# Speech

Governor Urban Bäckström

WEDNESDAY, 16TH JUNE 1999

# EMU and the changing shape of the financial system

## Foreign Bankers Association in the Netherlands

First I want to express my thanks for the invitation to discuss with you the future of the European financial system.

What makes this topic so relevant is that most people seem to agree that the banking system in Europe faces further structural changes. What are the forces behind this and how are they being handled by the financial system's practitioners? I shall be considering these intriguing questions, as well as how those of us who work in the central banks can facilitate and promote a stable development of the financial system.

### Introduction

Questions of this type are being discussed intensively in the light of the major technological advances that have changed communications and information in the past ten to fifteen years, leading in turn to new methods and instruments for the management of risks in the financial system. Together with all the opportunities provided by free and open capital markets, these changes have brought about something of a financial revolution. The new situation has also made it possible to separate the production of financial services from their distribution. At the same time, with the emergence of financial markets, the production of these services is tending to become increasingly standardised. To these factors can now be added



Telephone +46 8 787 00 00 | Telefax +46 8 21 05 31 | E-mail registratorn@riksbank.se

the changeover to the single European currency, the euro, which may lead to what I would like to call a 'europisation' of financial services.

The European scene is dominated by universal banks which, as the epithet implies, operate simultaneously in various segments of the financial market. Today, however, the rapid pace of financial innovations is putting traditional banking under pressure from several quarters. As a result, profit margins in the bank sector have tended to narrow in many countries. In numerous cases the price of bank equity has not kept up with the average level of stock exchange prices. The tendency for traditional banking to become less profitable is even more evident from the spread between conventional lending and deposit rates. These developments are clearly generating pressure for a transformation of the financial system.

Such a transformation may give rise to risks, for instance if it proceeds too slowly, with a loss of profitability in some quarters. It may also elicit more risky behaviour in an effort to make up for a decline in regular profit levels. A particular problem with financial enterprises is that, unlike other companies, they can keep their declared profits up by increasing the element of risk. An appraisal of financial enterprises that is based solely on their published performance may therefore be unduly primitive.

## Increased pressure to transform the bank sector

*Technology*

One of the strongest forces that to some extent affects every aspect of the production of financial services is *technology*. As in most other industries, technological innovations have far-reaching effects on the way banks produce their services.

First, of course, there are the opportunities of improving productivity. Processes that are paper-based or initiated manually can be dispensed with. The new technology can also be used for sophisticated risk management. At the same time, however, it affects how financial services are sold and distributed. New alternatives for this are growing rapidly at present. One example is the Internet, with a very strong increase in the number of users. In Sweden, for instance, this number is currently growing at an annual rate of 50 to 60 per cent. Telephone banks are another example of alternative channels for distribution that are already widely used.

The point of these new distribution channels is that they cut banks' costs for reaching customers and selling products. A transaction initiated via the Internet costs between 10 and 20 per cent of the sum for processing a transaction initiated via the branch network of a traditional bank.

These new sales outlets do, however, require sizeable investments, as is evident from a substantial increase in expenditure on new technology. Many of you who are here today are no doubt increasingly concerned about the escalation of costs for IT investments. In Sweden we have found that in the 1990s, technology-related expenditure has doubled as a proportion of total bank costs to a present level of

between 20 and 25 per cent. Meanwhile, the traditional banks still have to carry the expenditure for their regular branch network.

So although the new technology has many advantages for the traditional banks, it also has some drawbacks. Apart from the rising costs, it confronts the universal banks with far-reaching challenges. The new channels for sales heighten the potential for competing internationally without a physical presence and also give new types of operators greater opportunities of breaking into markets that the traditional banks used to be able to dominate by virtue of their branch networks.

Moreover, as I mentioned earlier, the new technology makes it possible to *separate the production of financial services from their distribution.* It is then easier for new players to market financial services that other players produce. The producers can specialise in particular product areas and thereby achieve economies of scale, while the new players are in a position to specialise in the distribution of an assortment of financial services they assemble from different producers, for instance via the Internet.

