor has a set of contracts with a range of internal and external suppliers of the components of these ultimate products and services. The value added by the bank contractor lies in the management of these internal and external contracts. Various forms of outsourcing are available: third-party processors; service bureaux; and facilities management contractors. In addition, two or more parties may establish a venture to undertake certain activities on a joint basis.

A major form of outsourcing is third-party processing on a line-of-business basis. Those functions that are most automated or specialised tend to be most outsourced, partly because this is where potential economies of scale are greatest. Developments in information technology have lowered the cost of performing information-intensive activities and thus economies of scale can be reaped. Examples of outsourcing include: mortgage processing; credit card administration; cheque processing; network operations and management; credit card issuance; student loan

processing; trust processing; securities safekeeping; ATM driving/switching; data centre activities; and balance reporting.

As technology becomes more intensive, specialised and expensive, it tends to be disaggregated, i.e. technology operations are broken up and split among a number of highly specialised technology companies which supply similar services to several banks. There are several reasons for outsourcing to be undertaken and to have become an increasingly common feature in banking:

- to reap economies of scale which cannot be obtained internally;
- to avoid installing excess capacity to cope with peak-load problems;
- some technology projects last for only a short period;
- some areas of endeavour may be too specialised to be undertaken internally;
- skills can be enhanced when technologists work on several projects;
- particular expertise may not be available internally and may be uneconomic to acquire;
- increased flexibility in the use of technology;
- to spread costs and risks;
- to break an internal monopoly when services are supplied exclusively internally;
- to change a cost structure, e.g. lower fixed costs.

Above all, a major advantage of outsourcing is that it transforms fixed costs into variable costs and hence reduces the requirement for, often large, upfront costs in developing and adapting processing facilities. If a firm conducts its own processing, for instance it pays, and must recoup through the pricing of its products and services, both the large fixed and small variable costs of the process. On the other hand, if it subcontracts the process, it pays the supplier a proportion of the supplier's fixed costs plus the variable costs. The whole procedure is economic if the higher variable and transaction costs through outsourcing are less than the fixed costs which would have been expended by the firm in producing inhouse. In addition, the outsourcing firm may find it economic to outsource even when this condition is not met because of the sharing of risks and the

greater flexibility secured through minimising its infrastructure and fixed costs. In general, firms with low fixed costs and capacity are more flexible, even if their variable costs are higher, than those with high fixed costs.

If there are significant economies of scale in a particular process, a bank can secure these economies in one of four ways: by being big; by outsourcing; by forming joint ventures with others; or by investing in a process and utilising its excess capacity for other banks. As an example of the last-mentioned, a bank may decide to establish a cheque processing facility and to provide the same service to others.

In a competitive market all banks are under pressure to gain cost advantages wherever these can be secured. In some cases banks may have gone as far as they can in cutting costs without a more fundamental re-engineering of their business (such as is implied in contract banking). If technology has the effect of increasing economies of scale, the issue becomes how banks can reap such economies. As noted, economies can be secured either internally or externally, but in some cases this may require a fundamental re-engineering of a bank. Paradoxically, the technology which increases economies of scale in bank processes (combined with the ability to deconstruct products and services and have components priced and supplied independently) also means that small banks can secure economies of scale by outsourcing some of their operations. This implies that both small and large banks can coexist, and that there will be a greater variety in the structure of banking firms. This is because economies of scale reside in bank processes rather than in banks *per se*. As a result of these trends the concept of the fully integrated bank is becoming out-dated. In effect, a bank becomes a “manager of contracts” (internal and external) on behalf of its customers. It becomes a “contractor bank”. This involves a new definition of the business of banks and a new way of managing relationships with customers. In the model of contract banking the essential functions of a contractor bank are to:

- maintain a customer interface;
- design products and services;
- set standards;

- establish internal and external contracts;
- monitor suppliers (internal and external contract holders);
- enforce standards;
- protect against moral hazards, especially when contracting with outsiders (who may have lower incentives to conduct their operations efficiently because they do not suffer the consequences of inefficiency); and
- create a set of internal and external incentive-compatible contracts, i.e. contracts which create incentives for a service provider to be efficient.

The skill is to manage these contracts more effectively and efficiently than competitors. In this sense, a bank is no different from any other firm. At the extreme, the possibility of a *virtual bank* emerges. This has an interface with its customers and seemingly supplies a set of integrated services and products. It is a contractor for other firms' products and services and a coordinator of a network of contracts. It is, in effect, a broker between the customer and the ultimate supplier of those services which make up the final products and services demanded by the customer. This may mean that comparatively small virtual banks can exist side by side with large banks. They may provide the full range of banking services, with the customer being unaware that the bank is in truth a network of alliances with specialist providers.

What is likely to emerge, in time, is a spectrum of different types of banks. At one end of the spectrum will be the traditional fully integrated bank which, because of the economies of scale in bank processes, will be very large. At the other end of the spectrum will lie the *virtual bank*. In practice, the majority of banks will lie somewhere within the spectrum, with some services being provided internally and others outsourced. It is ultimately a question of the balance between internal and external contracts, while many alternative structures are likely to emerge.

The development of outsourcing means that there can be a role for the small bank in a market and technology environment where many banking operations require a large scale to be economic. While there will be a trend towards greater consolidation in the banking industry, there will still

be a place for the smaller bank, though it will not display the traditional structure. Accordingly, banks will be under constant pressure to cut and contain costs as a permanent feature of strategy. The economies of scale to be derived through the application of technology will be one of the routes to follow to counter this pressure. However, it must be realised that economies of scale relate predominantly to banking *processes* rather than *institutions*.

Two conflicting pressures are emerging. On the one hand, technology (to the extent that it raises economies of scale) leads to the emergence of large banks and the consolidation of the banking industry. On the other hand, and working against this trend, the processes of *deconstruction* and *contract banking* imply that there are alternative ways of securing the competitive advantages of economies of scale.

2.3 Consolidation and globalisation

Worldwide the bulk of merger and acquisition (M&A) activity in the financial services sector is domestic rather than cross-border, although the latter has grown sharply since the mid 1990s⁵. The motives for bank consolidations are not homogeneous, and neither are the structure of mergers. Four types of mergers have been identified:

- *Intra-country: overlapping business*. In this case two commercial banks within the same country and with overlapping business structures merge (e.g. branch network). The main motive for this is

5 There has been more merger and acquisition activity in the financial services sector since 1997 than in the previous ten years combined. The number of banks in the US has fallen by one-third in the current decade and some of the mergers have really been massive (notably, Citicorp and Travellers). In 1998 announced M&A deals in financial services totalled over \$580 billion, of which \$500 billion was domestic and \$80 billion cross-border. In 1998 around 65 percent (by value) of mergers and acquisitions in financial services was in the US, and 26 percent in Europe. It has been estimated that since the beginning of 1997 the total of M&A activity in financial services has amounted to close on \$900 billion, which is \$60 billion more than the amount of all activity in the previous ten years. Within these figures a small number of megamergers in the US account for about 70 per cent of the total by value and close to 50 percent of the total of world activity in the sector. Outside the US two large mergers in Canada accounted for nearly half the volume of M&A deals in financial services in the first nine months of 1998.

usually to secure cost savings by eliminating duplication. It tends to be beneficial for efficiency and hence shareholder value.

- *Intra-country: non-overlapping business.* Here the motive is often to secure critical mass and/or national penetration of the market, rather than a local or regional focus (e.g. a merger between commercial banks and investment banks).
- *Revenue/Product enhancement.* One motive for a M&A is to develop a more product-diversified business structure. The links between banks and insurance companies, in order to develop bancassurance strategies, is a good example of this type of M&A.
- *Cross-border.* To date there have been few cross-border mergers between banks. However, it is likely that such mergers will occur in Europe as one of the effects of the common currency. The rationale would be scale and geographic diversification within the same currency area and monetary union.

Experience in the United States regarding the success of bank mergers is ambivalent. As a general observation, “in-region” mergers (i.e. bank mergers between banks with a significant geographical overlap) tend to be more successful at cost-saving than mergers involving banks with little overlap. However, cost saving may not be the only, or even dominant, motive for a merger. The fact that synergies and cost savings may be low does not in itself undermine the rationale for a merger. Nonetheless, it does seem to demonstrate, that if the motive is to cut costs, a M&A is more likely to be successful if the banks have a significant overlap.

The conventional wisdom that seems to be emerging is that the future lies with very large and widely diversified banks and that there will be a substantial movement in consolidation in banking both in terms of a large reduction in the number of independent banks and a substantial cut in the branch networks. In fact the two issues are related as one of the reasons for banks to come together (through M&A) is that the costs of cutting costs by reducing the scale of branch networks are often lower when done through consolidation than when individual banks seek to close branches on a unilateral basis.

While there are many pressures on banks to consolidate (particularly in several European countries), it needs to be recognised that in some countries there are also powerful impediments to the movement towards consolidation: existing ownership structures (such as mutual, cooperative, and state banks) militate against market-determined structures; labour laws often make it difficult for banks to cut costs by reducing staff numbers; ownership rules and fears about concentration of power can impose regulatory limits on consolidation; competition policy issues arise in bank consolidation; there are limits on the extent to which banks can be owned by foreign institutions and investors; and the regulatory authorities are often reluctant to allow hostile takeovers in a banking industry. In this last respect corporate control (a powerful disciplining mechanism imposed on management to be efficient) may sometimes be impeded in the banking industry.

There are various reasons for banks to seek M&A as part of the consolidation process in the global banking industry:

- *Economies of scale*: In many aspects of banking (notably bank processes) economies of scale have been rising over time. One way for banks to become more efficient by exploiting economies of scale is to become big through M&A activities. Some banks are seeking M&As on the assumption that it is necessary to be very large if they are to remain competitive in national and international banking markets. While this view has not gone unchallenged, there is no doubt that in some cases it has been a powerful motive.
- *Technology*: One of the factors raising economies of scale in banking is the impact of new information, processing, trading and delivery technology. The motive for some bank mergers is to secure economies of scale in technology. The cost of technology is very high and has become a major aspect of the cost structure of banks. In this regard, some banks cite the cost of installing new technology as a major motive for a merger.
- *Competition*: The pressure of competition (other banks, non-bank financial institutions, and new competitors such as supermarkets, etc.)

is a major impetus for some banks to merge or become bigger through acquisitions. It is not unusual in other industries for consolidation to develop after competitive pressures have become more intense.

- *Profitability*: Linked with competition is the dimension of profitability. In general, European banking is characterised by low rates of return, a fragmented structure with a large number of comparatively small banks in many of the countries, and evident over-capacity both in terms of the number of banks and the basic infrastructure (notably, the branch network)⁶. Shareholders often view mergers and acquisition as a route to increased profitability. This is partly because, in some cases, it is easier for two banks to cut costs when they combine (e.g. through closing duplicated branches and down-sizing excessive staff numbers) than if each operates independently. There seems to be some correlation between the degree of concentration in the banking industry and the level of profitability.
- *Capital market pressure*: The capital market is generally imposing more discipline on bank managements to raise efficiency and to focus on the rate of return on capital (rather than, say, balance sheet size or market share).
- *Diversification*: In many cases, banks seek a M&A as a means of diversification and as an alternative to building up their own diversified business portfolio from a zero base. Notwithstanding a possible “bid premium”, a bank may judge that the costs of acquiring an existing successful business are lower than building up a new business from scratch. The acquisition route has several advantages over organic growth: economies of scale are attained immediately; there are fewer learning costs; the business purchased is already

⁶ In many European countries competition has eroded profitability and rates of return on assets and capital. In many cases shareholders believe that banks are not sufficiently profitable as they are currently structured. The average rate of return on assets in European banks in the early 1990s was 0,27 percent. If the required rate of return on equity is around 15 percent, the rate of return on assets would need to rise to 0,75 percent.

successful; and there is no addition to the industry capacity in the new business area.

- *Efficiency gains*: The objective of securing efficiency gains is a central motive in many M&As in the financial sector. Such gains may be generated through four alternative routes: (i) through economies of scale; (ii) through the potential to raise X-efficiency; (iii) via economies of scope when a merger or acquisition links different product ranges; and (iv) by lowering the overall risk profile of a bank when businesses with different risk characteristics are merged⁷. Efficiency may also be improved by M&As if greater diversification improves the risk trade-off faced by the enlarged institution. Diversifying M&As may also improve efficiency in the long run by expanding the skills sets of managers.
- *Lower the cost base*: A major motive is to cut costs, such as back-office costs, which are often cited as an area for efficiency gains through mergers. In many cases it is easier for two banks to cut costs when combined than when each attempts to do so individually. If two banks combine, a more rational and efficient branch structure can be created by considering the two banks as a whole.
- *Risk profile*: New tools of financial engineering and risk management may be more efficiently produced by larger institutions. One study of the US looked directly at the diversification gains from improvements in the risk profiles of banks. The conclusion was that, when organisations are larger in a way that creates geographical diversification, efficiency tends to be higher and insolvency risks tend

⁷ Several studies of European bank mergers and acquisitions suggest that the potential for efficiency gains may be a dominant motive. In the US acquiring banks appear to be more cost-efficient than target banks on average. US studies found that acquiring banks are more profitable and have smaller non-performing loans than targets. Simulation exercises also indicate that substantial efficiency gains are possible if best-practice banks merge with less efficient banks. Several studies of European bank mergers and acquisitions (M&As) also suggest that the potential for efficiency gains may be a dominant motive. Large, profitable banks tend to be acquirers while small, unprofitable banks tend to be targets. Large, efficient banks tend to acquire small, less efficient institutions.

to be lower. There seem to be clear risk-profile gains from operating in several states in the US.

- *The “too big to fail” principle*: In some cases M&A may be motivated by an implicit view that large banks are either more secure than small banks or, if they do get into difficulty, there is a greater probability that the bank will be rescued. This may be of benefit to managers and owners. To the extent that this view is also held by customers, a large bank may be able to secure deposits more cheaply than small banks because the implied risk premium is lower.
- *Critical mass*: In some markets it may be necessary to achieve a fairly high critical mass before the business becomes profitable. In competitive markets which exhibit economies of scale there may be a need to develop critical mass on a fairly large scale. There may also be “reputational externalities” resulting from size.
- *Protective*: A bank may merge with, or acquire, another bank as a protective device. This could occur in one of two ways. One option is to merge with bank X in order to be protected from a forced take-over by bank Y. Alternatively, banks may merge simply to reduce the probability that they will be viewed as a future bid target. Size provides, to some limited extent, protection in the arena of corporate control.
- *Market share*: A bank may seek an acquisition in order to increase its market share or to protect an existing market position. A general motive for a M&A may simply be to secure a degree of market control.
- *Managerial ambitions*: M&A deals may also be motivated by managers wishing to build empires or maximise their own utility, based on issues such as expectations that remuneration packages for managers may be bigger in larger banks. Acquisition behaviour of banks may be motivated more by managers’ ambitions than by the interests of shareholders. Studies have shown that remuneration packages of bankers are related to size rather than the profitability of banks.
- *Global reach*: in some areas (notably investment banking) banks may merge in order to secure a global reach in a particular line of business. It is generally argued that banks will be able to develop profitable

investment banking strategies only if they have a global presence. For this to be feasible they need to be very large. This was one factor in the merger between the Swiss Bank Corporation and the Union Bank of Switzerland. That having been said, it is likely that only a few genuinely global investment banks will survive.

- *The crisis motive:* In some cases, M&As present a solution to either a systemic crisis or problems encountered by individual banks. It is not uncommon for regulatory authorities to seek to deal with a problem bank by brokering a takeover by a stronger institution. This has been a common response in the United States. During the Scandinavian banking crisis of the early 1990s many banks were either rescued or placed temporarily under state control. After adjustments had been made to their balance sheets, they were subsequently privatised and in some cases the new owners were existing banks. In other cases (such as in Latin America) the regulatory authorities also took the opportunity of a financial crisis to consolidate the banking industry. A similar remedy is often recommended for Japan. A restructuring of the banking industry following a systemic crisis has also occurred in several countries in South East Asia.
- *The European single market:* Within the European Union the development of a single market in banking and financial services is emerging as a major factor in the consolidation of the banking industry. As competition intensifies as a result of more cross-border freedom to sell financial services, and easier access is given to foreign markets through location, banks are likely (in the first instance) to respond by mergers within their own countries. A second stage could be the occurrence of cross-border merger activity in European banking.
- *The eurocurrency:* One of the major, specifically European, factors will be the move towards full monetary union within the European Union and the development of the common currency. In effect, the euro will remove a major barrier (exchange rate risk and foreign currency transaction costs) to the development of a truly single market

in the European Union. In many ways the euro will accelerate trends and accentuate pressures that are already evident within Europe.

- *The herd factor*: It is not uncommon for banks to “follow the herd” as a fashion develops. In some cases herd behaviour emerges because banks are subject to the same pressures and hence a common response arises. However, some bank strategies evolve not because of their intrinsic merit but simply because other banks are following a particular path or business strategy. There are several reasons for herd behaviour to develop. It may be to gain security, as a feeling of security is engendered by copying others because the management of the copying bank judges that the managements of other banks have superior knowledge. Alternatively, if many banks are following a particular strategy, other banks are induced to follow because it could be dangerous to stand aloof from an emerging trend even though there may be little evidence that the strategy is correct. It is often the case that a climate of opinion develops as more banks follow the herd, and a strategy eventually becomes viewed as “natural”. For instance, there is currently a view that banks need to be big in order to survive though there is little firm empirical evidence to endorse this judgement. A particular merger may take place because, if consolidation is viewed as the current trend, a bank will wish to choose its partner rather than be forced to accept one. Perhaps above all there is the question of risk analysis by risk-averse managers who believe they will be blamed if they stand aloof from what subsequently proves to be a correct strategy, but will not be censured if the strategy proves to be wrong because their defence will be that it was a systemic error made by all banks. Of course, the fact that all banks are behaving in a particular way does not make this a correct or rational strategy. It can be observed that many bank crises emerge following herd behaviour, e.g. sovereign lending, lending to property companies, speculative lending and trading. One of the problems of herd behaviour is that strategy is often not based on a careful analysis and judgement of the market, but simply on the fact that others are doing it.

Thus, two features stand out in the current wave of merger activity: it is increasingly a global phenomenon and it is occurring across many industries⁸. In summary the following points can be emphasised:

- There is substantial pressure in the European banking industry for consolidation into a smaller number of larger banking units.
- There is no single motive for M&As and the pressures can be divided into at least five broad categories: (i) secular; (ii) offensive and defensive strategies; (iii) crisis; (iv) catalyst; and (v) herding.
- Although the nature and structure of the banking industry varies between countries, the pressures are *global* in nature rather than *country-specific*.
- A major (though not exclusive) motive for current mergers is to raise efficiency and cut costs in banks. Potential efficiency gains can be significant. Such gains may be generated through four alternative routes: (i) economies of scale; (ii) the potential to raise X-efficiency; (iii) economies of scope when a merger or acquisition links different product ranges; and (iv) lowering the overall risk profile of a bank when businesses with different risk characteristics are merged.
- There is, however, often a distinction between the *potential* for efficiency gains and what emerges in practice through M&As.
- There is some evidence that scale economies have increased in recent years, and hence the rationale for consolidation may now be greater than in the past.
- Diversification is another major motive for bank consolidation, but the empirical evidence on the efficiency of such a strategy is equivocal.
- The idea that only very large and highly diversified banks will survive is almost certainly wrong because, while economies of scale are

8 The current consolidation trends in the banking industry should be considered in the wider context of other industries. There has recently been a major movement towards consolidation in many other industries. By the end of 1998 over \$2 000 billion of merger deals were completed in the world. In the first half of 1998 alone the value of deals amounted to \$1 200 billion, which compares with \$1 600 billion for the whole of 1997. Many of these (though certainly not all) occurred in the financial sector and included some mega deals: Citibank and Travellers (\$72,6 billion); BancOne and First Chicago (\$29,6 billion); and the Norwest bid for Wells Fargo (\$34 billion).

important in banking, there are many alternative ways of achieving such economies of scale, and being a big bank constitutes only one.

