Financial Integration in Western Europe

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Structural and Regulatory Consequences

SVERIGES RIKSBANK

Occasional Paper 10

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FOREWORD

Financial integration is well on its way in Western Europe. At the beginning of this year the EEA Treaty came into force. Sweden, as well as three other EFTA countries, will become Members of the European Community early next year, if their respective referendums have outcomes in favour of this.

The Riksbank organised in November 1993 a Conference on the effects of the EEA Treaty on the financial sectors. The aim of the Conference was to increase the understanding, among public authorities, academia and the broad public, of the changes in the financial sectors that could result from adapting to the EEA/EU legal system governing financial services. Experts on that topic from both the EU and the EFTA countries were invited to present their views, based on current research on that topic. Subsequently the experts prepared papers for this conference volume under the editorship of my predecessor at the Riksbank, Emil Ems.

I am glad to say that the papers in this volume contain a treasure of insights on the economics of regulation and integration relating to the financial markets. For this I wish to extend my sincere gratitude to the editor and the authors. Admittedly, the issues raised and questions asked exceed by far the solutions suggested and answers given. But this is as it should be when academics are called upon to provide guidance to the authorities. It is for scouts to indicate whether a passage through unknown territory could be found. To blaze and lay the trails is the task of engineers.

Peter Stenkula
Head of Financial Markets Department June 1994

I

INTRODUCTION

EMIL EMS*

On a lovely day in June 1989, EFTA delegates met for the first time with the EC Commission to prepare for the EEA negotiations on free movement of services and capital. The foundation stone for financial integration in Western Europe was laid that day. On the EFTA side several rounds of internal discussions had preceded the meeting, resulting in well-formulated diplomatic statements on principles for the co-operation to be, which were read by EFTA's Chairman to initiate the newly started dialogue. What a revelation to hear the response from the Commission! Expert after expert was called in by the Commission Chairman to give hour-long lectures on the various Community Regulations, Directives, Recommendations, Green Books, White Papers etc. pertinent to each field, and elucidating them in all possible detail.

That enhanced a traditional economist's awareness of the importance of institutional frameworks for the functioning of markets and helped to resolve a seeming paradox: why was it that *freedom* – to provide services all over Europe and to consume services produced anywhere in Europe – could be gained only by bowing to thousands of pages of legal text on a supranational level? The answer is simple. Left to themselves, many European countries would tend to keep national legislation which, to varying degrees, shelters national service markets from international competition. To roll back this sheltering necessitates not only international agreements but also efficient enforcement mechanisms; thus a supranational legal structure.

Less then two years after this pioneering meeting, a sequence of events in the Nordic financial markets reinforced the aforementioned economist's insights into the interplay between legislation and regulation and the functioning of markets. Having begun in Norway but now also evident in Sweden and Finland, financial institutions succumbed to a flood of lending losses that threatened the stability of these countries' financial systems. After having been reined in by a rigid legislative and regulatory system for decades, financial institutions had reacted strongly when this system had suddenly been loosened in the mid-1980s. The reaction had materialised as a wave of credit expansion overrunning these countries and leading to a speculative rise in asset prices which subsequently came to a sudden halt, followed by a rapid decline. The lesson we learned from this is that changes in the regulatory framework for financial services can have profound impacts on market behaviour.

The EEA has entered into force on 1 January 1994 and the participating EFTA countries are now in the process of adapting to the EU legal system in financial services. Furthermore, four among them foresee becoming Members of the EU early next year. The adaptation to the EU system puts new demands on public authorities like ministries of finance, supervisory bodies and central banks. Until recently the adaptation work was relatively passive. The Commission presented the EFTA authorities with a »fait accompli«, the »acquis communautaire«. What remained was to implement it in the national legislations. But in the future, the authorities in the EFTA countries, in particular those becoming EU Members, will face a clearly more active and challenging task; that of contributing to the continuing refinement of EU legislation concerning financial services.

It would be to the long-run detriment of the financial system in countries like Sweden if that contribution were limited to appeals for granting exceptions in the EU legislation concerning national idiosyncrasies or traditional structures still remaining from the old days of comprehensive regulation and the subsequent unfortunate period of transition. Rather one would wish for well-founded and constructive proposals for developing the EU legislation with the aim of furthering the efficiency as well as the stability of the financial system in Europe.

A stimulating task awaits the authorities also in the development of national legislation and regulation. The EU legal framework is just that, a *framework* which has to be interpreted and »filled in« with rules and regulations appropriate for national needs, again with an eye to the efficiency and stability of the national financial system.

For both these tasks insights in two areas are needed. First, a thorough knowledge of national and

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EU rules and regulations is necessary, but unfortunately not sufficient. Economic insights in both the normative and the positive sense are also needed. Normative economic analysis should come into play when scrutinising the motives for rules and regulations and discussing which of the latter should or should not be applied. Positive analysis is needed to understand how rules and regulations affect market behaviour and to gauge the impact of changing those rules.

To enhance these insights, the Riksbank held a Conference in Stockholm in November 1993. Scholars from the EU and the EFTA countries were invited to give presentations on the theme »EEA and the Financial Sectors«. The volume before you contains articles which were prepared by the experts subsequently. It is arranged in two parts, dealing with banking and insurance, respectively.

Each part is introduced by a summary of the Chairman for the respective session at the Conference; Professor Wihlborg on banking and Dr. Hörngren on insurance. Three scholars from the European Communities present, in their articles, a general picture of developments in the services sectors, in particular in financial services, against the background of European integration. Professor Sapir, who recently finished a major research project for the EU Commission concerning the services sector, analyses that sector at large. Professor Llewellyn provides an overview of secular trends in banking. Professor Dickinson, who also participated in the EU project on services, presents developments in the insurance sector. These general overviews are complemented by two papers which scrutinise the development of the EU legal system, by Professor Dermine in banking and Professor Finsinger in insurance.

These EU contributions are complemented by presentations from scholars in EFTA countries. Professor Zweifel provides an overview of the developments concerning regulation and structure in the insurance markets of the EFTA countries, while I attempt a corresponding analysis in banking. We both participated in an EFTA project in services carried out in parallel to the EU project headed by Professor Sapir. After this the papers concentrate on the financial services sectors in Sweden. Two experts from the Riksbank, Erik Blomberg and Eva Blixt, who also took part in the EFTA project, analyse the possible impacts of the EU legal system on banking and insurance, respectively. Finally, Professor Viotti discusses the need for regulatory changes in banking in Sweden and Professor Skogh provides, together with Göran Hägg, such an analysis for insurance. I would like to thank all participants for putting such an effort into their contributions and, last but not least, the Riksbank for getting us all together and making this volume possible.

All in all, the articles in the volume provide the reader with an intriguing »mosaic« of insights. Allow me to shortly outline two main themes, which emerge from this collection of thoughts, leaving it to Professor Wihlborg and Dr. Hörngren to provide a more comprehensive synthesis of the articles.

One clear »Leitmotiv« characterising developments in the financial services sectors is *increasing competition*. This trend could until recently be attributed mainly to technological changes and financial innovation as well as to domestic deregulation. The effects of opening up markets through EU legislation are also beginning to show up and will become more pronounced in the coming years, either directly or indirectly by encouraging further domestic deregulation. This increasing competitive pressure started in banking but is now also beginning to be felt in insurance, as that sector belatedly follows banking on the path of innovation and deregulation.

From increased competition follows continued *structural change*. It is easy to underestimate the adaptation of markets to changed circumstances. But a look back at, for instance, the structure of the Swedish banking market in 1985 and comparing it with its present status clearly demonstrates that changes in market structure and conduct have been far-reaching. I am convinced that we will be able to come to similar conclusions ten years from now with the probable difference that increased *foreign presence* will show up as an intrinsic part of the changes to be.

Increased competitive pressure will also influence the stability properties of financial markets. Even if the companies on the markets do live up to the new challenges by introducing more elaborate management systems and efficient pricing strategies, they will have to live with leaner profit margins and therefore become more vulnerable to external shocks and mistakes in business strategies than they were a decade ago in the sheltered environment of traditional regulation. Thus, failures in financial institutions are to be expected, not only in times of deep recession but also during periods of more ordinary business cycles. It is essential that the authorities develop strategies for dealing with such events in an orderly manner. This brings me to the other prevalent theme in the volume.

That theme is the recommendation that regulation of financial markets should cease to concentrate on *structure and conduct* and be reoriented towards monitoring *performance*, and in general be organised so as not to unduly limit competition.

The first part of the recommendation can be deduced from the needs to adapt to the EU legal system but its main motivation stems from an awareness amongst the authorities, as well as economists, that the traditional system of comprehensive regulation in banking and insurance did not deliver what it promised: to guarantee market efficiency as well as stability of the financial system. In fact, domestic deregulation during the 1980s has already meant a move away from that traditional system, with banking being the forerunner and insurance slowly following. Moving away from the old regulations thus raises the question of what should be put in their place.

The task is easy to describe but difficult to effectuate. It is to safeguard the stability of financial markets and to resolve possible market imperfections, arising from asymmetric information etc., without removing the incentives for competition among financial enterprises.

A first step in trying to achieve this task would be to encourage *measures which work in conformity with market forces*. By encouraging increased transparency in the activities of financial enterprises as well as private market mechanisms such as rating, reputation-building and industry warranty systems, the problem of asymmetric information (the problem of customers being less informed about the riskiness of the enterprises' portfolios than the enterprises) could be at least partly controlled.

The stability issue is pertinent in banking, but much less so in insurance. The focus on performance regulation might therefore differ between these two sectors. Nonetheless, an essential ingredient would in both sectors be to have a closer *public monitoring of solvency*, in particular of institutions which approach or fall below reasonable limits of performance. But such monitoring schemes, although coupled with corrective measures in case of need, will not be able to and should not prevent all possible failures. Thus implicit or explicit *procedures for orderly winding up of failing institutions* will have to be part of the regulatory system.

In that context, it is essential for market efficiency that the owners and managers of failing financial institutions carry the full consequences of failure. But should their customers also be made to pay? Or should they be sheltered by implicit public safety nets or explicit guarantees such as deposit insurance? The case for such schemes is stronger in banking than in insurance since the need to uphold stability in the payment system translates into trying to prevent »runs« on banks. In insurance, life-insurance in particular, the motive for guarantees in case of default of enterprises stems mainly from the need for consumer protection, which of course is a supplementary argument also in banking.

Answering these questions would be easy, if customers would, in spite of such guarantees, remain cautious in their relations with banks and insurance companies, and if the financial enterprises would maintain an appropriate attitude vis-à-vis risk-taking. Unfortunately, if customers always are bailed out in case of default, the incentives for such prudence are drastically weakened and market efficiency is endangered. Thus it is clear that there exists a conflict of goals between, on one hand, stability and consumer protection, and market efficiency on the other hand. The art of regulation consists of trying to alleviate that conflict, for instance, by devising safety schemes in such a way as to have customers share some of the loss at default, analogous to deductibles in conventional insurance. Intensified and more sophisticated supervision of the financial enterprises' performance could also partly compensate for the above-mentioned moral hazard effects of safety nets for consumers.

Although the new philosophy of regulation put forward in the present volume will not be able to fully solve the conflict, I am convinced that it can guide us towards a better compromise between the goals than was ever achieved with the traditional regulatory system.

II

BANKING

EEA and the Banking Industry – Chairman's Summary

CLAS WIHLBORG*

The aim of this note is to pull together the themes relating to structural and regulatory change in banking raised by the authors and in the plenary discussion of the conference. If I fail in this task I would like to pin the blame on the high quality of the papers. The analyses and insights provided there have raised more questions in my mind about the forces shaping the banking industry than I had before. The outlook I will provide accordingly consists to a large extent of questions that I believe should be addressed in order to provide a meaningful vision of the future. I have been assisted by the introductory speeches to the conference, which presented a list of issues for the plenary discussion. I structure my comments around these issues, referring also to the papers.

Does adaptation to EEA legislation lead to a substantial reduction of barriers to entry in the banking sector?

The removal of regulatory barriers to entry in the banking sector is referred to in nearly all of the papers on banking in this volume. There is no doubt that these formal barriers are being substantially lowered. An unresolved issue is the extent to which the remaining »natural« barriers in the banking sector are substantial. By natural barriers I mean those created by, for example, reputation, brand name recognition, and economies of scale or scope, irrespective of protection of domestic institutions by regulatory authorities. Ems and Llewellyn seem to assign less importance to these barriers even in retail banking than, for example, Dermine and Sapir.

Judging from the Swedish experience during and after the banking crisis in the early 1990s, the natural barriers are still high in retail banking for consumers, and for small and medium-sized companies without access to direct borrowing in securities markets. As an example, a sharp increase in interest rate spreads has occurred in the aftermath of the financial crisis, enabling banks to recover capital losses. The spread is now (November 1993) high by international, as well as Swedish, standards. Potential foreign competitors have been unable or unwilling to enter the market in spite of substantial profit opportunities.

It is clear that incumbent banks have a substantial advantage in terms of information and reputation as lenders. Therefore, the most effective means of entering or expanding in the Swedish market would be by acquisition of a bank or parts of a bank, including branches and personnel. It is costly, however, to merge two organizations with different cultures. If such costs are the main reason for lack of competition, we cannot expect EEA alone to create a highly competitive environment.

It is possible, however, that the barriers during the early 1990s are higher than normal because the potential candidates for acquisitions are burdened by bad loans and/or state-owned. Thus, any acquisition will have to involve negotiations about responsibility for bad debts. Governmental authorities will also be part of such negotiations. Therefore, the early 1990s might not be a representative period for the competitive environment in banking.

Another source of competition discussed in the papers (Llewellyn, Blomberg) is that of non-bank financial firms creating bank-like organizations. For instance, corporations in Sweden have considered expanding their services to employees to include limited deposit-taking, lending, and payment services. So far, this type of competition has been constrained by the regulatory authority. Another example of non-bank competition is the ICA retail chain's issuing of a card for purchases at ICA. Since »prepayment« on such a card is allowed, ICA is in effect accepting deposits, albeit on a limited scale. More far-reaching, IKEA is applying for a banking licence and insurance companies wish to start banks for pension saving.

In summary, there are still substantial barriers to competition in banking services for households, and for small and medium-sized firms. The lack of

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competition observed in the early 1990s may exaggerate the barriers, however. Over a longer period, banks are subject to competition both from foreign banks and from non-bank firms and financial institutions.

Can we expect substantial structural changes in banking as a result of the removal of barriers to entry?

Although »natural« barriers to competition may remain substantial in retail banking, the interbank market and the market for financial services for larger firms are already international and highly competitive. These services extend beyond traditional banking in the form of deposit-taking and lending. For instance, large corporations have their own bank-like finance functions, issuing commercial papers and bonds directly to financial investors and providing a range of services for the corporate group.

Llewellyn notes in his paper that there is a long-run secular trend away from banking. The implication of this trend is not necessarily that banks as organizations must shrink accordingly, since the organizations can change their product mix if regulation allows them to do so. In Sweden, as in most continental European countries, banks are »universal«, incorporating both commercial banks in the traditional sense and investment banks serving as underwriters for securities issues. They also offer funds for financial investors, corporate advice, wealth management services and trading activities.[1]

It seems that technological change and financial innovation have been more important sources of structural change than changes in regulation during the last decade. It is possible to argue that it is the regulatory framework that adjusts with a lag to the realities of the market place. Nevertheless, the activities of regulatory authorities matter for the structure of the financial services industry. National authorities have been and are reluctant to allow banks and other big financial institutions to founder. Even with the removal of international barriers to entry, this inclination of governments is likely to remain an obstacle to reductions in excess capacity.

As noted by most authors, excess capacity in banking is a problem. One reason is that the regulation of the range of activities banks were allowed to perform was quite restrictive in many countries well into the 80s. After deregulation, the ability of banks to offer a wider set of services improved, shrinking the need for traditional banking. Competing non-bank financial institutions avoiding regulation had already developed earlier. Thus, deregulation was followed by excess capacity, exacerbated by the secular trends noted above.

As shown by Blomberg, the problem of excess capacity is present in the Swedish banking sector. Thus, the structural changes before us will broadly imply a further consolidation of the sector, a process which is already on the way with the recent merger of two large commercial banks. Increased internationalization and the removal of barriers mean primarily that structural changes are likely to involve institutions in more than one country. As Ems and Viotti point out, a major problem facing regulators in the process is how they are going to allow excess capacity to be reduced while being extremely fearful of failures in the financial sector. I will return to this issue below.

What might be the future role of banks in a changed market environment?

There is general agreement that commercial banking in the traditional sense is bound to shrink as a result of technological developments and financial innovation. The firms we know as commercial banks may nevertheless continue to exist as suppliers of a broad range of financial services. How successful they will be in their new roles depends on a combination of factors related to the economies of banking and the regulatory environment.

The economic factors are economies of scale and economies of scope. If there are scale economies, the large provider of a particular financial service has a competitive advantage. Scope economies imply that there are synergies among a range of financial services. If these synergies cover the whole range of services, then truly universal banks of the German type would have a competitive advantage.

The empirical evidence regarding scale economies is that they are not general in the provision of financial services. This is pointed out by all the authors in the present volume. Where scale economies exist in specific tasks, they can be obtained in cooperative ventures among banks or in specialized firms serving as subcontractors.[2]

Scope economies exist because knowledge about a particular customer can be used across several services. These scope economies are often counterbalanced by possible conflicts of interest relative to the customers. The conflicts of interest are in turn counterbalanced by the bank's concern for its reputation.[3]

[1] Differences remain, however, in banks' rights to exercise control through equity-ownership. German banks are the most »universal« in the sense that their lending can take the form of equity-investment.

[2] See for example Dietrich (1991) and Sapir in this volume.

[3] One example is that a lender can use the information obtained as a monitor of a firm when serving as an underwriter and as an investor in equity and bonds. A conflict of interest can arise when the bank serving as an underwriter tries to get a loan repaid through a bond issue. A bank concerned with its reputation would be careful not to underwrite with such a purpose. US regulation separating banks and investment banks is partly motivated by such possible conflicts of interest.

It is very hard to evaluate the importance of scope economies. The empirical evidence is mixed. In countries where a broad range of services can be supplied by a bank, organizations offering the whole range of services coexist with narrowly focused specialists. The tendency of large non-bank firms to set up their own internal »banks« implies that they mainly demand specialists' services from the outside.

A regulatory factor influencing the future role of banks is the balance between home country and host country regulation and supervision limiting the activities of banks. The guiding principle of EU's banking directives is to apply the home country rule on a bank's activities across the union, while each member state recognizes other member states' rules (mutual recognition). As Dermine points out, there will inevitably be substantial host country supervision and regulation as well, limiting the importance of the highly innovative concept of mutual recognition of home country rules.

Some bankers have expressed fears that home country rule in combination with economies of scope and scale would provide the most universal banks in Germany with a decisive advantage over domestic institutions in other countries. This fear is certainly exaggerated for several reasons already mentioned above. First, scale economies are small if they exist at all, and scope economies are balanced by disadvantages of being a non-specialist. Second, natural barriers to entry are still substantial in traditional banking services. Third, host country regulation will remain in place partly because deposit insurance schemes will cover deposits held in each country. With some host country regulation and supervision in place, there are reasons to expect that each country's authorities will still favor domestic banks.

What might be the tasks of regulators and supervisors?

From a Swedish perspective, the issue of what regulators' role might be in the financial services sector may seem superfluous during these days of eagerness to adopt EU directives. Nothing in the EU or the EEA is set in stone, however, and Swedish, as well as other national authorities, have a responsibility to ask what role they should have within the broader European regulatory framework and to develop their national regulatory systems accordingly.

With this in mind, I will focus more closely on the question of what the tasks should or should not be. Banks, as well as the financial services industry as a whole, are subject to more regulation and supervision of their activities than other industries. The EEA objective of creating a competitive international environment for banking and related services is to a considerable extent contradicted by wide agreement among policy makers that the financial industry requires special treatment. By tradition, it is particularly risk-taking of financial institutions that is subject to regulation and control.

If such limitation of risk-taking by regulation is successful, then it is evident that failures will be fewer than in other industries. The competitive mechanism requiring exit of inferior firms is thereby partially eliminated. Furthermore, the development of more efficient institutional and contractual solutions to the information problems facing savers and investors in financial markets is impeded. Reducing this information problem facing financial investors about the use of financial resources is the primary role of financial institutions and markets. Rigidity of institutional structures in financial markets can therefore be damaging for the productive employment of new savings as well as the redeployment of accumulated savings.

The general role of the regulator of financial markets and institutions should therefore be to make the competitive mechanism work and to stimulate, or at least not hinder, the development of more efficient institutions and contractual arrangements. Going further in regulation should be done only if a strong case can be made.

The perceived need for limitation of risk-taking stems mostly from the role of financial institutions and, in particular, banks in the payment system in addition to their role in the allocation of credit. In order to prevent contagion effects of bank failures from threatening the payment system, lenders to banks obtain explicit or implicit assurances from the authorities. These assurances reduce the banks' aversion to take risk and, perhaps more importantly, they distort competition among banks. In a system without such assurances, banks would compete for funds by obtaining a reputation as good credit evaluators, while in an insured system, there is less to gain for a bank competing this way. Instead, banks tend to focus on volume.

Another reason for regulatory activity in financial markets is the perception that a large number of savers require protection, because they are less informed about the riskiness of banks' asset portfolios than bank-managers. Dermine discusses this argument for regulation in the present volume. In particular, the depositors' lack of information does not fully justify public insurance systems, because private market mechanisms such as rating, reputation-building and industry warranty systems could help resolve this information problem, albeit only if depositors are not insured. If fully insured, depositors will not have incentives to use such information mechanisms.

Viotti's paper in this volume discusses alternative ways of balancing the need for protection of lenders to financial institutions against the benefits of a well-functioning competitive mechanism. He leans towards a system of separate institutions issuing very short-term liabilities of direct relevance for the payment system, backed by safe and liquid assets guaranteeing the ability to repay the liabilities on demand. A limited deposit insurance system could complement these institutions.

One may ask why such a formal separation and deposit insurance would be needed in the first place. Would not a bank without any insurance want to hold separatly highly liquid and safe assets against short-term deposits in a competitive system? Uninformed depositors worrying about the safety of their deposits would then favor institutions that explicitly separate safe and liquid assets to cover their deposits. Thereby, each depositor need not become informed about the whole portfolio of the banks. In fact, money market funds are examples of such separated savings functions.

Granting that some form of deposit insurance is desirable, there are still problems with a deposit insurance that does not cover all deposits of an institution, because any uncertainty about an institution's viability may lead to a flight from it. This problem would be alleviated by separating those institutions holding very short-term liabilities of direct relevance for the payment system and by offering complete insurance for these liabilities, as Viotti suggests.

If an extensive insurance of the bank's whole liability side is required with the current structure of banks to prevent a run on banks in times of crisis, then it is preferable to look for alternative ways of protecting the payment system. The drawbacks of an extensive deposit insurance mentioned above have been widely recognized in the USA and I believe that the Swedish banking crisis is partly to blame on its implicit insurance. Theoretically, the moral hazard problem involved could be held at bay by intensive public supervision of banks' risk-taking and credit evaluation process, but experience indicates that supervisory authorities rarely detect problems of excessive risk-taking and bad credits before a crisis erupts.

The information problem facing a supervisory agency with the task of limiting banks' risk-taking is an additional argument for seeking other means of securing the payment system. Another is that deposit insurance favors deposit-taking institutions at the expense of other financial institutions that are subject to the scrutiny of suppliers of funds. This argument is particularly relevant when banks are involved in markets other than traditional loan and deposit markets.

These considerations lead me to the conclusion that the primary role of a regulatory authority should be to set up procedures for managing failures when they arise in such a way that the payment system is not threatened. Viotti discusses such procedures, where capital adequacy information is used as guidance for whether to take measures and what measures to take.[4]

Whatever signalling system one uses, fast-track bankruptcy procedures and cooperative procedures among banks for dealing with a bank failure should be developed to cope with the worst possible outcomes. Such procedures should allow the bad financial institution to fail and exit and the competitive mechanism to work without the threat of contagious bank runs. The supervisory authority need not supervise banks' risk-taking in general, a task it is ill-suited to perform. The difficulty of being sufficiently informed about risk induces the authorities to be overly specific in their regulation of activities. Thereby they contribute to a conservation of both working procedures and institutions to the detriment of the financial system. These negative consequences of bank regulation and supervision can hopefully be avoided by redefining the role of supervisory authorities as suggested.

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[4] Such a system has been implemented in the USA, where banks' asset choices become subject to supervision when capital ratios fall below a certain level. One wonders what information advantage supervisory authorities have in order to make effective credit allocation decisions.

The Changing Structure of European Service Markets

ANDRÉ SAPIR*

Service markets in Western Europe are undergoing important changes due to the advent of the internal market, in the EC as well as with the EEA, to globalization and to technological change. In contrast to tradable goods, most service markets are just starting the process of internationalisation, partly due to their intrinsic properties, such as the proximity requirement, and also to substantial government regulations. Future changes in the markets will be most pronounced in sectors characterized by a low degree of competition and a high degree of technological innovation, such as banking and telecommunications. Sectors with more moderate changes will include insurance. Least changes are foreseen in sectors like tourism. The national regulation of services markets will have to adapt to these changes as well as to the legal system underpinning the Internal Market. In particular, regulation should concentrate more on performance than on structure or conduct of enterprises and should not unduly limit competition.

Introduction

Services markets in Western Europe are undergoing important changes due to the forming of the internal market, in the EC as well as within the EEA, to globalization and to technological change. In order to assess the impacts of these changes one has to study the specific properties of these sectors. In particular market structure, sensitivity to the internal market programme and sensitivity to technological change are determining factors in this context.

The purpose of the paper is to provide such an assessment for nine services sectors: banking, insurance, road transport, air transport, telecommunications, distribution, construction and business services. The study is divided into three parts. The first identifies features that set services markets apart from markets for manufactured goods. The second derives the main factors determining the degree of competition prevailing on the various markets. The last part analyses the restructuring under way in the services markets of the European Communities.

Main features of service markets

In the European Community, like almost everywhere else, markets for service have long remained sheltered from competition, due to lack of mobility of service across markets and firms within markets. This situation is ultimately related to two factors: the intrinsic nature of service and government regulations.

Services have generally been considered as nontraded activities. Economists often attribute this to the fact that production and consumption must occur at the same time and in the same location. Depending upon the specific requirement of physical proximity between users and providers, four types of international transactions in services can, however, be distinguished:

1 Immobile users in one nation obtain services produced by immobile providers located in another nation. This can occur in some financial services and professional services, where transactions may flow via telecommunications networks.
2 Mobile users from one nation travel to another nation to have services performed. This situation is most frequent in tourism, education, health care, ship repair and, to some extent, distribution.
3 Mobile providers from one nation travel to another nation in order to perform services. Such a situation occurs in certain business services, transportation and construction.
4 Providers from one nation establish a presence in another nation in order to perform and sell services. This is the most common pattern of international service competition in areas involving frequent and close interaction between buyers and sellers. It is the dominant type in most business services, in financial services and in distribution.

Given the prevalence of type 4 situations, foreign direct investment (FDI) plays a crucial role in international service transactions. Yet, the border between

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the different types of international transactions, especially types 1, 3 and 4, is not impermeable. In many business services, for instance, much of the foreign work is provided by local establishments (type 4), while key personnel travel from the home office to provide specialized services (type 3).

Another feature of services that bears on tradability is the problem of asymmetric information between buyers and sellers. The quality of certain goods can be determined by consumers prior to a purchase. For other goods, the quality can only be learned after they are bought and consumed. In yet other cases, the quality is never fully learned, even after consumption. These three categories of goods have been labelled »search goods«, »experience goods« and »credence goods«. Since services only exist while they are being consumed, their quality cannot easily be assessed prior to consumption. Services are, therefore, rarely search goods. Most are experience goods, and a few (such as medical services) are credence goods. Thus, a major issue for services is information.

Although it can be argued that the ultimate quality of certain services depends on the interaction between users and providers, it remains that sellers know more a priori about product quality than buyers. The asymmetric information about product quality between consumers and producers which pervades many service industries has several consequences. First, the frequent use of reputation to signal quality implies that service markets are often characterised by non-price competition. Second, since reputation creates an incentive for long-term relationships between service firms and their customers, a decision by large customers to invest abroad tends to trigger a similar move on the part of service firms. However, the optimal sequencing in the decision to become multinational may not be unique. Third, being largely a sunk cost, reputation creates a barrier to entry which may severely reduce the degree of actual or potential competition in service industries. Consequently, changes in service sectors are less likely to take the shape of entry by new firms than restructuring among existing ones.

In almost all countries services are subject to more *government interventions* than most other activities. Instruments of public intervention cover a wide range of control. Public authorities may indirectly control economic activity by taxes and subsidies; they may intervene directly through regulation; or they may even operate directly through nationalised enterprises. Governments also intervene through competition policy.

Although other forms of public intervention are also common, regulation plays a dominant role in most service industries. In the presence of market failures, regulation may be justified on grounds of efficiency. Mainly three types of failures are relevant to service industries.

Imperfect competition prevails in most services. Some industries are natural and/or public monopolies (railroads and segments of telecommunications), in which case regulation may be required to prevent both excessive entry and monopolistic abuse. Others tend to be oligopolistic (certain transportation services as well as banking) and the so-called excessive or destructive competition argument may be invoked to justify regulation. The remaining service industries tend to operate under conditions of monopolistic competition and do not require regulation, except in cases of imperfect information.

The problem of *imperfect information* pervades many services. It often invites government intervention in the form of occupational licensing and certification (in particular in professional services such as accounting, law and medicine).

Externalities arise in certain service industries. Asymmetric information may generate a negative externality. In financial services, for instance, failure of one institution may cause problems to others. This situation calls for regulation through licensing and certification. On the other hand, positive externalities occur in activities, such as telecommunications services, where the value for one user increases with the total number of users. In this instance, government intervention may be required to encourage network compatibility and prevent entry deterrence.

Government regulations in services result not only in barriers to the mobility of firms within markets, but also often constitute barriers to the mobility of services across countries. Barriers to international transactions in services can be classified into four categories, each corresponding to one of the four types of transactions described above:

- Barriers to trade.
- Barriers to the movement of service users.
- Barriers to the movement of service providers.
- Barriers to foreign direct investment.

Moreover, government regulations may act as barriers to trade in services even if they are not intended to discriminate between domestic and foreign producers. In some instances, the divergence of national regulations across countries may be sufficient to prevent international transactions from occurring.

European service markets prior to the 1992 programme

This section examines the principal causes of fragmented European service markets, besides the proximity requirement. It is organised around three issues: »natural« determinants of market structure, natural and strategic barriers to entry, and government regulation. The analysis concludes with a taxonomy of service markets according to degree of competition on the market in question.

»Natural« determinants

Supply and demand conditions both act as »natural« determinants of market structure.

On the supply side, the major role is played by technology, with economies of scale and scope as crucial parameters. The nine service sectors considered here fall into three categories regarding economies of scale/scope.

Two sectors display *high economies*: telecommunications (economies of scale), and airline transport (economies of scope).

Two sectors display *little economies:* banking and insurance.

Five sectors display *no economies:* road transport, construction, distribution, hotels, and business services.

Economies of scale and scope are crucial factors in shaping the number of firms in an industry and, hence, its degree of concentration – although barriers to entry and regulation are also important in this respect. Depending upon whether an industry is composed of firms exhibiting low or high economies of scale or scope, its production will tend to be subject to a low or high degree of concentration. This relationship is confirmed by the sectoral studies which indicate the following:

Telecommunications is the *most concentrated* service sector (in most member states, there is only one firm).

Airline transport is also often *highly concentrated* inside Europe, with the exception of a few highly travelled routes (usually, to and from London).

Some financial services display *fairly high concentration* ratios. The Commission study indicates market shares (in 1989) above 40 per cent for the five largest banks in seven out of eleven member states. In life insurance, it reports that the three largest companies had (in 1989) market shares above 40 per cent also in seven out of eleven available member states. The degree of concentration is, however, much lower in non-life insurance, where the 40 per cent threshold is reached in only two out of eleven countries.

The remaining sectors (road transport, construction, distribution, hotels, and business services) have, usually, large numbers of sellers, implying *low concentration* ratios. Yet the actual degree of concentration may be far greater than a superficial conclusion based on the number of firms might imply. First, as is well known, the degree of concentration tends to vary a great deal depending upon the definition of the »relevant market« used for computing concentration ratios. This is particularly the case in service activities which tend to be spatially fragmented. In such activities, information about the degree of concentration at the level of member states has little meaning. Instead, knowledge about local conditions is far more relevant. It is likely to reveal important differences between large and small markets. This situation is well illustrated by the distribution sector, where high concentration often prevails in small local markets. Second, within many of these sectors or sub-sectors, there are segments where concentration is relatively high, even when computed at the national level. In fact, two types of activities often coexist. On one hand, there is the multitude of single-unit service firms. On the other, there is the growing number of multi-unit firms which provide standardised services in many locations. One example is the hotel business.

On the demand side, differences between consumers result in a great deal of product differentiation by suppliers in nearly all services. Among the nine sectors studied here, three stand clearly apart with a limited extent of product differentiation: telecommunications, road transport, and construction.

Barriers to entry

As commonly accepted, barriers to entry consist of factors that confer an advantage to incumbent firms over potential new entrants. Private entry barriers – barriers resulting from government actions will be treated below – may be either »natural« (i.e. exogenous) or strategic (i.e. endogenous).

Barriers to entry result from the existence of sunk costs, i.e. fixed costs associated with irreversible investments. Service industries typically incur fixed costs in two types of assets: tangible or physical (buildings and equipment), and intangible or immaterial (reputation). In most service industries, fixed tangible costs are not sunk. Among the nine sectors considered in the study, the only one with substantial physical sunk costs is telecommunications. On the other hand, reputation – in which services must invest heavily because of widespread asymmetric information problems – is largely a sunk cost. Reputation costs are, however, not equally sunk across the different service sectors. As far as the nine sectors are concerned, the following distinction seems appropriate:

Reputation costs are highly sunk in five sectors: insurance, banking, airline transport, business services, and telecommunications.

Reputation costs are less sunk in the other four sectors: road transport, distribution, construction, and hotels.