These tendencies affect the position of the European universal banks in several ways. New players have less difficulty in entering markets in that distribution with the new technology is cheaper than a traditional bank's branch network. It is also possible to buy into economies of scale by offering financial services that others have produced. The new players can then concentrate on marketing financial services without having to build up the competence that producing them internally requires. It is in such ways that the new technology exposes the traditional banks to increased competition. And stronger competition is always likely to result in decreased profit margins.

*Disintermediation*

On top of this, for some time now there has been growing competition from the financial markets. Bank customers are dropping traditional bank products, such as deposits and loans, in favour of instruments that are directly available in the financial markets. The traditional role of banks in converting savings into investments is thus becoming relatively less important. This phenomenon, *disintermediation*, can ultimately deprive the banks of certain balance-sheet items.

The tendency for large and medium-sized firms to borrow to a growing extent directly in the capital markets means that bank loans are declining in relative terms as a source of finance. The banks' interest income is accordingly under pressure. The same applies to the banks' margin on traditional lending in that increased financing with securities enables companies and local authorities to cite the financial markets when negotiating rates with the banks.

Disintermediation also affects bank liabilities because households are increasingly moving from traditional bank deposits to other, more long-term instruments for saving such as mutual funds and insurance policies. As a result, institutional investors will be playing a more and more prominent role as managers of long-term savings in Europe. To a considerable extent it is the banks that are suffering from this. These tendencies are being accentuated by Europe's ageing population and a growing proportion of individual financing in many countries' pension systems.

It should be added, however, that so far at least, the banks in most EU countries have coped successfully with the increased competition for savings. It may be asked, however, whether they can continue to do so. One indication that disintermediation has in fact had a considerable impact is that during the 1990s and relative to total assets, the level of interest income has fallen 30 per cent.

*EMU*

The advent of the economic and monetary union is also having various effects on the financial system. The most obvious is the cessation of trading in the national currencies of the euro area. This in itself affects the income base of European banks. But the euro's introduction is also influencing financial operations in Europe more profoundly. The euro area can be seen as a larger and more uniform market with about two hundred million inhabitants. Moreover, this large new market can be expected to attract investors.

The establishment of EMU will most probably accentuate the move towards an increasingly widespread disintermediation of saving and borrowing. A single European currency makes it easier to develop liquid and transnational markets for trading in corporate bonds. The size of the European market for these bonds had already doubled during 1998, albeit from a modest level. Very large volumes are probably needed to compete for commission income in a market of this magnitude, as well as operations on at least a European, if not a global, scale.

In that EMU makes the pricing of financial services more transparent and the new technology reduces the importance of geographical nearness, it is easier for bank customers to compare the prices offered by institutions in different countries in Europe. This, too, implies increased competition. Just the threat of such external competition will presumably oblige national banks to rationalise and restructure their operations in order to cope with the European players.

*Subdued return on financial investment*

A factor that has helped to sustain profitability in the financial system in recent years is the sizeable capital gains that have been generated in many of the world's equity and bond markets. In the United States, for example, the real increase in share prices since 1982 has averaged about 16 per cent a year, as against an average of between 6 and 7 per cent in the past 120 years and more. Similarly, long bond investments have yielded an annual real return of about 11 per cent, as against the historical average of only 3 per cent. It is quite simply the case that never before have *both* shares and bonds been such good investments over such a long period. In Europe, too, the convergence of long-term interest rates during much of the 1990s has resulted in very large, though temporary, capital gains. The return on investment in shares has also been high in many parts of Europe.

The accumulation of wealth in the United States has been accompanied by an almost explosive expansion of the financial sector to cater to the new demand for investment and other financial activities. A similar development has been noted in many other countries, in Europe as well as elsewhere. Sooner or later, however, the expected return on financial investments in the Western industrialised countries

will have to be adjusted to economic realities. That will also affect profitability in the financial system and increase the pressure for change still more.