- Often banks have more strategic choices than they imagine and there is a danger of automatically “following the herd”.
- There is no single, winning strategy which will apply to all banks.
- National banking systems are likely to evolve into pluralistic structures with different kinds of banks competing with each other.
- There are five major public policy issues which arise in the movement towards consolidation and bank mergers: the impact on competition and efficiency; the efficiency of the payments system; the vulnerability of the financial system and access to safety-net arrangements; the risk profile of banks; and access to credit by small companies.

2.4 Diversification

Central to the economics of diversification is the issue of the economies of scope. The argument is that a portfolio of different services can be produced and marketed by a bank more cheaply than if each service is supplied separately. Potential economies of scope derive from two sources: production and consumption synergies. The specific sources of potential scope economies are briefly summarised as follows:

- *Managing the client relationship*: If fixed costs (branch network, technology, etc.) can be shared between services, economies may be derived through diversification. There may also be staff and skill economies and benefits to be derived from reputation. Above all, information economies of scope may be large. A bank derives information from managing a customer’s basic bank account, which may be utilised in other services.
- *Distribution economies*: The branch network, and other delivery channels (postal, telephone, home visits, etc.), can be used to supply a wide range of services. Given the substantial fixed costs of delivery systems, the potential for economies of scope may be significant.
- *Marketing economies*: Several services can be marketed simultaneously, and a bank may gain both a marketing and reputation

advantage by being seen to be offering a wide variety of services. Some banks have developed advertising strategies focused on the message that they provide a full range of personal financial services (banking, mortgages, personal pensions, insurance, etc.).

- *Risk management*: To the extent that risks on alternative products or services are not perfectly correlated, economies in risk management can be secured within a diversified portfolio of services and products.
- *Consumer economies of scope*: Banks may also seek to exploit customers' perceptions that there are advantages in purchasing services from a single institution, i.e. there may be consumer economies of scope as well as producer economies. Such economies may derive from lower search, information, monitoring and transactions costs. There are, therefore, powerful reasons for banks around the world to diversify. Whether the alleged advantages and rationale are real in practice is of course a different issue.

Beside these arguments of economies of scope, there are other important features which can support a diversification strategy:

- *Lower costs*: Bank management may believe they can achieve lower costs or other market advantages, compared with existing suppliers of financial services. If a service is being supplied under non-competitive conditions, there is scope for banks (or any new entrant) to compete away the implicit economic rents.
- *Economic power*: A bank may be induced to diversify simply to gain economic power or competitive advantage through being bigger and offering a wider range of services to a possibly larger client base.
- *Minimising information costs*: A diversified bank may minimise information and monitoring costs by providing a wide range of services. Instead of assessing the creditworthiness of a customer on a separate basis for each financial transaction, an integrated account requires only one such information cost.
- *Exploiting available resources*: Banks may seek to exploit a potentially valuable resource such as the delivery system through a nationwide branch network. Although the development of delivery

technology may be eroding this comparative advantage, banks are increasingly conscious that they have a large customer base and easy access to it for a wide range of services.

- *Reducing portfolio risk*: In terms of banks' risk profile, and dependent on the nature, size and correlation of risks, diversification has the potential to reduce portfolio risk in an overall business structure. It provides a diversified source of income, not all of which is dependent on interest rates and financial intermediation through the balance sheet. Diversification also offers strategic opportunities to respond to shifts in demand and changes in market conditions.
- *Customer relationships*: Diversification may be viewed as developing a more intensive and extensive customer relationship with the potential to "tie-in" the customer to a more secure and continuing relationship. It may be the case that the more services a consumer purchases from a bank, the less likely he/she is to shift between banks, as the transaction costs of switching will be higher.
- *Reducing rigid demarcations*: As a result of financial innovation, many insurance products have become more akin to savings than insurance *per se*. Competition between banks and insurance companies for personal sector savings business has made banking and insurance products increasingly similar and competitive. The offering of insurance products has, for some banks, become a natural part of their competitive strategy, as insurance companies have increasingly been encroaching on banks' traditional business. In effect, as financial innovation has reduced the rigid demarcations between banking and insurance products, diversification into insurance by banks has represented a parallel form of institutional structural change. In this respect, new institutional structures have been a reflection of financial innovation in products.
- *Competition*: During the 1980s in many countries the personal sector invested heavily in insurance products, and insurance or insurance-related products offered by insurance companies gained substantial market share. As some banks have developed a strategy of giving

priority to the retail sector, they have not been able to ignore this growing area of personal sector business. As a result of increased competition for personal sector funds banks have seen their retail deposit-base undermined and become more expensive.

- *Demographic trends:* These, including future pressure on state pension provision, are viewed as favourable to the future development of savings, insurance and pension products.

2.4.1 Diversification within banking

One of the reasons for a bank to seek to merge with, or acquire, another bank is to broaden the range of products and services offered to its customers. It may judge that it has a valuable franchise in its customer base and that this can be extended through diversification. For reasons already noted, acquisition may be a more successful diversification strategy than organic growth. The linking of complementary expertise and competitive positions is a viable reason for mergers and acquisitions.

However, there are also questions regarding the economics of diversification, which is not invariably a successful strategy. Indeed, there is some dispute between those banks who believe a diversified business structure is likely to be most successful and others who adopt the alternative strategy: focusing on core business in respect of which they enjoy known competence and market strength.

With respect to other industries, most of the acquisitions in new fields of business were later divested, and more than 60 percent of the firms ended up by divesting more of their acquisitions than they kept. Large conglomerates are being broken up on the basis that the companies are valued more highly as sets of separate businesses than as a combined conglomerate. Some research indicates economies of scope in large banks especially through the economic use of information technology. On the other hand, other investigations fail to find unambiguous support for economies of scope or synergies. In the UK some banks have begun to “dediversify” by selling off parts of their non-core business. For instance, one of the largest banks (Lloyds-TSB) divested more than it acquired in

both 1997 and 1998. Considering the evidence related to universal banking, unambiguous support for economies of scope is difficult to find. The overall conclusion is that the alleged advantages of universal banking tend to be overemphasised.

Diversification and the evolution of financial conglomerates are not without their hazards. In some respects, structures in finance have been moving against the trend in the industrial sector. The challenge to financial conglomerates can be made on business and regulatory criteria (see table 1). With respect to business criteria, the main arguments are:

- The alleged case for financial conglomerates is based ultimately on economies of scope, which in practice often fail to materialise. Most of the empirical research on economies of scope fails to find conclusive evidence for their existence. For instance, very few cost savings have been found in studies investigating the consolidation of the outputs of different banks.
- The management challenges of controlling and developing a highly diversified business, and what can become an unwieldy bureaucracy, can be formidable. This may impose diseconomies of both scale and scope. Economies of scope are likely to be bounded by the increased difficulty of efficiently managing a complex, non-focused organisation. Only in very efficiently organised firms are internal markets competitive with external markets. So the argument becomes circular: internal markets are efficient if a firm is efficient, and what makes a firm efficient?
- Problems and conflicts may arise because of the different cultures, traditions and working practices of different facets of a financial conglomerate. Each may contaminate the other to the detriment of all.
- There is some evidence suggesting that management expenses per unit of output tend to rise as the product range widens.
- The management requirement of introducing a new business may be substantial and underestimated, with the result that not only is the new business not particularly successful, but managerial diversion may undermine existing business.

- A consumer’s image of traditional businesses may be contaminated by an unsuccessful venture into new areas.
- The regulation and compliance costs of a diversified business may be high. The more diversified a bank is, the more regulatory jurisdictions it may be subject to, and the greater are the compliance costs associated with regulatory requirements designed to guard against consumers being exploited by a conglomerate’s potential conflicts of interest.

Table 1: Impact of diversification by banking groups	
Favourable	Unfavourable
<ul style="list-style-type: none"> • Increases competition and therefore efficiency in favour of consumers • Reduces the business (portfolio) risk of banks by less concentration • Improves diversified sources of income and reduces dependence on a few restrictive sources • Enhances economies of scale and scope for producers and consumers (i.e. purchasing all financial services from a single institution) • Enhances the elimination of possible excess production capacity in specific activities (particularly in banking) • Enhances the flexibility of a firm’s response to shocks to “existing” business areas and minimises institutional risk through optimum diversification • Erodes entry barriers and economic rents for existing firms or cross-subsidies of existing suppliers • May minimise information and monitoring costs by providing a wide range of services • Enhances the utilisation of banks’ nationwide branch networks • May develop a more intensive client relationship with the potential of “tying-in” clients who prefer to deal with a secure institution (“relationship banking”) • Increases institutions’ ability to exploit their potential competitive advantages 	<ul style="list-style-type: none"> • Increases the concentration of power in the financial system, particularly if entry barriers are not reduced (i.e. <i>anti-trust</i> concerns) • Increases the business risk emanating from running a multi-faceted business enterprise, with complex and opaque structures • Increases system risk, since the larger the conglomerate, the higher the costs to society if it fails • May increase potential moral hazards (potential exploitation of conflicts of interest) within a firm, and increases the costs of policing complex boundaries such as “Chinese walls” • Makes it more difficult to match functional and institutional regulation, as the regulator is confronted with complex and opaque business structures • Complicates the lender-of-last-resort facility of the central bank and raises issues of competitive neutrality • Complicates regulation and supervision for the regulatory authorities, as it increases problems of coordination and responsibility • Makes it easier for consumers to be “locked into” a financial conglomerate (i.e. “paternalism”), because of the high transaction costs of switching suppliers • May increase the regulation and compliance costs of a diversified business • May increase the risk of contamination of a bank by risks elsewhere in a group

Two reservations are entertained about the uncertain empirical evidence, in addition to the evident methodological and statistical problems associated with the studies. Firstly, with substantial development of information and delivery technology, together with the new emphasis on cost control in banks, evidence on the basis of past performance may be a poor guide to potential future economies of scope. Secondly, the existence of economies of scope is a sufficient, but not a necessary, condition for banks to diversify, as such strategies may be motivated by reasons other than cost economies.

2.4.2 Diversification into insurance

Banking and insurance are potentially both competitive and complementary activities. However, some forms of insurance (notably life assurance) have become predominantly savings products competing with other savings products offered by banks. On the other hand, products such as home insurance are complementary to loan products offered by banks. Either way, there is a rationale for banking groups to offer insurance products: either to regain lost business or to reinforce the attraction of existing bank products.

At a more theoretical level there is a parallel between banking and insurance in terms of the fundamentals of the business. The similarities are that banks in their financial intermediation role are effectively supplying insurance to depositors and borrowers. Also by holding capital and applying the law of large numbers the management of risks in banking and the management of insurance share some features. Internationally, banking groups moving into personal insurance have been motivated by both *defensive* and *offensive* strategic considerations (see table 2).

In terms of risk analysis a crucial distinction has to be made between *own* and *agency* diversification. In own diversification the relevant criteria relate to how the new business affects the risk characteristics of the combined group balance sheet and exposure (e.g. the covariance of risks). A major form of agency diversification is an institution providing a wide range of services, but acting as a sales agent for other institutions which

absorb the balance sheet and capital risks. The key issue with agency diversification relates not to risk but to the efficiency of delivery systems.

Table 2: Strategic reasons for diversification into insurance by banking groups

Defensive factors	Offensive factors
<ul style="list-style-type: none"> • Financial innovation has made insurance products more akin to savings products • Insurance-related products represent a vast, growing area in the personal sector, which for strategic reasons cannot be ignored (e.g. the retail deposit-base is undermined by increased competition from insurers) • Increased capital requirements in respect of traditional bank business have made insurance broking an attractive alternative • Diversification into insurance becomes a strategic response to increased competition from other financial institutions 	<ul style="list-style-type: none"> • Demographic trends, including pressure on state pension provision, favours insurance products • With the erosion of bank profitability from the corporate sector, the strategic emphasis switches to retail business and “one-stop shopping” for financial services • Developing insurance business is seen as enhancing the economies of scale and scope • Distribution costs can be reduced when insurance is sold to a “warm” client base • Insurance is perceived as a new source of income, independent of traditional banking risks

There are many advantages to agency diversification: institutions may link complementary expertise; different institutions may offer mutually advantageous economies of access by utilising one another’s delivery systems; institutions may share one another’s reputation advantages; institutions may avoid many of the management problems of a diversified business; learning costs are avoided, as are the substantial “start-up” costs involved with own diversification; and agency diversification generates fee income without encumbering the balance sheet. At the systemic level the agency route means that firms diversify without raising the number of producers and productive capacity.

The agency route was initially viewed as being mutually beneficial to insurance companies and banks. Insurance companies gained access to nationwide delivery networks and lower distribution costs, and also gained access to the client base of banks. This also meant that, while the banks’ activity was restricted to distribution, capacity in the industry was not raised. The banks gained by being able to offer insurance products and the generation of fee income independently of the size of their own balance sheet, which raised the rate of return on their equity. They were

able further to exploit the capacity of their branch network. In the event, banks became a dominant delivery channel for life assurance.

Today, many bankers consider it more attractive to move from the distribution of others' insurance products to the manufacture and supply of their own (i.e. own diversification). If banking groups establish their own life assurance subsidiaries, they become manufacturers and suppliers of their own products. Different groups can adopt different strategies: *de novo* joint ventures between banks and life assurance companies; partnerships (with banks effectively subcontracting part of their life assurance operations to a life company); and acquisition of life companies. There are several reasons for the emphasis being likely to shift from agency distribution to manufacture:

- As an agency distributor a bank has little, if any, influence on product design. It is able to distribute only products offered by insurance companies and designed by them.
- Similarly, there is no control over product pricing.
- Acting only as a distributor means that income is earned (through commissions from the insurance company) solely at the point of purchase and at annual renewals in the case of annual premium policies. Banking groups are attracted to the idea of earning underwriting and fund management income and profits.
- Given the competitive pressures in the retail financial services market, there are strategic advantages in branding their own insurance products.
- Underwriting and fund management business are also viewed as reducing the volatility of banks' income over the economic cycle, given that income from insurance business is less cyclical than the traditional financial intermediation business of banks.
- Distribution-only business is seen as weakening the link with the client and introduces the client to institutions which may also be offering products in direct competition to those of a bank.

Overall, banking groups believe they have some major competitive advantages: (i) economies of scope; (ii) information advantages; (iii) a powerful franchise implicit in their client base; (iv) an efficient delivery

network which has hitherto been used to sell other companies' insurance products; (v) an ability to undermine insurance companies' traditional delivery systems by excluding them from their branches; and (vi) a good reputation and image, compared with some insurance companies.

The shift from agency towards manufacture will represent a significant change in the market and competitive environment for insurance companies, as it will raise industry capacity. This shift will further intensify competitive conditions in the insurance market and will close off major delivery capacity to those existing insurance institutions which have traditionally relied on banks. Overall, it will change the "bank/life assurer" relationship from being complementary to being competitive. As a result, banking groups may become a major competitive force in the life assurance industry and may well gain substantial market share. The main emphasis of a banking group's insurance business will probably fall on life and life-related insurance products, personal pensions and, in particular, products with significant savings components. Less emphasis will probably be placed on non-life products. There are several reasons for this:

- Distribution costs (in respect of which banks have an advantage) represent a higher proportion of total costs in the case of life products.
- More assets are under management with life products.
- Risks are more easily assessed and clearly defined.
- Life contracts are more similar to savings products which, to some extent, means that banks are offering alternatives for capturing the same savings business.

Although banking groups do already offer a limited range of general insurance products (such as home and property insurance), some banking groups may also be concerned at the prospect of jeopardising customer relationships through disputes arising in general insurance. The skill requirements are also greater in general insurance (e.g. underwriting and screening of clients). On balance, it seems that bank conglomerates will move from insurance agency diversification to own diversification in time to come.

2.5 Securitisation and monitoring techniques

In the US and UK asset-backed securitisation has developed as an important instrument of asset and liability management, and has also become an alternative means of funding bank lending. Asset-backed securitisation (whereby a bank is able to transform a portfolio of loans which it currently holds on the balance sheet into tradable securities issued by a bankruptcy-remote Special Purpose Vehicle (SPV)) offers many opportunities for banks to manage their assets and liabilities and to shift risks. There are many dimensions to this securitisation:

- It raises the liquidity of bank loan portfolios and transforms illiquid loans on the balance sheet into tradable securities. It thereby transforms non-marketable into marketable assets held off banks' balance sheets.
- It facilitates active asset management and affords a technique to change the asset composition of a bank's balance sheet within a given total.
- It raises the flexibility of a bank's balance sheet and facilitates diversification of the loan portfolio.
- By removing assets from the balance sheet it becomes a technique for managing risks and shifting risks to other institutions and to the market.
- It offers an alternative funding mechanism for bank lending.
- Depending upon how the securitisation is undertaken, it can release capital for a bank and can therefore also be regarded as a technique of managing capital.
- It can be a technique for managing interest rate risk.
- It is a technique which can widen the sources of funding for a bank and reduce its dependency on deposits and other traditional forms of asset financing.
- It can lower a bank's cost of funding both because it taps new sources of funds (e.g. from lenders who would not normally offer deposits) and because new (marginal) funds can be raised without raising the general level of interest rates.
- Because a bank can earn fees through the securitisation process, it is a

means of generating additional income and raising the rate of return on assets and equity.

- It enables a bank to concentrate on its core expertise (originating loans, risk analysis, administration, and maintaining the relationship with customers) even when it is not necessarily the most efficient institution at funding loans and holding assets on the balance sheet. In this way it can lower the overall cost of financial intermediation, as different institutions can concentrate on those parts of the lending process in which they have a comparative advantage.

The trend towards securitisation should be viewed in the general context of the wider aspects of structural change which is apparent in many financial systems (most especially the US and UK) and which will become increasingly relevant in other countries. There are many features of structural change which have a bearing on securitisation, including: the increase in competition (which means that not all assets traditionally held on the balance sheet of banks can necessarily continue to be held profitably in this way); the shift from institutions to markets in financial intermediation; the increased emphasis being placed on raising efficiency in the banking industry; and the increasing demand for banks to focus on the rate of return on capital as their principal strategic objective.

Securitisation is also relevant to the trend for banks to repay capital to their shareholders, particularly where a bank cannot earn a sufficient return on the assets to service its capital base adequately. It is in this sense that securitisation is also a technique for managing capital. For example, some banks in the UK have been simultaneously securitising part of the loans on their balance sheet (which reduces the need to hold capital because risks are shifted to others) and repaying capital.