The above information regarding the importance of barriers to entry measured by the extent of tangible and intangible sunk costs indicates that the nine services fall into three categories. The first includes services where barriers to entry are low (i.e. both tangible and intangible costs are little sunk): road transport, distribution, construction, and hotels. The second is one where barriers to entry are very important (i.e. both tangible and intangible costs are highly sunk): telecommunications. The last category comprises of activities which display an intermediate level of barriers to entry (i.e. tangible costs are little sunk, but intangible costs are highly sunk): insurance, banking, airline transport, and business services.

Government regulation

In all member states, governments regulate the functioning of service activities for a variety of reasons including market failures. Regulatory instruments are usually divided into two broad categories: those that affect the structure of the industry, and those that impinge upon the conduct of industry participants. The former govern the entry of new firms into the industry, while the later control the behaviour of existing industry members.

Most service sectors are subject to both structural and conduct regulations, but the intensity of restrictions differs a great deal across activities. Four situations can be found among the nine sectors studied here:

Four sectors have traditionally been subject to a *high degree of both structural and conduct regulations:* banking, insurance, airline transport, and telecommunications. The mode of government intervention, however, has not been the same in the financial as in the other two services. In airline transport and telecommunications, governments have generally been the owners of enterprises. Their control over the structure of the industry and the behaviour of its members (or, often, sole member) has been, therefore, direct and total. By contrast, in banking and insurance the role of government has been more indirect, even though it has been an owner of some firms in certain member states. Regulatory rules have been, nonetheless, stringent, mostly (but not exclusively) for prudential reasons.

Three sectors have been relatively *free of government regulation*: business services, hotels, and construction. The rules for entry into these industries are not very stringent, nor is there much in the way of restriction on the behaviour of their participants.

The distribution sector is *subject mostly to structural regulations,* albeit with great differences across segments. As the Commission study indicates, the segment most affected is that of large retail centres, where padlock laws have often been enacted to protect independent retailers. Some degree of conduct regulation also prevails in the guise of restrictions on opening hours.

Finally, the road transport sector is *subject mostly to conduct regulations*. As indicated by the Commission study, governments have instituted a number of rules that affect the behaviour of road hauliers, including quantitative restrictions, price controls and technical standards.

Taxonomy of European service markets

Based on the preceding analysis, it is possible to assess the degree of competition and characterise the type of market structure in service industries. Three distinct situations prevailed among the nine sectors studied here prior to the launching of the 1992 programme:

The *degree of competition was low* in the following four sectors, in decreasing order: banking, insurance, airline transport, and telecommunications. The market structure at the banking-insurance end of the range can be characterised as one of *oligopolistic competition*, given the average degree of concentration that prevailed. At the other end of the range, telecommunications, the most concentrated service sector, belonged to the category of *regulated monopoly*. The airline transport sector fell somewhere inbetween these two cases, depending on the precise route or segment considered, but on the whole probably closer to the former.

The *degree of competition was high* in three sectors: road transport, construction, and hotels. The first two, given their low level of product differentiation, were close to a situation of *perfect competition*. The third, with its relatively high degree of product differentiation, was probably closer to a situation of *monopolistic competition*.

The *degree of competition was average* in the remaining two sectors, distribution, and business services, which also belonged to the category of *monopolistic competition*.

The five sectors classified under the headings of perfect or monopolistic competition share an interesting and important feature. Economies of scale have traditionally been modest in these sectors. As a result, they have been characterised by a large number of small firms providing services to localised markets. As Michael Porter has noted[1], this situation is now rapidly changing with the emergence of the large multi-unit service firm, able to replicate services consistently and efficiently at many locations because it creates standardised facilities, methodology, and procedures to guide the behaviour of employees, and automates individual service delivery tasks. According to Porter, the multi-unit service firm is the vector of improving technology and growing internationalisation in hitherto traditional small-scale service sectors.

The restructuring of European service markets

Since the mid-1980s, service markets in the Community have undergone important changes as a result of not only the Internal Market programme but also technological change. Regarding the latter, the main recent development affecting services is the introduction of information technologies. More than in any other activity, information technology has transformed the nature of products, processes, companies, industries, and even competition in services. Most service industries are now characterised by a high information-technology content in product or process. In fact, over the past decade, the scale of investment in information technology by the service sector has been massive in all industrialised countries. For instance in the United States, it appears that the service sector now owns more than 85 per cent of America's installed base of information technology and has a far greater proportion of its total capital committed to information technology than manufacturing does. The new information technology has reduced the need for interaction between consumers and producers in several services, thereby enhancing their tradability. However, given the informational problem in most services, intra-firm trade is more feasible than arm's-length transactions among unrelated parties.

The intensity of the impact of 1992 and technological change varies a great deal between the nine service sectors concerned. Three categories of sectors can be distinguished. The first comprises sectors where the impact of both changes is high: banking and telecommunications (value-added services only). The second incorporates sectors where one impact is high while the other is low: construction, airlines, insurance, trucking and telecommunications (basic services only). The last comprises sectors with a low impact of either 1992 or technological change: business services, distribution, and tourism.

[1] Michael Porter, (1990), *The Competitive Advantage of Nations*, London, MacMillan.

The future shape of the European common market in services is likely to be guided by the following three conjectures:

> First, for most services the high degree of proximity required between consumers and producers implies that 1992 is not likely to greatly affect the location of production. Ownership of firms, however, could be vastly transformed as local service providers become parts of multinational networks. This may shift the production of certain activities from the local point of consumption to the headquarters of the multinational network.
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> Second, for most services the high degree of imperfect information about quality and the use of reputation mechanisms confers advantages to incumbents. This explains attempts by established firms to preempt unfilled niches (i.e. locations or market segments) threatened by potential entrants. Such behaviour, in anticipation of the 1992 liberalisation, can be observed in several service industries (such as airlines and banking). It may require a strong competition policy by European authorities to prevent incumbents from deterring entry.
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> Finally, for most service industries government intervention is likely to remain beyond the 1992 deregulation. Such intervention would require, however, a careful analysis in order to determine the appropriate level of authority (community, national, regional or local). It is likely that, in several instances, national regulations should be replaced by EC-wide interventions. In addition, whatever the appropriate level of intervention, more room should be made for market-based regulations.

It is too early to analyze in detail the combined effects of the Internal Market programme and technological change on the shape of European service markets. Nonetheless, fragmentary information allows us to comment on the three conjectures – regarding internationalisation, competition and regulation – presented above.

Internationalisation

With respect to the process of internationalisation, it appears that services lag far behind manufacturing in two respects. First, trade still accounts for a relatively small proportion of economic activity in services, i.e. the tradability of services remains relatively modest. Second, the current process of mergers and acquisitions in European services still retains a strong national dimension, even if many firms are regionally active outside their home market. In banking, for instance, there have been relatively few transborder mergers and acquisitions, at least at the retail end of the market. So far firms have pursued, instead, a strategy aimed at consolidating their position in the domestic market with a view to resisting more strongly the internationalisation of competition expected to result from EC liberalisation. A similar pattern prevails in most service sectors.

There are few service sectors where firms have acquired a truly European dimension. The most notable case is insurance, where the top European firms have recently become remarkably internationalised.

These findings seem to indicate a sharp contrast between services and manufacturing in the current process of mergers and acquisitions. Two facts appear to stand out. Firstly, as already indicated, in the EC, mergers and acquisitions in services would seem to tend to be more oriented toward the consolidation of the home market, while the process of international concentration is more advanced in manufacturing. Secondly, the (positive) correlation between a country's market size and the size of its corporations is stronger in services than in manufacturing. There are relatively fewer service firms headquartered outside the Triad (EC-US-Japan) which belong to the world's largest firms than in manufacturing.

Differences in the geographic scope of service firms exist not only between sectors. Within a given sector, the stage in the process of concentration – national, regional, or international – also differs significantly across countries. In some countries, the restructuring among domestic firms has already been completed and large corporations have been established which are engaged in a strategy of regional or international consolidation. Within the Community, the largest service corporations are concentrated in three countries: the United Kingdom, France and Germany. These few corporations are spearheading the burgeoning process of transborder consolidation in the Community. In the food distribution sector, for instance, an advanced stage of concentration has already been reached in northern Member States, while southern markets remain very fragmented. A few firms from the North have, to date, made significant inroads into the latter markets, but the creation of EC-wide corporations is still far away.

The change in *ownership* of service firms and the ensuing possible concentration in favour of a few corporations headquartered in London, Paris or Frankfurt has a number of important implications for EC policies (in particular, competition policy). On the other hand, the potential implications for the *location of production* are likely to be relatively minor, given the requirement of physical proximity between producers and consumers. The increased tradability of some services – resulting either from the removal of trade barriers or innovations in data processing and telecommunications – may, however, induce a partial relocation of production. Such relocation would produce a pattern of production inside the Community more in tune with the underlying competitive advantage of Member States than the present configuration.

Competition

The second conclusion concerns the problem of competition. This issue cannot be entirely separated from the third problem, which concerns regulation. As previously indicated, service sectors have traditionally been highly regulated. Among the nine sectors covered by the study, four have been subject to a high degree of both structural and conduct regulations, namely: banking, insurance, airline transport, and telecommunications. Such regulatory controls were often justified on efficiency grounds, as a means to remedy market failures which seem to prevail in service industries.

In recent years, public authorities in the Community have come to question the basic premise that regulation remedies market failures, and even does so effectively. Alternatives to traditional regulation are now proposed with a view to producing more efficient outcomes. The central feature of the new attitude by the Commission is the belief that regulation, by limiting competition, may hinder rather than foster efficiency in service industries, such as telecommunications, banking, insurance, and transportation. According to the *XXIInd Report on Competition Policy* of the EC Commission[2]: »*As they emerge from a long tradition of regulation and from confinement to small national markets, it is becoming clear that some of these industries are not efficiently organised and that their ... services are overpriced.*«

Most regulated services are provided by private or public enterprises operating according to strictly market principles. A few public services, however, are operated by public enterprises with statutory monopoly. Among the nine sectors covered by the study, eight belong to the former category. Only telecommunications belongs to the category of a public service provided by public undertakings with statutory monopoly. The problem of competition differs significantly between these two categories of activities.

According to Article 90(2) of the Treaty of Rome, undertakings entrusted with the provision of public services are subject to the rules of European competition policy »*in so far as the application of such rules does not obstruct the performance, in law or in fact, of the particular tasks assigned to them.*« Until recently, the Commission's interpretation of Article 90(2) was clearly biased in favour of granting monopoly rights to such undertakings, since it did not require Member

[2] Commission of the European Communities, 1993, *XXIInd Report on Competition Policy*, Brussels – Luxembourg.

States to provide proof that their exemption from competition rules was necessary for the *performance of particular tasks assigned to them*. This situation has changed in the late eighties. As a result, competition has increased in a number of service activities, such as telecommunications, previously reserved for public monopolies.

The situation is rather different in the other service activities, where regulation may have lessened competition, but not to the point of imposing public monopolies. In these activities, the Internal Market programme has resulted in two opposing effects on competition. On one hand, less stringent regulations on structure have allowed the entry of new firms into the markets. On the other, strategic alliances between incumbent firms in national or regional markets have attempted to deter such entry. The relative impact of these two effects is not always clear, but there are worrisome signs that the latter may often dominate the former. Such a situation would require stronger intervention on the part of European competition authorities to prevent anti-competitive behaviour.

Regulation

The last conclusion concerns the problem of regulation. As already indicated, the Commission feels that many services sectors are characterised by a high level of regulation by public authority. This has limited the scope for competition and reduced efficiency in these sectors. Recent EC competition policy has started to introduce competition in regulated markets. In its XXIInd Report, the Commission recognises, however, that »*competition cannot be introduced without taking due account of the particular characteristics of each industry*« and that regulation is important in the public interest.

A conflict between competition and efficiency could arise if competition rules prevented certain forms of government intervention deemed necessary to remedy market failures. At the moment, however, the Commission feels that the potential for such conflict is relatively unimportant given the extent of existing regulatory controls. Instead, it views the introduction of competition as a means to improve efficiency. At the very least, the Commission feels that »*existing [regulatory] arrangements can often be replaced by less restrictive arrangements without jeopardising [their] objectives*« of greater efficiency. The underlying assumption is that the relationship between regulatory controls and efficiency is shaped like an inverted U, i.e. that there is an optimal level of regulation. Present controls are judged to be beyond the optimal level, leaving room for lower controls and improved efficiency. However, lack of consensus on the precise location of the optimal level of regulation is likely, sooner or later, to result in frictions between the Commission and Member States.

Finally, concerns have often been expressed regarding the danger of a trade-off between competition and the desire for the provision of certain basic public services to the entire population. In fact, such a possibility is limited since the Commission is obliged, under Article 90(2), to take into account considerations of various public policy goals in assessing the application of competition rules to undertakings providing public services.

Secular Trends in Banking

DAVID T. LLEWELLYN*

The past decade has provided us with powerful case studies of the impact of deregulation and increased competition in banking. The pressure for further change has not subsided. Increased competitive pressures, the decline in entry barriers and the emergence of new suppliers of banking services, further changes in regulation, cost pressures, financial innovation, and technological changes will continue to erode the comparative advantages of the banks in their traditional role as financial intermediaries, and thus the value of the banking franchise. Banks are adapting by changing the way they conduct their business, focusing upon cost-reduction strategies, and incorporating a wider range of financial services in their business. Nevertheless we are likely to witness a further reduction in the number of banks in the global financial system. Thus the ongoing structural consolidation will continue in the years to come.

Introduction

The recent experience of banking, in Scandinavia and other parts of the world, offers a powerful case study of the impact of de-regulation, increased competition in banking, and the behavioural responses of banks. The focus of this paper is on underlying longer-run or secular pressures on the banking industry which are independent of the immediate predicament of banks. A central theme is that global pressures are likely to dominate country-specific factors in the future evolution of banking systems. For instance, the future evolution of banking in Sweden is likely to be shaped more by secular pressures than by the response to the recent sharp deterioration in financial performance. There is a danger that a myopic concentration on short-run factors (as powerful as they currently seem) could obscure more powerful secular pressures which will require major strategic responses by banks, credit institutions generally and the regulatory authorities.

This secular perspective follows a period of two decades in some countries, and one decade in others, of very rapid expansion of banks' balance sheet positions which is likely to prove to have been unsustainable. The next phase is likely to be one of more moderate growth of balance sheet positions, and thus a relative decline in the role of banks in the financial system, most especially *vis-à-vis* the capital market but also relative to non-bank financial institutions and non-financial banking institutions. It is also likely that on-balance-sheet business of banks will be a declining proportion of their total business. In effect, more institutions than banks will be providing banking services and major changes will occur in the nature of the business of the traditional banking firm.

Basic observations

Before considering the longer run secular pressures on banking industries, the scene is set by a series of general observations about banking globally. Although there are, and will be, major differences between countries, a series of common pressures operating globally on banking institutions are likely to dominate country-specific factors. These observations are designed to give an overall perspective on the analysis to follow.

As banks are enterprises in the normal economic sense of the word, it is instructive to consider the ultimate reason for the existence of any enterprise. Ultimately, a firm exists because it performs services or produces goods that cannot be performed or produced in other ways or by other firms, or because it has a comparative advantage in providing services. The position of a firm is potentially undermined, therefore, if either of these two conditions is eroded: it becomes vulnerable if it loses its traditional monopoly or alternatively if its competitive position *vis-à-vis* alternative firms is eroded. This is happening in banking. In particular, there is now little that banks do that could not equally be done either by markets, by non-bank financial institutions, or by non-financial banking institutions. In effect banks are no longer the exclusive suppliers of banking services.

When considering strategic issues in banking it is necessary to distinguish between the demand for

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traditional banking services and the position of banks in supplying those services on the one hand, and the actual business conducted by banks on the other. An instructive analogy is found with the history of the stage-coach industry: stage coach companies disappeared not because the demand for travel declined but because new methods of providing travel services emerged. Companies in any industry may decline either because the demand for the product declines or because new suppliers emerge. Although the demand for traditional banking services will rise throughout the rest of this century (and probably relative to incomes), this does not in itself mean that institutions called banks will automatically be the suppliers of these services. Similarly, it does not follow that banks in the future will only be conducting the traditional banking business they have conducted in the past.

Two major determinants of structural change in the banking industry are likely to emerge over the rest of this decade and beyond. Firstly, entry barriers into banking will decline further, with the implication that more institutions other than banks will in the future be providing traditional banking services. At the same time, it will become easier for banks to diversify into providing a wider range of non-traditional banking services. In particular, more of banks' business will be conducted off the balance sheet compared with the past.

Throughout the world, changes in regulation have fundamentally altered the business and competitive environment in which the banking industry operates, and this has short-run and long-run dimensions. With respect to the short-run, changes in regulation during the 1980s operated as a substantial »shock« to the financial system, and banks and other institutions made serious mistakes in their response to those shocks. However, the long-run dimension to the new regulatory environment is likely to be of more significance. Almost always and in any industry, regulation creates *economic rents* and protection. This protection frequently leads to increased costs, buoyant profits, and over-capacity. Historically, regulation in banking has been protective and has often had the effect of limiting balance sheet growth. It has also had the effect of limiting competition on the premise that »excess competition« in banking can lead to increased risk. In terms of the trade-off between efficiency and stability, stability has often been given higher priority than efficiency. Regulation in banking has also frequently condoned restrictive practices and anti-competitive devices, and has in general had the effect of limiting the role of price competition (Llewellyn, 1986). In turn profits were, in this regulated industry, reasonably assured, there was a high value to the banking franchise, and risks in banking were comparatively low as credit rationing was 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 over price competition. This in turn also led to an excessive cost structure. All of this created incipient excess capacity: it created capacity in the banking industry that was viable while the protection lasted but would prove to be unsustainable in the absence of that protection.

In many countries banks over-expanded during the 1980s (in some countries also during the 1970s) because they underpriced their products and services. This can be demonstrated by a few examples: competition (especially in wholesale and international banking) eroded lending margins to unsustainable levels; in many countries banks have not reflected adequate risk premia in their lending interest rates; the pricing of many banking products has been based on a complex network of cross-subsidies which are likely to prove to be unsustainable in a competitive environment; in many countries the regulation of interest rates, which frequently meant that the economic price of deposits was not being paid, conferred substantial »endowment profits« on the banks. Overall, it is unlikely that the rate of expansion of banks' on-balance-sheet business experienced in many countries during the 1980s will be repeated: history is likely to prove that this was an unsustainable rate of growth because much of the business was underpriced.

Capital, especially tier 1 capital, is likely to become a major issue in Swedish and global banking. In particular, the focus of banking performance will in the future be more related to the rate of return on equity than to considerations of the size of the balance sheet, the rate of growth of on-balance-sheet business, and considerations of market share. Capital is likely to become the banks' most scarce resource.

A central issue in Swedish and other financial systems in the years ahead will be the balance of financing undertaken by, respectively, financial institutions (including banks) and the capital market. In many respects, and especially for wholesale corporate banking, the capital market is a major competitor to banks and this trend will continue in the future. Technology has reduced transactions costs in capital markets, and financial innovation (the creation of new financial instruments) has widened the range of capital market facilities. It is likely, therefore, that in the future large corporations will find themselves financing their requirements relatively more in the capital market than from banks than has been the case in the past. A shift is therefore to be expected in the relative roles of markets and institutions in the years ahead.

The overall conclusion is that banking will not be as protected as it has often been in the past, and that as a result the value of the banking franchise is likely to decline. In many respects, banks are losing some of their competitive advantages in the provision of services and, increasingly as entry barriers come down, they are losing monopoly power. Most especially, the trend has been (and will continue to be) for non-bank financial institutions and non-financial banking institutions to become more serious competitors to banks in the provision of a range of traditional banking services. This is likely to accentuate problems of excess capacity which will become a major strategic issue for banks. In addition, the role of markets is likely to increase in the financial system and in the financing of the corporate sector in particular. Overall, therefore, it is likely that competitive pressures will intensify yet further and that banks will face competition from markets, the capital market, non-bank financial institutions, and non-financial banking institutions.

Secular pressures on banking

While the significance of the recent sharp deterioration in the financial performance of banks is not to be underestimated, the thesis is that longer-run, secular pressures are likely to be more powerful in determining the evolution of banking to the end of the decade and beyond. These pressures are likely to be more powerful than e.g. the responses to the banking crisis in Sweden. A component of the analysis is that banks over-expanded during the 1980s and to an unsustainable degree: this over-expansion was in part associated with the stock-adjustment effect of the change in the regulatory regime. For this reason, the growth of balance sheet positions is likely to be considerably weaker for the rest of the decade. In addition, deregulation has removed economic rents that were previously created by regulation. In the process, this has revealed excess capacity which was built up during the previously protective environment.

Starting from the basic observations outlined above, a series of inter-related *secular* pressures are identified that, in varying degrees, impact on banking, although they are likely to impinge in different ways in different countries, and to different degrees. These secular pressures may be less immediate than the current problems facing banks in many countries, but they are nevertheless likely to be powerful in the longrun and have major strategic implications.

Dominance of competition

The overwhelming pressure will continue to be increased competition. Contestability in banking has also been raised (Colwell, 1991). Banks will face more intense competition on both sides of the balance sheet: for deposits and loans. Entry barriers – both *innocent* (e.g. scale economies) and *strategic* (e.g. cartels) – will continue to decline. Technology is eroding traditional *innocent* entry barriers (such as scale factors and the requirement for a branch network for the delivery of financial services) and competition and changes in regulation are eroding some traditional *strategic* entry barriers (such as restrictive practices and anti-competitive mechanisms). As already noted, competition in the provision of banking services will come from three major sectors: financial markets (including the capital market), non-bank financial institutions and non-financial institutions. The traditional barriers that separate these four sectors (including banks) are steadily being eroded under the pressure of changes in regulation, technology, increased competitive pressures, and the evolution of strategic objectives of different parts of the financial system.

Asymmetric competition

Competition has a powerful impact on any industry. However, competition is working asymmetrically in the financial 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. As entry and regulatory barriers are eroded, banks will face competition from a wider range of potential competitors. Several examples in various countries can be cited where new entrants have been able to compete with banks in supplying traditional banking services. Companies such as Volvo in Sweden, British Petroleum in the UK, Renault in France, have all been able to internalise some of their banking services and, to some extent, provide a limited range of banking services to others. Some large corporate customers have become more creditworthy than their bankers, in which case it is not surprising that they both 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 many countries car manufacturers have acquired their own banks for the provision of credit to sales agents. As observed by Rosenblum and Pavel (1986), industrial and transportation companies, manufacturers and retailers have acquired insurance companies, finance companies and leasing operations. Again in the United States, AT & T has become one of the largest issuers of credit cards; in the United Kingdom, Marks and Spencer (a retail store) offers a range of financial services including consumer loans; in many countries several stores have begun to offer credit cards and other credit facilities. In the United States, General Motors and IBM offer short-term money market investment facilities and commercial loans to companies. In the United States and the UK even the standard current account service can now be provided by money market funds. Together with other factors, this trend has contributed to »excess capacity« in many banking markets. If entry barriers are eroding faster (and to a greater extent) than exit barriers, it is almost inevitable that excess capacity will emerge. The significance of the asymmetric nature of competition is that, in the presence of regulatory and economic barriers to banks diversifying out of finance and buying non-financial companies, the potential pressure on bank profitability of new entrants cannot be offset by symmetrical diversification.

Deconstruction

A further feature reducing entry barriers is the process of *deconstruction*. This involves the process of decomposing services into their component parts which may then be provided separately. An example is the standard loan which is not a single product or process but three processes in one: an *origination* process, an *administration* process, and the holding of an *asset*. These need not be undertaken by the same firm and if, for any reason, different firms have different comparative advantages in different parts of the process, the logical development is for each process to be supplied separately by the firm which has a comparative advantage in doing so. Firms which have an efficient capability for originating and administering loans (e.g. because they have a branch network) may not necessarily be the most efficient at holding assets on the balance sheet. Similarly, in the UK and US, credit card companies are subcontracting the administration of their business to outside organisations. A third example is the process of *securitisation* of bank loans: a bank makes a loan, temporarily holds it on the balance sheet, but subsequently securitises it on the capital market. This process of *deconstruction* or unbundling effectively lowers entry barriers as it means that new organisations are able to enter a market because they need not be involved with the whole process; they are able to concentrate on that part of a business where they have a comparative advantage. This is also related to the question of economies of scale. The major economies of scale in banking relate not to *institutions* but to *processes* and *functions*. In general, specialist providers tend to be more efficient than others. One of the major pressures in the banking industry in the years ahead will be the deconstruction process where each institution concentrates on that part of the business and those processes 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 also led to a *deconstruction* of the services traditionally provided by banks into their constituent components. Some of these services can now feasibly be provided more efficiently in the capital market. For instance, the general development of »pass-through« securities and securitisation in general has resulted in a segmentation of the origination, servicing, credit-evolution, and pricing of credit risk from the credit intermediation function (Eisenbeis, 1990).

Technology and delivery systems

Developments in technology will clearly have a powerful effect on the mode of delivering financial services. In particular, the branch network is likely to become less important for delivering financial services. On the other hand, *direct banking* (postal and telephonic delivery systems) will become comparatively more important. This has potentially important implications for competitive strategies in that institutions with a substantial branch network may find that what used to be a major competitive advantage because it created an entry barrier, becomes one of their most expensive problems. Developments in technology have the effect that financial systems are substantially over-supplied with infrastructure and overlapping delivery systems through a duplication of branch networks. One of the major strategic challenges will be to reduce the scale of the branch network.

Technology and information

Several theoretical approaches to the existence of banks focus upon various information problems and how banks are able to handle them more efficiently than the capital market and bilateral transactions between borrowers and lenders (see, for instance, Bernanke and Gertler, 1986, and Bisignano, 1992).

Technology has the potential to increase the availability and reduce the cost of information. This is potentially important because information has historically been one of the banks' major advantages. Given that ultimately financial institutions are in the »information business«, anything that impacts on the availability, cost and management of information has a decisive influence on their business. A combination of new technology, the increasing role of rating agencies, and more extensive disclosure laws are in effect reducing the banks' traditional information advantage. In some cases, information which was previously a private advantage to the bank has become more of a public good. Information technology will both increase the access to, and reduce the cost of, information.

Interaction of competition and regulation

The interaction of competition and regulation may create what has been identified as a »strategic dilemma of world banking« (Llewellyn, 1989). This has been related specifically to the Basle Capital Convergence (BCC) proposals, and is outlined in

Chart 1 Strategic dilemma of world banking

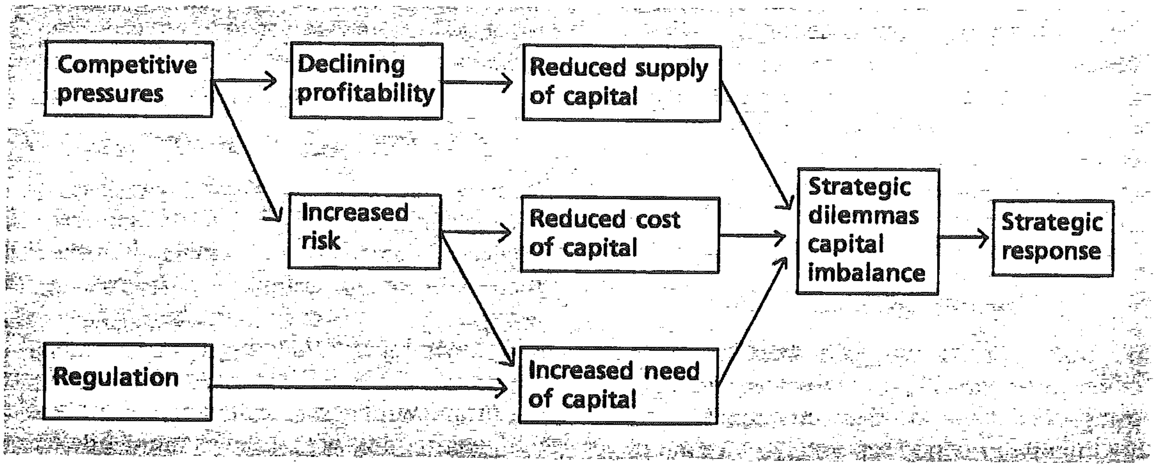

Chart 1. Competitive pressures have the potential to erode profitability and increase banking risks. The former reduces the potential supply of internal and external capital while the latter raises the cost of equity capital, and raises capital requirements. At the same time, regulation also raises capital requirements under the BCC regime. As put by the BIS, »The need for additional capital has coincided with a reduced willingness on the part of the markets to provide it.« The »strategic dilemma« is that the interaction of competition and regulation has the potential to create an imbalance in the supply and demand for equity capital in banking and to raise the cost of capital. The possible strategic responses to a capital constraint are outlined elsewhere (Llewellyn, 1992c).

Excess capacity

In its 1992 Annual Report the BIS identifies »the elimination of excess capacity in segments of the financial industry« as one of the key future issues. If entry barriers are declining faster and more substantially than exit barriers, it is almost inevitable that excess capacity emerges. The manner in which excess capacity is removed will prove to be one of the major strategic issues that banks have to face in the years ahead. However, the concept of »excess capacity« is difficult to apply precisely to banking, and is not unambiguous. In formal terms excess capacity is identified as a market situation and industrial structure where the level of output under monopolistic competition is too low to exploit the full economies of scale, and an increase in output (which would reduce excess capacity) would lead to losses. At the industry level there are too many firms each producing a sub-optimum level of output. Although normal profits might be made, there may be little incentive for merger or take-over activity. A downward shift in demand increases excess capacity. In order to identify such a case of excess capacity in banking it is necessary to demonstrate that there are increasing returns to scale and that normal profits are being earned. The empirical evidence with respect to the former is ambiguous (see Clark, 1988, for a review of the evidence) and, beyond a comparatively small size, there appears to be little evidence of a strong association between size and efficiency in banking. Arguably, small banks in many countries are characterised by increasing returns, in which case a consolidation of the banking industry through mergers would raise profitability. However, the empirical evidence with respect to economies of scale may not be relevant for considering the economic viability of bank mergers. Comparing existing banks and their cost structures is not the relevant test for whether two banks should merge. A bank, if it purchases another, is buying a delivery system, staff and the franchise of the other bank. If this franchise can be exploited within the purchasing bank's facilities (e.g. branches can be closed and staff reduced), economies of scale will exist.

Cost structure

As already noted, in some countries regulation of banking has been protective and has induced banks, in a generally weak competitive environment, to develop cost structures which are unsustainable in a more competitive market. To some extent, and in some countries more than others, banks have become locked into an uneconomic cost structure from which it is difficult to escape. Current cost structures are partly a reflection of strategies developed in an environment of low competition, high entry barriers, restrictive practices and cartels, protective regulation, and low technology, but which are now unsustainable.

Endowment profits

In many countries, banks earn significant endowment profits through »free resources« (reserves and interest-free deposits). These endowment profits have been eroded due to competitive pressures and the deregulation of interest rates and hence a significant traditional source of profits has become less powerful. 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 that the cost of retail deposits rises towards the level 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

Cross-subsidisation is a common pricing strategy in multi-product firms, including banking. Since competitive conditions between different banking markets are not homogeneous, prices of individual »products« (e.g. loans to different types of customer) do not accurately reflect relative costs and risks. 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« markets which are targeted and this erodes the »excess profits« earned by existing suppliers. This in turn forces a change in pricing strategies which, on the assumption that the cross-subsidisation was designed to raise overall profits, has the effect of eroding those profits. A particular and instructive example is found in the UK mortgage market which, prior to the entry of banks in 1981, was a virtual monopoly of the cartelised building societies. Although large mortgages are cheaper to administer and in general less risky, building societies traditionally charged a higher rate of interest on larger loans. In effect large mortgage borrowers subsidised smaller borrowers. This pricing policy partly reflected the mutual status of building societies. It is not surprising that, when entry barriers were lowered (due to a change in regulation) and banks entered the mortgage market on a large scale in 1981, banks immediately targeted the large mortgage sector. Within months this forced building societies to reverse their previous cross-subsidising pricing policies. The general prediction is that, as competition develops yet further, the potential for banks to engage in cross-subsidising pricing behaviour will be eroded. This would be a further factor eroding overall profitability.

Regulation

The author has analysed elsewhere (Llewellyn, 1992a and 1992b) the role of de-regulation in the banking crisis in Scandinavia and elsewhere. However, changes in the regulatory environment also have significant long-run implications. Regulation in banking has frequently had the effect of limiting competition and sustaining various restrictive practices, cartels and anti-competitive mechanisms. In various ways, especially because of the impact of limiting competitive pressures, regulation has acted as a protection to banks. Regulation often creates economic rents which can be used in various ways that would not be sustainable in more competitive conditions. As a result, in a regulated environment profits are reasonably assured, banks practice credit-rationing, risks are limited, costs may be increased to the extent that the rents earned through protective regulation are absorbed by managerial-expenses-preference behaviour, and excess capacity is created and sustained. It also tends to induce non-price rather than price competition. To some extent, therefore, regulation exaggerated the comparative advantages possessed by banks because it created a protective market environment. Deregulation implies that banks cease to benefit from, what in practice has often been protective regulation. To the extent that regulation has been protective, deregulation may have the effect of exposing incipient excess capacity in banking.

Money transmission services

One of the banks' core services is managing the payments system. Increasingly, however, it is likely that they will lose this monopoly as alternative suppliers of payments services are developed. The development of close money market substitutes for bank deposits, such as unit trusts, and money market funds, together with the evolution of cash management devices (e.g. use of zero balance accounts) means that there is less need to hold money balances in traditional bank demand deposit accounts. Excess balances can immediately and automatically be transferred to money market securities until needed for transactions purposes.