## Banks responding with major consolidation

I have outlined some driving forces that, singly and together, are fundamentally altering the conditions for traditional banking operations. An interesting question is how the banks have acted so far to accommodate these changes.

The most common strategy among European banks to date has been to cope with the increased competition by increasing the size and/or the range of operations. Behind the mergers of financial enterprises one can discern different conceptions that rest in turn on somewhat different financial arguments.

*One* type of merger is between banks that operate in the same geographical market and in largely the same fields. The main financial argument behind mergers of this type is that cost effectiveness can be improved through *economies of scale* in production and distribution. Besides slimming duplicate administrative and managerial functions, the merged entity can above all cut down its branch offices, which are generally very costly to run. While maintaining the aggregate income of the constituent banks, it is envisaged that in the new entity the costs for generating this income can be substantially reduced.

*Another* type of merger is between banks operating in different geographical markets. Important driving forces here are the possibility of filling out each of the merged banks' range of products, having a wider geographical presence and spreading costs over more customers.

A *third* type of merger is between banks and insurance companies. The financial arguments for this are a broader assortment of products and the wider coverage that the bank's organisation provides for selling insurance. There is also the possibility of selling more bank products to the former insurance company's customers.

### *Large is not always most profitable*

It is difficult to demonstrate that some of the strategies chosen by banks to cope with the winds of change will in fact improve their profitability.

As regards the economies of scale that banks are aiming to achieve, mainly through mergers and take-overs, there is little evidence from the academic world to show that these economies do in fact exist. The only definite conclusion to be drawn from the systematic studies is that cost effectiveness is determined, not by the size of a bank but by how its operations are organised. A notable finding from this research is that the degree of cost effectiveness varies more between banks of the same size than it does between banks that differ in size. It should be added, however, that the growing input of technology in banking indicates that economies of scale may have risen recently. But so far this is just an indication.

Neither is there any clear evidence that sizeable economic gains can be reaped in general by diversifying a bank's operations to cover a broad spectrum of products. The potential for achieving cost effectiveness by merging a bank and an insurance

company, for example, is often limited by practical difficulties in running and controlling a variety of activities in a single organisation. Large and *geographically* diversified financial firms seem to be the only exception here; studies show that in such cases cost effectiveness can in fact be improved.

In the wave of mergers and take-overs that is now in progress throughout the world there is thus a risk on account of the difficulties associated with trying to get two organisations to function successfully as a single unit. As I have just said, studies and practical experience show that mergers and take-overs often fail to yield the expected improvement in profitability and efficiency.

At times it seems as though the move in the financial sector towards increasingly large institutions involves a certain element of herd behaviour. Perhaps it is not only the large and diversified banks that will prosper under the new conditions. One sometimes gets the impression that mergers are now being initiated in a bid for largeness for its own sake. As in other industries, the recipe for success in the financial sector is probably to concentrate on doing what one does best and doing it even better. That may of course still involve making judicious structural deals. But it does seem that the consolidation of the European banking system, probably much needed in itself, should preferably be undertaken along these lines rather than by banks combining into larger units because they feel compelled to grow.

In the work of consolidating the financial system there may perhaps be lessons to learn from other walks of life. Strong competition in segments of the real economy is often met by becoming even more specialised. Large groups develop their commercial identity and rely on independent suppliers instead of internal production units.

The new facilities for separating the production of financial services from their distribution may result in a similar tendency here. In future banks will perhaps function as brokers, with a range of associated firms that specialise in the production of different financial services. The intrinsic value of the bank will lie mainly in a familiar and reputable name—its trademark—and the network of customers at its disposable. The bank may have specialised in some financial operations, but not in them all. For production it will rely mainly on external suppliers.