In many ways, securitisation changes the nature of banking business, as banks concentrate on some aspects of lending business (origination, etc.), while not funding assets in the conventional way, and not holding assets on the balance sheet, with the resultant risks and the need for capital. Given the increasing emphasis on the rate of return on equity, many banks will find that some business currently undertaken on the

balance sheet (and requiring capital backing) will not be sustainable because it will not earn a risk-adjusted rate of return sufficient to satisfy the cost of capital.

2.5.1. Types of financing

A perspective can be offered by briefly considering the two main alternative financial intermediation mechanisms (i.e. how funds are made available to those who need to borrow). In *market financing* (e.g. when a company issues securities) funds are made available to a borrower by investors on the basis of publicly available information. As the debt which is issued can be traded in a secondary market, the lender is not locked into an exposure to the borrower for the full maturity of the loan. Market participants and rating agencies monitor the behaviour of the borrower and, on the basis of this monitoring, there is a constant market repricing of the securities based on the market's perceptions of risk.

On the other hand, *intermediated financing* (e.g. when banks make loans to borrowers) is based on inside information held by a bank, and the assets created (loans) are not liquid or marketable, while there also is no constant market repricing of loans. The bank undertakes the monitoring of the borrower, and the bank is effectively locked into the borrower for the maturity of the loan. In other words, the bank uses its core competencies (origination capacity, information, risk analysis and monitoring capacity) to make loans which are held to maturity on the balance sheet and which are funded by a mix of capital and deposits.

However, a major characteristic of securitisation is that this strict dichotomy need not apply, and hence the distinction between *market* and *intermediated* finance currently is not as strong as has traditionally been the case. This is because, while a bank undertakes some of the processes involved in making loans (origination, etc.) and the loans are initially placed on the balance sheet, the eventual financing and holding of an asset is undertaken elsewhere. Securitisation involves splitting the different functions involved in making loans, and in particular means that, while banks continue to make loans (and are remunerated for this), they do not necessarily hold the assets permanently on their balance sheet.

While the analysis to follow is made from the perspective of the individual bank, securitisation also has systemic implications of some significance. Firstly, it has the effect of lowering entry barriers (and hence raising competition) because new entrants are able to make loans even though they may not be efficient at holding assets on their balance sheet). Secondly, it has the effect of shifting some risks away from banks. Thirdly, it implies a greater role in the financial system for the capital market. Fourthly, risks may be shifted in the system towards less regulated entities.

2.5.2 The nature of securitisation

Securitisation is a flexible technique which can be adjusted to different types of originator, using different types of assets, and a variety of funding techniques and instruments. Securitisation makes previously non-marketable debt marketable and thereby increases the liquidity of bank assets. In essence it involves the transfer of receivables into securities. It is a practical example of the concept of *deconstruction* whereby bank products (such as loans) are decomposed into their basic components, each of which can be priced and supplied separately. It implies a process of unbundling previously bundled products. Thus a bank loan can be deconstructed into various processes such as origination (locating the borrower), risk analysis, loan administration, maintaining the customer relationship, funding and holding the asset. Securitisation involves the funding process and the holding of the asset being conducted off the balance sheet of the bank, even though all the other component parts and processes of the loan are undertaken by the bank in the normal way.

In effect, it means that the component parts and processes of loans are undertaken by those institutions which have a comparative advantage in doing this. While a bank with a strong customer base and good customer relationships may have a comparative advantage in originating loans and conducting risk analysis as well as in loan administration, it may not be the most efficient at funding loans or holding them on the balance sheet. This may be because, for regulatory or other reasons, other agents may be

able to fund loans at a lower cost and may be required to hold less (or no) capital against them, compared with banks.

An SPV issues asset-backed securities, which are bought by investors in the market either on an open basis or through a private placement. The cash received is used to purchase a portfolio of assets assembled by the selling bank. The bank continues to receive interest on the assets during their remaining maturity and this is passed to the SPV, which now effectively owns the assets. The securities are serviced and eventually repaid by the SPV through the cash flow produced by the portfolio of assets. The SPV will pay administration fees to the selling bank. In addition, the bank maintains the relationship with the customer. Thus securitisation enables the bank to maintain its customer relationships and provide customers with the full range of services as in the past, but without the necessity of holding assets permanently on the balance sheet. In this sense the effect of securitisation is to raise the measured rate of return on assets and the rate of return on equity. The net effect is that a bank earns a higher proportion of its income off the balance sheet and becomes less dependant on the interest rate margin.

In essence, and providing the transfer of assets is conducted efficiently, securitisation transfers credit risk to others and hence a bank gains economies in the use of capital. *The objective of securitisation is to transfer a portfolio of assets to another party so that the risks are separated from the seller.* It protects the seller from the risks of the assets, and protects the investor (the buyer of the securities issued by the SPV) from the risks of the bank.

2.5.3 Securitisation programmes

A wide variety of assets have been securitised and, in principle, any asset type has the potential to be securitised. In practice, four conditions seem to be required for successful securitisation:

- a portfolio should be sufficiently diversified internally, which implies a large number of relatively small loans;
- assets should be homogeneous as mixed assets (e.g. mortgages, credit

card receivables, personal or consumer loans, and car loans), are difficult to rate and unlikely to appeal to specialist investors (who frequently want a particular type of loan or loans with a particular set of characteristics with respect, for instance, to maturity, interest rate formula, etc.);

- there should be a statistical history of losses on the asset type so that the risk characteristics can be assessed and hence the securities priced accurately;
- the terms attached to the loans (e.g. maturity, interest formula, etc.) within the portfolio need to be reasonably similar to each other to minimise the interest rate and maturity risks.

The key issue is that the characteristics of the loans within the portfolio should be such as to enable the risks of the portfolio to be accurately assessed, and hence the securities accurately priced without the benefit of inside information about the borrowers and their track record. This is particularly important, as normally capital market financing is conducted on the basis of publicly available information about borrowers. This is not possible with securitisation programmes.

Securitisation can also be undertaken by non-bank and commercial companies, which may securitise future income streams or receivables of one kind or another. Asset-backed commercial paper programmes have been developed in the United States, and for the seller they can be a cheaper source of funding than bank loans. The pattern is similar to that of a bank securitisation. The securitising firm transfers or assigns receivables to the SPV, which issues securities (e.g. commercial paper) backed by the receivables. The programme will be rated by a rating agency in the normal way, but it is usually necessary for a bank or some other agent to provide credit enhancement to the securities being issued by the SPV.

2.5.4 Securitisation as a source of funding

A key feature of securitisation is that it differentiates between the process of making loans and the holding of assets on the balance sheet of the originator. Clearly, the purchasers of the securities run a more specific

risk than would be the case if they made loans (offered deposits) to the bank itself. Investors in asset-backed securities choose a specific risk (e.g. mortgages) rather than sharing in the overall portfolio risk of the selling bank. This, to them, is the attraction.

If a bank issues more equity and debt to fund an expansion of its balance sheet, investors and depositors acquire a claim on the whole portfolio of the bank. The lender is exposed to the bank as a whole and the debt acquired is serviced by the bank from its overall earnings. On the other hand, if an investor purchases securities issued by an SPV, it acquires a claim on the specific assets behind the securities.

Some investors would be prepared to purchase asset-backed securities issued by an SPV (with the funds being used to buy assets from a bank), but would not normally make funds directly available to the bank itself. There are several possible reasons for this:

- the investor may be specialist and demand a particular and specific type of asset and risk rather than the general portfolio of a bank;
- the investor may be undertaking a hedge transaction which could not be done through an exposure to a bank's overall portfolio;
- the investor may already be at its credit limit to banks;
- the investor may prefer marketable securities rather than a bank deposit;
- the investor may prefer the particular type of securities being issued by the SPV.

From a bank's point of view there are two particular funding attractions: (i) it widens the sources of funding; and (ii) it is usually a cheaper form of funding. Because the risks are specific, asset-backed securities often appeal to specialist investors who would not normally make funds available to a bank *per se*. It is in this sense that the sources of funding are widened for a bank, because it enables the bank to tap a new source of funds.

Securitized funding may also be cheaper for a bank partly because it is tapping a new source, but also because it is meeting the specific investment requirements of particular investors in the asset-backed securities. In addition, by segmenting different funding sources, the

marginal cost of new funding can be lower through securitisation in that it is not necessary to pay higher rates of interest on existing deposits in order to attract marginal deposits to fund an expansion in the loan book. Further, to the extent that the assets are removed from the balance sheet, and that there is no remaining contingent liability, a bank does need to hold capital against the assets, which also lowers the bank's overall cost of funding. All this means that a bank can offer credit to its customer at a lower rate of interest.

However, depending on the nature of the risks being shifted through securitisation, it is necessary to consider the risk characteristics of what remains on the bank's balance sheet. Clearly, if low-risk assets are securitised, the average risk of what remains on the balance sheet is raised and this may lead to a rise in the cost of funding for a bank. On the other hand, the cost of funding could be reduced to the extent that, as a result of the securitisation, a bank is left with a more diversified balance sheet structure. It is possible that, while it is low-risk assets which are securitised, the effect is to lower the portfolio risk of the bank itself. It depends on the overall risk characteristics of a bank's portfolio before and after the securitisation. Accordingly, there is no universal rule about the impact of securitisation on the overall funding costs of a securitising bank.

2.5.5 Motivation for securitisation

The question arises as to what motivates a bank to securitise a proportion of its loan portfolio and to shift business off the balance sheet and transfer risk to others. Although motivations may in practice be quite complex, four general motives can be identified: (i) *asset transformation* or balance sheet management; (ii) *balance sheet constraint*; (iii) *funding*; and (iv) *fee income*.

(i) *Asset motive*: There are several reasons associated with banks' asset management which can make securitisation an attractive option. In this respect securitisation can be viewed as part of a bank's asset management strategy. Securitisation has the general effect of making the loan book more liquid to the extent that, if necessary, some loans can be packaged

and sold through securitisation. It also enables a bank to change the structure of its assets. Thus, if it judges that it has an excessive exposure to a particular loan category, it can lower its exposure by securitising all or part of such loans. In effect, a bank is able to manage risk and its exposure by passing risks on to others. Similarly, a bank may wish to diversify into a new area and yet be unable, perhaps because of a capital constraint, to do so by expanding its loan portfolio. The bank may also judge that the margins on alternative loans are higher than on those already on the balance sheet. By selling existing loans it is able to widen the overall lending margin on the balance sheet without expanding the balance sheet in total. The leverage effect is also greater through securitisation as a means of acquiring new assets than through expanding the balance sheet.

(ii) Balance sheet constraint motive: Clearly, if a bank faces a capital constraint (i.e. it has insufficient capital to support its existing assets), the capital ratio can be raised without injecting more capital into the bank through securitising some of its assets and removing them from the balance sheet. The bank may also use securitisation as a means of dealing with an existing interest rate or maturity mismatch. Some banks have been simultaneously securitising assets and repaying capital to shareholders, as the rate of return on assets is insufficient to generate the required rate of return on capital. In other words, in some cases securitisation is a reflection that banks have assets on their balance sheet that are insufficiently profitable.

(iii) Funding motive: As already noted, a major motive for securitisation may simply be to tap alternative sources of funds (which would not be available to a bank except through securitisation) and to lower the cost of funding. Either way, securitisation can be regarded as a competitive strategy for a bank operating in a highly competitive market place.

(iv) Fee-income motive: Because a bank earns fees through securitisation, this may in itself be a motive for securitisation. Securitisation need not be a “once-off” transaction. A bank may regard securitisation as an ongoing process through which it continues to make loans which it has no intention

of keeping on the balance sheet. In other words, this is also part of a bank's competitive strategy in that it is using its comparative advantages (originating loans, etc.) to earn fees through lending which does not imply expanding the balance sheet.

There are several reasons for securitisation to have developed in some markets in recent years:

- In some cases banks have faced a capital constraint;
- Banks (and shareholders) have become more aware of the requirement to earn a sufficient rate of return on capital from their business. The capital market has become more demanding of banks in this regard, and some banks have found that some of their assets are not sufficiently profitable to meet the capital market's (and shareholders) demands;
- Competition has reduced the profitability of some lending business;
- The demand for high-rated securities has risen in some countries (such as those which are created in securitisation programmes);
- Banks have sought to diversify their sources of funding;
- Competition has put pressure on banks to minimise the cost of funding;
- The development of rating agencies has facilitated securitisation.

The motivation for securitisation is particularly strong when balance sheet margins are low and the cost of capital to a bank is high. This suggests that banks may not always be the most efficient agents to fund loans and hold them on the balance sheet, even though they have many other strengths in the lending process.

It is almost certainly the case that in many countries banks have assets on their balance sheet that could be funded more cheaply in the capital market. It is likely that, as competition intensifies, banks will be forced to address this issue and securitisation will be one way of doing so.

2.5.6 Some risk characteristics of securitisation

The risk characteristics of securitisation are more complex than a simple issue of passing on risks to others. Reference has already been made to the effect which securitisation may have on the overall risk profile of a bank. This depends crucially on the type of risk which is shifted through

securitisation and also on the nature of a bank's overall portfolio before and after securitisation has taken place.

A further dimension is that risks are shifted towards institutions which are less regulated than banks. This may have systemic implications. However, the implications may be deemed acceptable simply because of the special nature of banks (and their systemic role), which creates a case for regulation which does not apply to SPVs or other institutions. In this sense, securitisation implies less credit risk being absorbed by banks.

There are also *adverse selection* and *moral hazard* risks to be considered. As for the former, banks may have an incentive to select for securitisation those assets which are particularly risky, and even more risky than the average for their class. At its extreme, there may be an incentive for a bank to behave recklessly by deliberately making poor quality loans because it has no intention of keeping them on the balance sheet since, through securitisation, it is able to pass on the risks to others.

There may also be a moral hazard in that, as the risks have been shifted and yet the monitoring of borrowers and administration of the loans are still conducted by the selling bank, the bank may be induced to take less care in both areas because it will not suffer the consequences.

While these dangers exist, and need to be guarded against, there are several protections. In the first place, a bank's own reputation is at stake. It may be able to securitise bad loans on one occasion but not do so continuously, as its reputation will be harmed, and the risk characteristics of past behaviour will be reflected in the price of securities. Secondly, a bank offers credit enhancement to a portfolio. Thirdly, a rating agency is almost invariably involved and its role is to make an objective assessment of the risk characteristics of a programme.

2.5.7 Implications of securitisation

Securitisation could lead to a reconfiguration of banking. Even with widespread securitisation, the incremental value of banks can largely be preserved. Banks will originate and service assets, while also processing the attendant risk in order to sustain these activities. Banks will therefore

continue to screen and monitor borrowers, design and price financial claims, and provide risk management services. For these reasons the relationship between banks and the capital market has become both competitive and complementary.

2.6 Segmentation and channels of distribution and access

From the start an analytical difference should be drawn between channels of distribution and those of access. In distribution channels the financial institution tries to reach its clients, while with access channels the clients try to obtain the various services offered by financial institutions (particularly credit facilities and payments services). The efficiency of financial institutions is reflected *inter alia* in the sophistication of their distribution channels and the way they perform market segmentation, while their effectiveness is shown by the degree to which people have access to basic financial services.

Usually segmentation strategies go hand-in-hand with specific channel strategies. For instance, in many industrial countries the heritage of geographic, rather than client-based structures, has resulted in undifferentiated branch networks which do not lend themselves to pinpointing profit responsibilities. Likewise, the failure of the banking industry to give access to unsecured credit to smaller individuals and corporates has resulted in increased “grey market” activities such as loan sharking and a highly fragmented microlending sector.

Ultimately segmentation strategies try to determine the customer value proposition. Segmentation is the basis of all customer-focused strategies (e.g. sales effectiveness). Traditionally segmentation frameworks have been based on *demographic* variables (such as life-stage, life event, age and income, ethnicity, etc.) and *attitudinal* variables (such as investment horizon, risk preference, price-sensitiveness, convenience-orientation or the relationship-oriented *versus* the product-oriented), but now the emphasis is increasingly on *profitability*. Clients can be segmented into various groupings depending on the profit made per client account. Once the profit profile of customers is known, the distribution channels of a

bank can focus specifically on the more profitable clients. The result is that segmentation strategy becomes highly dynamic and multi-dimensional, in the sense that product, price, channel, service, people and communication dynamically interact to maximise the customer value proposition. For some financial institutions this may imply that bank distribution channels have to be strictly separated from those of insurance distribution channels (e.g. the European banking model), while for other institutions it may be more profitable to integrate the distribution channels fully (e.g. the agency model followed by some South African banking groups).

Technology has a major impact on the way banking and financial services are delivered. In particular, it reduces the dependence on the branch network as a core delivery mechanism. In this respect, what historically has been one of the major competitive advantages of banks (the branch network which acted as an effective entry barrier) may have become one of their most difficult problems, as a significant part of the cost structure is determined by the basic infrastructure. With the development of new technology, a wide range of alternative delivery mechanisms becomes available and most especially through electronic media: ATMs, fixed and wireless telephone, home banking, interactive television, proprietary PC-based services, interactive multi-media kiosks, the internet, etc.

The likely future pattern is that banks and other financial institutions will develop delivery matrices with differentiations made both between products and services on the one hand, and different customer groups on the other. Banks will offer a choice of access routes. Thus a given service will be offered to different customer groups through a range of alternative delivery channels, and a given customer will also use a range of alternative delivery mechanisms. *Choice in delivery will be a key element in successful competitive strategy.* However, this is likely to be expensive as, to allow for customer choice, excess capacity may be needed in each delivery mode. This in turn is likely to lead to explicit charging for different delivery mechanisms. In addition, new types of branches are

emerging: machine-based; video conferencing with access to staff; “banking malls”; multi-media kiosks. Their location is also changing as some banks seek to place some types of branches in strategic locations such as stores with a substantial customer throughput. Developments in technology mean that financial systems are substantially over-supplied with infrastructure and overlapping delivery systems through a duplication of branch networks. Delivery strategies will be developed at two levels: a rationalisation of the branch network; and diversification in the structure of delivery systems.

Direct banking falls into two categories: (i) *telephone-based*: financial firms offer terms and conditions which are similar to their branch-based accounts, but attract customers with the convenience of a telephone service which is manned at all hours of the day, every day of the year; and (ii) *postal-based*: banks target large deposits by offering above-average rates of interest, offset by the low costs of running efficient processing centres which handle postal business only. In many other countries there has been a clear shift towards direct lending by banks and other financial firms, which is generally less costly than traditional delivery routes through the branch network. Direct lending is set to become a major form of delivery in the financial services sector. One estimate in the UK suggests that around 20 per cent of mortgages could be marketed through the direct route.

2.7 Cross-subsidising and other pricing policies

Cross-subsidisation is a common pricing strategy in multi-product firms, including banks. This necessarily implies an ability to segment markets. As competition intensifies, however, and particularly as economic or regulatory entry barriers are lowered, it is frequently “subsidising” markets⁹ which are targeted by new entrants, which erodes the “excess profits” earned by existing suppliers. This in turn forces a change in pricing strategies.

Traditionally, pricing has not been a major feature of competitive

⁹ Markets for those products or services which subsidise others.

strategy in retail financial services. However, the pricing of financial services has recently become a strategic issue and will become more so in the future. In addition to pricing becoming a more significant issue, there has been a growing consumer demand for more transparency in the pricing of financial services, and regulators have also demanded greater disclosure. Disclosure is itself a factor increasing the extent of price competition.