Capital markets and securitisation

In some models, the existence of banks is viewed as an endogenous response to imperfect and incomplete markets. In a world of zero transactions costs, complete and symmetrically available information, with a complete set of markets to cover all possible future states, there would be no market role for banks as financial intermediaries (i.e. their role in accepting deposits with one set of characteristics and creating assets with a different set). Although these conditions are not met in practice, the process of financial innovation and the creation of a wider range of financial instruments (*spectrum filling* as described in Llewellyn, (1985 and 1992d)), has reduced the degree

Table 1 Per cent of net funds raised by non-financial companies

	1970 Banks	1970 Other*	1980 Banks	1980 Other*	1990 Banks	1990 Other*
France	90	10	60	40	25	75
UK	95	5	80	20	20	80
US	45	55	55	45	(−65)	(70)
Germany	100	0	95	5	80	20

* Bonds, shares, and short-term securities.
( ) Billions of US dollars.

of market imperfections and incompleteness. The process of »spectrum filling« reduces the number and extent of discontinuities in the range of market instruments. Borrowers now have a wider range of capital market instruments. Van Horne (1985) argues that securitisation and financial innovation lead to more complete markets. In addition, new information and trading technology has reduced information and transactions costs in capital markets relative to bank lending costs (Karaken, 1987). Financial innovation and technology (together with the development of rating agencies) are eroding transactions and information costs and market imperfections which have been the basis of banks' efficiency and comparative advantage over capital markets (Eisenbeis, 1990). In addition, banks' own cost structures (including the cost of capital) may also have eroded some of their comparative advantages. Van der Hoeven (1993) also notes that the development of financial markets has offered appreciable improvements in the form of better price formation and versatile risk management. For reasons outlined in earlier sections, banks have been losing some of their traditional advantages *vis-à-vis* the capital market for corporate sector business. Table 1 indicates that in many countries, banks have been losing share in the financing of the corporate sector. The loss of share has been particularly marked in the US, where bank lending as a proportion of funds raised in credit markets declined from 49 per cent in 1980 to less than 17 per cent by the end of the decade. Overall, the capital market has become a more formidable competitor to banks and this is likely to develop further in an increasing number of countries.

Future evolution of banking

Having considered pressures that are likely to impinge upon the banking industry in the years ahead, this section discusses how these pressures may be resolved. In so doing an attempt is made to highlight some of the changes in the structure of the banking industry and the operation of the banking firm that may emerge.

Nature of banking

The traditional view of a bank is that of a financial intermediary: an institution which accepts deposits with one set of characteristics and makes loans or acquires assets with a different set. Emphasis is traditionally given to on-balance-sheet business. In the face of increasing non-traditional competition, together with the growth in domestic and international capital markets, banks are attempting to 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 the overall business as banks diversify into providing a wider range of services. In turn, this will erode what are in some countries traditional or regulatorily-imposed distinctions between the six major sectors of finance: commercial banking, investment banking, securities trading and broking, insurance, and fund management.

The structure of banks' income

As a result of this, it is likely that the proportion of banks' income earned through off-balance-sheet business will rise; off-balance-sheet income will rise relative to income derived through the net interest margin. This has already become apparent in many countries, though no discernible trend is yet apparent in Sweden. Thus in the UK, the proportion of gross income contributed by net non-interest income rose from 36 per cent in 1984 to 41 per cent in 1991, while in Sweden the proportion for commercial banks declined from 30 per cent to 25 per cent.

Further deconstruction

Competitive pressures are likely to mean that the process of deconstruction will develop further as banks and other financial institutions concentrate on those areas where they have a comparative and competitive advantage. This may mean that some parts of banking business will be broken down into component parts and supplied by different institutions.

Business objectives

The ethos of banking is likely to change yet further in the direction of focusing upon capital and profitability as the central strategic business objective. This has major implications for pricing, the sustainability of cross-subsidies, and the allocation and management of capital within the banking firm. Overall, the rate of return on equity rather than balance sheet size and growth is likely to become the dominant business objective, and this could significantly affect the internal culture of banks.

Management of risk

With respect to management procedures and given a potential capital constraint, a major imperative will be to develop risk analysis systems to precisely identify, measure and contain risks, and to internally allocate potentially scarce capital to different risk areas. This is especially significant given that, as competition intensifies on both sides of the balance sheet (from the capital market on the assets side and money market and mutual funds together with unit trusts on the liabilities side), risks are likely to rise on both sides of the balance sheet. Financial innovation is likely to develop further both as a means of creating new capital and equity instruments, and for economising on capital via mechanisms enabling institutions to reduce the overall risk of their portfolio. Diversification in a context of potential capital constraints also necessitates the development of internal control systems. In many industries, including finance, mistakes are made because of a lack of adequate control systems. This potential is particularly marked in finance as there is a tendency towards over-reaction which becomes increasingly hazardous in a capital-constrained environment where there is less scope to sustain the collective excess capacity that results from over-reaction.

Pricing of services

As part of the shift in objectives towards profitability as the ultimate end, banks will be under increasing pressure to give greater attention to the pricing of all of their services. In particular, competitive pressures are likely to erode yet further the ability of banks to cross-subsidise some of their business components. The general trend is likely to be towards the explicit charging of the economic cost of all aspects of banking services. This in turn implies a priority to identifying the costs of alternative services.

Cost strategies

Again as part of this overall strategy, banks will be forced to develop active cost management strategies. There are few banks that are not already under considerable pressure to substantially reduce costs. The more competitive market environment means that price competition will become more important. In the past, banks have often competed with each other in ways that effectively *increase* their costs in the absence of price competition. It is likely, however, that this will be reversed and increasingly banks will be under pressure to reduce their cost structures because of competition.

Consolidation of structure

It is likely that a consolidation into a smaller number of larger banks will occur within the banking industry. The BIS (1992) notes: »...forces are obliging many banks to consolidate ... whether the competition stems from within the industry or outside it, from other financial intermediaries, open capital markets or even non-financial companies themselves«. A »merger movement« has become a pronounced feature of the US banking industry, which is viewed as a »solution« to excess capacity, a lack of capital and to poor profitability (Frazer 1991). There has also been a marked increase in the number of mergers and acquisitions in banking in EC countries. The OECD notes a rise from 52 in 1984-85 to 239 in 1989-90. Major banking mergers have taken place in Austria, Denmark, Italy, Japan, Netherlands, Norway, Sweden and Spain. In Sweden, for example, the number of credit institutions has been greatly reduced through mergers, along with a decreased number of co-operative and savings banks and finance corporations. The financial crisis has accelerated the pace of restructuring and consolidation. The consolidation movement in Sweden is discussed in more detail in Blomberg (1993). Overall, the likely trend in many countries is a reduction in the number of independent banking units and a concentration to fewer and larger units.

New patterns in structure

Given the trend towards banks diversifying into insurance, the consolidation could also take the form of mergers between banks and insurance companies. This has already occurred in some countries. A yet more radical structural change (as envisaged by some strategists in the US) could conceivably be links (including possible ownership links) between banks and non-finance companies, though changes in regulatory attitudes would be required. The consolidation could also involve elements of trans-national consolidation, particularly with respect to joint ventures, mutual-equity holdings and strategic alliances between banking institutions in different countries. The ambition to complete the EC internal market in financial services has already acted as an impetus to such strategies.

Role of markets

A central theme is that markets could become more important relative to banks than has been the case in many financial systems in the past. As already noted, it is likely that, in some areas (e.g. large corporate business), banks will lose market share to the capital markets (*primary* securitisation). However, this need not displace banks altogether as there is often a requirement for »credit-enhancement« provided by banks. Leland and Pyle (1977) also argue that bank lending to companies itself signals an implicit rating to the capital market and may, therefore, increase the availability and lower the cost of capital market finance. Banks also face competition from markets on the liabilities side with the development of mutual funds and unit trusts with characteristics similar to bank deposits. This increased competition for deposits is likely to raise the relative cost of retail deposits, erode lending margins, and increase funding risks as the volatility of deposits might be expected to rise. However, the development of mutual funds and market-based deposits need not necessarily represent a total loss for banks. Many mutual funds and unit trusts are managed by banks and hence, while the bank itself loses retail deposits, the banking *group* (i.e. the bank plus the mutual fund) secures funds in other ways and acquires marketable assets. Thus while the development of securitisation is a potential loss of assets to the bank, and the emergence of mutual funds and unit trusts creates a potential loss of deposits, to the extent that the mutual fund is managed by the bank it is the *form* of intermediation through banking groups that changes rather than the total. On the assets side of the group the bank switches from loans to securities (possibly involving the same borrower), while on the liabilities side the switch is from deposits at the bank to customers' holdings of units.

Securitisation

Increasingly banks will come to securitise a significant proportion of their assets which will have major implications for banks. First, it implies that, relative to margin income, fee income will become an increasing proportion of banks' total income. Secondly, it implies that the relative contributions from the capital market and the banks to 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. Fourthly, the nature of banking business will change as banks become managers of securitised assets (*Economist*, 1992). 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 credit and holding it in the form of non-tradeable assets against their own capital. Securitisation does not mean that banks lose corporate sector business. It is more likely to mean that the role of banks in the process of company financing will change. It also implies that the future rate of growth of banks' balance sheets is likely to be considerably lower than in the past. At the same time, the process of securitisation in its various forms means that the traditional rigid distinction between capital market and bank financing will increasingly become less evident.

Retail banking

Within banking business, it is likely that a relative shift will occur towards retail business as it is in this sector that banks retain competitive and information advantages compared with the capital market. Competition in wholesale banking tends to be more intense than in retail banking as large corporate borrowers have access to global capital and banking markets. However, such a shift is likely to erode core profitability in the retail sector in the same way as competition has eroded profitability in wholesale banking business.

Delivery systems

A major strategic issue to be addressed by banks in many countries is the role of technology in changing the economics of delivering financial services (Howcroft, 1987). At the retail level the traditional mechanism has been the branch network which has also acted as an effective entry barrier. Almost universally there is excess capacity in the branch network, with a costly duplication of the basic infrastructure of banking. Delivery strategies will be developed at two levels: a rationalisation of the branch network, and diversification in the structure of delivery systems. Howcroft (1987) considers these issues in the context of larger-scale changes in the structure and management of retail banking operations.

Strategies to reduce the number of branches are frequently difficult to implement as, while costs are cut, so too is revenue as customers are lost to competitors. In some cases the major benefit of closing a branch is reaped by competitors who are able to absorb the franchise within their existing cost base. This problem can be resolved in three main ways: (1) by mergers or acquisitions with the intention of closing branches and exploiting the combined franchise at a lower cost than the sum of the amalgamated banks; (2) by banks acting co-operatively to close or exchange branches, and (3) by sales of branches to competitors.

The second delivery strategy will involve diversification as banks become less dependent upon the branch network as the predominant, if not exclusive, delivery mechanism. Developments in information and delivery technology will be the dominant pressure in the evolution of new delivery strategies. *Direct* banking falls into two categories: (1) *Telephone-based*: banks 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 (2) *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. Judging by experience in the UK, the immediate target market for telephone-based direct banking is 10-20 per cent of the population. However, the eventual potential may be much higher, since acceptance of new ideas can gradually diffuse through the entire population, especially when a new service appeals particularly to younger people. For instance, the initial potential market for self-service shopping (supermarkets, self-service gas stations and ATMs) was no doubt low, but has grown to be almost unlimited over time.

Conclusions

In various ways the related pressures of competition, de-regulation, financial innovation, and technology have eroded some of the comparative advantages of the banks in their traditional financial intermediation business. Regulation in earlier years exaggerated the comparative advantages possessed by banks because it created a protective market environment. Now, following de-regulation, banks in some countries are losing their predominant role as deposit-takers and lenders to companies. Market pressures are also eroding the market imperfections which gave rise to the banks' comparative advantage over intermediation in capital markets (Eisenbeis, 1990). Financial innovation and technology are eroding transactions and information costs and market imperfections which are the basis of financial institutions' efficiency over direct credit markets. In addition, banks' own cost structures (including the cost of capital) may also have eroded some of their comparative advantages. Above all, banks are no longer the only suppliers of banking services: there are many traditional activities of banks that can now be undertaken equally well by markets, non-banking financial institutions, and non-financial companies. The overall impact of these factors can be focused in a general proposition: that the value of the banking franchise is being eroded. For all the reasons discussed, banking markets are less the captive preserve of banks. As noted by Bisignano (1990): »With the decline in the franchise value of banks, the banking systems in some countries are shrinking. . .«

This does not necessarily mean a pessimistic outlook for *banking firms* as the business of the banking firm may change towards the provision of a wider range of financial services relative to the traditional financial intermediation and on-balance-sheet role. Banks will adapt and the nature of banking business will continue to evolve. However, it is unlikely that the market will continue to support anywhere near the current number of banks in the global financial system. Thus, the ongoing consolidation will continue in the years ahead.

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Banking Industry in the EC's Internal Market

JEAN DERMINE*

The EC internal banking market is operative since January 1993. Early evidence of effects of European financial integration shows that major driving forces in the industry's restructuring are competitive deregulation and taxation. Additional legislative work is needed to achieve open and stable financial markets. Home country control of international banks needs to be complemented by host country control. The deposit guarantee schemes should be modified by rendering insured deposits »first order claim«. A European authority is needed to ensure that banks do not exploit domestic rents to subsidize international activities. Finally, tax evasion is an issue that remains to be addressed by the EC authorities.

Introduction

At the Council of Ministers held in Milan in 1985, the European Commission proposed a detailed timetable for the complete integration of European markets by January 1993. The aim was to dismantle the technological, regulatory and fiscal barriers which prevented the free flow of goods, capital and persons in the European Community. As concerns banking and financial services in general, a major issue was whether regulation and supervision must be handled by a unique European authority, or whether it can be delegated to independent national central banks and supervisory bodies. After twenty years of trying in vain to harmonize national banking regulations, the European Commission adopted the principle of home country control and the opening of borders with minimal harmonization of regulations. Each country will recognize the competence of foreign authorities to regulate and supervise their own banks. This principle of decentralizing regulation and supervision was reconfirmed in the Maastricht Treaty.

The issues raised in the paper go beyond the creation of a European market, as they relate to international trade in financial services. At a time when the North American Free Trade Agreement (NAFTA) proposes to integrate further the economies of Canada, the United States and Mexico, and services are being included in a new GATS regime as a result of the Uruguay Round, it appears useful to have a critical review of the approach adopted for the integration of financial markets in the European Union.

The paper is structured as follows. The European banking industry and the early effects of financial integration are described in the first section. Section 2 gives a brief overview of the legislation developed by the European Commission. The regulatory issues linked to the integration of national markets are presented in the third section. Finally, two issues are identified which remain to be solved: Deposit insurance, and taxation of income on capital.

European banking structure

The EC banking industry contains 2183 commercial banks and 2478 savings or mutual banks. It is still a fragmented market where leading financial institutions have a substantial share of their domestic market (e.g., 84 per cent in the Netherlands, 77 per cent in Denmark). At European Community level, however, the five largest institutions control only 14 per cent of the market. In Europe, banks play a major role in the financial system, with a ratio of total assets to GDP of 1.7, compared to 0.8 in the USA, and 2.8 in Japan. Financial services represent a major source of employment and exports for several countries. Table 1 reports the results of a recent study by the OECD (1993) on the relative importance of financial services in international trade. The figures, which refer to the share of fees and commissions (excluding interest revenue) in trade, show sharp differences across countries, with France leading with a share of 5.7 per cent of exports of goods and services linked to commissions and fees.

As documented in Table 2, the type of ownership of banks in Europe is rather diverse. Of the 100 largest credit institutions, only 44 are privately owned. This raises the issue of fair competition between private and public institutions. So far and to my

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Table 1 Trade in financial services
In percentage of exports/imports of goods and services

	1988	1991
Belgium		
Exports	1.17	2.60
Imports	0.74	1.70
France		
Exports	1.50	5.7
Imports	1.70	6.3
Germany		
Exports	0.74	0.96
Imports	0.12	0.33
Switzerland		
Exports	3.00	3.80
Imports	NA	NA
United Kingdom		
Exports	2.40	3.20
Imports	0.09	0.20
United States		
Exports	3.80	4.70
Imports	1.70	2.30

NA: Not available.
Source: OECD (1993)

Table 2 Sector distribution of the 100 largest EC banks

Sector	Number of banks ranked among the 100 largest	Market share among the 100 largest banks Percent of assets
Public	42	37.9
Co-operative	9	11.0
Mutual	5	1.5
Private	44	49.6

Source: J. Revell (1989)

knowledge, no empirical studies have yet analysed this in depth, nor has any case been brought to the attention of the European Commission or the European court of justice.[1] The public ownership issue could diminish in importance with the large privatization programmes underway in several countries.

Over the last twenty years, banks from Belgium, Denmark, France and Spain have benefitted from regulations or »gentlemen's agreements« on interest rates paid on retail deposits. As Table 3 shows, interest margins on demand deposits have reached 11 percentage points on average in Belgium and France over the period 1980-85.

In contrast, spreads were much smaller in Germany and the Netherlands. The major reason for the divergence in spreads was that the market (interbank) interest rate was much higher in some countries than in others, allowing banks from the former group to realize more benefits from deposit rate control and pricing arrangements. Interestingly enough, the more recent period 1987-92 shows a clear pattern of convergence. Interest rate margins are going down in Belgium, France, Denmark and Spain, and up in the Netherlands and Germany. The convergence of spreads is a direct effect of the convergence of short term interest rates brought up by the European Monetary System and the abolition of capital controls.

Besides the convergence of margins on retail deposits, major impacts result from the competitive deregulation undertaken by national regulators attempting to enhance the attractiveness of their home market. An example concerns the reduction of taxes on interest income. The case of Belgium documented in Table 4 is symptomatic. Banks in that country used to benefit from tax-free low cost savings deposits (»carnet de dépôts«), which were highly competitive vis-à-vis other instruments, those being taxed at 25 per cent. In April 1991, the Minister of Finance lowered the tax rate on interest income to 10 per cent to reduce capital outflows to Luxembourg. As a result of the lost advantage, the banks have seen the low cost fraction of their funding base reduced from 49 per cent to 34 per cent in less than two years. It is my view that competitive deregulation and taxation have been much more powerful so far than market penetration by foreign institutions. As Table 5 documents, the market share of foreign institutions in domestic markets has not changed much over the years, whether in an open market such as that of the United Kingdom, or in a fairly closed market such as the German.

The creation of competitive financial products is forcing banks to reduce their costly branch network. This is often achieved by domestic mergers between the largest banks. Table 6 documents the major mergers that have taken place in Denmark, the Netherlands, Spain and Italy. As is quite apparent, countries such as France and the United Kingdom have not yet had a major restructuring.

Finally, besides domestic mergers, there has been a major expansion into life insurance to exploit more completely the distribution capacity of the branch network. Table 7 documents the major penetration of banks into insurance in Spain, France and the United Kingdom.

These are early results of banking systems preparing for more competition. They raise substantial issues of fair competition. Indeed, since individual

[1] In 1991, Mr Lilley, UK Trade and Industry Secretary, tried to block the acquisition by Credit Lyonnais of Woodchester Investment, an Irish-based finance company with interest in Britain. The argument was that the acquisition of a private firm by a nationalized French bank was »nationalization through the back door«. A British Monopolies and Merger Commission's investigation concluded that there was no justification for blocking the deal on competitive grounds.

Table 3 Interest margins and operating expenses of commercial banks

	Belgium	Denmark	France	FRG	Italy	Luxembourg	Netherlands	Portugal	Spain	UK	USA	Japan	Switzerland
Average margin on demand deposits[a]													
(1980–85) (percentage points)	11.2	16.2	11.7	6.5	4.3	NA	5.6	NA	14.5	10.8	9.0	5.6	4.8
(1987–92) (percentage points)	8.7	9.0	9.7	7.2	NA	NA	6.8	NA	6.0	7.0	7.5	5.4	6.8
Average margin on savings deposits[a]													
(1980–85) (percentage points)	5.6	8.9	4.3	2.8	3.4	NA	2.8	NA	10.7	2.5	1.0	3.8	1.3
(1987–92) (percentage points)	3.9	7.0	5.2	2.2	NA	NA	4.7	NA	9.0	2.0	1.0	2.0	2.6
Population per branch	1 816	1 677	2 189	1 564	3 800	NA	2 000	6 031	1 127	NA	NA	8 700[b]	1 622
Operating expenses per asset[b] (per cent)	2.6	2.8	3.2	2.5	3.0	1.0	2.5	2.5	3.5	4.2	3.5	1.0	2.0
Operating expenses as percentage of gross margin	0.66	0.65	0.65	0.65	0.63	0.41	0.65	0.47	0.60	0.65	0.61	0.61	0.55

[a] Current short-term rate minus interest rate paid on deposits.
[b] Excludes interbank assets; expenses on non-interbank is calculated as follows: Total expenses minus (interbank assets x 1/8 per cent).
NA: Not available.

Table 4 Structure of banks' liabilities in Belgium (interbank excluded)
Belgian francs, billions

	Deposits					
	Savings accounts	Demand deposits	Term deposits	Savings bonds[a]	Total	Savings and demand deposits as per cent of total
1986	607.3	450.9	677.6	447.6	2 183.4	48
1987	690.6	476.1	769.8	455.4	2 391.9	49
1988	766.6	517.7	805.0	465.0	2 554.3	50
1989	862.3	572.9	982.2	526.0	2 943.4	49
1990	757.5	581.2	1 229.3	673.3	3 241.3	41
1991	707.6	604.7	1 423.8	794.3	3 533.4	37
1992	667.3	588.0	1 500.0	889.3	3 644.6	34

[a] Known as 'bons de caisse', these are three- to five-year maturity deposits.
Source: Commission Bancaire (1992)

Table 5 Market share of foreign institutions
Per cent of total assets

	1986	1989
Germany	4.27	4.61
Belgium	46	47
France	10.9	13.0
Italy	2.45	2.9
UK	62.2	59.1
Japan	11.9/561	1.4
USA	17.9	21.4

Source: Goldberg (1992), Swary-Toft (1992)

Table 6 Domestic mergers in Europe

Belgium	1992	CGER Credit Communal
Denmark	1990	Den Danske Bank Unibank (Privatbanken, Sparekassen, Andelsbanken)
Italy	1992	Banca di Roma (Banco di Roma, Cassa di Risparmio di Roma, Banco di Santo Spirito) IMI – Cariplo San Paolo – Crediop
Netherlands	1990	ABN – AMRO
	1991	NMB-PostBank-ING
Spain	1988	BBV (Banco de Vizcaya-Banco de Bilbao)
	1989	Caja de Barcelona-La Caixa Banco Central-Banco
	1992	Hispano
Switzerland	1993	CS-Volksbank

Table 7 Market share of banks on the life insurance market
Per cent

Germany	3.9
Spain	74
France	37
Italy	<5
Netherlands	10
United Kingdom	40

Source: Association Belge des Banques (1993) countries are responsible for the type of ownership (private or public) and the degree of concentration on their domestic markets, there is the possibility that some countries will try to create national »champions« to compete on world markets. One needs a European authority to ensure that banks do not subsidize their international activities with oligopolistic rents earned on the domestic markets.[2] One could argue that oligopolistic rents will disappear in the presence of free entry. However, some industrial organization scholars, such as Vives (1991), take the view that retail banking does not seem to fit the model of »contestable markets«. In a contestable market, potential competitors discipline established firms since these are vulnerable to hit and run entry. In retail banking, fixed costs entailed in branching, the creation of networks (like ATM systems), the presence of switching costs for consumers, and reputation effects, could be effective barriers to entry. Only time will tell the significance of these barriers, which, in view of the significant market shares built in some domestic markets, should be monitored closely.

The EC approach to integration

In the context of *banking*, the 1985 White Paper calls for a single banking license, home country control, and mutual recognition. These principles are incorporated in the Second Banking Directive. All credit institutions authorized in one EC country will be able to establish or supply financial services in all the other countries without further authorization. The banking model adopted by the EC is the universal banking model. It permits banks to undertake investment banking activities and leaves it to national legislators and supervisors to regulate the eventual links between insurance, commercial and industrial groups, and banks. For instance, it is known that the Bank of England would not favor the ownership of banks by industrial groups, while this is allowed in France and Belgium. The Second Banking Directive calls for home country control on solvency,[3] but recognizes explicitly that host country regulations will apply for monetary policy reasons, for market risks, and to protect »public interest«. To address a need for minimal harmonization of regulations, the Directive calls for minimal equity, harmonized capital adequacy and large exposure rules, supervisory control of major shareholders and of banks' permanent participation in the non-financial sector.[4]

A supportive legislation is the Directive on complete liberalization of capital flows from June 1990. However, that directive contains a safeguard clause authorizing Member States to take necessary measures in the event of balance of payments problems.

The integration of *investment services* (investment banking) proceeds in a similar manner. The Directives for Investment Services in the Securities Field and for Capital Adequacy provide, from 1995, for a single licence as well as home country regulation and control of ownerships, capital adequacy, risk management and compliance with prudential rules. A major difference to the Second Banking Directive is that substantial powers are given to host authorities concerning rules of conduct of business. These include share registration and new issues procedure, securities prospectuses, investment management, investor protection, insider trading and related market practices.

The issue of *reciprocity* has received considerable attention in non-member countries. Two concerns have to be distinguished: The denial of national treatment by a third country on one hand, and the denial of effective market access comparable to that which the Community grants to third countries on the other. Article 9(4) of the Second Banking Directive deals with the situation where, in a third country, there is discrimination against Community financial institutions, compared to domestic counterparts. In this case, the directive provides for negotiation with the option to suspend new banking licenses for institutions from that country. In the second case – comparable access – Article 9(3) provides for negotiation with the country, but without that option. A report on the treatment of European financial institutions in third countries was published by the Commission in July 1992 (European Commission, 1992). Although it recognizes the existence of discriminatory treatment in some countries, the Commission recommends negotiation in the framework of the Uruguay Round. Moreover, the report makes no reference to a temporary suspension of authorization.

Finally, the December 1991 Maastricht Treaty on Economic and Monetary Union will reinforce the Single Market. Although the primary objective of the European System of Central Banks shall be to maintain price stability, there are explicit references to regulation and supervision.

> »The European System of Central Banks shall contribute to the smooth conduct of policies pursued by the competent authorities relating

[2] An alternative is to refer all mergers to a single European authority. But this would run against the principle of decentralization, very much in favour in Europe. Since September 21, 1990, the European Commission can only investigate mergers involving large firms operating in several countries.

[3] As discussed in Norton (1991), the EC directives have basic ideas in common with the Basle Concordat (June 1993) on guidelines for consolidated supervision, and the division of supervisory responsibilities between the home and host states.

[4] See Dermine (1990, 1993). Compliance with these regulations will be enforced by national banking supervisors.

to the prudential supervision of credit institutions and the stability of the financial system ... The national Central Banks are an integral part of the ESCB and shall act in accordance with the guidelines and instructions of the European Central Bank ... The ECB may offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States in the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system ... The ECB may fulfill specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings« (European Commission, 1992).

Although the exact rules governing the functioning of the new system have yet to be worked out, the Treaty is explicit on the principle of decentralization, and allocation of regulatory and supervisory powers to national central banks. It is only in very special circumstances and with unanimity of the European Council that the European Central Bank will be allowed to regulate or supervise.

The nature of market failures in banking markets

The EC approach of integration in banking leaves Western Europe with an interplay of national regulatory systems, with only essential regulations being harmonized. We can expect that regime to be subject to various changes in the future, due to competition in regulation as well as to Community efforts to extend the scope of harmonization. In this section an attempt is made to evaluate the EC regulatory system, starting from the economics of market failure. Mainly three types of market failures have been discussed in the context of banking: imperfect (asymmetric) information; the potential for bank runs and the related fear of systemic crises; and trade policy related issues.

Asymmetric information and consumer protection

The most important case of asymmetric information concerns imperfect knowledge about the solvency of a banking firm. The difficulty to evaluate the solvency of an institution raises an issue because an increase in the riskiness of the asset of a financial institution or in the degree of financial leverage (debt to equity ratio) tends to transfer wealth from debtholders (depositors) to shareholders, reducing the market value of debt, while increasing the value of shares. The reason for this is that an increase in risk (variance of asset return) allows the shareholders of a firm to reap potentially large gains, while limiting the downside risk to zero because of the limited liability characteristic of shares. With perfect information, debtholders (and employees) would react by increasing the interest rate (salary) to offset that transfer to shareholders. With imperfect information, depositors have difficulties to prevent such transfers of wealth, leading to suboptimal risk-taking in some financial institutions.[5] However, the existence of imperfect information per se does not yet justify public intervention. It has first to be shown that private mechanisms cannot succeed in solving the problem.

A natural solution to the imperfect information problem would be the provision of information and regulation of disclosure. However, the evaluation of bank risks is a costly activity which could create a »free rider« problem. The individual customer may prefer not to engage in information search and analysis on the assumption that other investors will do this. In such a situation the provision of private information is inadequate. Moreover, since information once produced is available to consumers at a very low transfer cost, the evaluation of banks should not be undertaken by each depositor but could be delegated to a public agency or a private rating firm. Furthermore, since small account holders may find the cost of interpreting the rating too high or since they care about risk-free deposits only, two alternatives could be developed. The first is to have deposit insurance, but it should be realized that this simply transfers the information problem from depositors to the deposit insurance agency. The second is to create risk-free institutions, that is, intermediaries investing all deposits in risk-free securities (the so-called »narrow« bank proposal). Depositors would then have the choice between institutions offering a higher but risky return and those providing quasi-risk free deposits. It would appear that the evaluation of risks is not inherently more difficult in banking than in other industries. A main difference is that it is quite likely that a large fraction of depositors care for risk free deposits, but these could be provided by the markets.

In addition to the disclosure and evaluation of information, there are two alternative private ways to reduce the imperfect information problem: Reputation and industry insurance-warranty. Reputation implies that firms who care for the value of their franchise and long run profits have an incentive to build internal control system to reduce risks and fraud. However, a tradeoff will exist between (potentially high) short term fraudulous profit and the benefits of long term reputation. An alternative is for a

[5] See L. White (1992) on the behavior of S&L institutions in the US.

firm or an industry to provide a warranty to guarantee the quality of the services offered. For instance, a private deposit insurance organized by the industry could guarantee clients against potential losses. Peer monitoring or industry self-regulation can also be encouraged to prevent deviant behavior.

This analysis has shown that the information problem could be solved privately on the market in several different ways: by disclosure, information gathering, reputation, and guarantees. However, whenever there is evidence that the market cannot discriminate among firms,[6] there is a case for the government to regulate entry and ensure a minimal quality, as is done for instance in the medical and legal professions. The argument is that regulation is necessary to maintain a minimum desired level of quality. In this context, a question arises as to whether this should be done privately or quasi-privately, as in Great Britain with the Self-Regulatory Organizations (SRO), or whether it should be public. The benefits of flexibility and industry expertise provided by private self-regulation have to be balanced against the risk of capture by the SROs, whose members have an obvious incentive to limit entry and competition. As there is currently no empirical evidence in favor of one system or another, we suggest allowing the national regulatory structures to compete.[7]

Competitive deregulation immediately raises the issue of the need to harmonize regulations at the international level. The answer to this question is again related to imperfect information. Competition among national regulators or private clubs is desirable whenever the parties can evaluate the quality of regulatory systems. For instance, competition among regulators in Tokyo, Paris, Frankfurt, London and New York will shape the developments of local stock exchanges and the outcome will be optimal if participants can discriminate among different regulatory systems. In this case, national treatment will be sufficient. Harmonization of rules to ensure minimal quality would be necessary only if the market cannot discriminate. This suggests that the degree of international harmonization could vary for different activities and classes of investors, the »informed« and the »non-informed«.

It has been argued that imperfect or asymmetric information creates the potential for a market failure, but appropriate rules on disclosure of information and competition between firms or regulators can solve a large part of the problems. One has to be careful to avoid permanent regulatory interference, which can create the »raison d'être« of public intervention. For instance, the creation of a safe and publicly insured deposits market reduces the incentives for information gathering and the creation of risk free funds.[8] This »laissez faire« policy should not imply that there is no ground for public intervention to compensate the unlucky or imprudent investors. The argument is that transitory transfer policies should be used in these cases rather than direct and permanent interference with the functioning of private markets.

Thus, the analysis of the first type of potential market failure, imperfect information, suggests that sovereign countries should supervise the services offered to the »non-informed«. In the European Union, the »public interest« criterion could be used to justify »host country« supervision. The second major argument for the regulation of financial institutions is the fear of bank runs and systemic risks.

Bank runs and systemic risks

Banks are by their inherent activities – funding illiquid loans with short-term deposits – exposed to the risk that depositors run to withdraw their funds. A run can be triggered by bad news about the value of bank assets or by any unexplained fear.[9] In both cases, there may be a loss since illiquid assets will be sold at a discount. Moreover, a bank failure could trigger questions about the solvency of other banks, leading to a systemic crisis. Here, a distinction should be drawn between a »domino« effect and a systemic crisis.

A »domino« effect exists if the failure of one bank would directly endanger the solvency of other banks. In my view, this risk is substantially reduced since banks are collecting and controlling systematically their counterparty exposure, helped also by netting arrangements.

A pure case of systemic run could occur if, lacking information, there is a run by depositors on all banks. A market failure exists because a co-operative solution among depositors cannot be enforced. Collectively, there is no incentive to run, but individually, there is the incentive to be first in line to collect the deposits at full value.

This market failure explains banking regulations and the establishment of safety nets to guarantee the stability of banking markets. They have taken the form of deposit insurance and lender of last resort interventions. I take the view that deposit insurance is unlikely to contribute much to reducing systemic risk

[6] Evidence is a strong word. In most cases, there will be a social-political belief of the need to protect consumers.

[7] An additional argument for this is that the »general equilibrium« costs of regulation are not fully understood. With the exception of a paper by Santomero-Watson (1977), most scholars have used partial equilibrium models to analyse the effects of regulations.

[8] In a well known case in France (CODEC), a distribution company was close to default on its commercial paper (held by money market funds distributed by banks). The banks intervened to absorb the losses. The first ratings on French money market funds were made public in April 1991, ten years after the creation of the market.

[9] Calomiris and Gorton (1991) argue that most of the bank runs are linked to a decrease in value of bank assets.

because it covers small deposits only, and that runs are likely to be initiated by large firms or financial institutions.[10] Therefore, lender of last resort remains the efficient tool to limit bank runs and systemic crises.

The safety net with deposit insurance or lender of last resort creates an additional problem in an international banking system. It concerns the *potential liability* of the lender of last resort. As lenders of last resort will be concerned primarily with their domestic markets and banks operating domestically,[11] it would seem legitimate that they keep some supervisory power on *all* institutions operating domestically. That is, host country regulation should apply to limit the risks taken by financial institutions and the exposure of the domestic central bank in cases of bailing out. An alternative to host country control is to harmonize completely the solvency standards of different countries, but experience has shown that it would be very difficult to reach an agreement on common harmonization of regulations and supervisory practices. Moreover, I do not believe that a centralized regulation is desirable. Competition between national regulators could produce efficient standards and prevent the regulatory capture by the regulatees, as has happened so often in banking in the last sixty years. It thus seems reasonable to let domestic supervisors keep some host supervisory powers on international banks having substantial funding at risk in their domestic market.