## The role of central banks

The process of change and development is not always entirely smooth, either in the real economy or in the financial sector. As we have seen in the past ten to fifteen years, there have been difficulties with bank crises in a number of countries, as well as rather abrupt corrections in money, equity and currency markets.

Now that economic policy in many countries is focused on low inflation and sound government finances, the general economic environment should be more stable. Even so, the oversight and supervision of the financial sector have challenges to meet. The authorities must step up their international cooperation. An intensive discussion is in progress under the device of a new financial architecture.

Financial legislation and supervision are increasingly aimed at allowing flexibility inside a framework decided by government. The players in the market are accordingly being given more and more responsibility for controlling themselves and each other. This can be achieved, for example, by requiring detailed, transparent accounts that enable outsiders to form a more accurate picture of a bank's financial position and risk exposure. As far as possible, in my opinion, the laws and supervision should be based on the principle of *market conformity* and thereby promote sound practice among financial firms. Transparency and clarity about the rules of the game for financial markets are important ingredients of the work by central banks and supervisors to promote financial stability.

The task of promoting the payment system's stability and efficiency is entrusted in most countries to the central bank. An important reason for this is the payment systems' central function in monetary policy. Another reason is the central bank's unique possibility of creating the liquidity on which the smooth functioning of the system continuously depends. Participants in the system may need a supply of liquidity from time to time in order to complete the flows of payments with other participants.

Central banks accordingly need to follow the forces that bring about changes in the conditions for banking operations because such insights are essential for an understanding of the altered risks such changes may entail for the financial system as a whole.

If more widespread disruptions were to occur in connection with the changing structure of the financial system, the central banks will need to have prepared routines that mitigate the repercussions on the financial system in general. Speed is essential in such situations, as we have learned not least from the numerous financial crises around the world in the present decade. But the problem of moral hazard makes it important that spheres of responsibility and roles for the competent authorities are clearly established in advance of any shocks.

I referred earlier to the strong forces that are at work for a *europisation* of the national banking systems in Europe. These forces include the deregulation associated with the development of the internal market and the introduction of a single European currency.

One problem in this context is that the present European system lacks a central body for the transnational European coordination of the handling of more serious shocks and the supply of liquidity that individual institutions may need. Together with the fact that financial enterprises in the European Union are supervised on a national basis, this adds to the difficulties in coordinating the transnational management of shocks. The problem is accentuated by the rapidity with which shocks are now liable to spread from country to country. Any measures may therefore have to be decided at very short notice, perhaps an hour or so. Thus, there are many reasons for doing more at the EU level so that any problems in the financial system can be handled more smoothly. One conceivable measure I feel should be discussed more thoroughly would be for a greater and more explicit part in the coordination of liquidity support and the management of transnational financial problems to be assigned to the European Central Bank.

## Conclusion

Over the past two decades many countries have deregulated their financial systems. For the first time since the outbreak of World War One, capital is again more or less free to cross national borders. There have also been major changes in communications and information technology, leading to new methods and instruments for the management of financial risks. As a result of all this, the financial system has become more extensive and globalised than ever before. This holds even though capital flows relative to GDP were also large at the turn of the previous century; at that time, moreover, the capital flows were partly of another type and they went to other countries.

The rapid pace and internationalisation of financial developments can be seen as a logical consequence of the globalisation of production of goods and services, together with the rapid expansion of international trade. This has increased the demand, from households and firms, for new financial solutions. The globalisation of production and increased trade call for a more highly developed and international financial system in order to make the best use of the opportunities for greater prosperity.

At the same time, however, the transition to a more global financial system is not without problems. Among other things, it creates a need for structural adjustments, a process that has already begun. I am basically optimistic about the ability of the European banks to face up successfully to the challenges that lie ahead. As a central banker, however, it is my duty to highlight the risks that this process may naturally involve for the financial system in general. What we at the central banks can do is follow developments closely, clarify the current rules of the game and, in the event of something happening that may affect the overall stability of the financial system, endeavour as early as possible to manage any problems that may arise in the payment system.