The general prediction is that, as competition develops further, the potential for banks and financial firms generally to engage in cross-subsidising pricing behaviour will be eroded. Overall, competition is likely to lead increasingly to an unbundling of financial products as competition develops within the different components of bundled products.

For all practical purposes, cross-subsidising has lost most of its power as a financial instrument in strategic planning. The threat of competitive “cherry-picking” has led to the process of deconstruction¹⁰ being accepted and established. Instead pricing policies are instruments used to favour or discourage a client in the purchase of certain products. The more efficient and liquid the market, the less scope for the firm to deviate from the ruling market price. Accordingly, pricing policies are used in respect of fine margin differences in the wholesale markets, while somewhat greater deviations are possible in the retail market (e.g. pricing policies still work well in the market for fixed versus variable-rate mortgages).

2.8 Regulatory capture

In the past regulatory capture and cross-subsidising often went hand-in-hand. The politicians in essence “demanded” of the banking industry the cross-subsidising of certain services for their voters, which the banks did in return for reduced levels of competition (without which such cross-subsidising would be impossible).

However, with the ongoing lowering of entry and exit barriers in banking today, the opportunities for regulatory capture have been reduced correspondingly. Moreover, the efforts of the regulatory authorities to

¹⁰ As stated previously, bank products (such as loans) are unbundled or decomposed into their basic components, each of which can be priced and supplied separately.

create “a level playing field” have reduced the scope for regulatory capture in that the enlarged competition is keen to ensure “fair play”.

Today the relationship between the regulator and the regulated has changed fundamentally – at least if compared with, say, a decade back. The emphasis is now on cooperation rather than regulatory capture. This difference is seen clearly, for instance, in risk management. No longer is the argument about the statutory capital adequacy ratio as such – instead capital adequacy is determined by the private sector’s value-at-risk models, where the quality of these models *inter alia* determines the ultimate quantity of capital to be kept by a bank.

3. EFFORTS TO IMPROVE THE EFFICIENCY AND EFFECTIVENESS OF THE SOUTH AFRICAN FINANCIAL SYSTEM

It is an illusion to expect that only large and highly diversified banks will surface in the strongly competitive environment which will emerge in the next few years. Instead success is likely to be determined by considerations peculiar to a bank (i.e. management efficiency, etc.).

Constituting only a small percentage of the global financial industry, South African banks have often little option but to adjust to international trends and standards. Although the aims of the financial industry are similar across the world, there still are major national differences in the way these goals are pursued. In this section the extent to which South African banks align their specific instruments to enhance their efficiency and effectiveness will be analysed.

3.1 Organisational structure, information management and cost-control management

Although the days of fully-fledged universal banking are waning, it will probably take a few years more before the South African financial industry is fully organised along the lines of financial conglomerates. The driving forces behind a conglomerate structure are better business focus, better cost-control management and an improved incentive structure for

top management. Currently most commercial banks in South Africa are already operating in competition with large separately capitalised securities firms (investment banking) and it seems only a matter of time before this trend will be followed by all.

Compared with abroad, the move by South African banking conglomerates into the development of insurance products has been relatively slow. One factor has been the statutory limitations on cross-ownership between banking and insurance companies. Another is that the major insurers are well-entrenched in their markets. Accordingly, banks have found it easier to enter the insurance market as agents (particularly in long-term insurance). For instance, the insurance brokers of Absa sell the products of various insurers and fund managers on an agency basis, while most other banking groups are selling only specific products.

Nevertheless, in the medium term, and now that regulatory changes in cross-ownership have made this possible, banking groups may well diversify into the development of insurance products (through 100% - owned subsidiaries) and *vice versa* insurance groups into banking. Banking groups will then exclusively sell own-branded life products through their branch networks. The strategy will be to sell through these traditional channels appropriate products targeting each market segment. For example, Nedcor is currently restructuring its insurance business with the intention of developing its own insurance products and selling them to its client base. Ultimately this will lead to competition between large financial conglomerates (i.e. the European *bancassurance* model), which – usually for historical reasons – may have either a greater or lesser exposure to banking or insurance.

With significant sections of the financial services industry now moving towards non-financial services companies (e.g. credit card business), only banking firms operating in the structure of financial conglomerates are able to compete effectively with such competitors. Increasingly banks are likely to diversify the supply of financial services through non-financial subsidiaries and of course by means of joint ventures. Here the financial conglomerate structure has major advantages over the universal banking

model in that the separately capitalised subsidiaries can be managed and sold separately, should changing economic conditions demand this. Moreover, with the unbundling of complex pyramid holding companies on the JSE, banks may be forced, for competitive reasons, to securitise larger parts of their traditional business.

In years to come South African banks will have to adjust to a far lower cost structure (say, a cost-to-income ratio well below 50%) to compete effectively with foreign competitors and microlenders (such as the black-empowerment group Theta, which operates on a group cost-to-income ratio of well below 30%). Worldwide, the banking industry is adjusting to the more efficient Anglo-US organisational structures, and the quicker this change-over occurs, the earlier South African financial institutions can enjoy the benefits and compete head-on with foreign institutions.

3.2 Rationalisation, joint ventures and subcontracting

Currently the average ROE of the South African banking sector is around 15%, with the leading commercial banks displaying ROEs in the region of 20%. This compares favourably with ROEs of about 10% in Germany, 14% in the US, 15% in Switzerland, Italy and France, but is less impressive compared with the average ROE of about 20% in the UK and Ireland¹¹.

However, the high ROEs of South African banks should be seen against the background of relatively high real interest rates and relatively low levels of statutory capital. The cost of secondary equity capital for most commercial banks is about 17% p.a. (i.e. real rates of about 9% p.a.), on which it is very difficult to achieve a positive yield (as the current ROE is too close to the cost of equity capital). Likewise, most South African commercial banks keep regulatory capital of about 10% of their risk-weighted assets, which is lower than that of top overseas banks. For instance, Investec's single-digit ROE is directly linked to its tier-one capital ratio of close to 16%.

¹¹ Since the beginning of 1990 bank shares on the JSE have risen by 22,4% p.a., compared with 10,7% p.a. for industrial shares. Clearly both from an international and a local perspective, the financial services industry in South Africa has done well over the past decade.

It is expected that increased competition and lower inflation will result in lower cost-to-income ratios, lower net interest margins and more modest growth in bank assets. These developments are bound to place severe pressure on the ROEs of banks, which in turn may enforce a total re-evaluation of their organisational structures. For instance, businesses that do not make the hurdle rate of 15% on their ROEs may have to be sold-off (i.e. rationalised), while securitisation may well result in the outsourcing of many traditional banking functions. Moreover, the close business interaction between financial services groups and companies specialising in retailing, data processing, information management and internet technology may result in various large-scale joint ventures ranging from virtual banking to the sale of even more and a larger variety of banking services in retail stores.

3.3 Consolidation and globalisation

Already the South African banking industry is highly concentrated, with the top six banking groups accounting for more than 85% of all bank assets. However, further consolidation is being proposed or is on the cards.

The trigger for further consolidation could be the anticipated fall in banks' cost-to-income ratios, lower interest margins, and the impact of AIDS on banks' operating expenses and bad debt exposures. To cope with these cost pressures (aggravated by increased foreign competition from the money and capital markets in London as well as from the 70-odd new foreign banks operating in the local market since 1994) major rationalisation and consolidation may be required, which is likely to be achieved more easily through the merger and acquisition of existing groups. In addition, the possibility should not be excluded that two of the large commercial banks will obtain a major foreign shareholder, should Old Mutual and Anglo American respectively decide to divest their local banking interests. Anyhow, if and when two of the major local banking groups merge, it is likely (considering international experience) that such an event will trigger further consolidation actions in the South African financial services industry. Moreover, should the capital market (i.e. the

Bond Exchange of SA) succeed in developing a better commercial paper market, excess capacity may be created in corporate banking, which in turn will fuel consolidation trends.

Current exchange control regulations, as well as the emerging market premium – currently some 50 basis points over interbank dollar funds – are still curtailing the true globalisation of South African financial institutions to a large extent. Limited foreign operations can be carried out (e.g. in Europe, and particularly in the UK), but overall no real globalisation is likely to take place except perhaps in fund management. Partnerships with foreign firms in joint ventures may be a more viable alternative.

Rather than South African financial institutions investing on a major scale abroad, it is more likely that local institutions will be included in globalisation through foreign involvements in local markets. Again the trigger for this development could be the expected fall in bank profitability during the next decade and thus lower P:E ratios for South African bank shares. Generally speaking a relatively low share price makes any company vulnerable to hostile takeovers and South African banks are no exception to this rule.

Traditionally, South Africa always faced major competition from the London securities markets (i.e. a financial centre in the same time zone). In fact, up to the Second World War, the South African money and capital markets were *de facto* located in London, and it seems that large South African companies are now completing a full circle by relocating significant parts of their business to London. Not only are blue chip corporates applying for primary listings in London, even more of the securities trade could move to London when remote trading is allowed on the JSE (as is the case in, for instance, Amsterdam, Frankfurt, London and Paris).

Considering the advantages of London – such as massive market liquidity, a great pool of skilled labour, a high degree of trading efficiency (owing *inter alia* to arbitrage transactions in related international markets) and the fact that distance means little with today's electronic markets –

there seems no firm commercial reasons for South African banks not to seriously consider relocating their treasury operations to London. Anyhow, the pressures of globalisation are primarily global rather than country-specific and the typical South African problems of massive crime, restrictive labour laws and AIDS may even accelerate a relocation of the securities markets.

Generally speaking, it is better to face the competition head-on (i.e. in the lion's den of London) rather than fighting a type of shadow battle in the backwaters of Johannesburg. Should these developments indeed materialise, the wholesale markets will be dominated by London, while the local money and capital markets will operate as a type of "derivatives market".

3.4 Diversification, securitisation and monitoring techniques

The question of how to develop a proper bancassurance company (within the context of a financial conglomerate) is the key to South Africa's diversification strategies. Compared with the European bancassurance model, the synergies between banking and insurance in South Africa remain intriguing in the sense that insurers, as shareholders, have operated largely on an arm's length basis with their banking colleagues. Even today banks sell life and non-life insurance products largely as brokers, marketing a wide range of products from several suppliers.

There are a number of reasons for the current agency model to change in South Africa:

- The effective concentration of control by major investment groups, using pyramid structures, is slowly coming to an end. Besides the black empowerment groups, which are all based on pyramid structures, other pyramids on the JSE are coming under pressure as the local market is becoming increasingly subjected to international standards (which are hostile to pyramids) and increased foreign competition (as the years of political and economic isolation have come to an end).
- The demutualised insurers, i.e. Sanlam and Old Mutual, will now face the scrutiny of local and foreign investors. These insurers may well find that their large exposures to commercial banking are not the

most lucrative investments imaginable, particularly measured against international standards.

- High real interest rates are not only anti-inflationary, but also do not promote life insurance products with their (ever smaller) “bonus” payments.
- The lower inflation rate and its rapid fall during the last few years are making “bonus-linked” insurance products less profitable (as these products were designed on nominal rather than real values).
- Insurers’ life premium business is losing market share to the unit trust industry, which is more transparent and operates on lower costs. Moreover, unit trusts are sold on the basis of relative performance.
- Banks may become increasingly hesitant to give their brokers access to their branch clientele in order to sell insurance and fund management from competitive institutions.
- Like their European counterparts, South African banks may conclude that banks’ distribution channels have to be separate from agency and broker channels in terms of price and product profile.

With the profitability of insurers under pressure and competition increasing, it is to be expected that the current agency diversification model used by South African banks will be critically re-examined. As South Africa becomes increasingly subjected to international competition, the initial objections to the European bancassurance model – i.e. inability of branch staff to cross-sell, legal constraints and pressure from insurance shareholders – will wear thin. Banks do have the distribution channels to sell both banking and insurance products. The legal constraints to bancassurance have already been addressed by the regulatory authorities, while insurance shareholders may well wish to switch their historical portfolio preferences if they are scrutinised by international investors.

Clearly, cross-selling will not be easy and not without major costs, but ultimately it is expected that South African banks will slowly move from their agency diversification model to the European model of product development and thus proper bancassurance. Such a move may also result in the merger of fund management units, which offers the potential of both cost savings and possible performance improvement.

Besides increased cross-selling of products within a financial group, the South African financial services industry may try to diversify to other countries. Should South African banks succeed against all the odds, they will be able to earn a bigger slice of their income abroad. Investec already obtains almost half of its earnings from Europe, while Stanbic gets a useful 10% of its net income from sub-Saharan Africa.

In times to come further financial disintermediation and securitisation are expected (particularly in the commercial paper market). For instance, by copying Aussie Home Loans, SA Home Loans tried to slash mortgage margins by 2–3% by way of securitisation in early 1999. Although still a minor operation of R500m, SA Home Loans could be the beginning of a major trend change. Of course, South African banks are also major players in the securities markets in their own right, but the success of securitisation is nonetheless gained at the cost of banks' net interest rate margins and therefore their main business.

Competitive pressures will intensify and this is likely to squeeze bank margins to the extent that some business normally held on banks' balance sheets will no longer be profitable. Related to this, the capital market is likely to become yet more demanding of banks, requiring an increasing rate of return on equity. This also means that banks may need to become more selective about the types of assets held on their balance sheets. Banks facing more intense competition are likely to use securitisation to restructure their balance sheets more efficiently and concentrate more on fee-income business.

Diversification and securitisation are bound to put even more pressure on South African corporate banks in time to come. This market segment is clearly "overbanked" at present. Ultimately even the rating agencies could be seen as competitors of banks in that they are bound to take over significant parts of the client monitoring process which traditionally were considered as bank business (e.g. rating agencies, in their client monitoring role, are crucial to the commercial paper market, which in turn is in direct competition with the business of financial intermediation by banks).

3.5 Segmentation and channels of distribution and access

During the next few years, strategies in respect of segmentation and channel management will play a dominating role in South African banking. The pressure is clearly on to identify as quickly as possible the profitability profile of clients. There is little debate in South Africa that the more profitable clients should be serviced with better channel management and better information (*inter alia* more transparent information), while unprofitable clients should be made profitable by supplying cheaper access channels.

The main outstanding questions in segmentation and channel management are currently the following:

- *Should banking channels be separated from insurance channels?* In essence the question here is whether South African banks want to follow the European bancassurance model (with own development of insurance products) or whether they prefer to continue with the agency diversification model (i.e. also selling the products of competitors).
- *Should insurance brokers be allowed to utilise the banks' branch information flows?* Any decision here has major ripple effects. Should insurance brokers lose their bank outlets and information flows, insurers will either be forced to tie up with other banks in an exclusive relationship (i.e. buying a bank distributor) or to watch their traditional bank broker network shrink. As insurers need banks much more than the other way round, it is not surprising that in the European market banks have won major market shares for their own branded life assurance products during the last decade.
- *Should the banking sector develop a specific access channel to address the competition of black-empowerment-sponsored micro-lenders?* Although providing banking services to the "unbanked" (i.e. about half of the South African population) is still a minor part of total bank business, the emergence of black empowerment groups cannot be ignored much longer. "Payroll"-lending can provide a very lucrative market, provided management stays close to its client base and cost structures are kept well below the cost-to-income ratio of 25%

(by using *inter alia* modern banking technology and the payroll collateral system). Obviously, the current poor access channels for the “unbanked” have to be improved not only for competitive reasons, but also for strong political reasons. Perhaps the future will see more joint ventures between formal banking and informal micro-lending operations.

- *To what extent will unbundling and outsourcing of traditional (non-financial) banking services improve distribution channels and market segmentation?* To mind comes “virtual banking” on the internet, the impact of mortgage securitisation, the supply of client information by banks’ economic and tax units or, for instance, joint ventures with retailers and high-tech companies.

As segmentation strategies ultimately centre on the client value proposition, the broad strategic philosophy of a bank will be reflected by this to a large extent. It is unlikely that there will be one “best strategy” in this respect, as the strengths and weaknesses of every bank differ materially.

3.6 Cross-subsidising and other pricing policies

Today most South African retail banks lack a precise view of what products and services are truly subsidised. Of course the more extreme forms of cross-subsidising have already come to an end, as the no-interest-bearing cheque accounts and the like have adjusted in price to their competitive alternatives.

However, within the next few years transfer-pricing technology will make the true extent of cross-subsidising much more transparent. It will then be only a matter of time before the competition will attack with better prices on those products currently used to make such cross-subsidisation possible in the first place.

Cross-subsidising of certain bank products (such as mortgage finance and bank fees to the broad public) is often favoured for political reasons, in that it broadens the scope of individuals using the financial system. However, a truly efficient market would make the cross-subsidising of

financial services impossible. Accordingly, as the efficiency of the financial system improves (owing to *inter alia* globalisation, consolidation and securitisation), the possibilities of cross-subsidising and other pricing policies (which implicitly entail a deviation from the market equilibrium price) will become progressively difficult to execute.

As the efficiency of the financial system increases, there will be less room for pricing strategies, i.e. competition will move to other areas than price, for instance, investment and retirement advice, educational information, etc. South African banking seems to be proving no exception to these global trends and as a strategic instrument the value of pricing policies is becoming less powerful (i.e. they can be used on the margins only but no longer in the grand design).

3.7 Regulatory capture

Over the years a close working relationship has been established between banks and banking sector regulators. Considering the dangers of systemic risk in the financial system at large and the fact that monetary policy is implemented through the private banking sector, it is unlikely that this unique relationship will change greatly.

However, even in South Africa the position of the banking sector regulator is changing. Foreign banks operating in South Africa demand “regulatory neutrality”. In future insurers may well become members of the payments system and the lender-of-last-resort facility may be expanded to include securities firms, while international regulatory harmonisation will require a level playing field for financial service companies in general. In such an environment it becomes more difficult for banks to capture their regulator. As a strategic instrument, regulatory capture like cross-subsidisation, seems to have had its day. Instead regulatory standards will be increasingly set by international regulatory bodies, while country-specific issues will be the exception rather than the rule.

Chapter 5

DEFENSIVE AND OFFENSIVE STRATEGIES IN BANKING

1. INTRODUCTION

The related pressures of asymmetric competition, falling entry and exit barriers, deregulation, financial innovation, technology and more demanding consumer preferences are, in various ways, eroding some of the comparative advantages of banks in their traditional financial intermediation business. They are also transforming the fundamental economics of banking.

Banks are no longer the exclusive suppliers of banking services. There are many traditional activities of banks which can now be undertaken equally well by markets and other types of financial and non-financial companies. However, with the exponential development of information, trading, processing and delivery technologies, the value added in the banking business is increasingly moving away from banks to specialist technology companies.

The pressures impinging on banks are changing all aspects of banking business and the fundamental economics of banking. They have the potential to transform:

- the structure of the industry;
- the relative role of financial markets and institutions;
- the type of business undertaken by banks;
- the type and range of institutions conducting banking business;
- the range of competitors to banks and the strength of competition; and
- the way in which traditional banking business is undertaken and delivered.

Because of deregulation, banks in some countries are losing their dominant role as deposit-takers and lenders to companies. Financial innovation and technology are eroding transaction and information costs and market imperfections, which have been the basis of banks' efficiency over direct credit markets. In addition, trends in banks' own cost structures may have eroded some of their comparative advantages.