In this respect, the recent history of international banking regulation is telling. In 1975, following the failures of Franklin National and Bank Herstatt, international supervisors adopted the Basle Concordat, according to which bank solvency would be assessed on a consolidated basis by the home country supervisor. A few years later, the failure of Banco Ambrosiano Holdings in Luxembourg in 1982 forced a revised Concordat (BIS, 1983), according to which solvency would be assessed jointly by home and host country supervisors. Finally, following the failure of Bank of Credit and Commerce International (BCCI) in 1992, the Basle Committee reinforced the power of the host regulator. »If a country is unhappy about the international supervision of a bank whose domicile is elsewhere, it can impose restrictive measures on branches of that bank on its territory... The most draconian sanction would be to ban the branches. However, a bank regulator might simply set a deadline for the bank and its home country regulator to meet the acceptable standards« (Financial Times, 1992).

[10] European deposit insurance is discussed in Section Four.

[11] It is well known that the Bank of Italy did not intervene to prevent the collapse of the Luxembourg-based Banco Ambrosiano Holding, because it created little disturbance on the Italian financial markets.

The analysis of the second type of market failure (bank runs and systemic crisis) leads to the following conclusion. Since domestic central banks will be primarily concerned with the stability of their domestic markets, they should have the right to control the solvency of banks operating on their domestic market. Since, in many cases, the solvency would depend on the solvency of an entire group, I would recommend *joint* supervision by the home and host country authorities. The case for sole »home country« supervision is weak as long as sovereign countries are responsible for the stability of their own financial markets.

Fair trade

Two issues will be dealt with in this context. The first relates to implicit guarantees given by central banks. The second refers to the possibility of cross-border subsidization.

Public safety nets can entail an implicit subsidy that affects competition. For instance, deposit financing can reduce the cost of funding loans because of the implicit guarantee given by the lender of last resort. To foster stability and create a level playing field, the Bank for International Settlements and the European Commission have enforced minimal capital requirements, and lending limits on large exposure. From the point of view of competition, the international harmonization of prudential regulations is warranted when the objective is to create a level playing field. But harmonization should be limited to that objective. Quite often the identification of a regulatory subsidy will be difficult. For instance, do links between banks and industrial groups provide a competitive advantage that is subsidized by the central bank, which takes a greater risk? It would seem to me that there is a case for harmonization only when the existence of a subsidy yielding a competitive advantage can be demonstrated. Such a case was pretty clear in the context of loan funding and capital adequacy. It is much more debatable in the context of the links between banks and industrial groups.

The second issue discussed earlier is the possibility that oligopolistic home markets could generate rents used to subsidize foreign activities. The issue arises because of the fear that some countries could allow concentration on their domestic banking markets. Quite obviously, the trade policies in the Netherlands and the United Kingdom seem to be quite different, with the British Office of Fair Trading likely to prevent excessive concentration on the domestic market.

To sum up, three potential sources of market failure calling for public intervention and harmonization have been discussed: *Imperfect information, bank runs, and fair trade*. It has been argued that in many cases a market for private information will be developed so that regulations should apply to very specific activities and classes of investors.

As sovereign countries will wish to protect their domestic banking markets, it seems reasonable that they keep some supervisory powers on all financial institutions operating domestically. In the context of international trade in banking services, this view is consistent with the pre-GATT agreement on financial services, i.e. the right for local authorities to enforce solvency standards on both local and foreign firms offering services. It is also fully in line with the recent American Foreign Bank Supervision Enhancement Act of 1991 (Misback, 1993), and the ruling of the Basle Committee on Banking Supervision accepting host country control for international solvency rules.

Unresolved issues in the EC legislative system

The approach adopted by the European Union for integration (opening of borders with minimal harmonization) has speeded up considerably the process of integration. However, one must recognize that several important issues are pending, in particular deposit insurance, and taxation of income on capital.

Deposit insurance

In the European Community, deposit insurance systems have been created recently in most countries.

Table 8 Deposit insurance systems in selected countries

Country	Coverage domestic currency	Coverage ECU
Belgium	BEF 500,000	12,100
Denmark	DKR 250,000	32,470
France	FF 400,000	60,000
Germany	30 per cent of equity per deposit	
Ireland	£IRL 10,000	12,350
Italy	Lit 1 billion (100 per cent for first 200 mil. and 75 per cent for next 800)	536,400 (100 per cent for first 107,000 and 75 per cent for next 428,000)
Luxembourg	FLUX 500,000	12,100
Netherlands	DG 40,000	18,800
Spain	Pta 1,500,000	9,765
United Kingdom	75 per cent of deposits (ceiling of £15,000)	75 per cent of deposits (ceiling of 19,350)
Greece	No system	
Portugal	No system	
Japan	Yen 10,000,000	80,000
United States	$ 100,000	85,000

Three features of the European insurance systems make them unique. The first is that, contrary to the FDIC in the United States or the CDIC in Canada, they are largely unknown to the depositors. Publicity is even forbidden in Germany. The argument seems to be that the announcement of their creation could reduce confidence in the banking system. Since the coverage per deposit is small and even incomplete in the United Kingdom and Italy, the systems are unlikely to contribute much to stability and one would have to rely on lender of last resort intervention of central banks to ensure stability. Secondly, since the coverage is different across countries, it could be destabilizing if depositors start to chase the best coverage. A third feature of the deposit insurance systems is that they cover the deposits of domestic and foreign banks operating locally. This could create an »accountability« problem. Indeed, any insurance activities require the monitoring of risks taken by the insurer, but the principle of home country supervision would not allow the control of the foreign entities by the domestic lender of last resort or the deposit insurance agency. The problem is well illustrated by the January 1992 winding up order made for Bank of Credit and Commerce International, a bank chartered in Luxembourg with significant activities in Great Britain. It automatically created a liability for the British Deposit Protection Board. This important case led to a review of deposit insurance systems in Europe.

A draft Directive on Deposit Guarantee Schemes was accepted by the Council of Ministers in September 1993 (qualified majority with opposition by one country, Germany). In principle, it provides for mandatory insurance for all EC financial institutions. The coverage per depositor is a minimum of ECU 20,000 (15,000 until 1999), with a franchise of maximum 10 per cent. The principle of home country would apply, that is, the insurance system of the parent bank would cover the deposits collected by domestic institutions and foreign branches. Two important exceptions to that principle are being made. In the case where the home coverage is too large vis-à-vis the host coverage, for instance a French bank operating in Belgium, the coverage of foreign branches cannot exceed that of the host country, to prevent unfair competition. In the case where the home coverage is lower than that of the host country, the foreign branch will have the right to obtain supplementary insurance from the host state. Finally, for the branches of non-EC banks, the host country will decide whether they should join an insurance system, with the provision that depositors will have to be informed about the decision made.

The motivation for the Deposit Guarantee draft Directive is illustrative, as it incorporates several of the arguments discussed previously: »deposit protection is as essential as prudential rules for the completion of the single market...the cost to credit institutions of participating in a guarantee scheme bears no relation to the cost that would result from a massive withdrawal of bank deposits not only from a credit institution in difficulties but also from healthy institutions following a loss of depositor confidence...«.

The creation of this system has two problems. The first, which is well illustrated by the German opposition to the draft directive, is that foreign banks could join the German scheme, but the German deposit insurance system would have no power to monitor the risk taken by branches of foreign institutions. This accountability problem has been mentioned earlier. The second problem is that deposit insurance contributes further to reduce private incentives for monitoring the solvency of banks. As I have discussed bearlier, the creation of risk-free deposits could be organized by the market (the »narrow bank« proposal), or alternatively, it would be preferable to make insured deposits »first order« claim. Since »first order (senior)« claims have priority of reimbursement in the event of a bankruptcy, customers holding uninsured deposits and thereby bearing larger losses in case of bank failure would then have incentives to monitor the solvency of financial institutions.

Taxation of capital income

To enhance the attractiveness of their home market, various countries have reduced the taxation of income on capital, at least relative to the taxation of labour income. From a fiscal policy perspective, it would seem that the creation of a single EC banking market should not affect the relative taxation of labour and capital income. Obviously, this will not be the case as long as there is no harmonization of taxation, or sharing of information by tax authorities. Table 9 reports the amount of liabilities of domestic banks vis-à-vis non-bank non-residents.

Even acknowledging the expertise of some banking centres, it would appear that the volumes of deposits housed in a few small countries are abnormally large. Commission proposals for a common withholding tax on interest revenue have been rejected so far by Luxembourg and the United Kingdom with the argument that the Euro-market would move to a non-EC country. An alternative proposal, that would suffer from a similar competitive concern, would be to lift bank secrecy for EC-investors. That is, the fiscal authority of one country would have the right to obtain information about bank deposits in another EC country. Similar information is currently available to the US Federal tax authorities. To reduce the size of potential capital outflows, I would recommend the lifting of bank secrecy for EC investors only. Investors from a non-EC country, being not affected by such a proposal, would find EC financial markets quite attractive. As concerns some EC investors, they might wish to migrate their bank account to a non-EC country. Information on tax evasion in the United States could help to estimate the likelihood of these capital outflows.

Table 9 External position of banks vis-à-vis the non-bank sector

$ billions

Country	1989	1992
Austria	10.9	8.9
Belgium	27.1	41.1
Luxembourg	77.2	121.6
Denmark	4.1	4.1
Finland	3.5	1.0
France	32.1	49.1
Germany	39.2	73.3
Ireland	4.4	4.9
Italy	9.1	9.2
Netherlands	31.9	42.2
Norway	1.4	1.3
Spain	20.4	29.3
Sweden	9.5	9.2
Switzerland	178.4	208.7
United Kingdom	266.4	313.7
Caribbean Centers	204.5	231.1

Source: BIS (1993). These statistics could understimate the external position of banks to the extent that fiduciary deposits are not reported

Conclusion

The purpose of the paper has been to analyze the EC's internal banking market. While most international agreements have used the national treatment principle and kept domestic authorization and supervision, the European Commission has used a powerful innovative method of integration: Opening of markets with single license, home country control, mutual recognition and minimal harmonization.

The policy conclusions of the paper are the following.

Firstly, early evidence of effects of European financial integration demonstrates that the banking industry is undergoing a major restructuring, driven by competitive deregulation and taxation. This process is only starting in some countries, such as France and the United Kingdom.

Secondly, the analysis of the economics of banking regulations calls for further work to maintain the solvency of banking systems. The banking literature has shown three main sources of economic failure calling for national regulations and the eventual harmonization of regulations. The first source of market failure is the traditional need to protect investors. I have argued that domestic regulation in that regard is only warranted in those cases where investors cannot evaluate the riskiness of the credit institutions' activities. Correspondingly, international harmonization of regulation is necessary if the market participants cannot discriminate among different regulatory structures. It is my view that information disclosure, competition between public or private regulators and the creation of risk-free funds will be satisfactory in most situations. In any case, different products and classes of consumers will require different regulatory treatment. I suggest to limit the »public interest« argument, which not only may limit competition but also harm the spontaneous development of private markets.

A second market failure calling for regulation and harmonization arises from the need to provide a safety net for liquid deposits and the legitimate need to limit moral hazard and risk taking by banks in that context. From this angle, host regulation may be justified to limit the exposure of the domestic lender of last resort. I also suggest that the deposit insurance scheme recently adopted by the European Council of Ministers should be modified. Insured deposits should be made »first order« claim, so as to increase monitoring incentives for uninsured deposits. The third policy issue is the »fair, level playing field«. From a fair trade policy perspective, I argue that the international harmonization of regulations is only necessary to limit implicit public subsidies which create a competitive advantage.

Thirdly, as domestic regulators will be responsible for controlling the ownership of domestic banks (public or private), and the degree of market power in their domestic market, a European authority must ensure that those banks do not exploit domestic rents to subsidize their international activities.

Finally, the achievement of an internal banking market should not lead to tax evasion. Substantial work remains to be done to prevent competitive moves to reduce taxation of income on capital.

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EEA and Banking in the EFTA Countries

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The financial markets in the EFTA countries have all been subject to domestic deregulation during the past decades. As a result, markets have been opened from »within«, leading to increased competition and substantial structural changes. The adoption of the EEA legal system in banking will accentuate that process, leading to increased foreign presence on domestic markets, increased cross-border trade and sharpened competititon, in particular in the retail segment.

Introduction

The aim of the article is to discuss the effects of the EEA Treaty on the banking industry in the EFTA countries. This task is at the same time easy and difficult. The easy part lies in describing the legal and institutional changes occasioned by adapting those countries' legal systems to the EEA legal system governing banking. The difficult part consists of trying to foresee the possible effects of such adaptation.

Nonetheless, an effort will be made to carry out a qualitative assessment of those effects, implying that the article does not concentrate on a forest of detail; rather, the discussion will relate to broad trends.

In the next section, the perspectives and methods of the analysis applied will be presented. The subsequent two sections deal with the internal liberalization of the credit markets in the EFTA countries, which precedes the adaptation to the EEA laws, and the effects that this liberalization had on market conduct and structure in the banking sector. Thereupon follows a presentation of the external liberalization due to the EEA adaptation and of the possible effects that adaptation will have on banking in EFTA countries.

Perspectives and methods

The analysis to be presented in this article is undertaken from an outsider perspective, the perspective of an industrial economist. In that vein, the main interest lies in investigating how market conduct and structure in the banking industry in EFTA countries would be affected by the changes in the legal system induced by participation in the integrated financial market within the EEA.

The methods of analysis used are qualitative and inductive. To obtain the intuition needed to predict future effects of institutional changes, the article takes a look into the past. In particular, changes in the EFTA countries' regulatory systems during the 1980s are described, together with effects of those changes on market conduct and structure.

Results from the backward-looking analysis are then applied to the future. As a starting point the essential differences from the EC/EEA legal system concerning banking have to be described. Having identified them, an attempt is made to visualise how removing those differences might affect barriers to entry and thereby the conduct and structure of the markets in banking.

A pervasive concept used in the analysis is that of *market contestability*, which links the conduct and structure of markets to barriers to entry (Baumol, Panzar & Willig [1982]). We assume that changes in contestability, or barriers to entry, caused by changes in the regulatory system as well as by other factors, constitute the main source of dynamism on the market place.

Of course, the visualization of effects on market conduct and structure has to be carried out with an awareness of mutatis mutandis. In the 1980s, as well as in the future, the environment of banking is constantly subject to change, changes in regulation and legislation being only one of several driving factors. The ambition in this article is not, however, to provide a comprehensive analysis of how developments in banking are being driven by the totality of environmental changes. Instead, the ambition is to isolate the *specific influences of regulatory and legislative changes*.

As a preliminary to deriving the impact of financial integration, one has to consider the ways in which basic legal concepts governing the EC Internal Market are being communicated to the EFTA countries. Essentially three waves of influence can be iden-

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tified. The first was one of inspiration. Quite soon after the publication of the EC White Book on the Internal Market (EC[1985]), the main principles put forward there made the authorities aware of the external barriers sheltering domestic markets. For instance, a sudden surge in the removal of remaining exchange controls in the late 1980s in Austria, Finland, Norway and Sweden may to some extent be attributed to this awareness.

The second wave was one of unilateral adaptation. In Sweden, for instance, a Government bill prescribed as early as 1988 that in future legislation, due regard should be paid to adaptation to EC standards. Similar decisions were taken in several other countries. As a result, several restrictions on foreign penetration of the market were lifted, e.g. the ban on branches of foreign credit institutions in Austria, Finland, Norway and Sweden.

The EFTA countries are now experiencing the third wave of influence. Concurrently with the completion of the negotiations on the European Economic Area (EEA), the authorities prepared proposals for a comprehensive adaptation, to EEA law, of the legal systems governing banking. Parts of those proposals have already been adopted as law by parliaments and further implementation is proceeding according to plan. Thereby, free establishment, free cross-border trade and harmonized essential standards will be introduced for banking, as well as a more competitive business climate through adaptation to the EC legislation on competition.

The opening of markets from »within«

By tradition, banking has been strictly and comprehensively regulated in EFTA countries, as indeed in most other countries. Regulation by credit market legislation, aimed at maintaining stability in financial markets, usually included conditions for authorization, operational rules and supervisory rules. Legislation was oriented towards institutions rather than towards financial functions, different types of credit institution being regulated by different laws. In addition, policy rules and recommendations issued by the central banks as part of their monetary policies, as well as exchange controls, determined to a high degree the conduct of credit institutions, mostly banks.

During a period from the late 1970s up to the end of the 1980s, substantial domestic deregulation took place in all EFTA countries prior to and concurrently with developments in the EC. The main trend was to abolish or diminish the rationing of credit volumes and regulation of interest rates implied by Central Bank rules and recommendations. This also made the regulatory legislation more comprehensive, encompassing institutions that earlier had thrived on the regulatory fringe, and provided more equal treatment of, at least, the various types of banking and savings institutions.

Switzerland was the first country to abolish most of the Central Bank rules, apart from liquidity requirements, in 1979. It is also an exception insofar as it has always applied a broad definition of bodies subject to credit market legislation and has imposed broadly the same type of regulation on all types of bank.

In Austria, the picture is more disparate. In 1979 the banking laws there were partly liberalized and the principle of universal banking established. Credit control by the Central Bank was removed in 1981-82. There was a partial reversal, however, when the authorities supported a banking agreement about interest rate setting in 1985 (»Ordnungspolitische Vereinbarungen«), and credit legislation was revised in 1986, reintroducing control of large credits and tightening liquidity requirements. At the same time, more modern elements were introduced, like raising capital adequacy ratios to up-to-date level, improving supervision and creating a realistic deposit insurance scheme.

The Nordic EFTA countries, like Switzerland, had introduced legislation before 1980 that treated the various types of bank in a broadly equal manner. They were late, however, in abolishing their credit control systems; this was only done, fully or partially, in the mid-1980s.

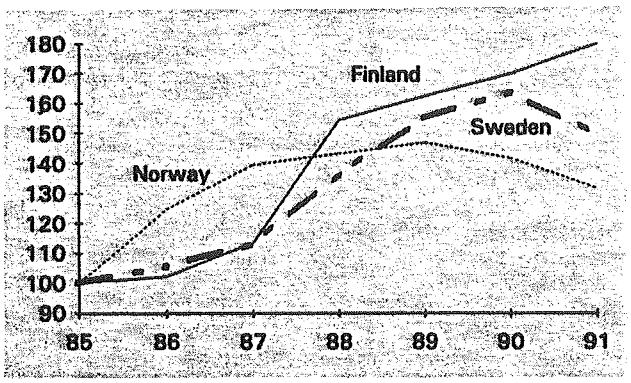
Effects on market conduct and structure

In all EFTA countries, market behaviour in banking in the first half of the 1980s can be described as oligopolistic, with the large commercial banks closely co-operating with each other as well as with the Central Bank on issues concerning credit volume and rates of interest. On the fringe of this system, new unregulated institutions appeared and grew, eventually being regulated or, as in Finland, being absorbed by the banks. Overbranching by established banks was a prominent outcome of this co-operative behaviour, as were other variants of non-price competition.

As deregulation gained momentum, this traditional type of market behaviour came to an end, the road towards its demise being somewhat different in the various countries.

In the Nordic EFTA countries, the major change in regulation came rather abruptly, in the mid-1980s, and was unfortunately not co-ordinated with necessary changes in the countries' tax systems and supervisory rules and practices. As a result, the changes in financial markets were rather dramatic, resembling a classic deregulation cycle, with an initial expansionary surge, followed by elements of crisis and, eventually,

Chart 1 Domestic credit as share of GDP
Index: 1980=100



Source: Yearbook of Nordic Statistics

market consolidation and restructuring, the latter not yet fully accomplished.

Having been relieved of quantitative restrictions and interest regulation, the credit institutions reacted by rashly expanding credit. Lending by banks rose by between forty-five (Norway) and eighty per cent (Finland), in terms of GDP share, within a few years after the domestic deregulation, each institution seeking to take advantage of the more liberal business climate by trying to expand its market share (Chart 1). This sudden expansion in activities, concurrent with the prolonged economic boom of the 1980s, fuelled a speculative bubble in asset prices, especially real estate prices.

It soon became apparent that credit institutions had overextended their activities into high-risk projects. Steeply rising rates of non-performing loans and credit losses resulted in a sharp profit downturn in the early 1990s and the advent of a financial crisis, when the economic boom ended and the speculative bubbles in the various countries burst. A major weeding out and restructuring of enterprises occurred during that downturn. In Sweden, for instance, the number of banks decreased by some 25 per cent between 1988 and 1992; mortgage institutions by about 15 per cent. Finance companies (which earlier had been unregulated) suffered most, more than half of them disappearing. This consolidation phase will continue in the Nordic countries in the years to come.

In the Alpine countries events were less dramatic, but elements similar to those described above can be discerned in Austria and Switzerland. In Austria, after the liberalization of legislation and concurrently with the abolishment of credit controls between 1979 and 1982, an expansionary phase was started, just as in the North, with a strong expansion of branches. This eventually also squeezed profit margins and eroded the solvency of banks, leading to the subsequent interest rate agreements and sharpening of legislation and supervision in 1985-86.

In Switzerland, when the Central Bank relaxed liquidity requirements and changed the conditions for participating in its clearing system in 1988, this likewise gave rise to an expansionary phase in the last years of the economic boom, contributing to an overheating of the Swiss economy and the beginnings of a speculative bubble in real estate prices. The Swiss authorities reacted promptly with restrictive monetary policies, which resulted in, for Switzerland, heavy credit losses, especially in the Suisse Romande and in some areas dominated by small cantonal credit institutions.

During the 1980s, considerable gross changes in the number of domestic institutions took place in all EFTA countries. Sweden and Switzerland experienced a marked increase in the number of finance companies. In Sweden, the trend was reversed in the second half of the 1980s, for reasons already explained. The number of Swiss companies also fell but this was due to growing competition from foreign finance companies. In all countries there was also a marked decrease in the number of savings institutions, mostly as a result of mergers.

As a result, concentration in banking has increased, measured in market share for the four or eight largest companies. However, these large companies have become more equal in size, which could mean that the fundamentals for competition did not suffer in this concentration process.

In the aftermath of the deregulatory phase, the financial crises in EFTA countries and the current economic downturn, we now see that the credit institutions are working hard to trim administrative slack; operating costs have indeed started to fall in recent years. In addition, the companies are beginning to apply modern methods for risk management, some of them as a result of lessons learned in the financial crisis. The leaders in this field are, of course, the major Swiss banks, which are now in the forefront of the international financial markets in derivatives. Thus, on balance, it seems that the financial institutions in EFTA now might be in a better position to face the challenges of external liberalisation than if domestic regulation had remained in the state of yore.

There are some lessons to be learned from these experiences with domestic deregulation.

- Changes in the regulatory system have a sizeable impact on market conduct and behaviour. In some EFTA countries one might even have wished the impact to be more modest.
- The structure of the financial markets cannot be considered as basically stationary. Stationary markets were a feature of the old, comfortable days of heavy regulation. Now that protective lid has been lifted. When assessing future changes in these markets, one better start by assuming that changes will be the rule rather than the exception.

– With the additional changes in external regulation now before us, an open mind is needed in order not to disregard the possible effects, which could be substantial, at least in the long run.

The opening of markets from »without«

In contrast to domestic deregulation, adaptation to the EEA regime leads to increased competitive pressure mostly from abroad, although some parts of the adjustment could give rise to increased pressure also by domestic contestants, as will be discussed below.

As in the EC, in 1980 the EFTA financial markets, with the exception of Switzerland, were mostly closed to foreign companies. During the 1980s the barriers were gradually lowered. Still, as recently as in the late 1980s, subsidiaries of foreign credit institutions were not allowed in Iceland, and foreign credit institutions could not yet establish branches in any EFTA country except Switzerland. In the Nordic countries, foreigners were not allowed to purchase shares to an unlimited extent in domestic institutions. Cross-border trade was virtually impossible in Iceland and basically limited to »wholesale« trade (interbank trade and banking services provided to large enterprises) in all countries but Switzerland, modalities in foreign capital transactions still presenting effective barriers to ordinary (»retail«) customers.

Table 1 gives an overview of the status of liberalisation prevalent at the end of the 1980s. This is an appropriate bench-mark date because it was then that the EFTA countries strove to adapt unilaterally to EC principles to the extent permitted by national sentiment. Without the EEA there is doubt that further liberalisation would have occurred beyond those limits.

The EEA will of course abolish remaining obstacles to the principles of single licence, home country control and mutual recognition.[1] In addition it will impose some harmonization of essential prudential rules such as solvency rules, rules on large exposure and accounting standards.

As to solvency rules, there is no large need for further adjustments since all EFTA countries have already incorporated the Basle Concordat in their national rules. The rules on large exposure mostly concern Finland, which by tradition has allowed a heavy involvement by banks in ownership of the large industrial companies. Adaptation to accounting standards mostly concerns Austria and Switzerland, which abide by the continental system of discretionary accounting (allowing, i.a., large silent reserves).

[1] The question arises how to deal in this context with Switzerland, which has rejected the EEA Treaty. Here it is assumed that Switzerland will adopt the legislative system concerning financial services as a result of bilateral agreements with the EEA States.

Table 1 Access to EFTA countries' credit markets in the late 1980s

	AT	FI	IS	NO	SE	CH
Freedom of establishment						
Subsidiaries	Yes	Yes	No	Yes	Yes	Yes
Branches	No	No	No	No	No	Yes
Acquisition	Yes, but..	No	No	No	No	Yes, but..
Freedom of cross-border trade						
Foreign custodians	Yes	No	No	No	No	Yes
Payments	No*	No*	No	No*	No*	Yes
Deposit accounts abroad	No	No	No	No	No	Yes

* Capital transactions were free but restrictions on intermediaries and payment channels discriminated against foreign competitors.

In addition to the direct adaptation to EEA rules in banking, however, there is the impact of other adaptations of that sector in EFTA countries. These include the EEA rules in company law in general, as well as the legislative system guiding the sector of investment services, or securities brokerage.

In that latter field, EFTA countries were more restrictive, as a rule, than in banking. By end-1980s, not even subsidiaries of foreign firms were allowed to be established in the Nordic countries or in Austria and the domestic exchanges had a monopoly. Furthermore, the countries usually reserved issuance services concerning bonds for their domestic institutions and did not look kindly on mutual funds placing their assets abroad. These restrictions are now being dismantled and will have to disappear completely with the entering into force of the EEA Treaty.

Possible effects of financial integration

When trying to foresee the ultimate effects of the adaptation described above, there is the risk of falling into the trap of the current visionary vogue. When the basic ideas of financial integration were first put forward, in the 1980s (EC [1988], Gardener & Teppett [1992], Ems [1993a]), a generally held opinion was that such integration would give rise to a considerable wave of establishments by non-resident companies, a substantially intensified cross-border trade and intensified competition in domestic markets. Through these developments the large companies in the European financial markets were thought to be able to exploit economies of scale and scope, possibly attainable in full only at an international level of business. Integration would finally be manifested by an equalizing trend in prices of financial services. Early estimates of such price adjustments indicated huge consumer benefits of the integration, amounting to about 0.75 per cent of GDP in EC countries (EC[1988]) and exceeding 1 per cent of GDP in the EFTA countries (Gardener & Teppett [1992]).

As the internal market is now taking its final steps towards completion, this first view has largely given way to a counter-proposition, albeit expressed in more cautious terms. Studies on economies of scale and scope do not indicate the substantial gains predicted in the earlier analyses. Thus one of the main incentives for Europe-wide establishment of banking companies is proved to be weak. The individual EFTA countries are also relatively small, and can be conceived as not being worth the effort of costly large-scale establishment.

As to cross-border trade, one can point to a number of reasons why customers may continue to prefer domestic suppliers of financial services, such as brand loyalty, preferences for domestic products and counterparts, differences in the legal systems of the countries involved (in particular contract law), currency risks and so on.

Granting that nobody can look into the future, an appropriate approach might be to investigate how barriers to market entry are being affected in different market segments and in various EFTA countries.

To start with wholesale banking, this is already thoroughly internationalised and thus a counter-example to the above proposition. It is not by happenstance that most of the foreign institutions which have been established in EFTA countries other than Switzerland, as result of a first external liberalization in the 1980s, deal in wholesale services. Although the initial conditions for establishment were rather harsh, only subsidiaries being allowed, foreign banks now hold between 1.5 (Norway) and 3 per cent (Austria) of bank balance-sheet assets in those countries.

The statistics, moreover, underestimate foreign banks' share of activities. The figures above do not include off-balance sheet items, which largely relate to wholesale trade, in which foreign banks are prominent. Also, subsidiaries of foreign banks tend to operate as figure-heads for financial activities carried out by their parent companies abroad. Thus, in Sweden, for instance, lending to large companies related, directly or indirectly, to foreign banks established in Sweden could easily amount to ten per cent of total balance-sheet assets.

Switzerland is, of course, the main example of a market place with a strong foreign presence. Of a total of about 600 credit institutions, almost 240 are foreign-owned, their activities not only directed towards wholesale trade, but also towards private banking.

Thus the main effects of adaptation to EEA legislation are to be expected, if at all, in retail banking. Several factors indicate a lowering of barriers in that segment.

The costs of establishing a market presence have substantially decreased – the forming of branches, and the acquisition of domestic banks with a branch network are now permitted. Foreign acquisition is politically acceptable in Austria and Sweden, and soon might be in Finland. Only in Switzerland can we expect lasting efficient barriers against acquiring banks with substantial branch networks.

Brand loyalty and preferences for services provided by the domestic institutions are subsiding in the Nordic countries in the aftermath of domestic deregulation and the financial crisis. In particular, decreased credibility of credit institutions that have incurred substantial losses, and high interest margins in the domestic institutions, contribute to such a weakening. Similar effects have been observed in Switzerland, with a distinct fall in retail deposits some years ago in view of wider margins and access to alternative receptacles for savings.

Customers seem to be getting more sophisticated and educated as financial systems evolve. This is true mostly of middle to high-income customers. In those groups the elasticity of demand for financial products is rising as the result of increased information about alternatives.

Remaining differences in taxes on capital returns increasingly encourage customers to place their savings cross-border. Switzerland and, until recently, Austria have no such taxes for sophisticated customers. Luxembourg is another noteworthy haven for tax-free savings. In the Nordic EFTA countries, middle-income groups in particular will become more aware of those differences and able to exploit them.

The opening of borders concerning securities trading will increase competition from both »within« and »without« vis-à-vis banks. Examples are the loss of the monopoly to issue bonds in Swiss Francs for banks established in Switzerland and the recent emergence of securities dealers in countries such as Finland and Norway outside of the banks.

Open co-operation or collusion between major domestic institutions, with a view to stifling minor competitors, can no longer be condoned by the authorities, since the EEA competition rules strictly forbid such behaviour.

Thus the barriers to financial market entry in EFTA countries will be subject to a multitude of erosive forces.

In the longer run this will certainly lead to a larger foreign presence in most EFTA countries. It will probably start by enlargement of the scope of activities of foreign banks already established on the domestic markets. Even in the near future, acquisition of a major commercial bank cannot be excluded in Austria, Finland, or Sweden. Further ahead, we may experience incipient competition, from foreign affiliates as well as cross-border, in certain retail sectors not so dependent on branch presence.

Examples would be banking services to wealthy (or even medium-income) customers and medium-sized firms, offering a full range of products from just a few offices established on the domestic markets or even from abroad (Vesala [1993]).

At the same time, the large domestic banks will not stand idly by while the foreign presence is increasing. They will react internally, by keeping their internal administration lean, continuously improving methods for risk management and asset management, rethinking their product strategies, introducing more competitive pricing (for instance, doing away with cross-subsidization of products). Externally they will certainly continue a strategy of defensive regrouping of companies. These reactions will most probably be observed even if foreign presence in the domestic markets were to remain modest, their main driving force being the *mere risk* of foreign presence.

More offensively, EFTA banks might also rekindle their strategies for internationalization. In that respect, Switzerland has not been hampered to a large degree by financial crises, so its major banks have continued their expansion abroad, participating actively in growing markets such as that in derivatives. The major Nordic banks are occupied with consolidation after the crisis and do not have the same impetus at present.

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EEA and Swedish Banking – the Main Impacts

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In the past decade a number of factors have affected the structure as well as the competitive situation of the financial sector in Sweden. While changes in regulation originating from within the country probably were the most important driving force in the 1980s, adaptation to EEA considerations is prominent in the 1990s. As Sweden continues to adapt to EC standards, the more competitive and international environment will affect the market structure comprehensively.

Introduction

In the past decade conditions in the Swedish credit market have changed dramatically. In the early 1980s the financial system in Sweden was strictly regulated and markedly institutional (mainly bank oriented). Since then the framework within which banks and other credit institutions operate has altered considerably, due to changes in regulation as well as to other factors. The framework will be subject to further changes in the 1990s, mainly due to EEA adaptation. The article provides a broad overview of these changes.

The next section outlines the main influences on the credit market as well as their effects on market structure in the 1980s. The following section deals with the need for adaptation to the EC legal system for banking and investment services. The final section attempts an outlook into the 1990s concerning the structure and performance of the banking sector.

Factors affecting structural developments

Chart 1 lists the main factors behind developments in the banking sector. *Changes in regulation* have had a major impact on the structure of the credit market. Banks, in particular, used to be sheltered by high regulatory barriers which successively have been reduced. Changes in Swedish regulation can be roughly divided into those which promote domestic competition and those that facilitate competition from abroad. During the 1980s the main impetus came from changes in domestic competition.

For most of the post-war period, the policy rules which regulated the business activities of banks and other credit institutions in Sweden had remained basically unchanged. It was not until the 1980s that the authorities adopted a policy of successive deregulation, mainly because the existing regulatory system was becoming inefficient, as new channels were created for the extension of credit. One of the major changes in regulation was the abolition of credit ceilings in 1985, which triggered changes in the structure of the credit market. Previously lending had been considered a rationed service. When customers no longer had to stand in line, in the course of a few years the GDP share for lending by banks, finance companies and mortgage institutions rose some 70 per cent (Chart 2). Deregulation also had the effect of permitting institutions to encroach on each others territories and allowing market forces to work more freely.

Besides domestic deregulation, *internationalisation* and *technological developments* have also affected the structure of the Swedish banking industry.

Both the real and the financial components of the Swedish economy have gradually become more integrated with the international economy due to the expansion abroad of Swedish non-financial firms as well as to the imbalances in Sweden's current account. As a result, and with liberalised capital movements, the Swedish financial sector has become largely integrated with international markets.

Technological developments have enabled credit institutions to supply new products and have reduced transaction costs. Technological innovation in computers and communications has facilitated the introduction of new instruments, such as futures, forwards, swaps and options. Furthermore, the secondary money and bond market has grown significantly. Another important impact of technological developments is the improvement of accounting and control systems within credit institutions.

A third factor that has affected the banking industry is the *development and growth of the securities market*.

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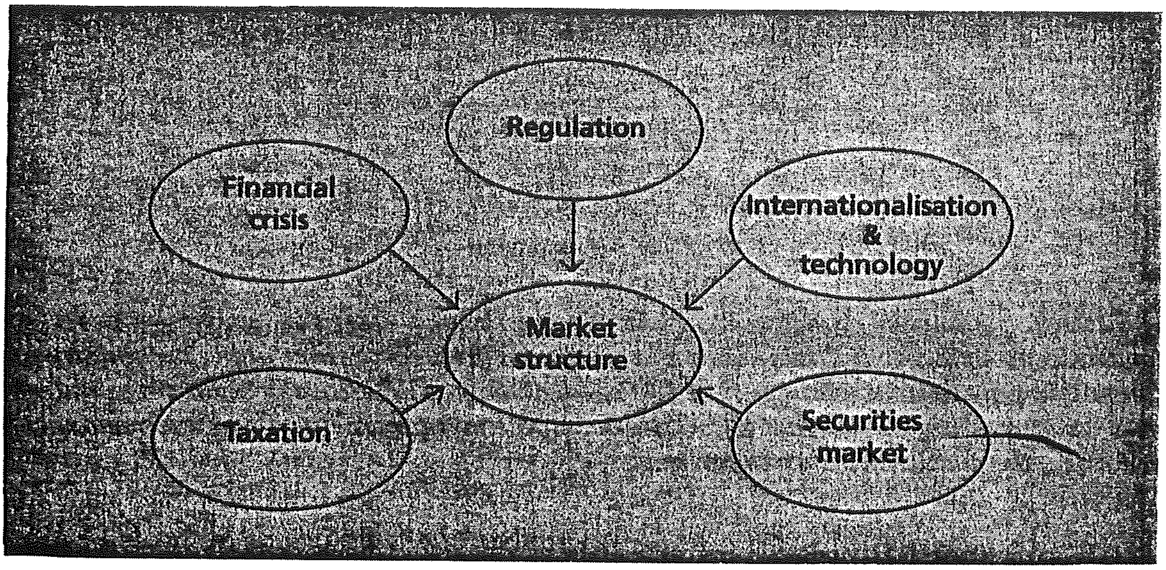
Chart 1 Factors affecting the banking sector



The securities market satisfies essentially the same need as the institutionalised part of the financial system, namely the allocation of capital and risks. It accordingly competes with the credit institutions.

Large, sophisticated creditors have explored other sources of financing than bank credits, for instance commercial papers. In this way, traditional bank lending meets more intense competition from securities. Investors also have a wider range of investment opportunities in non-bank financial institutions. Consequently banks face increased competition on both sides of the balance sheet. They have adjusted to the new situation by broadening their activities, increasingly acting as investment institutions and intermediaries dealing in securities and as financial advisors.

Fourthly, the *Swedish tax system* was reformed comprehensively in 1990-91. Tax bases were broadened and marginal rates of income tax were lowered and harmonised with capital taxes. This greatly reduced the deductibility of interest expenditure, the aim being to stimulate saving and capital formation. Another important element of the tax reform is the more equal tax treatment of different types of financial institutions and of financial compared with non-financial institutions. This was done, for instance, by curtailing provisions for tax exempt reserves.

A fifth aspect affecting the structure of the credit market is the *financial crisis*. In Sweden, problems in the financial sector became apparent when the long economic upswing turned into a recession and changes in the economic policy regime affected the credit market concurrently. This had the effect of bursting a speculative bubble in asset prices, mainly in real estate, which triggered the financial crisis.

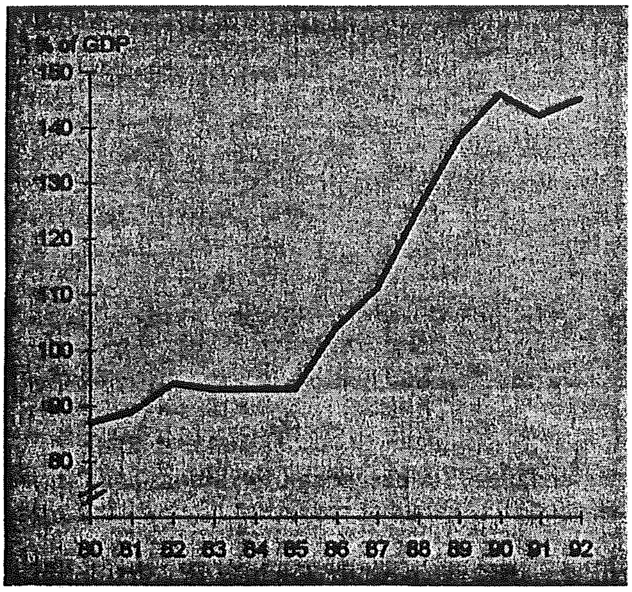
As a result of the old regulatory system, which gave priority to the financing of housing construction, Swedish credit institutions had more real estate related lending than their counterparts in most other countries. A major part of the loan losses accordingly stemmed from real estate related lending. Mostly, the crisis affected banks and finance companies through loan losses and drastically diminishing profits (Chart 3).

In the past decade or so the structure of the banking sector has changed considerably (Table 1). The diminishing number of companies mirrors both an initial over-establishment in some market segments and a move towards a more cost-efficient structure as a result of a more competitive environment.

The finance companies, being on the regulatory fringe, increased at first in both number and market share. The introduction of authorisation and cash requirements in 1988 ended the finance companies' competitive advantage stemming from liberal regulation. From mid 1988 to end 1992 their number fell instead from 320 to 133, of which no more than approximately 40 were active. In addition to new regulations, the over-established market for finance companies led to narrower margins. Many finance companies chose to expand total assets in order to sustain profits. This resulted in a marked deterioration of asset quality and a wave of bankruptcies.

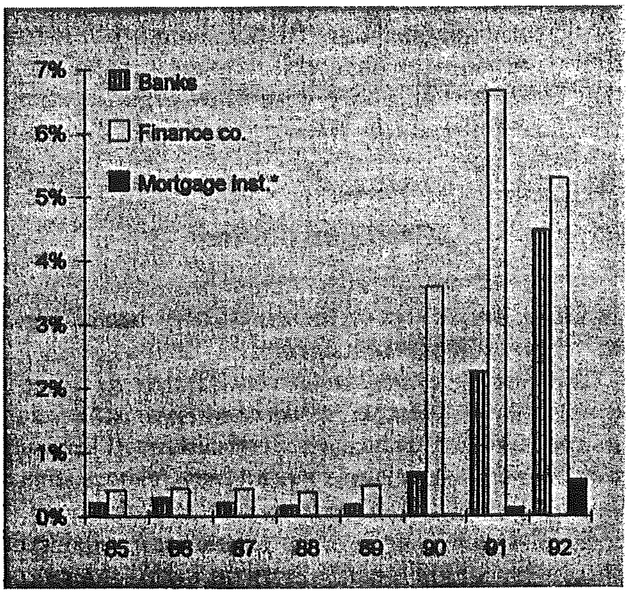
As a result of the financial crisis and attempts by commercial banks to improve their competitive position, mergers and acquisitions have taken place among these banks, mainly in the late 1980s and early 1990s. In the early 1990s the savings banks and co-operative banks followed suit by forming basically one bank each. The result is that the degree of concentration, measured as the four largest banks'

Chart 2 Credit institutions' total lending
Per cent of GDP



Source: The Riksbank

Chart 3 Loan losses in per cent of average balance sheet total



* No figures available prior to 1988.
Source: Financial Supervisory Authority

Table 1 Number of institutions in Sweden at year-end

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Commercial banks	14	14	14	15	15	15	14	14	14	14	12	9	10
Foreign banks*							12	11	10	10	9	8	8
Savings banks	164	162	160	155	149	139	119	115	110	109	104	101	90
Co-operative banks**	12	12	12	12	12	12	12	12	12	12	12	1	–
Finance companies	107	117	127	164	203	213	244	278	292	215	180	152	133
Mortgage institutions	22	20	21	21	22	23	24	25	25	26	26	23	21
Total	319	325	334	367	401	402	425	455	463	386	343	294	262

* In 1985 foreign banks were allowed to open subsidiaries in Sweden.
** In 1991 the 12 regional banks merged. In 1992 the co-operative bank was transformed into a limited banking company.
Source: The Riksbank

share of all banks' assets, has increased from 54 per cent in 1980 to 81 per cent in 1992. Within the group of large banks, however, competitors have become more similar in size. Thus, the increased concentration does not represent a move towards absolute dominance by a single firm and thereby to monopolisation.

Legislative and regulatory adjustments occasioned by EEA considerations

In contrast with domestic deregulation, adaptation to the EEA regime introduces competitive pressure from abroad.

The EEA Agreement provides for free cross-border trade in financial services, freedom to establish credit institutions in all EEA countries, mutual recognition of regulatory regimes, and a set of minimum supervisory and prudential rules. Through the EEA agreement Sweden will adopt almost all of the EC legislation relating to financial services, as well as the EC's provisions for free movement of capital.

Even before the EEA negotiations started, the Swedish authorities were giving priority to the introduction of EC standards in Swedish legislation (Government Bill 1987/88:66). Sweden is therefore well on its way in adopting these standards in financial services. Parliament approved the basic legislation in this vein in January 1993 and the rest is being implemented from January 1994.

When analysing the impact of changing legislation and regulation, it is appropriate to use 1 January 1990 as the benchmark date for adjustments arising out of participation in the EEA. The legislation at that date reflects broadly the unilateral adaptation to EC rules that Sweden would have desired to uphold without being a member of the EEA or the EC.

Credit institutions

The internal market in banking rests on three principles: a single licence, home country control, and harmonisation of essential rules.

The purpose of the *single licence* and *home country control* is to remove restrictions against foreign competition by introducing free establishment. Together with mutual recognition of regulatory regimes, these principles also imply free cross-border trade.

On 1 January 1990, most restrictions on market entry were still in force in Sweden. Establishment of foreign owned credit institutions was still limited. Neither were foreigners allowed to purchase shares in Swedish credit institutions. This meant that foreigners were at a disadvantage in competition with Swedish credit institutions. In fact, the only way for a foreigner to compete on the Swedish market was to open a bank subsidiary.

Cross-border trade was also limited at that time. Although trading in securities had been deregulated the previous year, the modalities for transactions were restricted. Payment had to be conducted through authorised exchange banks, foreign securities had to be deposited in a bank authorised by the Riksbank and individuals were not permitted to have deposit accounts abroad.

The loosening of restrictions for foreign credit institutions continued in 1990. As of August that year, foreign banks were allowed to open branches in Sweden. Foreigners were also permitted both to acquire shares in Swedish credit institutions and to establish subsidiaries in Sweden. At the same time, the market need test[1] for granting licences was replaced by a purely qualitative assessment. One year later, non-bank financial institutions were also permitted to open branches in Sweden. By the turn of 1991, all legal restrictions on foreign ownership in Swedish credit institutions had been abolished. However, foreign citizens could still be prevented from acquiring a company's shares by means of a restrictive clause in the articles of association. The possibility for a Swedish company of having restricted shares was revoked as of 1993.

Concerning cross-border trade, the restrictions on

Table 2 Foreign access to the Swedish credit market

	January 1 1990	January 1 1993
Freedom of establishment		
Subsidiaries	Yes	Yes
Branches	No	Yes
Acquisition	No	Yes
Freedom of cross-border trade		
Payments	No*	Yes
Deposit accounts abroad	No	Yes

* Trading and payments have always been free but restrictions on intermediaries and payment channels discriminated against foreign competitors.

the modalities for executing transactions and the ban on deposit accounts abroad were lifted on 1 January 1993.

Free establishment and free cross-border trade imply that each EEA member state has to recognise the other member states' regulations. In order to avoid undue »competition through rules«, a set of common minimum standards has been adopted for all EEA countries. This *harmonisation of basic requirements* concerns such matters as: own funds, solvency, rules concerning large exposures, annual accounts, and deposit guarantees.

On 1 January 1990, the Swedish rules had not yet been adjusted to those in the Community, though the regulations were not dissimilar. On 1 February 1990, Sweden introduced uniform international capital adequacy requirements for all credit institutions. Full adoption of the 8 per cent capital requirement in accordance with the EC Directive was implemented at year-end 1992. In 1991, the Financial Supervisory Authority in Sweden issued recommendations concerning large exposures that follow the EC recommendations from 1987.

In December 1992, the Community adopted the Directive on monitoring and controlling large exposures of credit institutions, which states that by year-end 2001, not more than 25 per cent of own funds may be placed with any one client or group of clients. This Directive has not yet been incorporated in the Swedish legal system. Some Swedish credit institutions would not be able to comply with these rules today, which means essentially that lending will have to be redistributed. Sweden has been granted a transitional period until 1 January 1995, to implement the Directive on large exposures.

A problem for credit institutions concerning large exposures stems indirectly from corresponding investment rules for life insurance companies, since the latter might render funding more difficult and costly for mortgage institutions. Today, several Swedish insurance companies exceed the limit prescribed for

[1] The bank authorisation (charter) procedure included a qualitative judgement, in that the applicant had to provide proof of a need for a new bank.

them, implying a need to reduce their holdings of bonds issued by mortgage institutions. However, Sweden has been granted a transitional period until 1 January 2000 and those institutions will thereby have a long period to adapt to the new rules.

Sweden has been granted a transitional period until 1 January 1995 to implement the Council Directive on annual accounts and consolidated accounts of banks and other financial institutions. However, during the transitional period, Sweden is obliged to recognise the annual accounts of other EEA countries in accordance with the Directive. This means that branches of credit institutions of other EEA countries established in Sweden shall not be asked to publish separate annual accounts.

The EC has adopted a common position for the Directive on deposit-guarantee schemes. It contains an anti-competitive measure in the form of a »no export« clause, whereby branches are not permitted to offer deposit protection exceeding that of the host state. Sweden has not yet adjusted the relevant rules to those of the Community, since it has been unclear how the latter would be formulated. In the meantime, the present unlimited guarantee from the Swedish Parliament for banks' obligations to depositors and creditors in practice implies a comprehensive and rather generous protection to depositors.

Sweden will in time also have to adapt to other EC legislation, such as regulations and administrative provisions relating to the reorganisation and the winding-up of credit institutions and prudential supervision of financial groups.

Securities market

The purpose of harmonising trade in securities within the EEA, as well as in the Community, is to establish a common securities market, where credit institutions and other institutions acting on the market are treated equally.

The principles of a single licence and home country control for the securities market were enacted with the adoption of the Directive on investment services in 1993, thereby completing the common securities market. The directive shall come into force no later than 1 January 1996. Earlier, these principles applied only to Undertakings for Collective Investments in Transferable Securities (UCITS) and related areas. Besides introducing those principles, the EEA agreement contains rules such as minimum requirements for stock exchange listed securities. Companies listed on an official stock exchange shall regularly publish information, report changes in major holdings of shares, and prohibit insider trading.

In 1990, the securities market in Sweden was still restricted in several ways, one being the Stockholm Stock Exchange's exclusive right to organise exchange trading in shares.

Table 3 Foreign access to the Swedish securities market

	January 1 1990	January 1 1993
Freedom of establishment		
Subsidiaries	No	Yes
Branches	No	Yes
Freedom of cross-border trade		
Securities trading	No	Yes
Payments	No*	Yes

* Trading and payments have always been free but restrictions on intermediaries and payment channels discriminated against foreign competitors.

Since then, the securities market legislation has been reformed to bring it into line with EC legislation. The new Mutual Funds Act, from 1991, represents an adjustment to deregulated capital markets and the removal of currency restrictions, but is also an adaptation to the UCITS Directive. In the same year, new insider rules and the Securities Business Act replaced earlier regulation as an adjustment to EC Directives in these areas. When new Stock Exchange legislation came into effect at the turn of 1992, the stock exchange monopoly was replaced by freedom of establishment in accordance with EC rules.

This freedom enables companies, including foreign enterprises, to gain authorisation as an exchange or market place. As a result, foreign UCITS and banks that are permitted to participate in exchange trading in their home country, can become members of the Swedish stock exchange. Foreign companies' branches can also receive authorisation as an exchange or market place in Sweden. Foreign companies may also obtain approval for conducting clearing operations for options and futures. Following the abolition of the Foreign Payments Act, there are no restrictions on cross-border provision of services related to securities transactions.

As is evident from Table 3, the Swedish securities market is today fully in line with EC standards. The principles of a single licence and home country control will, however, apply fully in the Swedish securities market first after the implementation of the Directive on investment services.

Implications of increased market access for foreigners

The integration of the Swedish financial market with that of other countries has been slow. So far foreign penetration of the Swedish credit market can be summarised as follows:

- In 1986, when subsidiaries to foreign banks were permitted, 12 foreign banks were authorised to conduct banking business in Sweden. Of these, six were from EC countries. Today, there are 8 foreign banks present on the Swedish market. Thus, some of the foreign banks, mainly Nordic, have exited the market again.

- In 1990 foreign banks were for the first time allowed to conduct banking business through branches. This had, however, no immediate effect since Swedish tax law prohibited the transfer of deductions for losses from a subsidiary to a branch. When this was changed in 1992, it initiated a number of conversions from subsidiaries to branches, starting with OKO-bank, a Finnish bank.
- The foreign banks held 2 per cent of banks' total assets in 1986 and 2.5 per cent in 1992. This increase in market shares is attributable mainly to EC banks. It is explained by the financial crisis, which has not affected foreign owned banks as much as Swedish banks. It should also be noted that the capital adequacy requirements have tended to result in foreign owned bank subsidiaries acting as intermediaries in lending to their parents abroad. Consequently, the actual market share of foreign banks is larger than the 2.5 per cent, and will soon show in the statistics, as subsidiaries are converted to branches.

Outlook and conclusion

Factors affecting developments in the 1990s

In this section, an attempt will be made to identify the main factors affecting the development of the financial system in the 1990s, as well as possible outcomes in terms of changing market conduct and structure. This is done against the background of West European integration. Three broad groups of driving factors are of relevance in this context.

First, changes in the legal system underpinning the financial sector will continue to have an impact in the 1990s, mainly because of EEA and EC considerations. This will give more leeway to market forces and increase the contestability of the credit market. The EEA Treaty reduces barriers for foreign competitors both in the form of establishment and in cross-border trade (see Tables 2 and 3 above).

Second, the financial crisis in Sweden and its aftermath will have implications for the structure of the Swedish credit market. The financial crisis is likely to speed up the process of broad restructuring triggered by the earlier deregulation and reinforced by the adaptations to the EEA system.

Third, technological changes will continue to play an important role in the 1990s. In the 1980s, the rapid introduction of new technology, mostly justified by not losing ground to competitors, did not always leave time for reflection and appraisal. In the 1990s, we can expect investments in technology to be more structured and geared to profitability. With an increased awareness of the risks inherent in banking, a large part of investments in production technology is likely to be in systems for managing and reducing risk. On the distribution side, technology might be put to use in particular to improve retail payments, mainly cross-border payments.

Emerging trends

The future trends that might arise as a result of the three factors mentioned above will be discussed under the following headings: contestability, profitability and risk, business conduct, and market structure.

Contestability. One main conclusion is that competition in the banking industry is more intense today than it was a decade ago, even though the financial crisis is temporarily reducing the incentives for competition. The adjustment to a new legal system as a consequence of the EEA and the EC is likely to go on reducing barriers to entry and increasing competitive pressure. Retail banking is likely to be most affected by financial integration, while wholesale banking to a large extent is already open to international competition. Nevertheless, Swedish retail banking will probably, at least in the short run, hold its ground because of remaining implicit barriers to entry stemming from national differences (e.g. history, language, and tradition) as well as customer loyalty.

Barriers to entry are also diminishing as a result of the financial crisis. Existing credit institutions are cautious in expanding lending, while maintaining wide interest margins in an effort to cover their loan losses. This provides enticements for foreign institutions. Moreover, the financial crisis has impaired confidence in Swedish credit institutions, affecting customer loyalty.

Previously, only one form of market entry from abroad was available, namely subsidiaries. Today, all four possible forms of market entry are permitted in Sweden: subsidiaries, branches, acquisitions, and cross-border trade. Given that a subsidiary is the most difficult form of market entry, barriers to entry from abroad have thus been lowered substantially.

The competitiveness of foreign owned credit institutions is improving as a result of deregulation in accordance with the EEA Treaty as well as of the financial crisis. An institution with sufficient capital might find it profitable to penetrate the Swedish market. Should the foreign owned bank want to compete on a full scale, the most relevant way would seem to be to buy one of the existing banks.

As a consequence of allowing foreign owned securities dealers in Sweden from 1990, banks are also facing increased competition in the area of securities trading.

While competition between different types of financial institution is becoming more symmetric, competition between credit institutions and non-financial institutions remains asymmetric. It is becoming easier for non-financial institutions to diversify into banking, while credit institutions are having problems with diversifying out of finance due to regulation.

Non-financial companies have been competing on the wholesale market for a long time. They have done this by setting up finance companies, obtaining funds directly in the securities market and doing their own currency dealing. A likely trend in the 1990s, in the aftermath of the financial crisis, is intensified competition from non-financial institutions in the retail market. Examples are already to be found in retail food chains and housing co-operatives, inviting deposits from customers and members. However, if non-financial institutions intend to compete in this field on a full scale, they would have to become credit institutions, thereby losing the competitive advantages stemming from the fact that they at present largely stay outside the regulatory system.

With large budget deficits, the Government will have a great need to borrow in the money and bond market in the years to come, thus increasingly competing with credit institutions for domestic funds. In addition the Government, as well as other issuers, will be forced to seek funding abroad to a greater extent than previously. However, this is getting easier in an integrated European financial area. The role of rating will probably grow and interest rates will have to be further differentiated to attract investors to riskier non-Government securities.

Profitability and risk. Profits in banks were high throughout the 1980s but have subsequently fallen to historically low levels due to the financial crisis. A return to the high levels earned before the deregulation is unlikely since both the deregulation and internationalisation have created an environment where a high economic rent cannot be maintained in the long run.

With the phasing out of untaxed reserves and reduced profitability, credit institutions will be more vulnerable to credit risk. Nor will these institutions be able to reap short-run profits by acquiring high risk assets at the cost of ultimately having to face loan losses. After the events in the 1980s, supervision is likely to become stricter and the banks' attitude more cautious. The risks, moreover, are likely to be more interrelated with the rest of the world. In addition, increased disintermediation will mean that the more risky parts of the portfolio are likely to stay in the credit institutions, thereby raising their overall risk exposure.

Since risk will prevail while profit margins may not be as high as before, volatility will have more severe implications than previously. In such an environment, the appropriate managing and pricing of risk is likely to be one of the keys to success in the years to come. We can expect to see new and better techniques for managing risk in all viable credit institutions, for instance, internal systems that adjust the returns on capital for the amount of risk taken (Risk Adjusted Return On Capital, RAROC).

Business conduct. Heavier competition and reduced profitability will have a strong impact on business conditions. These changing conditions are likely to lead credit institutions to search actively for new ways of conducting existing business, as well as for new areas of possibly profitable activities.

In the 1980s, the prevalent pricing strategy was cross subsidisation, which means that the price of a specific product or to a particular customer did not exactly mirror the cost and risk involved. For example, savings accounts have traditionally subsidised transaction accounts. However, as competition is intensified, this cross subsidisation will no doubt be more difficult to uphold. Enterprises specialising in narrow niches would be prone to compete in market segments where diversified banks overcharge due to cross subsidisation. Thus, for instance, the number of institutions specialising in savings accounts could well increase if banks continue to use those accounts to subsidise transaction accounts and advisory services. Under these conditions the financial groups can be expected to have more directly cost-related pricing in the future.

The earlier regulatory regime enticed domestic banks to over-extend their branch networks. The large number of branches today is an implicit barrier for new entrants. However, the main activities of branches lie in the provision of standard products. In the years ahead, these services will probably be available to a greater extent by telephone and computer links. Branch networks will then be a less effective barrier to entry. In that the Swedish market appears to be over-branched, at least locally as in major cities, a reduction in the number of branches can be foreseen. This process had in fact started before the financial crisis and was accentuated by it.

As discussed previously, in order to comply with the limit on large exposures, several Swedish insurance companies will have to reduce their holdings of mortgage bonds. Under the new conditions, some of the largest mortgage institutions will no doubt have trouble in finding sufficient alternative buyers for their issues on the Swedish money and bond market. Conceivable solutions will be more active issuing of bonds abroad or securitization of assets (asset-backed securities).

As a response to increased competition from the securities market, credit institutions might attempt to compartmentalise assets by degree of risk and collateralize them in a more systematic form to attract investors, e.g. by securitization. In the 1980s this was done on a very limited scale. In the 1990s it might be an attractive alternative for achieving lower borrowing costs and a better use of capital. Another advantage is that the institutions might find it easier to satisfy the international capital adequacy requirements. Finally, it might become easier to attract foreign funding, since the new type of instrument would be more transparent. At present these developments are hampered to some extent by the fact that the Government guarantees all commitments made by bank groups and other major credit institutions. Thus, in the short run these guarantees distort the market incentives for urgently needed changes in risk management.

One can expect bank groups to expand into some new areas, while individual mortgage institutions and finance companies return to their basic activities, at least in the short run. Banks might offer more extensive advisory services, partly in response to competition from securities dealers. This might also be needed as the financial system becomes increasingly complex and sophisticated, confronting savers and investors with a wider range of investment opportunities. Related areas where advisory services might be needed are taxation and insurance.

Further expansion into non-banking areas, such as insurance services, is also likely. For instance, in an attempt to increase the competitive environment for insurance, from 1994 onwards, banks in Sweden will be allowed to offer pension savings schemes with premiums deductible for income tax. This is an area with growth potential, particularly as the state pension scheme is due to be reformed.

Moreover, as a result of the financial crisis, banks will have large portfolios of real estate which formerly constituted collateral for failing loans. The way these portfolios are managed will have implications for future bank profits as well as for other companies in these segments of the market.

With the growth of the securities markets, banks will further expand their off-balance sheet activities, trying to gain shares in those markets. Thus, banks may get more involved in assisting investments through guarantees and back-up facilities.

Finally, in the 1990s, banks will again put more effort into low-risk activities that did not have priority in the 1980s. This implies more emphasis on possibly profitable segments of retail banking.

Market structure. While the existence of economies of scale in banking may be questionable, there are other arguments in favour of large banking groups. One is the gain from producing and providing new instruments, due to economies of scope and established credibility on the interbank market.

At the same time, the existence of new financial instruments tends to erode the potential economies of scale and scope. Thus niche-companies can use the new instruments to diversify risk even with small and homogeneous portfolios. So while one can expect the major banking groups to maintain large shares of the financial market, there is also likely to be a parallel trend towards specialisation or niche-playing.

The presence of foreign owned banks in Sweden is currently tending to change from subsidiaries to branches. This is a natural consequence of legislative amendments following the EEA Treaty permitting branches. For foreign banks, the main advantage of a branch compared with a subsidiary is that the former relies on the parent bank's capital base, giving it more leeway in lending. Another aspect is that home country control will apply, which can confer a competitive advantage instead of previous disadvantages if regulation is less restrictive in the home country.

The Swedish securities market is also being transformed from a virtually closed market to freedom of establishment under EEA rules. This will provide opportunities for specialisation and niche-playing which are likely to spur the emergence of new, smaller enterprises that trade on own account, participate in securities issues or as back-office companies. On the stock market, the abolition of the exchange monopoly may lead to additional exchanges (market places). A larger share of »cross-border« trade in securities is also likely, in which case foreign market places, such as Copenhagen, could take even larger shares of the trade in Swedish securities.

Since technology is fuelling innovation in financial instruments and market places are becoming sophisticated, a growing number of investors and borrowers will find the securities market an attractive alternative to the market for institutionalised credit. It is therefore to be expected that the securities market will continue to grow at the expense of the credit market.

Given free capital movements and liberalised cross-border payments, tax evasion may become more prevalent as a consequence of higher taxation on capital income and wealth in Sweden compared with some other countries. Swedish credit institutions might then be induced to assist customers by maintaining a presence in the form of subsidiaries in tax havens such as Luxembourg. On the other hand, Swedish establishments abroad will remain restrained in the near future by the current financial fragility. In addition, the benefits of having foreign establishments have been reduced by the abolition of exchange regulations, making cross-border trade easier. With the international harmonisation of capital adequacy requirements, moreover, there will be less scope to exploit lower requirements elsewhere. On balance, one might expect that some Swedish banks will withdraw from foreign locations.

Conclusion

In the aftermath of the financial crisis and the adaptation to the legal system in the EEA, barriers to entry are being reduced. This points to a further increase in credit market competition in the 1990s. The structure of the financial market can be expected to move towards further diversification across traditional boundaries. At the same time, the degree of concentration on the Swedish credit market is likely to remain high, with a few bank groups as dominating players. However, smaller niche-companies may compete for profitable segments, thereby ultimately reducing the scope for cross-subsidies in the major groups. Competitive pressure also has the effect of eroding profits, making the credit institutions more sensitive to risk and thereby necessitating more advanced risk management systems.

The securities market is likely to grow at the expense of the market for institutionalised credit in the 1990s, due to ongoing innovation in financial instruments and market development. Besides being a strong competitor with the market for institutionalised credit, the securities market will also provide more opportunities for credit institutions to participate with off-balance sheet activities. Furthermore, changes within the securities market, permitting freedom of establishment in accordance with the EEA Treaty, will also make the securities market itself more contestable.

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Regulation of Swedish Banking after the Crisis – Making Deposit Insurance Work

STAFFAN VIOTTI*

In the aftermath of the financial crisis, credit institutions should be discouraged from excessive risk-taking while being under the umbrella of public protection. When an explicit deposit guarantee according to EEA rules is introduced it should be accompanied by an explicit monitoring scheme. Under that scheme, supervisory authorities should be empowered to intervene actively as soon as a bank shows signs of getting into financial difficulties.

Introduction

The Swedish banking system is currently in a state of transition which might prompt quite different considerations depending on the perspective taken. *On the one hand* the Swedish banking industry is involved in the worst financial crisis since the 1920s. Gigantic loan losses accumulated over the period 1990-93 have seriously affected all Swedish banks. In September 1992 the Swedish government felt it had no choice but to issue a general guarantee to the banking sector. Even though it is far from clear to what extent bad management and senseless loan behaviour within the banks are to blame for the financial crisis, the banking sector has suffered considerably in terms of lost good-will and confidence in the eyes of the general public.

On the other hand the economic situation for most Swedish banks seems to have improved considerably during the second half of 1993. Although provisions for loan losses have continued to grow, bank earnings have risen markedly, partly as a result of falling interest rates and widened spreads between loan and deposit rates, but also due to huge profits from brokerage and market-making activities, not least in foreign currency dealing.

A year after the general guarantee was issued it seems that the reconstruction process in the Swedish banking industry has come a long way, with most of the banks showing clear signs of being back in business.

Although the bank crisis cannot be said to be definitely over until loan losses begin to come down to normal levels, more attention should now be given by the authorities to long-run issues.

One such issue that must be considered, though it has yet to be clearly confronted in Sweden, is deposit insurance. The aim of this paper is to analyze deposit insurance from various angles and to provide broad recommendations concerning *deposit insurance* schemes for the Swedish scene. The analysis takes its inspiration from the U.S., where the design of various deposit insurance schemes has been a hot topic for some time.[1]

Government guarantees – implicit or explicit

It should be clear that in the current Swedish regulatory system there is no *explicit* deposit insurance scheme. Of course the general guarantee offers government insurance not just to depositors but to all stakeholders in the banks except shareholders and some low-priority bond holders. But before the guarantee was announced in September 1992 there was no explicit guarantee that the government would bail out depositors in the event of a bank failure. On the other hand there was probably widespread agreement that the government would most certainly come to the rescue in an emergency. In other words there was general consensus about *implicit* deposit insurance.

Before the deregulation of the Swedish financial system began in the 1980s, banks had limited opportunities to expose themselves to risk. The regulatory and prudential controls associated with the privilege of a bank franchise largely prevented risk-seeking behaviour. Instead, the regulatory system exacted costs in terms of general inefficiency, inertia and inflexibility in the banking sector.

With the erosion of tight controls on bank activities the situation changed. It is all too evident today that

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[1] The European perspective on deposit guarantee schemes is presented in Professor Dermine's article in this volume.

risk-taking in banking became excessive in the late 1980s. One should, however, be careful about interpreting this as evidence that banks deliberately exploited the implicit government insurance by engaging in risky ventures on a large scale. A more reasonable interpretation is that the banks and other players in the financial sphere were not fully aware of their risk exposure. The rapid deregulation took banks by surprise and gave them freedom to expand lending before they had established appropriate systems to measure, evaluate and manage credit risk. In too many cases bank executives were blinded by the immediate positive effect on net income of additional loans. The seemingly safe positions in terms of high (book-value based) equity capital levels most certainly did not convey a sense of high risk exposure to bankers. Furthermore, most Swedish banks had (and still have) a rather diffuse ownership structure. Bank management has less incentive to exploit implicit government guarantees, since they lose their jobs if things go badly and get less of the upside if things go well than equity holders.