In short, the value of the banking franchise is being eroded, i.e. banking markets are less the exclusive preserve of banks. Although the pressures on the banking industry are substantial, this does not necessarily mean a pessimistic outlook for banking firms, as their business is likely to change towards the provision of a wider range of financial services relative to the traditional financial intermediation and on-balance-sheet roles. Banks are not so much in decline as recreating themselves in a different way. The successful development of corporate strategy is ultimately a question of defining comparative advantages and developing alternative ways of exploiting such advantages. Thus, while banks may continue to have information advantages with respect to their customers, this does not necessarily mean that these are to be exploited only in the form of making loans and/or holding loans on the balance sheet. Information advantages can be exploited in many other ways, such as servicing capital markets. While banks may lose market share in some of their traditional markets, they will gain and develop other business and use their core competencies in different ways.

Currently there are two contrasting views about the future of banks. At one end of the spectrum there is the view that banks are losing their historic comparative advantages and that their role in the financial system is in permanent decline. The alternative view is that the pressures operating on the banking industry are transitory and that many of the new entrants will find they have no enduring core competencies in financial services. The truth is likely to lie somewhere in between. Banks will continue to be subject to secular pressures which are moving against them. They nevertheless retain powerful core competencies and these can be

exploited in new ways and in different markets. Banks' core competencies will limit the extent of any secular decline.

This may, however, require a radical review of what business banks are conducting and how core competencies can be exploited for competitive advantage. It may also require a restructuring of banking firms. The topics on hand are analysed along the following lines in this chapter: section 2 develops the concept of an overall matrix embracing (i) the external pressures on the banking sector; (ii) the consequences thereof for the banking industry; and (iii) the defensive and offensive strategic responses of banks. The proposed matrix is only a crude generalisation of a complex issue. For instance, both the external pressures and the consequences thereof for the banking industry are interrelated. Moreover, wherever a line is drawn in the sand (i.e. marked by an asterisk in the matrix), a potential border dispute is created. It needs to be repeated that the exposition in section 2 is foremost of a conceptual nature and significant refinements could be made in such a framework. Section 3 focuses in greater detail on the underlying pressures of change, namely regulation, technology and consumer preferences. These external forces are fundamentally and rapidly changing the economics of banking. Lastly, sections 4 and 5 look briefly at a few of the strategic responses of banks to these new business challenges.

2. THE “SECULAR PRESSURE / STRATEGIC RESPONSE” MATRIX

Banking as an industry and banks as firms are likely to face substantial structural change over the next decade. There are a number of reasons for the changes in national banking systems possibly being so substantial:

- a powerful *combination* of pressures operating on the banking industry;
- some of the pressures (notably technology) challenging the core of financial business; and
- with entry and exit barriers continuing to diminish, competition is not only intensifying but is coming from new types of competitors.

It is largely changes in regulation, technology and consumer preferences that are transforming banking and changing the fundamental economics of banking. For instance, changes in regulation (i.e. both deregulation and reregulation) greatly affect the competition from non-financial banking institutions (such as supermarkets). They increase the potential for deconstruction (i.e. the unbundling of products and processes into their component parts, which in turn allows for “cherry picking”). They lower entry barriers as new entrants are not required to offer entire service or product ranges. They enforce more comprehensive disclosure and a code of business conduct on banks, while at the same time the authorities give less regulatory protection. Last but not least, regulation sets new “fit and proper” standards (including corporate governance and/or deposit insurance requirements) which in turn not only lower the exit barriers from banking, but also give greater confidence to investors.

Likewise technology is a major source of change in banking, as it affects all the core competencies of a bank, namely its technological expertise in areas such as information analysis, processing, risk analysis, monitoring and delivery. Moreover, technology enhances the strength of the securities markets *vis-à-vis* financial institutions. Markets are often able to compete very successfully with banks in the supply of credit.

The third fundamental cause for change in the banking industry is the enhanced position of the consumer who is demanding better quality products and services; more transparency (particularly in product, price and fee structures); integrity; competency; and better access channels. Often regulatory “fit and proper” standards go hand-in-hand with investor protection issues and consumer preferences. Accordingly, consumer demands and regulatory requirements are increasingly intertwined.

Faced with these challenges, the banking industry’s strategic responses have been both defensive and offensive in nature, depending *inter alia* on the country or the specific firm. Those banking firms who prefer to wait for better business opportunities in times to come generally have adopted defensive strategies (such as improved cost-efficiency strategies). In contrast, more aggressive banking firms have elected to beat their

opponents immediately, with offensive strategies usually involving major expansionary strategies (i.e. large-scale consolidation, diversification and globalisation strategies).

The matrices reflected in tables 1 and 2 (p. 163 and p. 178) give a bird's eye view of the interrelationships between (i) general secular pressures (which are operating on nearly all industries today – i.e. changes in regulation, technology and consumer preferences); (ii) the impact of these changes on the banking industry specifically (e.g. lower entry barriers, better information technology or consumers demanding better quality investment products and financial advice); and (iii) the defensive or offensive business strategies developed by banks in response to these secular pressures.

The matrices do not reflect any interaction between the secular pressures. For instance, financial innovations such as the Internet will have a major impact on finance, not only because it will improve access channels to consumers, but will improve information flows to investors, and has the potential to undermine exchange control regulations. Accordingly Internet banking will in time enforce changes in financial regulation, enhance the position of the consumer, and result in very different information and processing technologies. Likewise there is a close interaction between the various specific pressures impacting on the banking industry. For example, lower entry barriers result in increased competition (often of an asymmetric kind) and greater contestability both in financial markets and products.

From the banking industry's point of view all these pressures on business are a given. What banks do have in hand are various business instruments which can be combined in specific business strategies. The matrices show two classes of strategies, namely defensive and offensive strategies. In a defensive strategy a firm is internally focused and usually tries to obtain cost or organisational efficiencies; i.e. it is using available time to improve the inner workings of the enterprise, while waiting for business opportunities to arise. In contrast, an offensive strategy is trying to beat the opponent (i.e. the competition). Time is now of the essence, as

the ultimate strike has to be made within a well-defined time frame (because opportunities evaporate with time as the competition moves in). However, the matrices are unable to reflect the close interaction between defensive and offensive strategies. For instance, an offensive strategy usually flows from a successful defensive strategy in a previous period, i.e. no offensive strategy is likely to be successful unless a firm has strong operational, cost and organisational efficiencies. As in chess, an offensive strategy does not imply that the defence can be ignored, although a firm cannot be on the defence and on the attack at the same time.

Table 1 (p.163) presents ten defensive strategies, namely:

- exploiting the core competencies of banks (which other non-bank competitors do not have by nature of their businesses);
- contract banking;
- economies of scale and X-efficiency;
- supervision and incentive structures;
- segmentation;
- cross-subsidisation
- share buybacks
- compliance arrangements;
- corporate governance; and
- regulatory capture.

In each of these ten strategies the various business instruments discussed in the previous chapters are used in different combinations.

Likewise eleven offensive strategies are presented in table 2 (p.178), namely:

- diversification;
- globalisation;
- consolidation and M&As;
- securitisation;
- commoditisation;
- pricing and gearing;
- risk analysis systems;
- information management;

- distribution channels;
- organisational structure; and
- joint ventures.

In short, the secular pressures confronting the banking industry are a given, while the various business instruments are combined in specific business strategies to address these short- and long-term challenges. The art of strategy is to combine the business instruments in the most efficient and effective way. Sections 4 and 5 below give an overview of how some banking institutions responded to the secular pressures confronting them. Various strategic responses are of course possible and the ultimate choice of strategy is dependent on *inter alia* the specific strengths and weaknesses of a banking firm and the type of national jurisdiction under which it operates. Accordingly the conceptual relationships indicated in tables 1 and 2 are specific to one particular banking firm only and may even change over time – in essence tables 1 and 2 summarise one specific approach on how to face secular pressures in the banking industry, although other, and even better, combinations are also possible. Usually the better the problem is understood, the better the strategic response: indeed, the further a firm can look back, the better the firm can look forward. With strategy, a firm often has to place itself beyond the immediate problems of the day, because “if it stays inside the frame, it does not see the picture”. Therefore, section 3 will first investigate in somewhat greater detail the secular pressures, and only thereafter attention will be given to a few defensive and offensive strategies.

3. SECULAR PRESSURES FACING THE BANKING INDUSTRY

In broad terms banks are confronted with three secular challenges, namely:

- changes in financial regulation;
- improved technology and ongoing financial innovation; and
- more demanding consumer preferences.

In respect of regulation, the last two decades have seen major changes in the minimum standards of risk management and corporate governance rules. Today, any firm that is able to fulfil these minimum entry requirements can request a banking licence, which has resulted in significantly lower entry barriers. Likewise, exit barriers are forced down by means of regulation. For instance, deposit-insurance schemes imply that the authorities can quickly close down a bank if they do not have to worry too much about the savings of small investors. As a result new entrants (both local and foreign firms) are entering banking markets, competition has increased sharply and cross-subsidising becomes almost impossible, while in the process more excess capacity is created, which in turn increases the competition to even higher levels. To face the often asymmetric competition of non-financial banking firms (such as supermarkets) financial firms are increasingly unbundling and deconstructing their products, which ultimately results in very contestable markets and products. Last, but not least, the role of the state in safety-net arrangements has changed fundamentally over recent years. Increasingly the state is dependent on the use of financial markets rather than pay-as-you-go schemes, which also changes its approach to financial markets in general.

Of course, banks themselves can have a major influence on financial regulation, technology and consumer preferences, but the secular pressures are nonetheless largely external in that, for instance, financial regulation is often more influenced by minimum international standards than by local banking preferences. Therefore banks' business strategies have to focus on these external pressures, which often have major consequences for the banking industry in general. A few of the more important consequences will be discussed in this section.

3.1 Business consequences of changes in financial regulation

Regulation has the potential to create and sustain *economic rents* and protection. This protection frequently leads to increased costs, strong profits and excess capacity. Historically, regulation in banking has been

protective and has often had the effect of limiting balance sheet growth and the allowable range of business that banks can undertake. It has also had the effect of limiting competition on the premise that “excessive competition” in banking can lead to increased risk and potential systemic hazards. Regulation in banking has often condoned restrictive practices and anti-competitive devices, and has in general had the effect of limiting price competition. In turn, profits in this regulated industry have been reasonably assured. There has been a high value to the banking franchise and risks in banking have been comparatively low, as various forms of credit-rationing have been the norm. At the same time, costs tended to rise to exploit the economic rents created by a protective environment, and non-price competition dominated price competition. This in turn created an excessive cost structure.

The universal trend today is for public policy priorities to shift towards enhancing banking efficiency through competition and in the process public policy has become less protective of the banking industry. As competition in banking becomes increasingly globalised, the ability of individual countries to remain isolated from this general trend is severely limited.

3.1.1 Minimum “fit and proper” standards

In many ways, there is an increasing international dimension to the regulation and supervision of financial institutions, and arrangements in all countries need to recognise and adapt to this trend. It is potentially hazardous for any major country to imagine that it can stand aside from international regulatory standards, and develop its own regulatory arrangements in isolation. Autarky is no longer a viable option. There is a general trend towards the international harmonisation of regulation. Therefore the international regulatory community increasingly expects all major countries (and, in some cases, less than major countries) to conform to internationally agreed approaches for the regulation and supervision of financial institutions in general and banks in particular.

However, there is a major difference between *wholesale* and *retail*

business in the sense that the requirements for incorporating the international dimension into regulation are far greater in the former than the latter. Indeed, to a large extent the regulation of retail business can be left mostly, if not entirely, to purely domestic jurisdictions where each country can choose its own regulatory requirements.

Currently the regulatory authorities are guided primarily by the International Accounting Standards Committee in respect of accounting rules, by the Bank for International Settlements (BIS) in respect of banking laws, by the International Organisation of Securities Commissioners (IOSCO) and the European Union for securities markets legislation, and by the International Association of Insurance Supervisors (IAIS) and IOSCO for insurance legislation.

3.1.2 Diminishing entry barriers

A major determinant of the intensity of competition in any industry is the strength of entry barriers, i.e. the ability of new firms to enter a particular line of business. Competition frequently intensifies in an industry, not because existing firms begin to behave differently or develop new strategies autonomously, but because an existing equilibrium and stable pattern of behaviour are disturbed by new entrants.

There are several factors leading to a decline in entry barriers in banking:

- Scale has become less important to the extent that processes can be subcontracted as, through the lower fixed costs of subcontracting, economies of scale can be obtained from specialist providers of processing services. Economies of scale are reaped in *processes* rather than firms, which means that, if processes can be subcontracted, economies of scale can be secured by firms of varying size.
- Regulation with respect to allowable business has generally become less restrictive.
- In many cases of non-financial firms entering banking business, the ease of entry has been facilitated by banks being prepared to act as partners. This is partly a case of different institutions applying their

respective comparative advantages within a joint venture (e.g. between a bank and supermarket). Joint ventures make it easier both for new firms to enter financial services markets and for existing specialist firms to diversify into a wider range of financial services.

- The development of information technology enables new entrants to access and process customer information. This is further facilitated by the ability of financial firms to develop partnership links with specialist technology companies.
- With the evolution of Internet banking, new entrants gain a competitive advantage as consumer search costs and customer loyalty are eroded with consumers gaining wider access to alternative suppliers.
- The increasing ability to securitise assets means that new entrants are not necessarily bound to hold assets on their own balance sheets.
- Developments in new forms of delivery (e.g. telephonic) enable new entrants to exploit new technology as easily as incumbents. Technology is eroding the comparative advantage secured through a branch network, which historically has acted as a powerful entry barrier to the extent that it was the dominant channel of delivery of some financial services.
- Deconstruction enables new entrants to compete by subcontracting some of the financial services processes. This lowers entry barriers in three ways: (i) new firms can compete without themselves undertaking all the processes involved in a particular service; (ii) it enables entry without substantial upfront fixed costs involved with some processes (i.e. the sunk costs for new entrants are low); and (iii) new firms are able to enter without having all of the necessary skills, as gaps in expertise (e.g. investment management) can be obtained from other firms.

Banks are increasingly looking at the core elements of their business on a stand-alone basis rather than necessarily as part of an integrated business. One of the major pressures in the banking industry in years to come is likely to be the deconstruction process in terms of which each institution concentrates on those parts and processes of the business in which it has a comparative and competitive advantage.

In a similar way, developments in the application of options and asset pricing theory, securitisation, and the evolution of contingent claims and guarantees, have led to a deconstruction of the services traditionally provided by banks into their constituent components. Some of these services can now be provided more efficiently in the capital market. For instance, the development of “pass-through” securities and securitisation in general has resulted in a separation of the origination, servicing, credit-evaluation, and pricing of credit risk from the credit intermediation function.

3.1.3 Diminishing exit barriers

While entry barriers have fallen, exit barriers for new entrants are also low, although not negligible. Low *exit* barriers for newcomers pose as substantial a competitive threat as do low *entry* barriers. New firms are more likely to enter an industry if exit barriers are also low. Entry barriers to financial services have diminished, and this is combined with low *exit* barriers for *new entrants*, but high exit barriers for *incumbents*. This combination of entry and exit barriers represents a powerful new element to competition in the retail financial services sector. New delivery mechanisms and the reduced need for a branch network simultaneously lower both entry and exit barriers for new entrants. The original need for a branch network to be effective in delivering retail financial services acted as both a high entry and exit barrier.

3.1.4 Excess capacity

Excess capacity can be evident in various ways, for instance too many banks in the industry (“overbanked”), too much basic infrastructure or too much technological capacity.

(i) Too many banks

If entry barriers are falling faster and more substantially than exit barriers, it is almost inevitable that excess capacity will emerge in an industry. However, the existence of excess capacity does not mean that new firms will not enter. If new entrants believe they have a competitive advantage *vis-à-vis* incumbents, it may still be rational to enter an industry which has excess capacity. In some areas this has occurred in financial services. The

corollary is that there is more pressure on incumbents to adjust. The manner in which excess capacity is removed in the banking industry will be one of the major strategic issues which banks will face in years to come. Compared with other industries, the concept of “excess capacity” is more difficult to define and measure in banking, as output and hence capacity is more difficult to measure.

There is almost certainly an excessive volume of capital in the global banking industry in that, given the market and competitive conditions, it is unlikely that the required rate of return on capital can be earned in the long run. In developed countries it may be that the market is not big enough to support the current volume of embedded capital in the traditional banking industry. The total volume of capital could be excessive for two reasons: (i) regulation may impose an unsustainable capital requirement on banks; and/or (ii) the business environment may have changed in such a way that the industry, as currently structured and the amount of business it is able to conduct, can no longer support current capital levels. This may be because new firms have entered or because demand has shifted away from banks (e.g. switched to the capital market).

(ii) Excessive infrastructure

“Excess capacity” also relates to the basic infrastructure and branch network rather than the number of banks *per se*. In most countries the number of branches is excessive with an implicit duplication of banking infrastructure, fixed costs and delivery facilities. This excess capacity can be reduced either by individual banks closing their branches or by merging banks and closing overlapping branches. In many recent bank mergers a central argument has been the need to rationalise the branch network. A coordinated strategy can be more effective than each bank acting unilaterally given that, in some cases, a major benefit from a branch closure may accrue to a competitor which is able to absorb a larger customer base from the bank closing a branch without adding to its own costs.

An alternative strategy, when faced with excess distribution capacity, is to attempt to supply more products and services through it. Faced with excess distribution capacity banks have two broad strategic alternatives:

reduce capacity or pass more business through existing capacity. In this respect, there is a close parallel between excess capacity in capital and infrastructure.

(iii) Technology capacity

In many areas of financial processing, the impact of new technology is twofold: it creates more substantial economies of scale (lower average costs) and it increases the volume at which the optimum scale is reached (lowest point on the average cost curve). In a competitive market, a financial firm is under pressure to minimise costs and to move to the lowest possible level of average costs. A firm which has the optimum scale with old technology may nevertheless be less economic than larger competitors with new technology. Indeed, installing new technology may (because of high fixed costs) conceivably imply higher costs at the previous optimum level of output. If a firm cannot secure maximum economies of scale, it may achieve it by subcontracting the relevant process. Thus, while the development of technology may appear to be adverse for small firms, they may be able to offset this by subcontracting (*inter alia* to other banks).

(iv) Staff

Similar arguments apply to staff. As technology and capital replace people in the economics of banking, excess staff capacity emerges. This is one of the many ways in which the fundamental economics of banking are changing. In the UK, for instance, the number of people employed by the six largest clearing banks has declined substantially over the past few years. On the other hand, in many European countries labour market laws impose constraints on the ability of banks to reduce the number of employees.

3.1.5 Banking markets have become more contestable

The power of competition to constrain the behaviour of incumbent firms in an industry is not so much indicated by the degree of competition prevailing at any point in time, than by the extent to which the market is *contestable*. A market is said to be contestable if entry and exit barriers are low, i.e. if it is easy for new firms to enter an industry but also easy for

them to exit. In such a market environment, competition is not measured by the number of firms currently in an industry. If entry and exit barriers are low, incumbent firms will be under pressure to behave as if they are operating in a market with many competitors. If incumbent firms' costs, profits or prices are excessive, new firms will easily enter and this *threat* of entry constrains the behaviour of incumbent firms.

Banking markets (rather than necessarily the banking industry) have become more contestable. The distinction is made because it is now possible for banking products and services to be unbundled and for new firms to enter some banking markets without offering the full range of traditional banking products and services. Several factors have raised the contestability of banking markets:

- All of the factors previously mentioned relating to lowering entry barriers.
- The development of information technology increases the supply and lowers the cost of information enabling new entrants to access and process information.
- Regulatory barriers have been eased as regulation has become less restrictive about the type of firms that are able to offer banking services and products and, where necessary, acquire banking licences.
- The development of credit-scoring techniques, coupled with greater access to information, enables new entrants to assess credit risks without having gained the experience through managing a borrower's bank account over a period of years. This lowers the economies of scope advantages traditionally possessed by banks.
- The process of deconstruction means that new firms can enter a market and compete without undertaking all of the processes involved in a particular product. It also means that new entrants are able to offer banking services without having to incur substantial fixed costs at the outset.
- Securitisation means that loans need no longer be held permanently on the balance sheet of an originating institution. The emergence of *contract banking* also makes it easier for new firms to enter banking

markets. A particular implication of outsourcing is that scale becomes less significant in that a small firm is able to obtain economies of scale from external suppliers of some component services.

- As new channels of delivering banking services (most especially electronic) have emerged and developed rapidly, the branch network (traditionally an entry barrier) has become relatively less significant. New entrants are able to offer banking services without the necessity of an extensive and costly branch network with concomitant heavy fixed costs.
- In some banking markets (notably wholesale lending) the steady globalisation of banking markets has made local markets increasingly contestable as large-scale borrowers have access to global banking markets.
- The development of Internet facilities for banking products and services has clearly enhanced the contestability of banking markets, by lowering the marginal cost of financial transactions, search costs, information costs and price discovery. Above all, the Internet means that search costs for consumers and advertising costs for suppliers have been lowered substantially. It also means that distance between supplier and consumer has become less significant. All this is particularly significant as Internet transactors are among banks' most profitable customers. Internet banking also erodes relationship banking and encourages consumers to unbundle their demand for banking services.
- Many bank products have become increasingly commoditised and sold almost exclusively on the basis of price. The commoditisation of some financial products has made such markets more contestable and made competition more perfect than in the past. By allowing the unbundling and rebundling of bank products, and their separable delivery to customers, technology contributes to a general commoditisation of bank products. As bank products have become increasingly commoditised, competition has developed on a product-by-product basis by price alone rather than as part of a relationship.
- Consumers have become more prepared to "unbundle" banking

products (i.e. regard each product as an independent transaction rather than as part of a total banking package). This makes banking markets more contestable, as new competitors are able to focus on a narrow range of products and need not offer the full range of banking products and services.

- Linked to this, consumers have become less conservative about the type of firm (including non-financial firms such as supermarkets) they are prepared to deal with when conducting banking operations and buying bank products and services. Just as financial and non-financial firms have diversified, so too have consumers with respect to the firms they are prepared to consider as “financial” firms.

The abovementioned considerations are important when judging the nature of the competitive environment in which banks operate. They are also relevant when making judgements about the competition implications of bank mergers.

3.1.6 Increased asymmetric competition from new entrants

Effective competition can emerge through many alternative routes: (i) the existence of similar competing firms in an industry; (ii) a high degree of contestability in an industry and in particular low entry and exit barriers; and (iii) because consumers have alternative ways of satisfying their demands and are not dependent upon the products offered by particular firms. A customer demand for bank services and products is a *derived demand*, i.e. bank products are not valued in themselves but for the contribution they make to some underlying demand. Increasingly, alternative ways have emerged to satisfy consumers’ demand for the services traditionally provided by banks. In particular, corporate customers can increasingly satisfy their demand for credit facilities (including short-term, floating interest rate loans) in the capital market. Consumers are also able to use money market funds for their short-term deposits and even payments requirements.

Competition is not a new phenomenon in banking. However, three particular aspects regarding the way competition is evolving gives it a new dimension:

- entry barriers are declining and hence banks face competitive pressure from a wider and more diverse range of competitors;
- as a result of deregulation, the regulatory environment has become less protective of the banking industry; and
- competition has increasingly become global in nature.

Banks now face more intense competition on both sides of the balance sheet: for deposits and loans. On the liabilities side, banks in many countries face increased competition from unit trusts, money market funds and life assurance companies. In many countries the proportion of personal sector assets in the form of liquid deposits is decreasing, while that in illiquid, longer-term insurance and investment products is rising. Some major life assurance companies have recently secured bank licences in order to compete for traditional deposits. There is now a wider range of substitutes for bank deposits. Financial innovation has provided savers with greater flexibility in managing their portfolios by enhancing the available choice of instruments, and by making existing instruments more accessible. Consumers have greater choice whereas historically, to some extent, they have been locked into bank deposits.

It is partly because of these trends that banks in some countries now offer unit trust facilities within their groups so that deposits lost by a bank are not lost to the overall group. In effect, an original process of disintermediation (depositors at banks switching to markets) has been followed by a countervailing process of “*re*-intermediation” as banks have themselves come to offer market instruments to investors. On the assets side, competition for loan business comes from capital and money markets and other institutions.

As entry and regulatory barriers have been eroded, banks have to face competition from a wider range of competitors. For instance inhouse banks: companies such as Volvo in Sweden, British Petroleum in the UK and Renault in France have all been able to internalise some of their banking operations and, to some extent, provide a limited range of banking services to others. Some large corporate customers have become more creditworthy and have a higher credit rating than their bankers.

Therefore it is not surprising that such organisations displace banks and to some extent offer banking services to others. Two of the largest corporate lenders in the United States are the General Electric Company and the Ford Motor Company. In some countries vehicle manufacturers have acquired their own banks for the provision of credit to sales agents, while several non-financial companies have become major issuers of credit cards.

Banks are also vulnerable to the encroachment of non-financial technology companies offering Internet facilities. Such companies control communication networks (and access to them) and could effectively become brokers directing consumers to the best products. This could mean that consumers develop loyalty to intermediaries rather than to product providers. As a progression intermediaries could, using the information made available to them (via data-mining technology), design new products themselves.

Competitive pressures intensify most powerfully when competition develops from outside a traditional industry as entry barriers decline. This is partly because new entrants often have different cost structures, are less bound by fixed costs and are often more prepared to challenge traditional industry practices. The implied increased contestability of financial services markets poses competitive threats to financial institutions. New firms may enter financial markets but also have the capacity subsequently to exit these markets at low cost. This may mean that there is a constant inflow and outflow of new competitors. The range of new competitors may constantly change as each new entrant experiments with financial business which may, or may not, prove to be permanently profitable. Such “hit and run” competition offers permanently higher competition to incumbents even though the population of competitors may be constantly changing.

(i) Common characteristics of new entrants

The entry of non-traditional suppliers of banking services significantly intensifies competitive pressures and the degree of contestability of financial services markets. There are several common characteristics of such new entrants which account for their strategies:

- Entry barriers are low for reasons already outlined.

- New entrants are able to exploit new forms of delivery.
- Exit barriers are low partly because of the scale of entry. Banking and financial services are a comparatively small part of the new entrants' business and exit can be undertaken without fundamentally changing the nature of the business. New entrants are competing in a business that is core to existing financial firms but peripheral to their own. In addition, new entrants are able to enter banking business without the necessity of high upfront fixed costs.
- They have a core competency and reputation in retailing as well as an image of quality, reliability and customer service.
- New entrants are usually highly focused in their product ranges and do not offer the full range of financial services offered by banks – they are able to choose those sections of the business of incumbents in which they judge they have a competitive advantage. Unlike their banking competitors, they are not under pressure to offer the full range of (in some cases unprofitable) bank services.
- This focus is partly associated with banks' pricing policies which frequently create cross-subsidies – uneconomic services are sustained in part by subsidies from other parts of the business. A new entrant, on the other hand, is able to price services without cross-subsidies, as it may choose products which banks are pricing so as to subsidise other parts of the business. In effect, new entrants are able to “cherry pick”. This is particularly evident in the deposit market where in the UK some supermarkets are offering considerably higher rates of interest than banks. This in turn is partly a reflection of the cross-subsidies within banks – “free banking” is paid for largely through low interest rates on retail deposits.
- New entrants tend to be highly focused within the value-chain. With the potential for deconstruction, a lot of high-cost processing is subcontracted to specialists including, in some cases, bank competitors or partners.
- In many cases overall costs are lower than in incumbent firms.
- Because of the ability to subcontract large segments of processing,

and effectively buy into economies of scale through specialist processors, new companies are able to operate with comparatively low fixed costs.

- New entrants also avoid legacy costs in that they do not have an existing cost structure based on past technology. In effect, they are able to avoid the transaction costs of re-engineering a business to adapt to current conditions, and to technology in particular.
- In most cases, new entrants are able to exploit the value of a franchise associated with their brand name. New entrants tend to be household names associated with companies in which the consumer has a high degree of trust. In effect, new entrants believe they can “brand” the financial products or services being sold, i.e. the name attached to the product adds value in consumers’ minds because of the general reputation of a company. One of the key functions of a brand is “quality certification” which is especially significant in cases where, as with many financial contracts and services, the consumer is unable to determine quality at the time of purchase, and where the post-sale behaviour of the seller can affect the value of the product to the consumer.

(ii) Asymmetric competition

To some extent, competition works asymmetrically in the finance industry – developments in technology, and the general erosion of entry barriers into banking, mean that it is easier for non-bank financial institutions and non-financial institutions to diversify into banking than it is for banks to diversify out of financial services. Thus, in the UK, while Marks & Spencer offers a range of financial services (including loans), Barclays Bank does not sell men’s and women’s clothes and frozen food. Similarly, a subsidiary of British Petroleum has a banking licence but National Westminster Bank does not drill for oil.

To date the extent to which banks have diversified out of finance is very limited. This is partly due to regulation which often limits the ability of banks to diversify out of finance more than the ability of non-financial companies to diversify into banking and financial services. It is not an uncommon business strategy to respond to a decline in the value of an

existing franchise by seeking to extend the franchise through diversification. The significance of the asymmetric nature of competition is that banks are impeded in their strategy of extending the scope of the banking franchise in response to its declining value in traditional markets and business areas.

(iii) Market impact

It would be wrong to measure the impact of new entrants in terms of their market share. It is unlikely that customers will close existing bank accounts in order to shift business to the new entrants. This is partly because these entrants do not offer the full range of banking services. The impact on banks and other financial firms derives not so much from market share considerations as from competitive conditions. Although the market share of new entrants may not become significant, the overall impact could be large because it forces incumbents to respond by offering services at lower cost and/or higher quality. Markets in financial services have, as a result, become more contestable and this, rather than market share, impacts on incumbents' competitive behaviour.

(iv) Problems for incumbents

New entrants pose a substantial threat to incumbent financial services firms. Incumbents face several difficulties in making strategic responses:

- to some extent they are locked into a cost structure which is difficult to address in the short run;
- they have high fixed costs;
- their brands are weak and often have, at best, a neutral public image;
- they are often wedded to cross-subsidy pricing strategies;
- they are often committed to providing the full range of financial products and services; and
- new entrants are in some cases targeting their most profitable customers.

Devising appropriate competitive strategies is particularly difficult when competition comes from new firms whose underlying economics are different. This is one of the central strategic challenges for traditional financial services firms.

3.1.7 Evolving role of the state and privatisation

There have been substantial changes in the role of the state in many industrial countries and these frequently have significant implications for the structure of the financial system and the business of financial institutions. Two trends in particular are emphasised: (i) in most countries where major parts of the banking system have been in state ownership a programme of privatisation is creating more market-owned banks which are subject to the discipline of competitive pressures and the capital market; and (ii) under the pressure of demographic trends, and the consequent burden on national budgets, social safety-net arrangements (social security structures, etc.) which have been based on state provision are also being changed.

This has important implications for the future structure of national financial systems as, to date, state-provision has been based on a pay-as-you-go basis without the buildup of funded schemes. This also means that such provisions have bypassed banking and capital markets. As safety-net arrangements (notably pension schemes) are increasingly privatised, large funded schemes will accumulate and these will be increasingly managed through private capital markets and financial institutions. Overall, changes in the role of the state mean that a large proportion of financial flows that have traditionally been channelled through the public sector will gravitate towards private markets and financial institutions.

3.2 Business consequences of changes in technology and innovation

Technology is transforming the fundamental economics of financial services just as it has with many other industries. However, unlike in the case of other industries, technology in finance is changing both the *production* and *distribution* economics simultaneously. Technology is changing the underlying economics of each of the core business components of banking, namely *information, risk analysis, monitoring, trading, processing and delivery*.

The power of technology has been and will be decisive – it acts as both a threat and an opportunity to banks. It enables existing services to be

provided more efficiently and new services to be offered; increases the economies of scale in bank processing; enhances management's access to information; lowers entry barriers in some areas; and changes the economics of delivery. Technology has the power to transform the basic economics of any industry. In this respect banking is no different from other industries which have been transformed by technology. Technology has the potential to increase the availability and reduce the cost of information. This is a potentially powerful force as it both reinforces and challenges one of banks' major core competencies – information. Given that banks are ultimately in the “information business”, anything impacting on the availability, cost and management of information must have a decisive influence on their business.

A large part of the added-value in financial services is now provided not by the product provider but by intermediating firms. An increasing number of banks and other financial institutions (including non-financial companies supplying financial services) are joining forces with non-financial organisations to form strategic alliances. These include technology companies providing specialist services within the value chain. The rationale of these alliances is to work together to devise ways of operating on the basis of complementary core competencies and the economics to be derived through each partner specialising in areas where its core competencies are most powerful.

The potential of the Internet is both a threat and an opportunity for banks, as with all suppliers of banking and financial services. It has the potential to challenge two aspects of the basic economics of banking: information and delivery. By its very nature it increases consumers' access to a wide range of information, and adds a further dimension to the delivery of financial products. “Instant trading” on the Internet has become commonplace in the US and the technology exists for its development in many other industrial countries.

To date it is largely technology companies in joint ventures with banks who are developing the potential for “home banking” and allowing a wide range of standard banking and other financial transactions (payments,

funds transfers, securities transactions, purchases of financial products) to be conducted from a customer's home at any time of any day. In some countries, software packages (e.g. Quicken) have been developed to make this an easy and readily accessible option. Both hardware and software companies could come to challenge banks in some aspects of their core business. Whether, in the course of time, banks could become disintermediated on a major scale remains to be seen.

In due course the Internet could become the dominant medium for relatively simple and standard transactions. In the US several banks have formed joint ventures with a group of computer companies to provide a "financial services super highway". Banks are experimenting with electronic shopping malls, and several banks and building societies in the UK offer services through the Internet. The potential impact of the Internet on banking is substantial:

- the marginal cost of transactions is virtually zero;
- the distance between consumer and supplier becomes meaningless and of no economic significance – this may result in more cross-border competition;
- the consumer usually pays the access costs;
- as an increasing number of rival banks and financial firms open Internet sites and home pages, the cost of information to the consumer and the search costs for rival services and products become very low, which in itself increases competitive pressures in the market;
- the transaction costs of switching between competitors are reduced, which is likely to have the effect of eroding customer loyalty; and
- it further erodes the necessity of having a branch network to supply financial services and also further lowers entry barriers.

While for many consumers using the Internet may initially appear formidable, this will ease as Internet financial directories develop. Internet companies offer facilities such as comparable data for products and services, general market information, information on a full range of personal financial topics, price and terms quotations, and online trading.

In addition, the capital market is becoming more demanding and is

imposing greater discipline on banks' management to raise efficiency and to focus on the rate of return on capital. In many cases this represents a marked cultural change and requires new approaches to management and the conduct of banking business. This is especially the case in some Continental European markets where, traditionally, capital market pressure has been weak. This new focus is in part a product of the increasing globalisation of banking and financial markets.

Banks and other financial firms have come under increasing capital market pressure to focus on the rate of return on equity (ROE) as the ultimate business objective. ROE has steadily displaced considerations such as market share, growth and balance sheet size as the measure of business performance. This in turn is changing the internal management culture of banks and financial firms generally. Greater emphasis is now being placed on the management of costs, the structure of pricing, the management and allocation of capital, and overall profitability. This represents a significant change in the way financial firms behave in the market place. It implies that all business decisions are increasingly being subjected to the ultimate test of the rate of return on equity.

Given this new emphasis on ROE, many banks will find that some of the business currently brought onto the balance sheet (and requiring capital backing) is not sustainable in that it does not earn a sufficient risk-adjusted rate of return to satisfy either the cost of capital or shareholder value considerations. Many banks, including those in the US and UK who have repaid capital, recognising this imperative, have divested some of their business and withdrawn from some markets and businesses where the rate of return on capital has been judged to be inadequate currently or in the long run.

It also explains why some banks have recently adopted a programme of returning capital to shareholders if the options available to utilise capital internally (expansion, diversification, acquisitions, etc.) do not satisfy strict capital market criteria.

3.3 Business consequences of changing consumer preferences

Consumer expectations and demands are also changing as a result of the

secular pressures identified and especially the greater competitive pressures evident in the market for retail financial services:

- consumers will become increasingly aware of greater competitive pressures in the banking industry, and they will seek to exploit these to their advantage;
- there will be increased demand for higher standards and greater reliability;
- it is almost certain that consumers will increasingly come to demand convenience and quicker access to financial services and products;
- consumers are likely to demand greater choice in the range of products and in the range of financial services on offer (including, for example, internationally marketed financial products and services);
- in particular, a wider range of access and delivery mechanisms will be demanded;
- with access to more and cheaper information, consumers will become more sophisticated in their demands and will, in turn, come to demand more information about what is being offered by financial firms; and
- consumers will expect more integrity, competence and transparency from their financial advisers.

Overall, consumers will increasingly recognise the shift in the balance of the bargaining advantage between them and the suppliers of financial services. Consumers have increasingly become aware of choice.

At the same time banking products and services have become increasingly unbundled for consumers. This has been partly enhanced by financial innovation and increased transparency, which in turn are in part products of competitive pressures.

4. SECULAR PRESSURES AND THE DEFENSIVE COUNTERSTRATEGIES OF BANKS

A defensive corporate strategy *waits for better times and opportunities*. Accordingly it wants to have time on hand. As in the military, some of the weaponry available to business is exclusively defensive in nature, while other instruments can be used for both defensive and offensive strategies.

For instance, improvements in a bank's cost-efficiency are possible without any outside pressures and are therefore defensive in nature. In contrast, securitisation as a business strategy can be undertaken according to both defensive and offensive motives, i.e. depending on whether the ultimate aim is improved business efficiency or whether it is a response to increased competition from the capital markets.

Defensive corporate strategies are defined as those which aim specifically for cost and organisational efficiency improvements, and better capital management. The ultimate goal is a better ROE, irrespective of the strategic manoeuvres of the competition. Three defensive strategies will be discussed in this chapter; namely strategies based on (i) exploiting core competences; (ii) seeking cost and organisational efficiencies; and (iii) improving the management and allocation of capital.

4.1 Strategies based on exploiting core competencies

4.1.1 Introduction

Overall, banks are potentially vulnerable for two general reasons: (i) other types of firms and institutions are offering banking services; and (ii) different ways are emerging of performing the role traditionally played by banks. In various ways the related pressures of competition, deregulation, financial innovation and technology have eroded some of the comparative advantages of banks in their traditional financial intermediation business. In addition, new information and trading technology have reduced information and transaction costs in capital markets relative to bank lending costs. Financial innovation and technology (together with the development of rating agencies) have been eroding transaction and information costs and the market imperfections which have been the basis of banks' efficiency and comparative advantage over capital markets. Historically, regulation has tended to exaggerate the comparative advantages possessed by banks because, to some extent, it created a protected market environment.