Even if *deliberate* excessive risk-taking may not have been prevalent before the financial crisis, incentive problems of this kind must be considered when thinking about financial sector behaviour *after* the crisis. It is obvious that the long-run effects of having an explicit but vaguely formulated – and non-priced – general guarantee like the one in the Swedish financial sector will be rather detrimental. First, with general government backing, incentives to handle risk are relatively weak in the »insured« sector. Second, competition from players not covered by the guarantee, for instance insurance companies and foreign-based financial institutions, will be hampered. Altogether the pricing of risk in the economy would gradually become distorted.

One way to handle this problem would be reregulation. In a thoroughly regulated system a guarantee – explicit or implicit – would not in itself be the cause of perverse risk behaviour. Such an approach is not recommendable for a number of reasons. One is that it would prevent the economy from taking advantage of the huge potential welfare gains that the technological breakthroughs in the financial sphere might confer. Experience shows that reasonably unfettered market forces are the prerequisite for such innovation processes. But even if this view of the benign effects of deregulation and decentralisation is not shared, far-reaching reregulation is hardly a viable alternative for Sweden, at least not in isolation. Technological changes have tied national financial markets much more tightly to world markets. Financial innovations in response to regulatory interventions quickly create means to circumvent the regulations. It seems therefore that reregulation would have to be very drastic and all-encompassing to be effective. Such a process would mean a derogation from the EEA legal system for the financial sector, which is unrealistic.

The alternative for Sweden, as for most other European countries, is therefore to design a system in which banks are allowed to play an active role as innovators and entrepreneurs at the same time as there are credible and cost-efficient guarantees for system stability and consumer protection. Finding the appropriate design for such a system is not an easy task. The usual starting point for the economic's analysis is to acknowledge that an instability problem seems to be inherent in the traditional bank. By a traditional bank we mean a financial institution that combines a liquid liability side of par-valued deposits, with opaque, illiquid assets in the form of loans. The instability problem arises from the fact that the »first-come first-served« characteristic of deposits may lead to a bank run caused merely by self-fulfilling rumours. Contagion effects on other banks might then lead to a general flight to currency.

Even though careful study of the mechanisms purportedly causing these instability tendencies may somewhat downplay this potential threat against the payment system, it is fair to say that it would be *politically* impossible in Sweden, as well as in other countries, to propose a free banking system with no elements of state guarantees – explicit or implicit – to bank depositors. Therefore some kind of government scheme is needed that credibly signals that the banking and payment systems are fail-safe.[2]

Three approaches to deposit insurance reform

The US deposit insurance system has provided this safety, but evidence from for instance, the S&L crisis shows that this has been done at too high a price in terms of social costs. Reform proposals have therefore been put forth in abundance. Three main approaches to reforming the US system can be distinguished. The first is an attempt to improve the existing deposit insurance schemes by introducing appropriate insurance premiums. The second, the narrow bank proposal, takes the opposite approach. Instead of trying to refine the deposit insurance system, it envisages radical change in the structure of the banks themselves, in such a way that deposit insurance – if needed – becomes a rather simple issue. The third approach, reflected in the recent reforms that have actually taken place in the US, is less radical. It takes the traditional bank and deposit insurance as given and recommends a more elaborate scheme to handle banks that seem to be getting into trouble. In the following we will briefly discuss each of these approaches.

[2] It should be added that as a member of the EEA, Sweden will probably have to adopt a deposit insurance scheme.

Appropriate pricing

In the US, the Federal Deposit Insurance Corporation (FDIC) charges flat premiums with no risk adjustment. In the 1970s Merton (1977) analysed deposit insurance in an option pricing framework and laid out the principles for fairly priced insurance premiums. Although straight-forward in principle, the implementation of risk-based insurance premium schemes turns out to be quite difficult in practice. One major reason lies in the typical opaqueness of the asset portfolio in the traditional bank. This makes it hard for an outsider to monitor the bank on a regular basis. But even with a relatively transparent portfolio the problems of constructing risk-related premiums are formidable.

There seems to be growing awareness even among academics – bankers and regulators have been sceptical all along – that the approach with refined risk-related insurance premiums is not fruitful, at least not without further reforms. It tries to solve the problems within the framework of the traditional banking concept. But if the problems are built into and fundamental to that bank model, it may seem necessary to try a radically different approach. A basic question is whether the traditional institutional links between liquid deposits and illiquid loans could be uncoupled. This relates to the question whether these links have to do with economic factors as opposed to being a historic relic. To be more specific, are the economies of scope and other economic advantages of having one inseparable institution combining loan and deposit-taking activities the main reason behind the actual predominance of such institutions? Or was this true only in the more primitive financial systems of the past, when alternatives to banks were scarce, and the foundation was laid for the legal and regulatory framework, which is largely still in place?

The narrow bank approach

The so-called narrow bank approach[3] proposes reforms, starting from the latter view. The narrow bank model has been presented in a variety of versions. Their common basic ingredient is restrictions on the assets that can back deposits with government insurance. Those assets should have low risk and easily lend themselves to market valuation. In the extreme case only short-term default-free government debt would be allowed. Other versions include long-term government debt and high-grade corporate debt instruments. With such transparent and continually market valued assets, the risk exposure of the deposit bank is limited or at least easily evaluated. Fair insurance premiums are relatively easy to charge.

There are also a number of suggestions on how a narrow bank reform could be implemented. In the most clear-cut version there would be a breaking up of the bank into different legal units – loan banks and deposit banks. It has been pointed out, however, that such drastic institutional measures are not necessary. One possible alternative is a holding company construction, with the loan bank as one of the subsidiaries, legally related to other subsidiaries only via the holding company. In the most traditional version, insured deposits would be backed by collateralized government and high-grade debt instruments *within* the original bank unit. Instead of breaking up the bank, there would thus be earmarking of assets to specific liabilities, i.e. insured deposits.

There is little doubt that most of these narrow bank proposals are feasible in the sense that they do achieve credibly safe deposit banks which make it easy to price a possible deposit insurance. The key question, however, as pointed out by critics of the narrow bank model, is what would happen with the loan bank. Bank loans would have to be financed one hundred per cent with borrowing not covered by government insurance. Partly this would consist of direct capital market issues of bonds and commercial papers – the finance company model. But it could also be achieved through the channelling of long-term household savings which, for instance, households choose to hold in uninsured accounts to earn higher returns.

In my view the narrow bank approach to reform is worth serious consideration and should not be seen as just an academic construction. Perhaps its main virtue is that it stimulates a rethinking of the role of banks in the economy and focuses on functional rather than institutional aspects. Such a focus is becoming increasingly important with the rapid development of new financial instruments and markets, which make it possible to create near-substitutes to traditional products in ever increasing variants.

Narrow banks – too drastic a step?

Both among academics and among practitioners and regulators there are fears that narrow bank reform would be too drastic a step.[4] One argument is that such reform would inevitably require some break-up of the traditional bank. This would lead to costs in terms of lost synergy and also considerable restructuring costs in the transition phase.

The synergy argument is perhaps not so convincing. For example, the proposals for building on collateralized deposits within a loan-making bank need not lead to much loss of synergy between deposit-taking and loan-making activities. They are still performed in the same institution. Granted that the transitional

[3] For an overview, see Merton & Bodie (1993) and references there.

[4] See for instance Goodhart (1993) and Benston & Kaufman (1993).

costs are easily underestimated, both by economists, who prefer to focus on »grand design« and long-run benefits, and by practitioners, legislators, and regulators, who may focus too much on immediate problems of a practical and legal nature.

There are, however, some structural issues that need to be dealt with in narrow bank proposals, even in their collateralization versions. How do we know that loan banks, whether as independent units or as part of a universal bank with collateralized deposits, can find the appropriate funding channels? And even if such channels are found, will the financing of small and medium-sized companies, which have no direct access to the capital market, become more expensive? In other words, one would like to know more about what constitutes a loan bank and about the credit allocation mechanisms in which banks seem to play a vital role, before one dares to recommend reforms involving narrow bank solutions.

Another important question is whether the distinction between insured and uninsured deposits inherent in the narrow bank framework can be credibly upheld. Could politicians really resist the pressure to bail out uninsured savers in a failing loan bank? If savers generally believe in bail-outs there is not much point for them in paying the higher price for *explicitly* insured deposits. On the other hand, if savers are *not* certain about being bailed-out, flight-to-quality problems may appear, with detrimental consequences for the supply of bank credits. If the economy is expected to enter a downturn – maybe leading to a depression – savers may want to convert their high-interest uninsured deposits into insured deposits to meet the threat of possible bank failures. This may in turn cause disruptions in the loan intermediation process, which would further contribute to the downturn in the real economy.

All in all, even if there are reasonable answers to most of the questions raised concerning the viability of narrow bank solutions, conservative bias and a »we know what we have, but not what we get« perspective among bankers and regulators would lead to a favouring of less radical solutions.

Deposit insurance with more efficient monitoring

The so-called Federal Deposit Insurance Corporation Improvement Act (FDICIA) from 1991 is an example of a scheme with more intensive monitoring. That reform is very much in line with proposals put forward in the Shadow Financial Regulatory Committee by, among others, Benston and Kaufman.[5] These proposals aim for solutions to the deposit insurance problem that supposedly do not require modifications in the existing institutional structure. In other words, the traditional bank is accepted as the benchmark institution for deposit insurance reform.

The reform proposal has two basic ingredients; one consists of stricter, more accurate and more market oriented bank capital requirements and the other of more elaborate schemes to handle situations in which bank capital has fallen below adequate levels. Bank capital would include equity and all debt not explicitly insured. Capital-to-asset ratios would be specified with assets measured at market values and appropriately including off-balance sheet items.

The idea is then to formulate a system that makes explicit which actions will be taken vis-à-vis the bank in the case where bank capital falls below specified levels. These actions should be such that it would be in the interest of the bank and its shareholders to ensure that capital is kept on adequate levels.

An illustration

The basic ingredients in the Act can be elucidated by an example, presented by the Shadow Financial Regulatory Committee (see for instance Benston & Kaufman 1993). Four explicit, predetermined tranches of capital-to-asset ratios are specified in the example.

1 Banks are considered to have adequate capital if it amounts to, say, 10 per cent or more of their total assets, preferably measured in terms of market or current values. Those falling into this first tranche would be subject to minimum regulation and supervision.

2 Banks with capital-to-asset ratios of, say, 6 to 9.9 per cent would be at the first level of stricter supervisory concern. A bank in this second tranche would be subject to increased regulatory supervision and more frequent monitoring of activities. It would be required to submit a business plan to raise more capital. At its discretion, the supervisory authority could require the bank to suspend dividend payments and obtain approval before transferring funds within a holding-company system and could restrict the bank's asset growth.

3 The third tranche is the second level of supervisory concern; it is reached when a bank's capital ratio falls below 6 per cent and is at least 3 per cent. Banks in this range would be subject to intense regulatory supervision and monitoring. The supervisory authority would be required to suspend dividends, interest payments on subordinated debt, and outflows of funds to the bank's parent or affiliates. The institution would have to submit an emergency plan for its immediate recapitalization to the tranche-one level.

4 Finally, when a bank's capital falls below 3 per cent of its assets, it would be in tranche four: mandatory recapitalization and reorganisation. The supervisory

[5] See Benston & Kaufman (1993) and references there.

authority must place the bank in a conservatorship, which could be charged with recapitalizing the bank or liquidating it in an orderly fashion within a short period by merger or sale of individual assets. The present owners and subordinated debt-holders would have the option of implementing quickly the plan submitted when the institution moved into tranche three, or of electing not to inject additional funds into the bank. If the owner and debt-holders chose not to recapitalize the bank, any residual value from its sale or liquidation of its assets would be returned to them, after allowing for costs incurred.

According to its proponents this system would give adequate incentives to banks to correct a deteriorating situation before the supervisory authorities are forced to intervene. And through the tranche system it would give the supervisory authorities a chance to intervene in time. Furthermore, there is no doubt about when the authorities *have to* take measures. It is interesting to note that the above scheme could also be seen as an improvement and refinement of the capital adequacy rules according to the Basle Concordat – the so-called Cooke rules. One way to interpret those rules is that they introduce default and bankruptcy rules for banks (and other financial institutions) that are considerably stricter than for other corporate firms. The problem is that virtually nothing is said about what actions will be taken by government authorities (and possibly other creditors) once a bank has dipped below the 8 per cent level prescribed by the Concordat. The FDICIA tranche system can be seen as an attempt to remedy this deficiency by stating explicitly the rules of the game between the existing shareholders and the creditors, e.g. the deposit insurance corporation.

Weakness of FDICIA type solutions

As should be expected, FDICIA type solutions also have weak points. One main concern is with the proposed market valuation of bank assets and collateral. Because of the inherent opaqueness of the bank loan stock, it would be difficult to implement. Another problem, which paradoxically may be caused by too effective market valuation, is that high volatility in asset values could give rise to drastic and unnecessary changes in bank ownership and management. According to Dewatripont and Tirole (1993): »Unlike historical cost accounting, market value accounting makes the solvency measure very volatile and generates inappropriate transfers of control rights«.

Is there a remedy to this unattractive »automaticity« in the reaction scheme of bank regulators? Dewatripont and Tirole argue »in favour of an intermediate method of accounting, in which, as under historical cost accounting, market specific fluctuations are not reflected in the solvency measure, but in which, unlike historical cost accounting, an automatic adjustment of the net worth offsets the change in the shareholders' incentives«. Their basic suggestion is that a distinction is made between macro shocks and bank specific shocks. To quote Dewatripont and Tirole again: »Because (bank) managers (by definition) do not control macroeconomic shocks, their welfare, and therefore their compensation and the interference they face from outsiders, should be insensitive to such shocks. Because interference by shareholders depends on the bank's capitalisation, the macroeconomic shock should be perfectly offset by an equal distribution of dividends if the bank's performance exceeds the minimum solvency ratio.

Conversely, if the macroeconomic shock puts the bank's solvency below the minimum ratio, managers are unduly punished if control shifts to debtholders, or (in the context of voluntary recapitalization as in the Basle agreement) if shareholders refuse to recapitalize and leave control with the regulator. On the other hand, a mere adjustment in the minimum solvency ratio to the average solvency of banks is too lax a policy, as shareholders are more prone to take risk (sic) when the bank is poorly capitalised. This reasoning thus calls for a recapitalization requirement softened by some contribution of the regulatory agency in bad times, for example through pro-cyclical deposit insurance.«

These arguments indicate that there may be ways to handle the problems that would come up in an FDICIA type system. They would, however, require more discretionary behaviour from the regulatory authorities. We know from experience that in such a system there is always a risk of misdirected regulatory interference.

Swedish reforms

For several reasons a scheme of the FDICIA type would perhaps fit the Swedish environment better than the US. First, as in most European countries, the Swedish banking system consists of a relatively small number of banks. In comparison with the US, with its unique banking structure with over 12,000 banks, the task for the supervisory authorities is considerably less complex. Second, the handling of supervision and control is carried out by a single regulatory body in Sweden, while this responsibility in the US is shared by a number of institutions. Conflicts and competition between regulatory authorities is thus not a problem in Sweden, whereas in the US such conflicts are supposed to have contributed to regulatory inefficiencies. Third, the present handling of the Swedish crisis banks by the Bank Support Authority has taken on some important features of the above scheme. Although, of course, it was set up *after* the crisis was a fact, it has operated according to the idea that the deeper the bank is in trouble the firmer will be the Authority's grip over it and the more costly it will be for the current shareholders if they do not manage to recapitalize the bank. It is interesting to note that uncertainty about what would actually happen with a bank dipping below the required 8 per cent level, probably aggravated the Swedish banking crisis. Judging, for instance, from the extremely low market valuation of S-E-Banken shares at the beginning of 1993, most shareholders seem to have feared that further erosion of the capital base below 8 per cent would lead to financial support from the state against a substantial issue of new shares to the government. Such an issue would drastically dilute the value of existing shareholders' equity stakes.

When investors, in early 1993, started to notice the improvement in the general macro-economic environment, especially the impact of lower general interest rates, they realized that the banks' financial situation might improve rather quickly. Also S-E-Banken, investors thought, could possibly manage without state financial support or with support in forms or amounts that only partially reduced earlier shareholders' equity value. As a result, the S-E-Banken share started to skyrocket, increasing its value ten times compared to the bottom notation within a couple of months.

As demonstrated above, the FDICIA type solution is not problem-free. While a solution along these lines is probably the best in a shorter perspective, the problems may turn out to be serious enough to call for new reforms. Maybe in a longer perspective the development of the financial system will create new and better conditions for a narrow bank solution to the regulatory problems. In many respects this functional solution is more in line with the new view of banking and financial intermediaries. With securitization and the development of new contracts and designs for the financing of small and medium-sized firms, it may turn out that the potential problems in the loan bank are less serious or could be handled by appropriate policy measures.

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III

INSURANCE

EEA and the Insurance Industry – Chairman's Summary

LARS HÖRNGREN*

The purpose of this note is to try to identify the main themes in the conference concerning future developments in the structure and regulation of insurance markets in Europe. Given the broad range of interesting issues raised in the following papers and the discussions at the conference, and the inherent complexity of the processes governing the future of the various segments of the insurance industry, e.g., in the interplay between market forces and regulation, this is a difficult task. It goes without saying that the EEA agreement is but one of the elements shaping the future. A unified view on these issues, let alone definite answers to the crucial questions, is not to be expected.

However, I will try to present some of the insights from the conference on the major forces shaping the insurance industry in the years to come, supplemented by some personal reflections. To narrow the scope, I will put special emphasis on the Swedish situation. To organize the presentation, I will take advantage of the questions raised in the introductory speeches of the conference and discussed in plenary session.

Will adaptation to EEA legislation lead to a substantial removal of barriers to enter insurance markets?

The answer to this question depends to a large extent on the relative importance of regulatory and natural barriers to entry. Access to a national market can be made by new resident competitors and by foreign firms starting to market their services across national borders. The EEA agreement will affect the ease with which cross-border trade can take place. It will also lead to deregulation at the national level, in particular, due to the third generation insurance directives. Consequently, both types of market access need to be considered when discussing the future industry structure.

In this context, as so often when discussing insurance, it is essential to look at different segments of the industry separately. At the one extreme is reinsurance, which is a wholesale activity that for a long period has been internationalized and characterized by limited regulatory concern. Here, the impact of EEA legislation is likely to be small, as the industry structure is already conditioned by market forces.

In markets for consumer oriented insurance products, both life and non-life, the potential for change is greater, these segments in most European countries having been closely regulated for a long time. So far, the regulatory changes in the direction of more liberal rules have also been relatively modest in scope. However, in Sweden at least, there are indications that regulatory changes can have substantial effects on industry structure. Perhaps the clearest case is the rapid expansion of unit-linked life insurance after its introduction in 1990. The process of deregulation is likely to speed up in the years to come. Adoption of the third generation EU directives will require abolition of price regulation and control of product innovation as well as relaxation of asset management rules. This will probably lead to increased competition, potentially also in the form of new entry.

It is difficult to assess the role of foreign entry in this process. There may be technological scale economies in some areas of insurance, giving large, internationally active firms a potential advantage. However, as noted by Dickinson,[1] insurance products are sold on the basis of trust, implying that reputation, brand-name recognition, etc. are important, in particular in consumer oriented insurance. This creates natural barriers to establishment of new entities in foreign markets. As pointed out also by both Zweifel and

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[1] All references in the text refer to articles in this volume.

Blixt, this means that cross-border expansion is likely to take place through take-overs and joint ventures, rather than through branch establishments. As the option to make acquisitions is already available in Sweden, at least in non-life insurance, it is not obvious that the EEA agreement will make that much of a difference in this sector.

In the life insurance sector, on the other hand, there is an important constraint on acquisitions in that Swedish companies are not allowed to pay dividends to shareholders. This means that they function as mutual companies irrespective of their formal legal status and that the equity capital is minimal and economically uninteresting. However, the ban on dividend payments is likely to disappear within the next couple of years, opening up new possibilities for foreign market penetration also in life insurance.

Local presence is normally important in non-life insurance, since in property insurance, for example, *ex ante* risk assessments and *ex post* loss assessments must be made at the place where the property is located. On the other hand, many life insurance products, such as pension insurance, can be distributed without local presence, e.g., via independent insurance brokers. Such brokers may gradually come to play a more important role as insurance markets become more and more internationalized, as pointed out by Blixt and by Hägg and Skogh. A crucial question is whether sufficient consumer confidence can be established for foreign insurers acting via third party brokers to make a significant impact on the position of the incumbent national firms. On this issue, only time can tell.

A remaining constraint on cross-border trade is that many countries have favorable tax rules for pension savings that apply only to premiums paid to resident insurers. In Sweden, this advantage to domestic firms is partly offset by higher tax rates than in many other EEA countries on the return on assets held by life insurance companies. This implies that so called capital insurance, i.e., life insurance for which premiums are not tax deductible, is likely to continue to migrate to insurers in countries with more favorable tax systems, unless tax rates are harmonized. Consequently, divergent tax rates will affect trade in insurance. However, it is difficult to predict the degree of tax harmonization in the EEA in the years to come, which means that it is hard to assess the quantitative importance of this factor.

To summarize, barriers to entry in the insurance industry are likely to be reduced. This is partly due to the EEA agreement and the single licence system. The competitive conditions are also influenced by the changes in the national regulatory systems that are under way as part of the broad-based revision of insurance legislation in the EEA countries. Consequently, the main impact from the EEA agreement will perhaps not be in more widespread cross-border trade or establishment, but in the general increase in contestability of insurance markets, putting increased pressures on established insurers.

What changes in the structure of insurance markets are to be expected?

From the tentative answer to the first question, that market access will be improved, it follows that changes in industry structure are likely, at least in the areas of insurance most affected by the new rules. These are retail (mass risk) non-life insurance and life insurance. Reinsurance and large non-life risks, on the other hand, are already highly competitive and internationalized.

The greatest changes can be expected in life insurance markets. This is traditionally the area most closely regulated, both in terms of entry and price and product regulation. As mentioned above, many countries have favorable tax rules for pension savings. This has given the companies providing pension insurance an advantage in the competition for long-term household savings. Although promotion of savings in illiquid forms may be motivated on the grounds that it encourages people to complement public pension systems, it is not obvious why such tax incentives should be limited to savings in a certain class of life insurance policies. In general, it can be argued that any form of savings that cannot be touched before a certain point in time should be eligible for such favorable treatment.

In Sweden, this line of argument has led to the introduction of a new type of tax deductible savings, in the form of individual retirement savings accounts that have no insurance element. Accounts eligible for favorable tax treatment can be offered not only by insurance companies, but by banks and authorized fund managers as well. As the system was introduced as recently as in January 1994, it remains to be seen how attractive it will be, but it is likely to add to the erosion of the position of the traditional insurance companies. The success of unit-linked insurance indicates that savers prefer alternatives that are more transparent and give them greater flexibility and stronger influence over the financial risks. The financial opaqueness of traditional life insurance companies has become a competitive disadvantage.

The major Swedish life insurance companies provide unit-linked insurance and will also compete for their share of the new individual retirement savings. However, banks, using their branch networks as distribution systems, have been more successful in the unit-linked market so far. Banks have also made substantial inroads into the market for traditional life insurance by setting up or buying insurance subsidiaries, selling in particular highly standardized pension insurance policies. It thus appears that life insurance companies in Sweden, and elsewhere, face major competitive challenges and may need to revise their distribution methods in order not to lose shares in the market for long-term savings.

Legislative change is one force reshaping the insurance industry. Another important element is the development of new techniques, particularly in the area of information processing and distribution. The insurance industry is information intensive. Not surprisingly, therefore, it has been fundamentally affected by developments in computer technology.

This process is far from over. Finsinger points to the potential for using computer-based expert systems to classify customers and make more accurate risk assessments. Similar systems may be used in life insurance to create insurance contracts suited to the individual customer's needs by freely combining standardized components available on the computer. The customer can, at the point of sale, see what various combinations cost and what benefits they will provide.

The demand for savings plans that provide additional coverage for the retirement period is likely to grow for demographic reasons and because of growing concerns for the sustainability of public pension systems (cf. Blixt). These are problems faced by all European countries, although perhaps to varying degrees. In Sweden at least, the major source of growth in private life insurance has been the sale of standardized pension insurance contracts to people wanting to complement their compulsory pensions, derived from the public sector and from employment based pension plans. Over time, it is likely that customers will become more sophisticated and demand insurance policies better adapted to their individual needs. Whether distributed with the help of computer based expert systems or not, life insurance products will have to offer greater flexibility than in the past, not least in the choice of financial instruments and financial risk levels, to satisfy these demands.

What will be the future tasks of regulators and supervisors?

Consumers turn to insurance companies to obtain protection from various major risks to life and property. Failure on the part of the insurer to fulfil an insurance contract, after an accident has occurred, say, may have disastrous consequences for the individual. He is therefore concerned about the solvency of the insurer. At the same time it is quite difficult for an individual consumer to assess the reliability of an insurance company, especially in life insurance where the contract often stretches over several decades. There is thus demand for (centralized) monitoring of insurers and for control of their solvency.

The fundamental *raison d'être* for supervisory authorities and for regulation of the insurance industry is therefore to protect policyholders from the consequences of the default of an insurer. In contrast to banking, where systemic risks related to self-fulfilling expectations of insolvencies are important, regulation and supervision in insurance markets can be analyzed exclusively in terms of consumer protection.

In addition to the concerns for the solvency of the insurer, customers (and regulators) care about the »fairness« of the contracts, the treatment of insurance claims etc. These types of consumer protection issues are not specific to the financial services industry, however, but appear in virtually all areas. What sets insurance, together with banking, apart is the concern about insolvencies among the providers of the services.

The goal of protecting policyholders from insolvencies can be achieved by preventing bankruptcies from ever occurring. This strategy has dominated the regulatory systems in most countries, not least in Sweden, as noted by Hägg and Skogh. It tends to lead to strict material rules and the use of *de facto* anti-competitive regulations. Consumer protection thus comes at the price of low efficiency, not least in a dynamic sense.

A process of liberalization of insurance regulation is under way all over Europe, based on the conviction that the traditional regulatory regimes have become too confining and, in many respects, inefficient. The system being in a phase of transition, it is difficult to predict the shape of the future regulatory framework. It is therefore easier to comment on the direction in which the development should go.

One desirable feature would be a stronger focus on policies aimed at protecting consumers from the *consequences* of defaults, as opposed to preventing bankruptcies from occurring. Systems of guarantee funds would be one way to achieve such a shift in focus, as discussed by Finsinger. A guarantee fund is effectively a form of reinsurance, protecting the insured without necessarily rescuing the insurer, no matter what difficulties the company may get into.

Since a guarantee fund transfers risks to another party, such a system must be combined with supervision in order to control the moral hazard incentives. Consequently, guarantee funds do not eliminate the need for regulation and supervision, but may permit a shift in focus. Given that the interests of the consumers are taken care of by the guarantee fund, the supervisor's task is clearly defined to protect the guarantee fund from assuming undue risks from insurers. Solvency control comes to the fore and insurers with low insolvency risks can be given a wider mandate than in a system based on direct controls that do not take into account the health of the individual company.

The tasks of insurance supervisors are still formidable. Even though better equipped to determine the quality of insurance companies than individual consumers, the information that the supervisors need is exceedingly complex. To argue that they should give up trying does not make sense, however, if for no other reason than the political necessity in any democracy to offer some protection to insurance customers, just as depositors in banks are always covered by explicit or implicit deposit insurance. Seen from this point of view, guarantee funds for consumer insurance make this government protection explicit and may in fact enable the government to limit its exposure, e.g., by introducing elements of coinsurance and deductibles in the guarantee fund systems.

Although guarantee funds should be financed by premiums paid by the insurance companies, the costs will ultimately be borne by the insured. However, the insured also bear the costs of regulations aimed at preventing defaults, e.g., in the form of low efficiency in the insurance industry. Provided that a system based on guarantee funds can make way for more efficient regulations, it is possible that the consumers will get the same or even better protection at lower costs.

In my opinion, more widespread use of guarantee fund systems is the appropriate direction in the development of the regulatory system, although the likelihood of such a development is difficult to assess. Moreover, there are problems that must be solved in setting up such systems. For example, they must be constructed so that they do not involve subsidies to the companies that can sell their policies by advertising that they are reinsured. Determining fair reinsurance premiums in such a system may prove a difficult task.

Mispriced guarantee fund systems would be a problem also in the context of the EEA. Exporters of insurance based in a country with an overly generous guarantee fund system would have a competitive advantage. The incentives for the home country to provide such a subsidy would seem to be weak, however, as the beneficiaries are citizens of other countries.

Efficiently priced guarantee funds, on the other hand, introduced nationally in a setting with free cross-border trade and home country control, may be an interesting case of competition between regulatory systems. If customers want protection from guarantee funds, companies having their home base in countries with such systems will gain market share. The pressures to introduce guarantee funds in other countries will mount, not least, one would expect, from representatives of the insurance industry, who otherwise often tend to oppose such proposals.

Changing Pattern of Insurance Markets within Western Europe

GERARD M. DICKINSON*

Insurance markets in Western Europe have grown rapidly over the last two decades, with life insurance and private pensions increasing faster than non-life insurance. Especially since the mid 1980s, the competitive structure of most national insurance markets has exhibited major change: consumer awareness has increased, banks have become more active as distributors and producers of insurance products, and foreign insurers have secured, mainly through cross-border take-overs, larger market shares. The prospect of even greater change can be expected during the second half of the 1990s in the light of greater deregulation brought about by the implementation of the 3rd Insurance Directives and a greater exploitation by producers, intermediaries and consumers of information and communication technologies. The number of independent insurance groups within Western Europe can be expected to continue to fall, possibly declining from its current level of some 2500 groups to about 1500 by the end of the decade.

Growth of insurance markets in a global context

In discussing the changing pattern of insurance markets within Western Europe, it is useful to look first of all at the overall growth of these markets in a global context. Table 1 shows the distribution of global spending on insurance into four major regions between 1970 and 1991 for both non-life insurance and life insurance. Non-life insurance includes a wide range of property, liability, transportation, credit and health insurances, while life insurance embraces conventional life insurance and annuity policies, linked-life insurances and insured pension contracts. Reinsurance represents transactions between insurance companies to spread risk and hence are included in these overall spending figures for personal and corporate consumers.

It can be seen that the global demand for non-life and for life insurance has grown rapidly over the last two decades. Even though these figures are in money terms, the demand for insurance has also increased in real terms in all regions. Indeed, insurance has grown faster than local GDP in most markets. Spending on life insurance and other long term insurances has increased at a faster rate than on non-life insurance, reflecting to a significant degree the growing long-term saving by ageing populations, which have often been encouraged by national governments through fiscal incentives.

Table 1 Spending on private insurance in Western Europe relative to the global market 1970 and 1991

	Non-life insurance		Life insurance	
	1970	1991	1970	1991
North America (per cent)	63.2	44.8	61.9	29.6
Western Europe (per cent)	27.5	34.8	20.4	31.0
Japan (per cent)	4.9	12.3	12.2	30.3
Rest of world (per cent)	4.4	8.1	5.5	9.1
World market (per cent)	100.0	100.0	100.0	100.0
World market (US$ million)	66,094	670,715	44,053	743,648

Source: Derived from Sigma (Swiss Re)

Table 1 also shows that insurance markets within the Western European countries have been growing faster than those in North America. To a significant degree this reflects the fact that private insurance markets in the United States and Canada developed at an earlier stage than those in Europe and are now showing signs of maturing. The dramatic growth of Japanese insurance markets is apparent, although the rates of growth are a little overstated due to the strengthening of the Yen against the US dollar over the period.

If one looks at the pattern of growth within the individual countries of Western Europe, one finds this general picture confirmed. In Chart 1 the proportion

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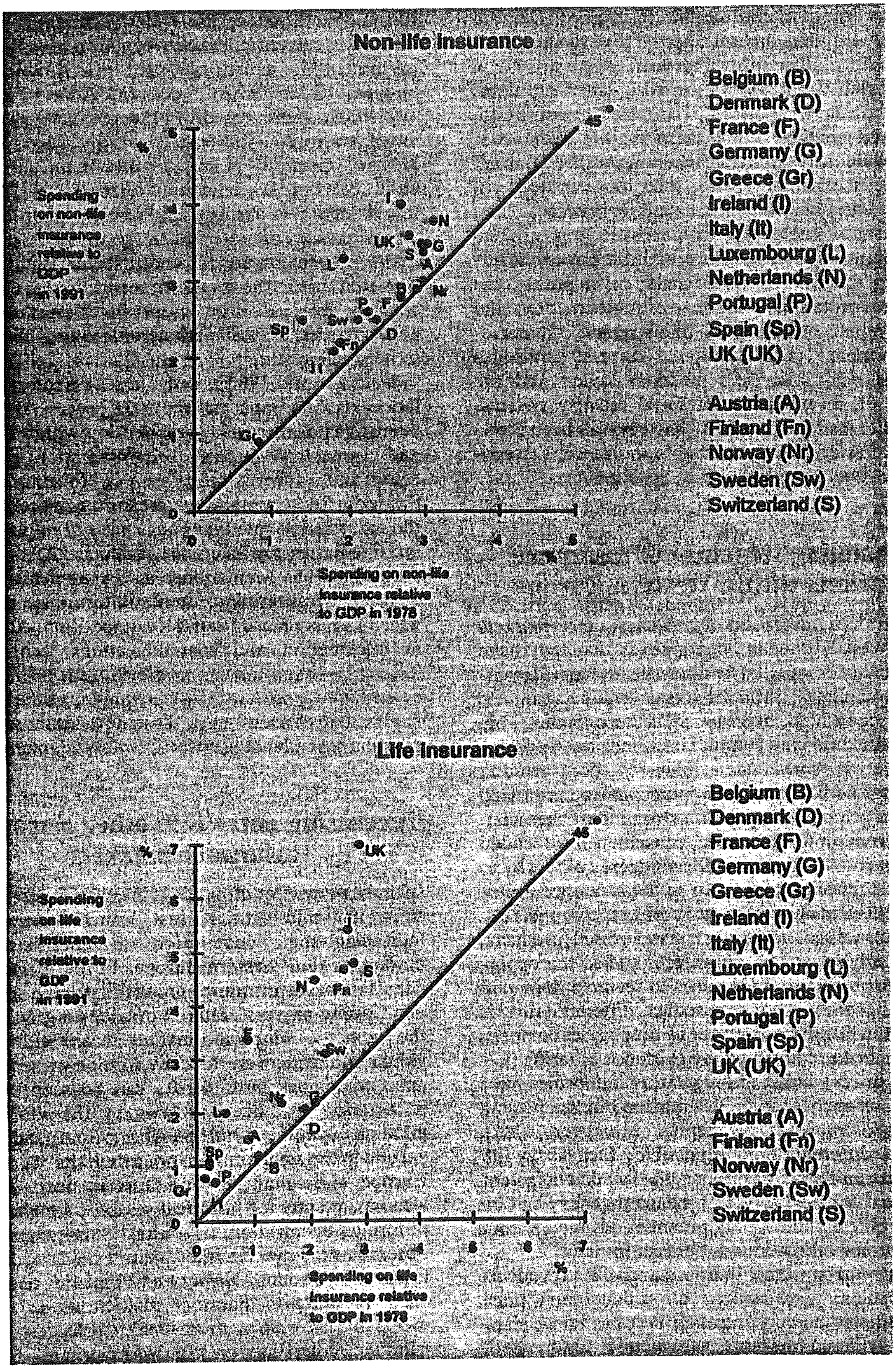
Chart 1 Growth of insurance spending to GDP in Western Europe 1978 to 1991



of insurance spending relative to local GDP in 1991 is graphed against insurance spending to local GDP in 1978, for both life and non-life insurance. It can be seen that spending on insurance relative to local GDP increased for all countries between 1978 and 1991, a pattern that would be confirmed if other end dates were used for comparison. The faster growth of life insurance spending compared to non-life insurance is again evident. Insurance markets in southern Europe have been expanding faster than those in northern Europe, largely reflecting a catching up process. The significant variations that exist across Europe are due to a complex interplay of factors; these include differences in the pattern of economic development, the historical evolution of national insurance markets, the structure and ownership of industry and commerce, demographic characteristics, cultural attitudes towards risk-taking and personal saving and the degree of pervasiveness of social security systems. While life insurance markets have overall been growing at a faster rate than non-life insurance, the variations between countries have been greater.