In effect, banks in some countries are losing their predominant role as deposit-takers and lenders to companies. Market pressures are eroding the

market imperfections which gave rise to banks' comparative advantage over intermediation in capital markets. Financial innovation and technology are also eroding transaction and information costs and market imperfections which are the basis of financial institutions' efficiency over direct credit markets. Banks' own cost structures (including the cost of capital) may also have eroded some of their comparative advantages. Companies in any industry may become vulnerable in three circumstances:

- consumer preferences for products and services change;
- demand shifts away from traditional firms as entry barriers fall and new suppliers become available; or
- consumer preferences change as alternative ways of satisfying their demands emerge.

4.1.2 The core competencies of banks

The traditional theory of the banking firm (the so-called "existence" literature) emphasises a number of key elements which underlie the role of banks and create a rationale for their existence:

- information advantages;
- imperfect markets;
- delegated monitoring;
- the insurance role of banks;
- commitment theories;
- regulatory subsidies; and
- the special role of banks in the payments system.

Given their importance in the theory of banking and the potential vulnerability of banks, each of these is now considered in turn.

(i) Information advantages

A bank's overwhelming advantage is the information it has on its customer base which is obtained through economies of scale, investment in information systems and expertise, and economies of scope or synergies. By managing customers accounts and through a bank's continuous monitoring of customers, the bank necessarily acquires

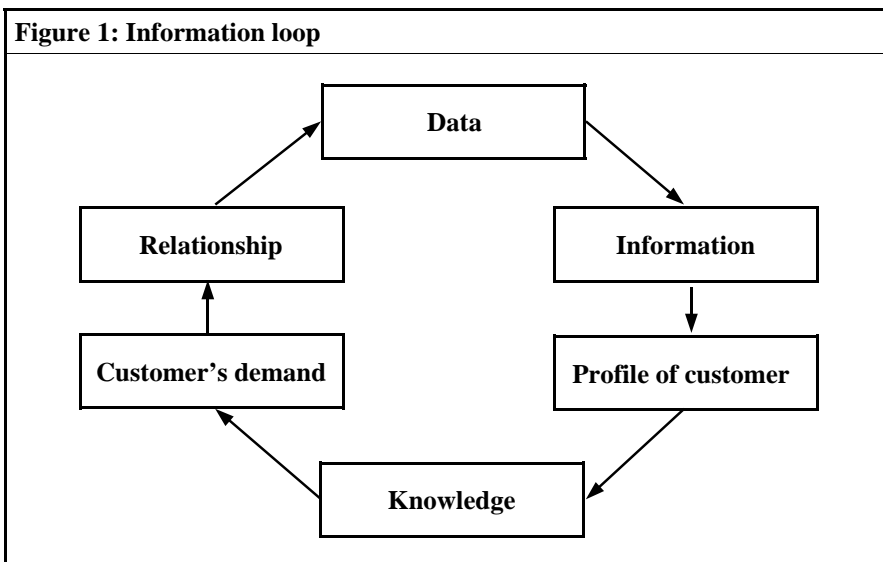
information which can be used in various ways. Information gained through one part of a business operation can be used in others.

Banks are essentially in the “information business”. In this regard, banks need to focus on two elements: the gathering, storing and retrieval of *data* (which in itself is of little value); and the transformation of data into usable *information*. Banks have a great deal of data but there is also enormous potential to transform this into valuable information. Within the information loop (see figure 1) a distinction is made between data and information. A bank has a substantial amount of miscellaneous, low-value *data* about its customers. This needs to be transformed into high-value *information* (for a profile of its customers) and then into *knowledge* about what products and services customers are likely to demand. Through this transformation of basic data a bank acquires the potential to build up an enduring relationship with customers, which in turn provides more data.

Several theoretical approaches to the existence of banks focus upon various information problems in financial transactions, and how banks are able to handle these more efficiently than a capital market or bilateral transactions between savers and borrowers. Banks have a comparative advantage over capital markets in four circumstances: (i) when information on enterprises and their projects are not easily transferred to open markets; (ii) when problems arise over monitoring borrowers’ behaviour; (iii) when, for competitive reasons, firms do not wish to make information publicly available; and (iv) when borrowers do not wish to be subject to the discipline of continuous public scrutiny. With personal customers, banks gain valuable information by managing their bank accounts, as transactions through such accounts reflect customers’ income, wealth and expenditure patterns.

The information rationale for financial intermediation is that banks can solve *ex ante* (adverse selection) and *ex post* (moral hazard) contracting problems more efficiently than can be done either directly between ultimate borrowers and lenders or through markets. Several factors are operating to erode some of banks’ traditional information advantages *vis-à-vis* alternative suppliers of intermediation services. Firstly,

technological developments have reduced the cost of acquiring and accessing information for alternative suppliers. Secondly, rating agencies have developed both to make information more widely available and accessible, and to assess information on behalf of potential investors. This is of particular value to capital market transactors. Thirdly, disclosure regulations (most especially in the United States and the UK) have been extended with the effect that companies now disclose more information. This means that, in some cases, information which was previously a private monopoly of a bank has become more of a “public good”.



The development of information technology also increases the availability of and access to information for institutions other than banks. There is something of a vicious or virtuous circle: as capital markets become more efficient, firms have a greater incentive to disclose more information in order to secure access to capital market facilities. In turn, this increased supply of information enables capital markets to function more efficiently and to act as greater competitors to banks in their lending business. The comparative advantage that banks have in obtaining and assessing the creditworthiness of borrowers and resolving asymmetric

information problems, appears to be declining, primarily in those countries with increasingly sophisticated capital markets. In various ways, therefore, banks are losing some of their traditional information advantages which have been the core of their comparative advantage.

(ii) Imperfect markets

One general theory of banking firms is that banks exist because financial markets are imperfect and incomplete. However, the process of “spectrum filling” (approaching the Arrow-Debreu state) reduces the number and extent of discontinuities in the range of market instruments. Borrowers now have a wider range of capital market instruments. Securitisation and financial innovation contribute to the ideal world of complete markets. In addition, new information and trading technology have reduced information and transaction costs in capital markets relative to bank lending costs.

Technology has also reduced transaction costs in capital markets and, as already noted, has had the effect of reducing information costs and making information more publicly available to capital markets. In general, the more complete contracts are, the easier they are to securitise. The process of financial innovation generally has the effect of enabling more complete contracts to be constructed. Overall, market pressures have been eroding the market imperfections and incompleteness which have given rise to the banks’ comparative advantage over markets.

(iii) Delegated monitoring

As contracts are necessarily incomplete, borrowers need to be monitored to ensure that their behaviour maximises the probability that loans will be repaid. The question is: who is best able to undertake such monitoring, bearing in mind that it is a costly activity? In parallel with analyses which emphasise information problems runs a strand which emphasises the role of banks as monitors of behaviour. In effect, investors (who become depositors in banks) delegate the monitoring role (both in assessing projects and monitoring subsequent behaviour) to banks which have two comparative advantages: (i) economies of scale in monitoring; and (ii) an

ability to reduce the cost of monitoring by diversification. Banks reduce information and incentive problems via monitoring.

However, along with the increased availability and lower cost of public information, the development of rating agencies also challenges the traditional role of banks as delegated monitors. Monitoring can become a fee-based activity rather than an integral part of a bank loan process. There is, therefore, reason to question the alleged superior information, screening and monitoring roles of banks, as other intermediaries may be equally efficient in such roles.

(iv) Insurance role of banks

Banks implicitly provide some insurance services which insurance companies are unable to provide, because the risks do not meet the standard characteristics of explicitly insurable risks (i.e. losses being readily observable and verifiable (no asymmetric information); the absence of moral hazard, inducing the insured to behave in a manner which is prejudicial to the interests of the insurer; and the diversifiability of risks). Lenders (depositors) to banks face the risk that they may need funds before the maturity of a non-marketable loan. Liquidity needs are unexpected but not highly correlated between transactors. By pooling risks (having a large number of depositors each with uncertain future liquidity needs) a bank is able to predict its own liquidity requirement to meet its depositors' liquidity needs. The greater the number of depositors, the more predictable the liquidity requirement, and a bank is able to minimise its own holdings of liquid assets to meet this demand. By pooling risks a bank is able to provide liquidity insurance to risk-averse depositors facing private liquidity risks. Banks are thus able to hold non-marketable assets.

However, the development of unit trusts and money market mutual funds has had the effect of eroding the banks' traditional advantage as suppliers of liquidity insurance. Consumers who traditionally maintain liquidity in banks are now able to earn a higher rate of return in money market funds, while at the same time securing the advantages of liquidity. This is especially the case in those funds which also offer payment facilities.

(v) Commitment theories

An important feature of the relationship between banks and their customers is commitment. The argument is that there is a two-way commitment between customers (most especially corporate borrowing customers) and their bank. Thus, although there is no formal contract, a bank commits to support a customer in good and bad times in return for which the customer agrees to conduct its banking operations predominantly with one bank. This two-way commitment is not feasible for other institutions, as their products and services are very specific and contractual and are not designed as a “safety-net” in the event that the customer unexpectedly needs funding.

(vi) Regulatory subsidy

A further strand of analysis focuses not upon intrinsic advantages possessed by banks, but upon the implicit subsidies they receive through various forms of protective regulation: deposit insurance; implicit lender-of-last resort facilities; or regulation that limits competition. Regulation may accentuate whatever economic advantages banks possess and may in the process create economic rents for banks. There is a powerful strand in the history of regulation based on the alleged dangers of “excessive competition”. Regulation frequently has the effect of limiting competitive pressures and sustaining restrictive practices and cartels. However, the general trend of deregulation means that these protections have been gradually eroded.

To the extent which regulation previously sustained excess capacity the process of deregulation is likely to reveal the extent of such overcapacity. An industrial structure built up in a protected and non-competitive environment is likely to be unsustainable in more competitive market conditions. In general, regulation has become less protective of the banking industry as public policy priorities have increasingly been given to enhancing competition and efficiency in financial systems.

(vii) Payments advantage

Some banking firm theories emphasise the advantage banks have because

they have a monopoly in, and are an integral part of, the payments system. However, banks are also losing these monopolies. It now seems only a matter of time before other types of financial institutions (e.g. insurers) will be admitted as members of the payments system. In many countries, the development of money market mutual funds and unit trusts with payments facilities offers a challenge to banks' traditional monopoly in this area. Similarly, the development of credit and debit cards is eroding this same monopoly, and an increasing proportion of transactions can now be executed without the need for even a temporary stock of funds in a traditional bank account. The development of electronic barter has the potential to undermine banks' traditional monopoly in the payments system.

In general, this is a threat to banks based on a challenge to two traditional assumptions: that transactions require money; and that only banks can issue money. Money is a convenient facility, as it means that transactors do not need information about the standing of the payer as would be the case if payments were made through the transfer of other assets. However, technology also facilitates the verification of the standing of transactors: a particular example is the development of smart cards. Information can now be easily stored in such cards, which in turn can be issued by a variety of firms other than banks.

4.1.3 Use of core competencies

While banks' core competencies may be permanent and enduring, the way they are exploited at any point in time is influenced by a variety of factors. When formulating business strategies in an environment where the banking industry is subject to substantial structural change, a bank needs to identify at the outset:

- its particular and basic *core competencies*;
- which *markets* these competencies can effectively service;
- the range of *products* and *services* to offer in these markets; and
- the particular *way* in which core competencies are to be applied, which may be different from the way in which they have been applied in the past.

In the final instance, the successful development of corporate strategy is ultimately a question of defining core competencies, and developing alternative ways of exploiting these. Given the competitive pressures banks now face, and the other secular pressures identified earlier, the business profile of banks is likely to change significantly over the coming years:

- while a lot of what banks currently do will gravitate towards markets (*primary* and *secondary* securitisation), banks will be able to exploit their core competencies (e.g. information and risk analysis) to service their customers;
- banks will move even further in the direction of financial services firms and conglomerates of separate businesses rather than purely financial intermediaries;
- a declining proportion of banks' income will be earned through the net interest margin and from on-balance-sheet business;
- off-balance-sheet business will develop further;
- a wider range of delivery channels will be offered to customers;
- new ways will emerge for conducting traditional banking business;
- the internal management of banks will continue to change with increasing emphasis on cost-management strategies, pricing strategies, the sustainability of cross-subsidies, and risk analysis and management. Increasingly it will be the risk-adjusted rate of return on capital which will be banks' ultimate strategic focus rather than considerations such as balance sheet size;
- the structure of banking firms will change – banks will move in the direction of *contract banking*, with emphasis on core competencies and banks become managers of internal and external contracts on behalf of their customers; and
- a greater differentiation between banks will emerge as individual banks choose different positions in the strategy matrix (see section 5 below).

In the face of increasing non-traditional competition, together with the growth in domestic and international capital markets, banks are attempting to diversify and redefine their businesses. The traditional financial

intermediation role of banks (most especially with respect to the corporate sector) is likely to become a relatively less important part of their overall business. The universal trend towards bancassurance, where insurance and deposit-taking are mixed within one firm, is a powerful example of diversification.

4.1.4 Off-balance-sheet core strategies

Banks are able to use their core competencies in a variety of different ways and not only through on-balance-sheet loans. There has been a trend in many countries for off-balance-sheet business and income to rise as a proportion of banks' total business and income. This trend is likely to continue. There is a powerful parallel between on- and off-balance-sheet business in two respects: the same basic functions and services are being provided; and the same core competencies (e.g., a bank's information advantage) are being applied. It can be shown that this applies to the two major areas of off-balance-sheet business: contingent claims (loan commitments, guarantees, swaps and hedge transactions, and investment banking activities); and financial services (loan-related services, trust and advisory services, brokerage and agency services, etc.). Thus on- and off-balance-sheet business presents alternative ways of exploiting the same core competencies. For instance, an information advantage can be used either to make on-balance-sheet loans (with profit earned through the interest margin) or to offer a guarantee or back-up line of credit to a borrower making a capital market issue (with profit earned through fee income).

Increasingly, banks will securitise a significant proportion of their assets and this will have major implications. Firstly, it implies that fee income will become an increasing proportion of banks' total income relative to margin income. Secondly, it implies that the relative size of the capital market and banks in the financing of the corporate sector will shift towards the capital market. Thirdly, it also implies that the liquidity of banks' balance sheets will increase to the extent which they hold securitised assets on the balance sheet. In effect, the securitisation of assets and banks' holdings of such assets mean that one of the traditional

special characteristics of banks (the holding of non-marketable assets) is being challenged. Fourthly, the nature of banking business will change as banks become managers of securitised assets. It may also mean that banks will increasingly operate as originators and packagers of credit risks which are ultimately assumed by others. In some senses securitisation undermines much of what banks have traditionally been paid for – analysing non-standardised credits and holding them in the form of non-tradable assets against their own capital.

4.2 Strategies seeking cost and organisational efficiencies

Cost efficiency and organisational efficiency are closely related, in that a bank cannot be really cost efficient in an inefficient organisational structure. Although today there is a tendency for banks to become ever bigger and more diversified, this is not invariably a successful strategy. In fact some banks (e.g. Lloyds-TSB in the UK) are beginning to “de-diversify” by selling off parts of their non-core business. Indeed, diversification, and the evolution of financial conglomerates, is not without its hazards. In some respects, structures in finance have been moving against the trend in the industrial sector where the business efficiency of conglomerates has been challenged, and some have been broken up into their component parts. The challenge to financial conglomerates can be issued on business and regulatory criteria. With respect to business criteria, the main arguments are:

- The alleged case for financial conglomerates is ultimately based on economies of scope, which in practice often fail to materialise. Most of the empirical research on economies of scope fails to find conclusive evidence of their existence. For instance, very few cost savings have been found in studies investigating the consolidation of the outputs of different banks.
- The management challenges of controlling and developing a highly diversified business, and what can become an unwieldy bureaucracy, can be formidable. This may impose diseconomies of both scale and scope. Economies of scope are likely to be bounded by the increased difficulty of efficiently managing a complex, non-focused organisation.

- Problems and conflicts may arise because of the different cultures, traditions and working practices of different facets of a financial conglomerate. Each may contaminate the other to the detriment of all.
- There is some evidence suggesting that management expenses per unit of output tend to rise as the product range widens.
- The management requirement of introducing a new business may be substantial and underestimated. Consequently the new business may not be particularly successful, while managerial diversion may undermine existing business.
- Consumers' image of traditional businesses may be contaminated by an unsuccessful venture into new areas.
- The regulation and compliance costs of a diversified business may be very high. The more diversified a bank is, the more regulatory jurisdictions it is subject to, and the greater are the compliance costs associated with regulatory requirements designed to guard against consumers being exploited by a conglomerate's potential conflicts of interest.

The unbundling of a financial conglomerate into operationally independent profit centres – be they divisions or separately capitalised subsidiaries – each with very specific ROE targets, often takes place to overcome the inherent problems of too large an organisation as discussed above, and to improve cost efficiency. The pressure is mounting for all institutions in the financial services sector to develop dynamic cost-management strategies. The more competitive market environment means that price-competition will become more important. In the past, institutions often competed with each other in ways which effectively increased costs because of the absence of powerful price competition. It is likely, however, that this will be reversed as institutions will increasingly come under pressure to reduce their cost structures. This is even more likely to be the case as financial products become increasingly homogenised. In practice, significant reductions in costs require a major restructuring of branch networks and the number of employees given that, for banks, the cost structure is determined largely by the branch network and the number of employees.

Overall, banks will be under constant pressure to manage costs strategically and to seek economies wherever these can be secured. A major issue is how far banks can go along this road without a fundamental re-engineering of their business. Institutions are required to develop cost management *strategies* rather than once-off cost cutting exercises. A new culture of cost-management has emerged as a permanent and continuing feature of competitive strategies.

4.3 Strategies based on improving the management and allocation of capital

Excess capital (capital in excess of what is needed to support the current or expected level of assets) raises the rate of return on assets which banks are required to earn in order to service their capital base. However, the same competitive conditions which have caused banks to lose some lending business also make it difficult to increase the rate of return on assets. Faced with excess capital, banks have three broad strategic options:

- They could expand the balance sheet, perhaps by making more risky loans, which may have the effect of eroding lending margins. If this induces banks to make loans without incorporating the true risk premium, it could ultimately lead to a destruction of capital.
- They could make acquisitions (e.g. purchase an insurance company), although there is ample empirical evidence that banks with excess capital often pay a premium when making acquisitions. This makes it difficult subsequently to earn a sufficient risk-adjusted rate of return on such investments.
- They could repay capital to shareholders.

The last option may be the optimum strategy if regulation limits the extent to which bank capital can be deployed in new business areas, which does not, of course, limit where shareholders can invest external to a bank. Many banks in the US, and some in the UK (e.g., Barclays, NatWest, Halifax), have made repayments of equity capital to shareholders. Shareholders have more options to allocate capital externally than banks have internally, i.e. capital may be more valuable to shareholders when it is passed back to them to use outside a bank than when it is retained inside

the bank. It is possible to have global excess capital in banking even while each individual bank believes it is short of capital. The two are not contradictory. If each individual bank seeks to increase its share of a limited market, its own capital may be insufficient to support its planned business profile. But in the aggregate banks may have too much capital for the total amount of profitable business which is available.

There are several advantages to a bank, faced with surplus capital, reducing the surplus by buying back shares and retiring equity capital:

- It removes the basic dilemma of either having to reduce the rate of return on equity (which may be resisted by shareholders and may adversely affect the share price) or raising the rate of return on assets (which may not be possible in highly competitive market conditions).
- It is likely that the share price will rise. Any positive effect on the re-rating of the price of bank shares offers a degree of protection against hostile bids.
- The rate of return on equity and earnings per share are raised.
- It is a powerful signal to shareholders and the capital market that the bank is keeping faith with shareholders by having their interests at the centre of the bank's strategy.
- Because of this and the beneficial effect on the share price it is likely that, if in the future a bank needs an injection of equity capital, shareholders and the capital market will be more accommodating and offer a better price. A share buyback does not have to imply a permanent loss of capital.
- Reducing excess capital may also have the effect of removing the moral hazard faced by a management which may become less disciplined when capital is plentiful. It can be argued that financial institutions which are capital-constrained are less likely to engage in reckless lending.

More generally, the focus on the rate of return on equity acts as a powerful management incentive and discipline.

5. SECULAR PRESSURES AND THE OFFENSIVE COUNTERSTRATEGIES OF BANKS

With an offensive strategy the aim is *to beat the opponent* within a set time frame. Moreover, a firm taking the offensive is more inclined to concentrate on earnings and scope of business than on cost and economies of scale. In contrast to a defensive strategy, where time often means waiting, in an offensive strategy a firm is working against the clock – i.e. the *coup de grâce* has to be delivered with speed and force at the right time. By their nature offensive strategies are externally focused, embracing business instruments such as: diversification; globalisation; consolidation (M&As); sharp, even predatory, pricing; and aggressive financial gearing.

This section will consider three offensive strategies:

- seeking operational and geographic expansion;
- engaging in competitive pricing strategies; and
- restructuring internally and externally.

The response by the regulatory authorities to banks' consolidation strategies is discussed briefly at the end.

5.1 Strategies based on operational and geographic expansion

Competition has increasingly become global in three respects:

- some customers have global financing options and are able to arbitrage between domestic, foreign, and international banks and capital markets;
- banks are not restricted to business within their own country; and
- as a result of regulatory entry barriers having fallen, it has become easier for banks to locate in foreign countries.

Banks and financial markets are facing increasing competitive pressures emanating from a global financial system – the geographical domain in which competition operates has widened. National banking systems are increasingly in competition with each other as they effectively become subsets of a global system. This has a tendency to equalise the price of some banking services, to compete away relative inefficiencies

Table 2: “Secular pressure / strategic response” matrix: Offensive strategies

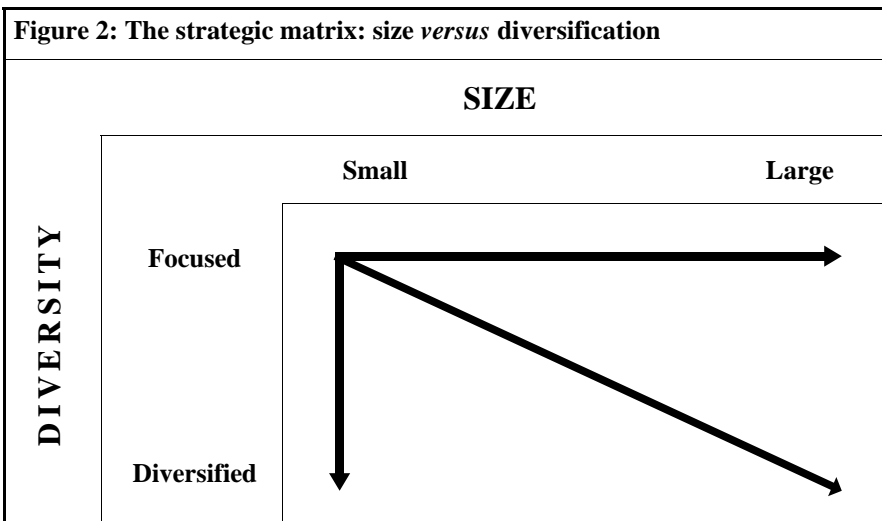
External challenges	Regulation						Technology and innovation						Consumer preferences										
	Minimum fit and proper standards	Lower entry barriers	Lower exit barriers	Excess capacity	Market contestability	Asymmetrical competition	Privatisation	Information	Processing	Risk analysis	Monitoring	Delivery	Disintermediation	Trading	Quality and reliability of products and services	Safety of investments	Choice in range of products	Transparency and disclosure	Integrity and honesty	Competence	Accurate pricing	Convenience of services	
Consequences for the banking industry																							
Business instruments																							
Offensive strategies																							
Diversification				*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Globalisation				*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Consolidation and M&As				*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Securitisation				*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Commoditisation				*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Pricing and gearing																							
Risk analysis system																							
Information management																							
Distribution channels																							
Organisational structure	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Joint ventures				*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*

and monopoly profits which might exist in some national systems, and to some degree to reduce the extent of structural differences between national systems.

Globally, the banking industry is responding to competition and scale pressures by consolidating into a smaller number of larger banking units. The evolution of national banking systems and the business of banks is always and everywhere influenced by a combination of *country-specific* and *global* pressures. In the years ahead the relative role of these two sets of forces is likely to change, with global pressures becoming more decisive than country-specific factors. Thus the structure of, say, the South African banking system and the business operations of banks in South Africa will be more influenced by the pressure of global developments (those which impact banks in all countries) than factors specific to South Africa. In other words, the pressures operating on banks in South Africa will have much in common with those influencing, say, the Spanish banking system. This is partly because the dominant pressures are themselves global in nature. This may suggest that differences between national banking systems could become less pronounced. In Europe this is likely to be reinforced by the adoption of a common currency, and the further development of the “internal market” programme.

The two dominant trends in banking strategy (size and diversification) can be represented on a strategy matrix as depicted in figure 2. The general trend is for banks to seek to move from left to right along the horizontal axis of the matrix (i.e. to become larger), and from top to bottom (i.e. to become more diversified). As already noted, this sometimes constitutes a combined strategy, as some mergers take place not only to secure economies of scale but also as a means of acquiring a more diversified business structure. Today the global trend is towards the bottom right-hand segment of the matrix. This strategic trend could be an illusion, however. Success is more likely to be determined by considerations internal to a bank (management efficiency, etc.) rather than by applying any particular model on the size-diversification matrix. For a bank to think otherwise, and to build strategies exclusively on a particular

model in the size-diversification matrix, is a delusion, and potentially a dangerous one, for this would divert attention away from what really matters: having a clear and credible strategy, and being good at doing what the bank chooses to do.



There are several reasons for being cautious concerning the conventional argument about the existence of economies of scale as a rationale for bank mergers, and about the efficiency of diversification:

- *Limited evidence.* An enormous amount of research has attempted to identify and measure economies and diseconomies of scale in banks. The results are, at best, inconclusive and ambiguous. Overall, except in the case of comparatively small banks, there is little support for the proposition that large banks have lower average costs than smaller banks. Economies of scale seem to be exhausted at comparatively low levels. In fact, there is some evidence that increasing size has the effect of raising unit costs. The overwhelming conclusion is that the major determinant of a bank's cost level is not size *per se* but its own internal efficiency. In other words, the variation in costs between banks of similar size is greater than that between banks of different size.
- *Banks versus banking.* When considering economies of scale, a

distinction must also be made between banks and bank processes. Individual bank processes (cheque clearing, credit card administration, etc.) do show economies of scale. Combining the two conclusions seems to suggest that there are no clear economies of scale in *banks* (in that large banks do not consistently have lower average costs than smaller banks) but in *banking*. This is an important conclusion as, while competitive pressures will force banks to lower their costs, there are other ways of achieving economies of scale in bank processing other than by being a big bank. For instance, banks can establish joint ventures to conduct their processes or can also subcontract or outsource some of their processes to third-party suppliers. In effect, banks can buy in economies of scale. The fact that there may be economies of scale in banking does not mean that banks need to be big to secure these.

- *Labour and social security laws* and regulations, in some countries (especially European), make it difficult and/or expensive for firms to reduce employment costs which, in many instances, is the main rationale for a bank merger.
- *The track record*. Experience also indicates that mergers are not always successful in achieving their objectives. Looking at industrial experience more generally (i.e. not only in finance) reveals that only about half of the mergers which have taken place achieve their objectives. There are numerous examples of mergers which have subsequently been unwound. Overall, the empirical evidence about the success of takeovers and the market for corporate control is very mixed. It cannot be said that the market works perfectly. In the US, for instance, many of the conglomerates created by mergers and acquisition activity have subsequently been unbundled.
- *Diseconomies of scale*. Emphasis is usually placed in public debate on economies of scale. However, there can also be diseconomies of scale: i.e. average costs rise beyond a certain size of firm. There are many possible reasons for this: inability of management to control a very large organisation; more bureaucratic procedures; weakening of

innovation in large bureaucracies; etc. There is nothing in the theory of economies of scale that suggests the average cost curve continues to fall as size increases.

- *Transaction costs.* Leaving aside the ultimate end-result of a merger, there is ample evidence that the transaction costs of merging two very large organisations can sometimes be substantial and divert management attention for some considerable time. Even if, in general, large banks are more efficient than small banks, it does not automatically follow that merging two banks will achieve economies of scale.
- *Size is not in itself a sustainable competitive advantage.* It is an illusion to believe that size in itself creates competitive advantages on a sustainable basis. There are many factors which determine the competitiveness of any financial firm, but size *per se* is not one of them.

As competition becomes increasingly global in nature and many of the pressures (e.g. technology) are universal, no bank anywhere will be immune from the pressures operating on the global banking industry. However, the necessary adjustment may be impeded in some countries by, for instance, labour laws which make it difficult or expensive to close branches, amalgamate and reduce the number of employees. Retail financial services firms (banks, fund management institutions, insurance companies, etc.) face formidable challenges – they are losing some of their past monopolies and comparative advantages which have underpinned their dominant position in the financial system. In particular, as entry barriers into the industry decline, traditional financial firms are facing new types of competition from a wider range of competitors.

Three major structural shifts in the pattern of financial intermediation have become evident in many countries and these are likely to accelerate in the future:

- from institutions to markets (most especially in wholesale lending business but also in some retail business via securitisation);
- within the institutional sector from deposit-taking institutions to non-

bank financial intermediaries such as pension funds, insurance companies and mutual funds; and

- towards a new set of non-finance companies offering banking and other financial services.

The relative decline in the proportion of total financial assets held by deposit-taking institutions has become one of the major structural changes in many financial systems.

5.2 Strategies based on enhancing competitive pricing and trading

The more the competitive forces increase in any industry, the more accurately prices have to be set. Banking is no exception to this observation. Accurate pricing implies not only improved cost efficiency, but also enhanced trading opportunities. In fact, by pricing their products inaccurately, banks open themselves to major competition by non-bank institutions. In this context cross-subsidisation is becoming a major issue for banks, not only as a defensive strategy to fend off the competition, but also as an offensive strategy to make inroads into those markets where pricing is inaccurate.

Cross-subsidisation is a common pricing strategy in multi-product firms, including banking, where, because competitive conditions between different banking markets are not homogeneous, prices of individual “products” (e.g., loans to different types of customers) do not accurately reflect relative costs and risks. There are several reasons (in the past at least) for cross-subsidies having been sustained in banking: (i) high entry barriers to newcomers which effectively protected the subsidising business components from external poaching; (ii) banking was considered to be a bundled service; (iii) customer loyalty to the full-service concept of banks has been strong; (iv) search costs for consumers have been high; (v) banks lacked data on the details of their cost structures; and (vi) banks had a concept of “fairness” which made them reluctant to differentiate substantially between customers even in the face of different costs and risks between them.

There are cross-subsidies between different customers, products and processes. This necessarily implies “subsidising” and “subsidised”

products, which also presupposes an ability to segment markets. As competition intensifies, however, and particularly as economic and regulatory entry barriers are lowered, it is frequently “subsidising” markets which are targeted by new entrants and this erodes the “excess profits” earned by existing suppliers. This in turn forces a change in pricing strategy which, on the assumption that the original cross-subsidisation was designed to raise overall profits, has the effect of eroding aggregate profits. It is partly because banks cross-subsidise parts of their business that new competitors have been able to enter some niche segments of banking business. However, this entry is also likely to erode banks’ ability to sustain cross-subsidies.

In many countries, banks earn significant endowment profits through “free resources” (reserves and interest-free deposits). As these endowment profits have been eroded due to competitive pressures and the deregulation of interest rates, a significant traditional source of profits has become less significant. Historically, the existence of endowment profits due to banks’ access to cheap retail funds has acted as an entry barrier to foreign banks.

To the extent which the cost of retail deposits rises towards the level of that of wholesale funds, the implicit competitive advantages enjoyed by banks with access to retail funds is eroded and foreign banks and new suppliers are able to compete on less disadvantageous terms.

Cross-subsidies within banks are becoming vulnerable both because entry barriers are declining and because of the process of deconstruction noted earlier. The general prediction is that, as competition develops, the potential for banks to engage in cross-subsidising pricing behaviour will be eroded. This would be a further factor eroding overall profitability. The erosion of cross-subsidies has the effect of raising costs on some services and lowering profits.

5.3 Strategies based on internal and external restructuring

The competitive advantages flowing for instance from economies of scale and scope, and technology, will be different for different institutions. Therefore firms will not all have the same strategic options. Owing to the

competitive pressures operating on the banking industry the structure of the financial system will change, which in turn opens the possibilities of restructuring internally and externally by refocusing organisations internally or entering into joint ventures and strategic alliances with external organisations.

Table 3 outlines a spectrum of structures which may emerge. While distinctions should not be drawn too rigidly, a key strategic issue for individual banks is their positioning within this spectrum. It is likely that a few *comprehensive financial conglomerates* will emerge, which will offer the full range of wholesale and retail financial services. These are likely to be the largest banks. Alongside these there is likely to be a tier of *retail financial conglomerates* offering a very wide range of exclusively retail financial services. The third category indicated in table 3 is what might be termed *core-cluster institutions*. These are institutions which have a dominant business (e.g. savings and mortgages) but diversify into a limited range of other services. Different institutions in this category will have different clusters of additional services. Some, for instance, will include personal pensions and life assurance, while others may include fund management services. Thus, while the general strategy is the same, institutions within this category will be differentiated by their particular product mixes.

More focused institutions (*specialist-focused institutions* in table 3) will concentrate almost exclusively on their existing core business. Their strategy will be to maximise whatever competitive advantage they have in a narrow range of business. Even more focused institutions are what may be termed *niche segmentation institutions* which specialise within a small segment of a big market. The market may be limited but profitable for a small number of suppliers.

The sixth group identified (*joint ventures*) is a special case of the process of deconstruction described earlier. If the economies of scale in some processes are greater than the scale which can be incorporated within a particular institution, joint ventures involving a sharing of facilities can be a viable strategic option. Existing examples include banks

which subcontract their credit card administration, and institutions which subcontract mortgage administration.

Finally, *non-traditional retail financial services firms* who have core competencies in dealing with customers, especially at point of sale, can offer financial services through their own delivery systems, usually in collaboration with existing suppliers such as banks.

Table 3: Possible future structure of the retail financial system	
1. Comprehensive financial conglomerates	Institutions offering the full range of wholesale and retail financial services.
2. Retail financial conglomerates	Institutions offering a wide range of retail financial services to the personal sector.
3. Core-cluster institutions	Institutions offering a small range of financial services around a core business.
4. Specialist-focused institutions	Institutions offering focused business and concentrating on a core competence.
5. Niche segmentation institutions	Institutions catering for particular niche segments of larger markets.
6. Joint ventures	Institutions joining with others to share facilities.
7. Non-traditional retail financial services firms	Supermarkets, etc., concentrating on a limited range of retail financial services and products in collaboration with existing suppliers.

The implication is that there is more than one successful strategy, and there is no presumption that the only successful companies will be those who are big and offer a wide range of financial services and products. Successful companies will be those who do what they seek to do in an efficient and competitive manner.

5.4 The regulatory response to consolidation strategies

Any consolidation within the banking industry necessarily has public policy issues to consider, not least because the consolidation of the banking industry into a smaller number of larger units may have implications for competition. A conflict may emerge in this dimension of

public policy – particularly in Europe, and in small countries in other parts of the world. On the one hand, governments will wish to encourage the development of more efficient banking systems within their countries and this may be an argument in favour of allowing greater consolidation. At the same time European banks will be under competitive pressure in some markets from the giant American banks which are currently being formed. A public policy dilemma is likely to emerge in this area because, although the giant banks being created in the US are very large compared with many European banks, their market share within the US remains comparatively small and does not in itself raise serious competition issues. It has been estimated, for instance, that the market share of the combined Citicorp and Travellers banks will still amount to less than 10 percent of the US market. On the other hand, any European bank created through mergers which would come anywhere near the size of Citigroup would have a virtual monopoly within its own country.

There are public policy issues over and above the general impact on competition:

- the efficiency of the payments system;
- the vulnerability of the financial system and access to safety-net arrangements;
- the risk profile of institutions; and
- access to credit by small firms.

(i) Payments system

Consolidation can have several effects on the efficiency of the payments system. Firstly, mergers reduce the amount of inter-bank payments processing because payments between consolidating banks become “on-us” items, and hence do not require inter-bank transfers. Secondly, many of the remaining inter-bank payments may be cleared more quickly because there are fewer endpoints to which to send payments information or instruments. Thirdly, consolidation may improve efficiency by allowing banks to find more efficient means to exchange payments. It may also allow banks to form more efficient payments networks, which is not possible with a more fragmented banking system. There is some

evidence, for instance, that countries with more consolidated banking systems make greater use of electronic payments systems. Consolidation may also raise scale efficiency in back-office operations and in processing.

(ii) Stability of the financial system

A major public policy issue in bank mergers is their impact on the stability of the financial system. In particular, there is a concern that, if large banks fail, the systemic consequences are potentially more serious and the moral hazard associated with the “too-big-to-fail” principle is accentuated. It also makes it more difficult to organise industry rescue operations by other banks purchasing failed banks.

(iii) Risk profile

On the other hand, there is a systemic advantage to the extent which large, diversified banks are less likely to fail. One study in the US looked directly at the diversification gains from improvements in the risk profile of banks. The conclusion was that, when organisations are larger in a way that creates geographical diversification, efficiency tends to be higher and insolvency risks tend to be lower. There seems to be clear risk-profile gains from operating in multiple states in the US. This creates something of a public policy dilemma: while the probability of a large and diversified bank failing may be reduced through consolidation, the seriousness of any failure that does occur is greater.

(iv) Small firms

In many countries (notably the UK, Canada and Australia) the impact of bank consolidation on competition in the small-firm sector of the banking market and the availability of credit to small firms are particular concerns. Research indicates that consolidations of large banks tend to reduce small business lending, whereas consolidations involving small organisations tend to increase small business lending. In addition, banks in more concentrated markets tend to charge higher rates on small business loans. However, there is also evidence that the negative effects are partly offset by increased lending to small firms by other institutions in the same local market.