Changing structure of insurance markets within Western Europe

A general characteristic of most insurance markets within west European economies is that they have been mainly dominated by domestically-owned insurance companies. Market concentration has not usually been high, even in smaller economies. One reason for this is the fact that insurance has traditionally been a conservative industry, both from a consumer and supplier standpoint, having grown up within a given country with a strong local character. Apart from motor insurance, consumers have tended in the past to display a significant degree of loyalty to their insurance companies or to the insurance agents and brokers through whom they effect their purchases. Many insurances are rather standardised products, particularly in non-life insurance, and so the opportunity for insurance companies to secure a dominant market position though product differentiation is difficult, while in many parts of Europe price competition has been reduced by the existence of tariffs (i.e. agreed prices) which the regulatory authorities have tended to encourage in the interests of minimising insurance company bankruptcy. Moreover, where product differentiation is possible, such as in life insurance and private pensions, the fact that no patent laws exist for new products means that they can be copied quickly and so any potential advantage from product innovation does not persist for long.

Because of consumer inertia, standardised products and regulatory restrictions on product and price competition, the concentration that has taken place within national markets has mainly come about through take-overs and mergers rather than through organic growth. In most Western European countries, the market share of the largest insurer in non-life insurance currently lies between 10 per cent and 15 per cent, while in life insurance it is in a higher range between 10 per cent to 25 per cent. Across the region as a whole, there were in 1993 some 2,500 independently controlled insurance groups (about 4,000 licensed insurers), a number that has fallen from about 3,500 at the beginning of the 1980's. Despite this reduction in number, it is clear that there is still a large number of enterprises, certainly larger than exists in the commercial banking sector. But it should be noted that in the insurance sector there has been a tradition for mutual or co-operative insurance companies to exist in most markets and many of these tend to be small in size.

Since the mid-1980's, in the face of greater deregulation and the impact of the 1992 process, there has been signs of increasing competition within markets and a greater propensity for consumers to be more active and to switch their insurers. To some extent, this increase in competitive pressure has been due to the more active role that banks have been playing as intermediaries for insurance products. At the same time, there has been an increase in the market entry of foreign insurers into domestic insurance markets which has also caused a spur to competition. Advances in information and communications technologies have also been having a transforming effect on competitive positions, by allowing insurance companies that efficiently use these new technologies to obtain a cost advantage over their less adaptive rivals.

Increasing entry into other European insurance markets

It has been evident throughout the 1980's, particularly since the mid-eighties, that insurers have been increasing their penetration of other insurance markets within Western Europe. In the main, it has been the larger insurance groups that have been the main prime movers. Table 2 provides a grouping of the extent to which the market shares within individual countries were held by foreign-owned insurance companies in 1991. As can be seen, foreign penetration has been greatest in the developing markets of southern Europe – Italy, Spain and Portugal and in the smaller, more open markets of northern Europe – Belgium, Ireland, Luxembourg. Austria also has, mainly for historical reasons, a high degree of foreign penetration. In contrast, it is interesting to observe the lower market shares held by foreign insurers in Sweden, Norway and Finland, due in no small measure to statutory restrictions on foreign ownership as well as to the major role that mutual insurance companies play in these markets.

Table 2 Foreign share of domestic insurance markets in 1990
Branches and locally controlled companies

Per cent	Non-life insurance	Life insurance
Above 50	Ireland	Ireland, Portugal
40 to 50	Austria	Luxembourg
30 to 40	Belgium, Spain, Luxembourg, Netherlands	Austria
20 to 30	Greece, Italy, Portugal	Belgium, Netherlands
10 to 20	Denmark, France, Germany, UK, Norway	Denmark, Germany, Greece, Italy, Spain, UK
5 to 10	Switzerland	France
under 5	Finland, Sweden	Finland, Norway, Sweden, Switzerland

This foreign penetration has been achieved in part through the establishment of new branches and subsidiaries and the expansion of existing operations. But take-overs have been by far the most important means by which foreign insurers have strengthened their market presence. The reason why take-overs have been the principal means through which market shares have been enlarged, reflects the inherent difficulty facing new entrants that wish to quickly increase their penetration of a foreign market, when their reputations are unknown by local consumers and when local regulation and market practices inhibit significant price or product differentiation.

Reasons for the increasing regionalisation of insurance markets

What are the reasons behind this greater regional expansion of European insurance enterprises? First, the larger insurance companies, the prime movers in this regional diversification, have seen diminishing returns from expansion within their domestic markets compared with better growth and profit prospects in the wider regional market. This has been particularly so for insurance groups in northern and central Europe, which have wished to position themselves to take advantage of the potential of the less developed markets in southern Europe, especially in the fields of life insurance and private pensions. Second, the prospect of expanding within a more economically integrated European Community, which has been further stimulated by the 1992 programme, has given an additional spur to this expansion. This has come about not just because of the wish of insurance groups to acquire a stronger regional presence themselves, but because their major corporate clients have also been expanding across Europe. As their large manufacturing, commercial and trading customers have extended their operations across Europe, insurance companies have been under competitive pressure to strengthen their own regional networks in order to supply the on-the-spot services demanded by these customers. In a service industry, such as insurance, companies need to have a local presence to provide pre-sales (risk assessment and product tailoring) and post-sales (loss assessment and claims settlement) support.

The larger insurance groups have had the internal capital and management resources to develop their own regional networks to service their corporate clients. On the other hand, some of the medium-sized insurance groups without adequate resources have sought to combine forces to create jointly-owned networks, through strategic alliances and joint ventures, in order to keep up with their larger rivals. These strategic alliances and joint ventures have, however, usually been second best solutions.

In analysing these strategies of European insurers in more detail, it is important to make the following distinction. Pan-European networks have only been commercially necessary in servicing the insurance requirements, especially the non-life insurance requirements, of their larger corporate clients. For the personal and small business sectors, there is no such commercial imperative and so insurance companies have entered European markets on a more selective basis when seeking to expand their operations in these market segments.

Growth of cross-border take-overs and joint ventures

The increase in penetration of other European insurance markets by European insurance companies deserves a little further discussion. The author has estimated in a recent study for the European Commission[1] that between 1984 and 1990 there were 171 cross-border take-overs,[2] mergers and joint ventures. Cross-border mergers have been very few in number. Their distribution by size is given in Table 3. As can be seen, most of the acquired companies have been small, with over 80 per cent having had a market value of less than 50m Ecu.

If one looks at the pattern of these take-overs and joint ventures in more detail, one find that it has been mainly the larger insurance groups that have been the initiating agents in these acquisitions. Particularly active in this take-over activity have been the large state-owned French companies and the Swiss com-

[1] See Dickinson, [1994] pp 183–210.

[2] A take-over was defined as one where over 50 per cent of the issued shares of a company has been acquired.

Table 3 Size distribution of insurance company cross-border take-overs, mergers and joint ventures within the EC, Switzerland and Sweden 1984 to 1990

Value in Ecus	Number of transactions
1000m and over	4
500m to 999m	3
200m to 499m	11
50m to 199m	13
under 50m	140 (est.)
	171 (est.)

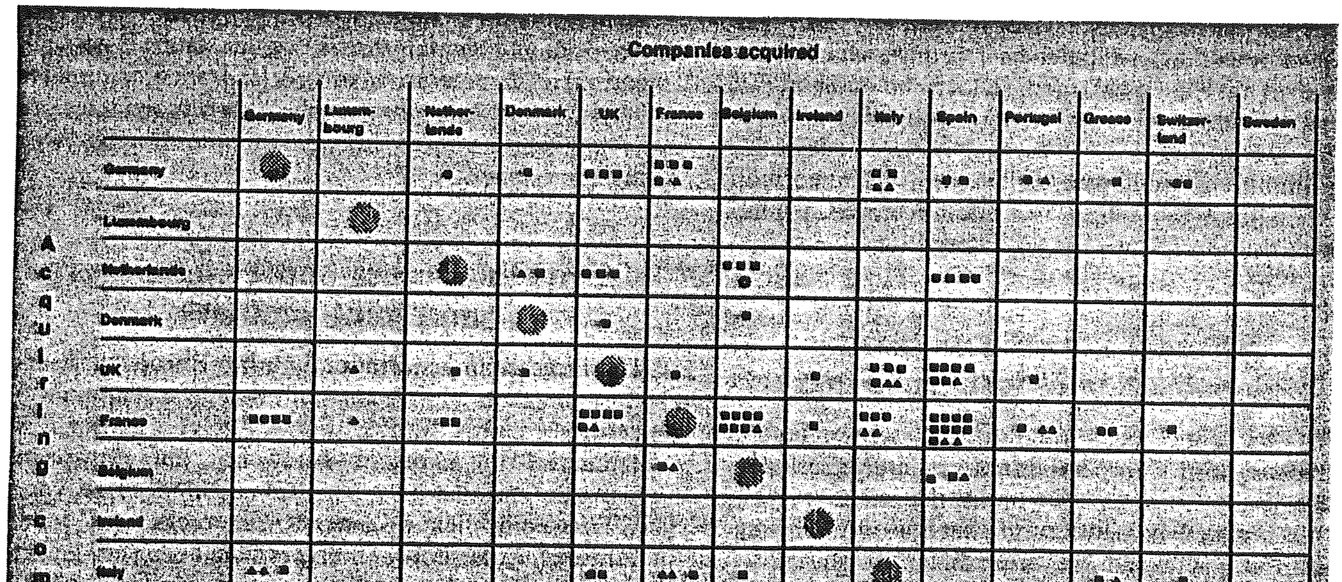
Source: G.M. Dickinson, »Insurance Sector« in *Market Services and European Integration*, European Commission, 1994

panies. To a significant degree it has been the larger insurance groups based in northern and central Europe that have been acquiring the small to medium-sized companies both in northern Europe and in the fast growing southern European markets, especially in Italy, Portugal and Spain. The geographical pattern of cross-border take-overs, joint-ventures and mergers from 1984 to 1990 across the EC, Switzerland and Sweden is given in Chart 2.

Clearly, take-overs have featured more in these amalgamations than joint ventures or acquisitions of minority stakes. Where possible, large insurance groups usually prefer to exercise management control over their foreign affiliates, wishing to integrate them into their wider strategic, financial and reinsurance systems. Joint ventures have tended to take place where large companies cannot obtain full control of a local company or where medium-sized companies have joined forces in order to create a European network.

As these acquisitions have been taking place, there has been a reaction within many national insurance markets. Small to medium-sized companies, and indeed some large companies, wishing to avoid being taken-over have set up a variety of defence mechanisms. These defence mechanisms have included cross-shareholdings, the issuance of preference shares with significant voting rights or changes in the articles of association to disenfranchise unwanted shareholders. In some countries existing legislation has, directly or

Chart 2 Cross-border take-overs, joint ventures and mergers among insurance companies 1984 to 1990



Source: G.M. Dickinson »Insurance Sector« in *Market Services and European Integration*, European Commission, 1994 indirectly, deterred foreign take-overs. Another consequence of this take-over process has been that a number of small to medium-sized companies have merged among themselves to avoid unfriendly advances.

Cross-border mergers have been few in number. The principal one was the merger between the Belgium insurer, Groupe AG, and the Dutch insurer, AMEV, in 1990.

Strategies of European insurance groups in a global setting

Analysing the corporate strategies of the major European insurance groups throughout the 1980s, one sees that although there has been a strong emphasis on extending operations across Europe, this expansion has not been restricted to the region. A number of European insurance groups without an existing presence in North America have entered these markets, again usually through acquisition. Similarly, expansion into the fast developing economies of the Far East and Latin America has also been in evidence. A number of large European insurance groups would have wished to enter the large and relatively profitably Japanese insurance market. This has been proved difficult to achieve, since the Ministry of Finance in Japan has been restrictive in its granting of licences to new companies, while the availability of companies for acquisition has also been restricted and in any event the cost of acquisition would generally be too high, because of high Japanese stock market values and the strong Yen. A few of the large European insurance companies have managed to obtain a licence to set up new operations in Japan in recent years, but their market share is low, under 1 per cent in non-life insurance and negligible in life insurance.

While some large European insurance groups have been expanding in the North American markets, it is interesting to observe that few of the large US insurance groups have been involved in a significant reciprocal action in Europe. For the most part the large US insurers have mainly sought to consolidate their European networks to service their multinational clients and this has been done primarily by setting up new companies across Europe. The author estimates that the share of Western European insurance markets as a whole held by US companies is less than 4 per cent for non-life insurance and less than 2 per cent for life insurance. Japanese penetration of the European markets is even less. For the most part Japanese insurance companies have mainly confined their activities to servicing the needs of Japanese multinationals in Europe. In servicing their multinational clients, Japanese non-life insurance companies have either set up joint ventures with local insurance companies in a particular market or have used the pan-European networks of the large insurance brokers. In respect of personal insurances and insurances for non-Japanese corporations, Japanese insurers have not to date shown a very active interest. One reason for this is the relatively lower profitability of non-life insurance in Europe compared with Japan. Similarly, Japanese insurance companies have not shown much interest in expanding into the European life insurance market; the buoyancy of their own domestic market has been such that they have not so far needed to look abroad for profitable expansion opportunities.

The changing co-operative and competitive interfaces between insurance and banking

One of the features of the last decade has been the changing relationship between the insurance and banking systems, which in many countries have historically been kept apart through government regulation. With greater deregulation within the financial system, and the ensuing greater competitive pressures within both the banking and insurance industries, the boundaries between insurance and banking have become more blurred. Banks, and to a lesser extent insurance companies, have begun to diversify their activities into each others' territories. The process of change has not been limited to market entry; through greater product innovation, new substitute products have emerged for the more traditional insurance and banking products. The growth of the investment sector, particularly the growth of private pension funds and mutual funds, has intensified this area of competitive interface.

One particular area of development has been the role that banks play as marketing outlets for insurance. The entry of banks (commercial, saving and mortgage banks) into selling insurance has been the feature of most European countries in recent years. The form of the relationship has varied. Sometimes the bank has set up a distribution agreement with a particular insurance company and sometimes a new insurance company has been formed as a joint venture, with the insurance company managing the underwriting and claims functions and the bank managing the marketing functions. However, over time banks have realised that the marketing of insurance, especially life insurance and private pensions, is a profitable activity and a number of the larger banks have gone one step further. They have used their holding company structures to set up their own wholly-owned insurance companies or have bought existing insurance companies.

It has not always been the banks that have been initiating these changes. The larger insurance companies have also seen the benefit of using the reputation of banks to sell their products and to increase their market shares. Moreover, the large pan-European insurance groups when entering another market have seen cross-border tie-ups with local banks as an efficient means of market penetration.

It is interesting to observe that insurance companies are much less able to act as distribution outlets for banking products. This is because insurance companies have historically tended to be less close to their customers, often using insurance agents and brokers as their links with customers. This contrasts with banks where the distribution and production operations has always been integrated. This lower degree of contact with the customer, and indeed in some cases a poorer reputation, has meant that insurance companies have been less able to market banking products, even if they had wished to.

While banks have set up or acquired insurance companies, there have been a few cases of insurance companies setting up or acquiring smaller banks, although it must be said that these acquisitions have been much less frequent and on a lower scale than in the case of bank diversification strategies.

One has seen recently in the Netherlands that the relationship between banks and insurance companies has gone one stage further, with mergers between the two. The merger of Nationale Nederlanden and NMB Postbank group to form the ING group and the merger of the second largest Dutch bank, RABO, with the insurer, Interpolis, are the notable cases. The Dutch regulatory authorities approved these mergers. Whether mergers between insurance companies and banks will be allowed to become a general feature within Europe is still an open question. Central banks and the regulatory authorities are likely to be worried about the undue concentration of power and the potential vulnerability to the financial system as a whole arising from such a concentration. An interesting economic question is whether a financial system is potentially more or less stable over time if there are fewer yet stronger financial conglomerates compared with a system that is more diffuse.

It should also be noted that there has been a strengthening of the interface between insurance companies and banks in other areas apart from the marketing and production of insurance. The insurance sector has increased the underpinning role that it provides to banks as financial intermediaries. This support has manifested itself in the form of a growing supply of credit risk transfer facilities, through credit insurance and various types of financial guarantees. In addition, through their investment activity in the bond and swap markets, life insurance companies have indirectly assisted the banks to manage their interest rate risk exposures and as major purchasers of bonds arising from loan securitisations have thus assisted them in their liquidity management.

Changing interaction between the state and the private insurance sector

The relationship between the state and private insurance sector within Western Europe has always been one of relatively close contact. The intensity of interaction has varied across Western Europe, reflecting different political and economic traditions.

In recent years there has been a general trend across western democracies for governments to play a less pervasive role in social insurance than they have hitherto. This reflects in part political changes, but it also reflects the fact that governments are unable to justify to voters the higher taxes (or state borrowing) necessary to support this government role. In recent times a major change has been the transfer of more of the responsibility for income-maintenance programmes within social security systems onto the private insurance sector. This has been particularly evident in the fields of pensions, health-care financing, workmen's compensation and other disability insurance programmes. The cost of supply of these social securities programmes, in the face of ageing populations with high expectations, has been a major determinant of this shift. In most countries in Western Europe there exists some form of tax incentive to encourage this process of transfer. These tax subsidies are viewed by governments as a good investment for the tax payer, since the taxes foregone are expected to be more than offset by lower tax support needed in the future. Not only have governments sought to encourage the role of the insurance sector, but they have recognised the need for a more co-ordinated approach between the state and private insurance sector. This gradual shift away from the state to the private sector is something which should provide a major stimulus to the growth of the private insurance sector in the rest of the decade and beyond.

In the area of non-life insurance, there has also been evidence that governments wish to transfer more responsibility to the private sector. One such area is export credit insurances, particularly those related to short-term credit risks. It is gradually being recognised that the private sector has better information systems for pricing such insurances and can spread the attendant risks more effectively through national and international reinsurance networks.

At the same time there still exists across Europe a number of government-owned insurance enterprises, reflecting in part traditional market structures and in part post second world war nationalisations. State-owned or state-controlled insurance companies exist in France, Greece, Italy and in certain Länder in Germany. There is a general move towards the privatisation of these state-owned companies. Apart from changing political attitudes, the motivation for change has come from a recognition that state-owned companies need to be able to tap the market for equity capital to finance their future growth. In the early 1990's Portuguese insurance companies were privatised, and there are plans in place for the French and Italian state-companies in the near future. The extent of the privatisations will vary, since some governments may still wish to retain some equity stake in the companies after privatisation. Where governments still plan to retain equity stakes, this suggests that the motivation behind the privatisations is primarily financial rather than political.

Regulatory progress towards a common market in insurance

As a part of the Treaty of Rome, there has been the aim to create a common market in insurance. The process by which this common market would be created was planned to entail two stages. In the first stage, there would be the right of establishment, i.e. the right for a community insurer to set up a branch or a subsidiary in another member state. In the second, there would be right for insurers to sell insurance on a cross-border basis. Separate directives for establishment and cross-border provision were considered necessary for life and non-life in view of their different legal and financial characteristics. The freedom of establishment and of cross-border business for reinsurance was agreed early on in 1964, since reinsurance was already essentially international in nature. The Establishment Directive for non-life insurance was agreed in 1973 and for life insurance 1979 and by the mid-1980's the Directives had been implemented into the national insurance laws of most member states. Despite their slow introduction, the Establishment Directives have in general worked well. Insurance companies have found it relatively easy to obtain licences to set up branches or to form new insurance companies in member states. The fact that a national regulatory authority would require a branch of another Community insurer to adhere to the same regulatory system as a local insurance company was a key reason why the implementation of the Establishment Directives did not prove unduly contentious. The introduction of »Services« Directives, i.e. freedom to sell on a cross-border basis, has been less easy. Partial agreements on these freedoms were introduced for non-life insurance in 1988 and for life insurance in 1990, although their implementation into national law has been relatively slow.

Gaining agreement to create a common market in insurance, i.e. the full freedom of an insurance company to supply either through a local establishment or on a cross-border basis, and the concomitant freedom of consumers to buy cross-border, has been proved difficult. A breakthrough in what was essentially a regulatory impasse occurred with the introduction of the principle of the single licence, which allowed for home country regulatory control. But there is little doubt that the political pressure brought on by the relatively speedy agreement on the Banking Directive acted as a major spur. The single licence principle was made much more acceptable by the concept of mutual recognition, since it essentially allowed the regulatory authorities in member states to retain their own systems of supervision, subject to some minimum agreed standards. The alternative route, which had been previously pursued of seeking the prior harmonisations of regulation, tax and contract law were abandoned, because of the length of time that such an approach would entail. Following close on the agreement of the Banking Directive, the Life and Non-Life »Framework« Directives (3rd Insurance Directives), combining both establishment and cross-border freedoms, were adopted in June 1992 for non-life insurance and November 1992 for life insurance. These Directives are planned for implementation by member states by July 1st 1994. In the past national governments have been slow to implement insurance directives into national legislation, but there is sufficient political determination behind the current Directives so that they are likely to be implemented on time by most member states.

One major consequence of these new Directives is that they will also address issues of competition policy within national insurance markets. With the main exception of compulsory insurances, price agreements, known as »tariffs«, will be phased out, and the prior approval for the introduction of new insurance products by regulatory authorities will be removed. Moreover, greater freedom has been accorded to the investment policies of insurance companies, by widening the range of approved securities and by reducing the quantitative restrictions on investment holdings, especially in the holding of shares and foreign investments. This reduction in investment restrictions will be particularly important for life insurers, since it will permit greater product innovation as well as allowing them to earn higher rates of return on policyholder savings and thus strengthening their competitiveness in the long term savings market.

The EEA Agreement in October 1991 resulted in the existing EC Insurance Directives being agreed to be extended into the EFTA countries. Current negotiations are being carried out on the timing of the introduction of the more liberal 3rd Insurance Directives.

As the GATT prepares to widen its terms of reference to incorporate trade in financial services into future rounds of negotiations, it is worth observing that an initial view has been taken that the EU experience will be good model to adopt for insurance and banking. However, the extension of the EU model into the global context will be a slow process, requiring a step by step approach.

Outlook for insurance markets in Western Europe

In view of continuing economic integration within Europe, it is likely that there will be a greater concentration within European insurance markets, particularly as there are still a relatively large number of insurance groups. It would seem reasonable to speculate that the number of independently-controlled insurance groups will fall from its present level of some 2500 to about 1500 by the end of the decade. The process by which this concentration takes place will be complex. It has already become evident to acquisitive insurance groups that there is a shortage of companies available for purchase. This has been due in part to the fact that many insurance companies which were willing to be acquired have now been acquired, while those that did not wish to be purchased have set up defence systems against predatory attack. The ownership structure of insurance industries in a number of countries has also reduced the scope for take-overs, since there are many mutual insurers and small to medium-sized insurers, which are either privately-owned or owned by industrial or commercial groups. With an imbalance between demand for and the supply of insurance companies for purchase, acquisition costs have risen and this itself has deterred demand, at least in the short term. There are a number of instances of companies that have bought smaller insurers, especially in southern Europe, and have subsequently realised, when profit expectations have not been met, that they had paid too high price for them; a number of these small insurers have subsequently been sold, usually to larger local companies.

Thus the process of concentration will in future be achieved to a large degree through agreed take-overs and mergers. Larger companies will still be able to persuade owners and management of the benefits of take-overs. There will continue to be pressure on some of the smaller mutual insurance companies to merge in order to pool their capital, IT and management resources in the interests of survival. And with greater competition, it is possible that the rate of insurance company insolvencies may increase in the future, which tends to be handled in many European countries by the regulatory authorities finding a larger and financially sound insurer to take-over the failing company. While there are economic and commercial reasons to expect that there will be further concentration within the European insurance industry, especially when the current recession ends, it should be noted that it will still be possible for smaller insurance companies to survive. Apart from reinsurance and insurances for large multinationals, there is no evidence for major economies of scale in either insurance production or distribution and so smaller insurance companies can specialise in product and consumer niche markets. This is especially so in the field of life and private pensions where there is greater scope for product differentiation.

It should also be recognised that most of the larger European insurance groups now have their own network of operations across the EU. When the Insurance Directives are implemented into EFTA countries under the EEA Agreement, some of the larger European insurance groups might also seek to enter some of the more protected markets within EFTA. While there remain restrictions on foreign ownership of national insurance companies, this will deter large scale entry, although these restrictions will also have to be gradually phased out in compliance with the Agreement. At the same time, medium-sized insurance companies that have hitherto not ventured significantly outside their domestic markets may well be encouraged to do so, if in a more limited way than their larger competitors, possibly in collaboration with other medium-sized insurance groups which do not possess the resources on their own.

If one looks at the take-overs that have taken place within Western Europe over the last decade one finds that there have only been a few take-overs or mergers between large insurance groups. Because of the difficulty of finding suitable targets for take-over, it is possible that in the mid 1990s the larger insurance groups may decide to embark on agreed mergers. These mergers could well be within national markets or cross-border. Such mergers, if they occur, are likely to be second preferences to a full take-over, as they would be seen as the only way of gaining a more dominant position quickly in the regional, and indeed global, market place. There is no commercial imperative for such mergers, but if a few of these mergers do take place this will tend to cause a reaction across the industry, with other large groups feeling that they must respond. Such an occurrence would lead to a more rapid restructuring of the European insurance industry.

The implementation of the 3rd Insurance Directives, which will allow cross-border marketing of life and non-life insurances and cross-border purchases of insurance by customers, will add an extra dimension to competition within insurance markets. But there will be a limit to the extent to which cross-border business will replace business supplied through a local establishment, since in providing insurance there is often the commercial need to have an on-the-spot presence. However, for certain insurance products, which are standardised or commodity-like in nature, and for particular well-informed consumer segments, cross-border insurance business will grow. It is more likely to develop in non-life insurance than in life insurance, apart possibly from term life insurances, since life insurance products are less commodity-like in nature and usually need to be integrated into local tax and social security systems.

For large industrial and commercial enterprises, many of whom already operate through their own insurance companies, called »captives«, cross-border business already takes place in the form of reinsurance. Indeed, one reason why captive insurance companies have been set up by multinational firms is in order to exploit the greater freedoms that have existed for reinsurance transactions, both within Western Europe and indeed globally. The large insurance brokers will prove to be an important catalyst in the speed of change in the growth of cross-border business. Insurance brokers acting for clients can supply them with the requisite on-the-spot services through their own networks of offices and can handle claim settlements for insurers, as well as arranging their insurance cover outside national boundaries. Indeed, banks themselves could play a similar role with respect to personal insurances. A key determinant of the speed with which cross-border business will take place is advances in communication and information technologies. Increased compatibilities of networks, lower costs and greater user awareness of these technologies will be conducive to the growth of cross-border business.

The growing competitive interface between banks and insurance companies will also pose interesting challenges in the future. The competitive tensions between the large insurance companies and the large banks have already begun to manifest themselves, as banks have set up their own insurance companies or bought existing ones. Insurance companies are likely to respond by strengthening their own links with smaller insurance intermediaries which because of their size will be less able to set up their own insurance companies. There will, most probably, be greater efforts towards the direct marketing of insurance, since an insurance company can thereby exercise greater control over its distribution channels. Paralleling the recent experience in the Netherlands, the issue of whether banks and insurance companies will tend to merge across Europe is unclear. Whether the larger banks and insurance companies will wish to merge is one issue; whether the regulatory authorities will allow such mergers to take place is quite another. One can argue on either sides of these two sets of issues. My personal view is that such mergers could take place within the smaller markets in order for these combined enterprises to meet the competitive challenges from the larger pan-European banks and pan-European insurance companies. There may also be mergers in countries with less developed financial systems, where the cultural differences between the two sectors is less entrenched.

For the larger European economies, with established financial systems, it is less likely that governments will allow a significant degree of merger activity between the banking and insurance sectors. This is not only because such mergers would pose concerns for regulation and for competition policy, but also because the stability of the financial system as a whole may be made more vulnerable. Whether shareholders of insurance companies would support such amalgamations is also open to debate, as stock markets have tended to favour the unbundling of operations, in view of the fact that shareholders can themselves diversify across the financial sector through adjusting their own investment portfolios. For shareholders to be convinced, the synergy gains (economies of scope) from such amalgamations will have to be clearly identifiable and the existing management be seen to be capable of exploiting them.

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An Integrated Insurance Market in Western Europe – Selected Issues

JÖRG FINSINGER*

Although the integration of insurance markets in Western Europe is making headway, obstacles to foreign presence on national markets remain. Differing contract law and national taxes and subsidies are examples of such barriers to establishment and cross-border provision of insurance. In particular, tax breaks for life insurance may be closely related to the performance of life insurance policies.

Concomitant to increasing integration, the traditional regulation of the behavior of insurance business is giving way to new approaches to safeguarding customers' interests, such as solvency regulation combined with early warning systems, a procedure for detecting and controlling companies at risk and a guarantee fund to bail out customers in the case of bankruptcy.

Introduction

Insurance business in Europe will change markedly as a result of European integration. In this paper some basic economic issues relating to that change are dealt with. As a background for the analysis, a new perspective on the nature of insurance and on the reasons for foreign market presence is presented.

For most European insurance markets, integration requires deregulation with respect to the supervisory laws. Financial supervision will be largely harmonized. Premium and profit regulation, as well as contract approval procedures characterizing the so called »material« regulatory systems, will be abolished by the third generation of directives. Deregulation opens up new dimensions for competition and will bring larger market shares to independent agents. Market shares will become more volatile and hence the value of insurance companies will fall along with their profits.

National contract laws and discriminatory tax systems are examples of remaining barriers to entry. Taxes not only distort the competition between national markets but perhaps more importantly between different forms of savings instrument. If life insurance saving is subsidized by tax breaks while other savings instruments are not, the performance of life insurance contracts can be lower than that of competing savings contracts and still be attractive to consumers. The evidence on life insurance performance in 14 selected countries is not sufficient to prove this point but is at least consistent with the hypothesis.

Electronic underwriting may facilitate foreign market entry. In particular, life insurance contract offers can be »transported« onto any intermediary's personal computer via modems or other electronic networks. Electronic underwriting will increase the possibilities for risk selection.

While many national supervisory systems place emphasis on regulations affecting all businesses in an industry, in order to rule out bankruptcies completely, and thus feature a high level of intervention, many US States, France and also Great Britain rely on ex-post solvency control. With ex-post solvency control, only businesses at risk are subject to far-reaching interventions. The criteria according to which businesses are classified as »healthy« or »at risk« are of great importance. They are the core of early warning systems. Early warning systems, combined with guarantee funds, can protect consumers without subjecting the industry to excessive regulations. Guarantee funds insure policy holders against the failure of their insurer. In order to keep moral hazard at bay, the protection of the policy holder should not be full; rather there should be a deductible (excess) and some coinsurance.

The nature of insurance

Insurance is a financial transaction. The insured transfers funds to the insurer, and expects to receive money back in the case of claims. If there are no claims, the funds paid to the insurer are lost. If the insured has a legitimate claim, he may well draw out considerably more money than his accumulated premiums. For the entire set of policy holders, it is true that they expect to receive back approximately what they put in, plus

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interest, minus administrative costs and profits to the insurer. Policy holders, like the depositories of banks, are creditors to the firm. When the insurer sells the policy, it incurs a liability.

The basic principles of insurance are spreading and diversification of risk. Some insurance theorists hold the law of large numbers to be the natural law governing insurance business. However, the law of large numbers requires the risks, which are pooled, to be independent and identically distributed. Most insurance lines, however, are composed of highly correlated risks. More generally, the losses in many lines partly depend on secular causal factors. Losses in automobile insurance, for instance, are closely linked to general economic activity and to gas prices. In boom periods and in periods with lower gas prices, demand for driving rises. Immediately after the oil price shock, insurers' losses fell dramatically. As another example, liability claims in the US rose dramatically, not as consequence of the stochastic nature of the underlying risks, but rather from secular changes in the way the legal system (in particular juries) perceived the liability. Thus, the profits of insurance companies depend, as in any other business, on secular changes in systems and markets. The stochastic aspects focussed on by some insurance theorists are of minor practical relevance.

The trade and balance of payments consequences of insurance reflect two streams. The inflow of premiums and the outflow of benefits. The services that consume real inputs constitute only a part of total revenues. Administrative and selling costs rarely exceed 50 per cent of revenues. Insurance can be regarded as an investment transaction and a service rolled into one.

When a foreign subsidiary is established, the bulk of the transaction services, such as selling, claims processing, and management, will be furnished by nationals of the host country. Liquid assets to back reserves will usually be held in the currency of the host country. The major consequences of such investment-type activities for the home economy will be an initial outflow of capital to establish the subsidiary and the export of some management manpower and managerial expertise, and finally the repatriation of the profits the subsidiary earns.

Reasons for foreign market presence

There are a number of apparent reasons for insurers to provide insurance services across borders or to establish insurance subsidiaries in foreign countries:[1]

- They follow businesses to other countries. If a business cannot use its preferred insurer with whom it has a long-term relationship, in foreign markets, it is as if an additional cost were to be imposed on it. Thus, requirements to use host country insurers, or regulations which have that effect, can be a subtle but effective way of deterring entry.
- Insurance profitability in particular in expanding economies may be higher than in the home country. If risks are large in absolute terms (e.g. environmental liability), there may be insufficient capacity in some countries to cover the risk.
- Insurers seek risk diversification. In spite of the general availability of reinsurance, geographic dispersion may help to spread risks. This is particularly true for catastrophic losses. From a cost perspective, risk diversification is similar to exploiting economies of scale and scope.
- Insurers seek prestige and use international operations for public relations. An international image may enhance an insurer's reputation.
- Insurers seek to diversify investments across countries. To the extent that national regulations prevent the spread of investment risks across countries, the establishment of a subsidiary in the foreign country may provide an attractive solution to this problem.
- Insurers seek countries with regulatory frameworks facilitating their operations.

The operation of an insurance company does not require any specific resources other than capital and the know-how necessary for underwriting. From a theoretical perspective, international trade in insurance is beneficial only to the extent that the exporting company has a comparative advantage. As trade barriers for capital have disappeared, comparative advantages can mainly be traced back to either long-term relationships with domestic customers or to the fact that the domestic legal system and regulatory framework are better adapted to the provision of specific types of insurance. It may well be that Lloyd's plays such a dominant role in unusual types of insurance cover because British law is more flexible than continental law. The doctrine of »Utmost Faith« and the use of warranties allow the British insurer to request information about the insured risks which would not be possible in some other EC countries. For instance, it is well-known that to some extent in France, but even more in Germany, the insured may withhold information or give wrong information without the insurer being able to cancel the policy or withhold the payment of claims. Also, it is well-known that in some countries the regulations concerning the investment of capital and reserves are stricter than in others. Stricter regulations often mean a lower return on investments and hence a higher price of insurance. Thus, less strict regulations may confer a competitive edge to insurers operating in foreign markets with stricter regulations.

[1] Cf. Schroath, F.W., (1988).

Applicable law rules as barriers to entry

The EC Directives are meant to open up insurance markets across Europe, but in the mass markets entry barriers will persist and thus true freedom of service will not be established. An insurance policy is the set of legal rights conferred to the parties involved. The Directives subject mass insurance products to the respective national insurance contract laws. Therefore, a contract exported into a foreign country actually is transformed into a new contract with quite different legal properties. In other words, an insurance policy of country A cannot be sold as such in country B. To the extent that the risks or the costs associated with a policy change as it crosses the boundary of a legal system, freedom of service is indeed limited.

Take for example a policy designed under the legal doctrine of »Utmost Faith«. The risks and costs of such a policy under a less strict legal system will be higher. Therefore it must be sold at a higher price. But it could well be that certain elements of moral hazard, enticed by the incentives generated under a less strict system of warranties and obligations on the part of the policy holder, may undermine the viability of the policy.

This limitation will still shield national markets and thus protect national insurers from competition. At the same time, exporting insurance is made somewhat more difficult.

European integration, deregulation and the value of firms

As more freedom of service is permitted, highly regulated markets will have to be deregulated. Otherwise the companies subject to stricter regulations will be disadvantaged. So far the process has been very slow, with small adjustments at each step. At first glance, markets in transition from a highly regulated to a more competitive environment should provide good opportunities for entry. A closer look at the mechanics of regulation and deregulation shows, however, that an ongoing process of deregulation discourages entry and thus represents a temporary barrier to entry. Regulation affects the value of certain investments. In particular, it affects the value represented by a set of insurance contracts. More concretely, consider the substantial costs of acquiring business. Typically the cost of acquisition runs from one tenth to a half of total premium volume. Clearly, these costs are reflected in the value that a portfolio of insurance policies represents for a company. Regulation generally raises the cost of acquisition and at the same time reduces competition, which results in a stabilization of market shares. The causal chain is complicated. Regulation favours tied distribution channels, which in turn raises the cost of acquisition and substantially limits marketing strategies via independent sales organizations.[2] It can be shown that the shares in highly regulated markets are more stable. Regulation thus increases the assets of insurance companies. Regulation brings windfall gains to the industry. Hence, it is profitable to enter a market before it becomes regulated in order to benefit from these windfall gains. In contrast, deregulation reduces acquisition costs and hence devalues the intangible capital represented by insurance policy portfolios. Deregulation brings windfall losses to insurers. Hence, entry into markets which are in a process of deregulation must bring losses. The process of deregulation thus discourages entry prior to its completion.

It was hypothesized that an insurance contract is worth more to a company in a regulated than in a competitive environment. This is tantamount to saying that regulation induces rents.[3] There is no easy, accurate test of this hypothesis. It is obvious that such rents would be reflected in the value of companies. If firm value is measured by market capitalization (the total value of outstanding stocks, calculated from current share prices), the hypothesis suggests that this value relative to the volume of business must be higher in regulated than in competitive marktes. The difficult problem is how to measure the volume of business. Clearly, premium volume is the wrong measure because it represents the volume of contracts weighted by their respective prices. The prices in regulated markets, however, tend to be substantially higher, the price differential being the »source« of the regulation induced rents. Premium volume itself incorporates these rents. It is then obvious that the frequently used measure, market capitalization divided by premium volume, cannot reflect these rents – they appear in the numerator as well as the denominator. The correct procedure requires an adjustment of premium volume. The appropriate correction factor is an index of the price level.

Table 1 provides average values for market capitalization divided by the price-adjusted volume of business. Unfortunately, data were available on just a few companies[4] for each country. The averages, therefore, are not necessarily representative of the respective countries. But they are consistent with the proposed hypothesis. The companies in the least regulated countries, the United Kingdom and the Netherlands, are indeed worth less than those in the highly regulated countries – in the sense explained above.

[2] An in depth statistical analysis is provided by Finsinger J. and Schmid F.A. (1994) pp. 30.

[3] This does not necessarily mean that the firms in regulated settings are more profitable.

[4] They were selected by Fox-Pitt, Kelton (1990).

Table 1 Market capitalization divided by the price-adjusted volume of business

Italy	2.66
Belgium	1.93
Spain	1.62
Germany	1.00
France	0.95
United Kingdom	0.80
Netherlands	0.44

Sources: Fox-Pitt, Kelton, (1990); own calculations

In conclusion, investment is not to be recommended in foreign European markets at a time when these markets are in the process of being deregulated.

Life insurance performance and tax privileges for life insurance

In many European countries life insurance enjoys tax privileges. Except for Great Britain and Sweden, life insurance can be regarded as a strongly subsidized industry. The subsidization is generally justified by

Table 2 Tax privileges for life insurance products in Europe

Country	Tax on life premiums	Premiums tax deductible	Tax on maturity value	Tax on insurance companies
Sweden	0 %	Pensions: Up to a maxium of 33 600 SEK for incomes below 336 000 SEK, 10 % of income above and twice this amount above incomes of 680 000 SEK Endowment Policies: No	Pensions: Yes Endowment Policies: No	Pensions: Returns on reserved capital taxed at the rate of 0 % until 1990, 10–15 % until 1992 and 10 % since 1992 Endowment Policies: Returns on the respective reserved capital taxed at the rate of 40 % until 1992 and 25 % since 1992 (as in GB)
Germany	0 %	Partly	Endowment Policies: Non-taxable provided contract duration exceeds 12 years Pensions: A fixed part is regarded as interest and taxed as such	Wealth tax 0.6 % on taxable part of equity
Belgium	4.4 %	Partly	Non-taxable provided contract duration exceeds 10 years	N.a.
Denmark	0 %	Partly	Endowment Policies: – Non-taxable – Annuities and pensions taxable	Returns on invested funds are not taxed
France	0 %	Partly	Endowment insurance: – Non-taxable provided contract runs for more than 6 years, capitalisation (savings) contracts non-taxable provided contracts runs for more than 8 years	N.a.
Greece	0.4 % (2.4 % pure risk)	N.a.	N.a.	N.a.
Great Britain	0 %	Not since 1984, certain pensions schemes enjoy cert. privileges	Non-taxable in the hands of the policy holder, but income minus expenses taxed at the source	25 % on investment proceeds with offset for expenses
Ireland	3 % of first-year premiums	N.a.	N.a.	N.a.
Austria	4 %	Partly	Endowment Policies after 10 years of contract duration are exempted from taxation	Companies' profit but not the investment returns on invested funds
Italy	2.5 %	Partly up to 2.5 Million p.a.	2.5 % on bonus payments. Beginning with the 10th year reduction of this tax by 2 % p.a., 60 % of annuities taxable	N.a.

the special role of life insurance as a supplement to old-age pensions. However, it is clear that any form of safe long-term saving can be regarded as a means to supplement old-age security. The fact that such other forms of saving are not subsidized means that they do not command the same intensive lobbying.

The subsidies have a threefold impact. First, subsidies mitigate the competition from non subsidized products, mostly savings plans and investment funds offered by banks and other institutions. Hence, the performance of life insurance products can be lower than in a world with symmetric tax laws on different forms of savings. Second, capital is attracted to investments which do not yield the highest return for society as a whole. Finally, they act as a barrier to cross-border trade, since only domestic companies enjoy the priviliges.

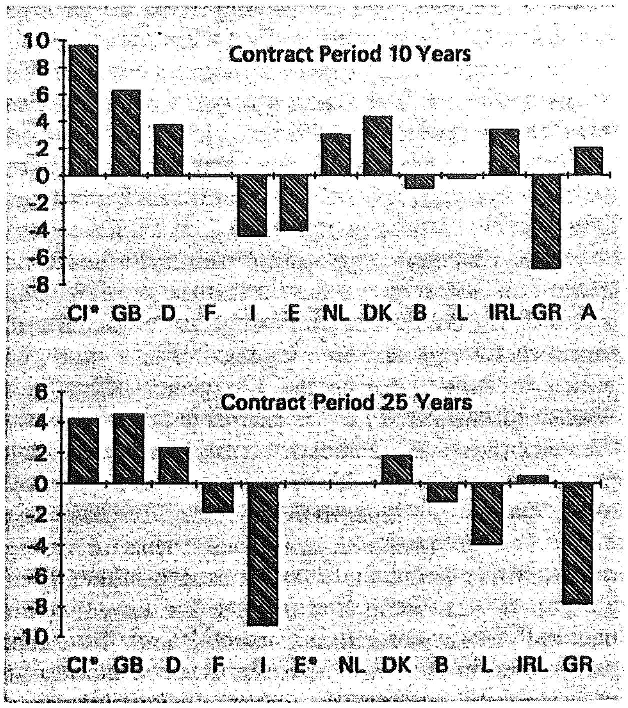
As a simple rule, tax laws should be symmetric and treat long-term savings equally. In some countries tax authorities hold the view that tax breaks should be given to those who save for old age. But then all saving instruments which provide capital for old age must be favoured. Some tax authorities emphasize the risk aspect and give tax breaks for contracts which combine savings and life insurance as long as there is a risk element. The latter philosophy reflects a willingness to subsidize the risks covered by life insurance. However, rational economic arguments in favour of such a subsidy do not exist.

Chart 1 indicates the performance of life companies in the European Communities. Corresponding figures for Sweden were not available to the author. However, for the period from 1987 to 1992 rates of return on endowment policies were supplied to the author.[5] The average nominal return was 8.8 per cent, while the average real return was 2.4 per cent. Relative to the performance of the EC countries presented in Chart 1, the returns appear to be average. However, capital policies in Sweden are taxed inside the life insurance companies. As Table 2 indicates, the investment returns were taxed at the rate of 40 per cent until 1992. In view of this fact, the performance of the Swedish life insurance companies seems to compare favourably with the other countries.

The conclusions from the above performance comparison are the following:

- British life insurance policies exhibit the highest yields (6.3 per cent) next to Channel Island policies (9.6 per cent, see below) for the 10 year contract period. This contract period is characterizced by a booming stock market. For a contract period of 25 years the German and the Danish life policies performed slightly better than the British policies. However, British insurance policies are implicitly taxed while German and Danish policies are not. In Great Britain, the investment income from the policy holder's savings are taxed within the firms at a rate equal to 25 per cent. Expenses, however, can be deducted. The tax system is called the income minus expenses method. As a result, British insurers must show high pre-tax returns to beat other forms of investments.
- Life companies subsidized by tax privileges can compete favourably with other forms of investment in spite of low returns.
- Channel Island policies are simply British policies issued on territories where the British income minus expenses tax does not apply. Hence policies from the Channel Islands enjoy the same privileges as the policies from most insurance industries on the continent. Their excellent performance proves the British life insurers to be the unrivaled leaders in Europe.

Chart 1 Real rates of return of life insurance savings to consumers in the respective national currencies for contracts written 10 years and 25 years ago and maturing today



CI* Channel Islands
E* Not available

Source: Versicherungswirtschaft, Heft 6, 1993 (inclusive Jersey, Isle of Man and Guernsey)

Today tax rules are applied in a discriminatory manner. The Bachmann case is often cited as a justification. However, the circumstances of the case were rather specific and it is likely that in another typical case the European Court would rule that discriminatory rules favouring national industries, i.e.giving priv-

[5] I am grateful to Eva Blixt for the charts.

iliges to nationally provided contracts only, are not legal. It is also likely that the Commission will not tolerate, in the medium run, that European Market Integration in this area is thwarted by protectionist national tax laws. The tax privileges for life insurers will ultimately be coordinated on a European level.

The political reasons given for the tax breaks differ across countries. The starting point of all arguments is the encouragement of savings for old age. However, not only mixed life insurance contracts maturing after the age of 60 can be said to provide funds for old age. Other forms of savings can be said to fulfil the same objective and therefore should obtain an equal tax treatment. Sometimes it is said that the pure risk part is crucial for the justification of the tax break. But all forms of savings can be packaged with a pure risk policy to match the mixed life policy. Clearly, a consistent argument for the exclusive tax privilege of life insurance policies does not exist. If economic logic prevailed, similar forms of savings would be taxed along the same lines and therefore life insurance mixed savings products and other forms of investments, in particular the relevant bank products when combined with some sort of pure life cover, would become close substitutes. Banks and insurance companies might then co-operate more closely all over Europe. An industry such as the Swedish insurance industry with long experience of co-operation with banks, may have a competitive edge in such an environment.

Electronic challenges to insurers in an integrated European market

Given the strict regulation and standardization of insurance products under the traditional national systems of »material supervision«, the principle of insurance came to be regarded as risk elimination by pooling. Providing very different policy holders with the same contracts and even the same premium (tariff), was conceived as a virtue of good insurers. The basic principle of insurance was regarded to be the pooling of risks rather than underwriting. The law of large numbers was misinterpreted as the central law of insurance.[6]

It is, however, well known that pooling different risks in the same type of policy and at the same premium creates severe moral hazard effects and thus increases the total risk borne by society and ultimately makes insurance more expensive. If a policy holder can choose to become a higher risk without having to pay the corresponding higher premium or without having to accept a larger deductible or other less favourable conditions, then he will do so and behave less carefully or invest less in risk reduction or damage prevention. Thus pooling is costly and inefficient.

In more deregulated markets, insurance companies will begin to tailor contracts to the individual risk. Insurance companies in the formerly regulated countries will have to acquire more expertise in risk selection and pricing. At the same time, considerations of risk management will become more widespread. This is what underwriting in the full sense of the word means.

Underwriting can be supported by electronic means. Some insurance companies[7] already have a fully integrated system of electronic underwriting for typical mass risks. The agent or broker types the relevant client information, his characteristics and his demands, into a computer and the software classifies the risk of the client and calculates a premium rate. Various expert systems assessing the client's risk are on the market.[8] The policy can be approved by the expert system and printed immediately. In the evening the agent parks his computer in the docking station. Overnight, the computer links up with the central data processing unit of the insurer. The new policy data is transfered and the corresponding commission together with other relevant information flows back to the computer so that the agent sees his performance and corresponding commission as well as the latest news on the screen the next morning. Clearly, the computer helps with all aspects of administration, not just bookkeeping.

For life insurance such systems supply the agent with a financial planning instrument. Key data on the client are typed into the computer. The computer calculates the pension or invalidity or sickness payments to which the client is entitled. The computer also calculates the pension of the wife and children in the event of the father dying. The more sophisticated versions analyse the time profile of incomes, consumption and capital requirements, such as for housing, education of children etc. Thus, the cost of advice as well as of underwriting in the mass risk markets can be reduced.

The consequences of introducing such electronic underwriting and financial planning tools could be dramatic. First of all, the costs of selling insurance will be reduced while at the same time the quality of the marketing will be improved. Cross-selling opportunities increase. If banks make intelligent use of the new technologies, they can gain large market shares at the cost of the traditional sales forces of insurance companies. If brokers are not successful in setting up their own electronic underwiriting and marketing networks, they inevitably will be driven out of the non-commercial markets.

[6] Cf. the section on the nature of insurance at the beginning of this paper.

[7] For instance the Laurentian in Great Britain.

[8] A leading expert system for assessing the risks of life and health cover has been developed by the Kölnische Rüchversicherung (Cologne Reinsurance).

Information networks for independent agents could be set up, going beyond simple quoting services. New offers could be sent to the agents' personal computer in such a network at virtually no cost. Expert systems will be of help to the agent to choose the right marketing strategy, to assess individual risks and to accept or refuse risks along the guidelines set by the insurer. This can be done across any national border provided the network costs do not increase much with distance.

From a legal perspective the age of electronic underwriting offers the possibility of documenting the sales process. Thus, an obligation to file the sales communication could be introduced, making »best advice« principles enforceable.

Regulation – new rules of the game

The consumer can estimate the solvency of a financial services agency, a bank or an insurance company less well than the management of the business. This unilateral information advantage can lead to insolvency problems occurring more often than desired from the policy holders' or depositors' perspective. This is the primary reason for setting up regulatory bodies, which attempt either to decrease the likelihood of insolvencies occuring or to reduce or neutralise their undesirable consequences. Financial services, bank deposits and insurance contracts are, therefore, more secure than they would be in unregulated markets.

Regulation, however, is costly. The costs of the regulatory authority are visible; but regulation costs for business are mainly invisible. Therefore it can easily happen that the induced costs of regulation exceed its benefits. Such over-regulation should be avoided. Some regulatory interventions meant to prevent insolvencies can be abolished or can be modified, if a guarantee fund is set up. In the following the role of insurance guarantee funds in regulatory systems that focus on financial supervision rather than on price, product and conduct control, is analysed. This form of protecting the consumer from the consequences of insolvencies is applied in the UK, the US and in a more rudimentary version in France.

In the UK and the US[9] the continuous supervision of solvency has become part of an early warning system. As long as there are no signs of solvency problems, the regulatory authority does not resort to discretionary intervention into the behavior of individual firms. Only when a business has been classified as being at risk, is direct interference with the management's freedom to act considered. These interventions may consist of the request to increase equity capital, restrictions on the disposal of asset investments, the appointment of a special emissary, as well as the withdrawal of the licence to trade and the initiation of bankruptcy proceedings.[10]

An essential element of an early warning system is the solvency criterion, with which businesses eligible for public interference are singled out. The solvency criterion can be strict or less strict, depending on which deviations of financial ratios from the standard values are still regarded as healthy (or solvent). Accordingly, most impending insolvencies are recognised early if there is a strict solvency criterion. In this case, the likelihood of insolvent businesses being classified as healthy (type I error) is small. However, the likelihood of healthy businesses being classified as at risk (type II error) is correspondingly large.[11]

Some of the arguments presented in the following carry over to solvency control and deposit insurance in banking. However, banking is different for at least three reasons. First, banks are susceptible to runs. Second, bankruptcies of banks destroy less customer-specific knowledge than do bankruptcies of insurance firms.[12] Third, financing the insurance guarantee fund by levies proportional to premium volume shifts the cost of the fund to policy holders (analogous to a sales tax) and thus the beneficiaries of the funds can be made to pay. Such a financing rule is not as easily applicable to deposit insurance.

Principles of solvency regulation and guarantee funds

Most regulatory solvency rules in traditional systems of »material supervision« restrict all businesses' freedom to act, no matter whether they are highly solvent or close to insolvent. A case in point is price regulation. Such restrictions of the freedom to act are ultimately directed at the prevention of insolvency. In principle, they should not go any further than absolutely necessary, since the interventions tend to distort market behavior. The level of intervention should, therefore, not be any more than is necessary to accomplish an appropriate level of security.

Regulatory intervention in business at risk of becoming insolvent has to be viewed in a different light. The restrictions on the freedom to act, for example, can be justified by the acute danger of

[9] Regulation is largely standardised in the US, although there are great differences between individual States in other respects. See Finsinger (1987) and Harrington, S. (1984).

[10] There are states in the USA where the scope of interference is limited to withdrawal of the license and liquidation. However, the management of a business with financial problems may be susceptible to moral suasion in the face of such threats.

[11] Through the analysis of more solvency information or the introduction of more efficient classification criteria, both mistakes can be reduced concurrently to a certain degree. See corresponding stastic methods like, for example, the discriminant analysis.

[12] See Finsinger, J. (1990) for a more detailed discussion.

insolvency. There is a case of unjustified intervention only if a business is classified as at risk but is actually healthy. Such wrong classifications occur more often when the solvency criterion is more strict. The need to avoid unjustified interference in the freedom to act of a business accordingly calls for a minimisation of the Type II error for a given probability of Type I error.

An insurance company's risk of insolvency depends on its capital, its size, the choice of risk categories, the insurance contract clauses, the size of premiums, reinsurance, the composition of the capital investments, its involvement in other business and a multitude of other factors. In addition, the total risk depends not only on the risks of its capital investments and the loss or damage risks (eg. measured by their variance) but on their interdependency (eg. measured by the covariance).

It is difficult to calculate the insolvency probability of individual firms, taking into account all these factors and their intercorrelations. There is a promising theory, but it is far from being applicable to regulatory policy.[13] It is, however, possible to recognise businesses at risk by their business data.

A solvency audit must be designed to enable early recognition of financial problem situations. If the outcome is negative, supervisory measures are started. Therefore the solvency audit can always be seen as a kind of warning system.

Warning systems can work well or badly; they have to be closely monitored. Fortunately, there is hardly any other area of supervision where more innovations have been made possible in the last decade. With the help of computers great amounts of data can be easily processed, insurance companies can be closely observed and better early warning systems can be developed using other statistical procedures. Better warning systems allow earlier and safer recognition of insolvencies and in more than one respect they create more space for freedom of competition.

As a result of the audit, businesses are classified as belonging either to the group of »non-suspicious« solvent businesses or to the group of businesses at risk of insolvency. In the first group as few insolvencies as possible should occur in the course of the coming year. The Type I error ought to be small. Even for another 2–3 years the occurrence of insolvency in this group should be unlikely. Secondly, in the absence of further supervisory measures, as many businesses as possible should become insolvent in the next few years in the group of businesses at risk. In other words, no healthy businesses are to be classified as »sick«, i.e. the Type II error is to be small.[14] To summarize, with the help of the solvency criterion the businesses can be split into two groups: the solvent and the critical.

In the case of a business being classified as risky according to the solvency criterion, the first step of intervention would be to prescribe measures for the prevention of insolvency. If these measures are not successful, the supervisory body would search for an insurer willing to take over the company, which by that time may be insolvent or on the brink of insolvency. Given solvency rules of the EC type, an insolvent company would still be one with positive equity. Hence, the company would continue to have a positive value. Taking into account the large acquisition costs of a portfolio of insured risks, which typically lie in the range between 5 per cent and 30 per cent of the premiums, companies eager to acquire the portfolio would often exist. Only if a takeover could not be arranged, would bankruptcy proceedings have to be started. In a regulatory system with a guarantee fund, the claims of the policy holders would be met out of the fund. As a method of financing the fund, the total sum of fund payments could be apportioned to the insurance companies according to their market share measured in premium volume.[15] The allocations (levies) could be smoothed over time so that they remain approximately constant over the years. The costs of the supervisory body are often allocated to the businesses in the market according to their market share.[16] Chart 2 shows plausible curves of allocation (levy) depending on the stringency of the solvency criterion.

When the solvency criterion is lenient, the allocation (levy) required to fund the bankruptcy guarantee is large. The allocation does not fall much until the solvency criterion reaches a certain critical level. The reason is that one of the most important elements of a solvency criterion, indeed in bank regulation the single most important element, is the minimum capital requirement. When the capital at stake is small, the management of a financial intermediary may find it rational to take high risks in the hope of realizing high returns and thus to restore adequate capitalization. Such a strategy will often fail and lead to bankruptcy. The best example of this effect is given by the recent failures of Savings and Loan Associations in the US.[17]

The experience with insurance guarantee funds in Great Britain and the US shows that under the currently applied solvency rules the probability of insolvencies is small and therefore the allocations

[13] Cf. Cummins, J. D. (1988).

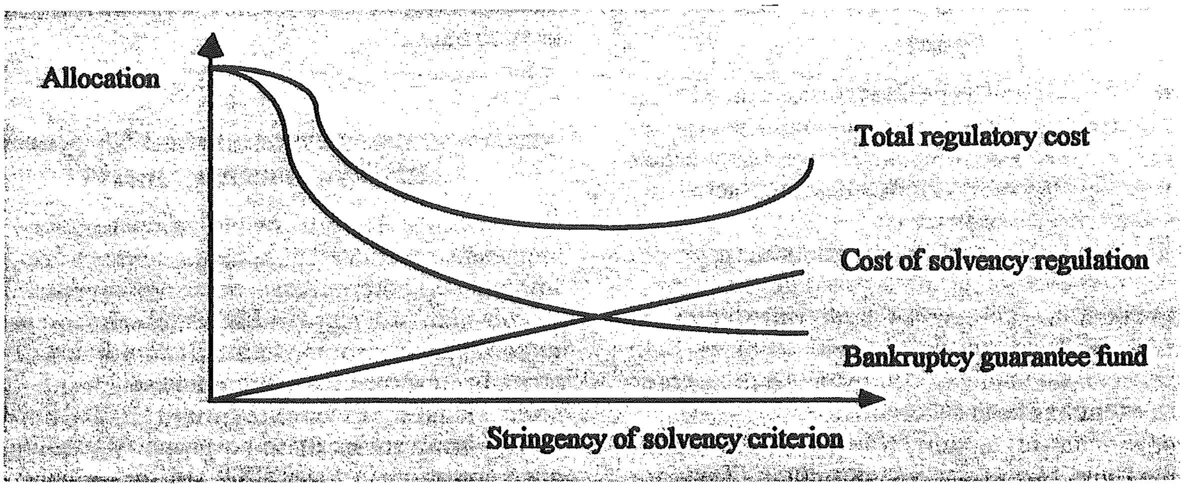
[14] See note 11. Discriminant analysis can be used to find the optimal solvency criteria.

[15] For the advantages and disadvantages of various financing procedures see the descripton of the U.S. schemes in the following section.

[16] In Germany, the costs of the Federal Supervisory body for insurance are financed by up to 90 per cent by the businesses through allocation (See Section 101 VAG). For other countries such a view is still interesting from a welfare perspetive.

[17] Cf. Scott, K.E. (1990) and Finsinger, J. (1990).

Chart 2 Allocation (levy) of regulation costs and bankruptcy guarantee fund depending on the stringency of the solvency criterion



(levies) required for the financing of the guarantee fund are small.[18]

It has been argued[19] that bankruptcy guarantee funds contradict the principles of a market economy, because well-managed businesses have to finance the bankruptcies of badly-managed businesses or those whose prices are too low. This view is wrong, not least because the cost of the bankruptcy guarantee fund is shifted to the policy holders. Thus the policy holders basically pay a premium for the protection of their claims.

In the long run all businesses have to allow for the allocation when calculating their prices.[20] According to well-known theorems, a full shifting[21] of the cost takes place with perfect competition when the supply curve[22] is elastic, or with imperfect competition in an oligopoly when mark-up pricing rules are applied.[23] Put differently, the businesses cannot possibly bear the allocation burden. In a competitive environment they earn the appropriate market return on their investment. This holds in the absence as well as in the presence of bankruptcy guarantee funds.

It is interesting to note that the allocations (levies) can be analysed in exactly the same way as taxes. Consistent with the tax equivalence principle, the incidence of the tax does not depend on the side of the market on which it is levied. The incentives of two parties, and the resulting allocation, would not change if the policy holders paid the insurance premium. In this sense it can be said that policy holders pay for the insurance which covers them in the event of an insolvency of their insurer; policy holders pay for the insurance of their insurance.

It has been argued that guarantee funds may change management incentives to engage in price wars. However, the setting up of a bankruptcy guarantee fund has no direct influence on the interest of business in a solid price policy. The risk of losing their equity capital as a result of ruinous prices is not reduced through the existence of the fund. This is because the fund only settles claims of the policy holder and not of the businesses. The principle of the market economy is not reversed – as is claimed by some insurance companies, the German supervisory body and even some officials of the Commission of the EC.[24] There is only a lack of incentive on the consumer's side. Policy holders select their insurance company with less care, for they are now insured against the insolvency of the insurance company through the bankruptcy fund. Also, more risky firms do not have to charge lower premiums in order to attract policy holders. This is a typical example of »moral hazard«. The solution to this lack of incentive lies in establishing the appropriate »excess« (franchise or co-insurance). Clearly, the excess will not succeed in creating the fully informed customer. But this could not have been the purpose of the excess. For with fully informed customers there would be no need to set up a guarantee fund in the first place.

[18] See the descriptions of the US and UK schemes in the following section. In the US the average levy (allocation) was 0.06 per cent of premium volume. In the UK the levies were even lower on average.

[19] For Germany, see Farny, D. (1987). The Commission of the EU has recently held a similar view and also Angerer (1985).

[20] Contrary to current practice, allocations should not be linked to market shares of the previous year, but only to the current year. Thus the businesses would be burdened equally in proportion to the current turnover.

[21] See Due, J.D., and Friedlaender, A.F., (1981), p. 376 and p. 380.

[22] The supply function of the insurers is regarded as being extremely elastic. As a consequence the thesis of the »unlimited capacity« of supplying insurance has been developed. Critically to this see Finsinger, J., (1988), Chapter IV, pp. 57–60.

[23] This kind of premium calculation is prescribed to West German insurers in important areas by the supervisory body. See Finsinger, J., (1988) Chapter V, pp. 73–75, as well as Finsinger, J. and Kraft, K., (1984).

[24] See Farny, D., (1987), p. 1019.

Experiences with solvency control and guarantee funds

France

In France all price regulations in insurance have been abolished. Until the late 1960s a guarantee fund did not exist. Since then such a fund has been established exclusively for 3rd party automobile insurance; the fund has only been used twice.

The ability to fulfil the insurance contracts is guaranteed in France through an ex post control of the financial decisions. This makes the solvency audit the core of the French supervisory system. Since 1938 there has been no »faillite«. In this sense the ex post control system has been successful.

Solvency control is administered by 30 active controllers and two executive controllers. They are mainly graduates of the elite school »Ecole Polytechnique«. Many of them are mathematicians and actuaries.

The controllers are each responsible for certain businesses and areas. They are therefore able, with time, to gain a great deal of experience. Because of their many years' experience it is not considered necessary, for the time being, to create a system of solvency indicators (financial ratios) which can be used schematically for early recognition. The controllers are not bound by fixed rules for their audit. The frequency and intensity of controls depend on the assessment of the business risk. Although controls are to be carried out at least every 3 years, businesses at little risk are not even controlled every 5 years. On the other hand, up to 3 audits per year are carried out in the case of problem businesses or in branches which incur losses. In some years of crisis, 30 per cent of the market was subject to a »Rapport Complet«.

If the aditors discover solvency problems, they give advice on how to deal with them. The business has to present a »Plan de Redressement«. This plan for convalescence is examined by the auditors. The subsequent management decisions are monitored. If no »Redressement« is possible with these measures, an attempt is made to arrange a »Transfer d'office«. If such a takeover cannot be achieved, the stock of policies is distributed among all companies in the market (»Transfer de Contract«). Any losses associated with these policies can be regarded as the contributions (or levies) of the healthy insurers to the bankruptcy insurance created by this instrument. Thus the setting up of a guarantee fund can be avoided. If such a fund exists at all in third party automobile insurance, it is only because it orginally served a different purpose. It had been created as a safeguard against the demands of those drivers who were not insured or insolvent. Over time the old function lost in importance and the fund was able to take over a new function.

In a typical year like, for example, 1986, two »Plans de Redressment« and one »Transfer de Contract« were demanded by the supervisory body and successfully applied.

Early warning system in the US property-liability insurance market

In the USA the level of public involvement varies from state to state. While some states are almost unregulated, others have price regulation, often of the »file and use« type, which is less strict than under material supervisory systems. It could never be that strict in any case as a comparatively large product variety makes the evasion of price regulation possible.

The insolvencies of some property-liability insurance companies in the USA led to a revival of the discussion about insurance supervision. Some reform proposals were worked out by the legislator. A bill, proposed by Senator Magnuson in 1986, was intended to provide the federal government with significant control facilities. Not only were the insurers' behavior to be centrally supervised, but the federal supervisory body was to be given extensive rights of intervention for rehabilitation or liquidation of financially weak insurers. Additionally, a standard insurance protection system was to be created after the model of Federal Deposit Insurance.

Vigorous opposition formed against these proposals to create a strong supervisory body on a federal scale. Until then, supervision had generally been the individual state's concern. Some states rejected intervention in insurance markets because they believed it was to their advantage to have worked with fairly unregulated markets. Other states had operated with active solvency control, others still put the main emphasis on price control.

Already at the turn of the 1960s, the states began to move away from the tendency of increasing ex ante controls of insurers' behavior. In some states – in the eyes of the legislator – a proliferation of regulations restricted the freedom of businesses.[25] In »liberal« states, though, some strict ex ante regulations existed as well. A less restrictive but at the same time more efficient system of consumer protection was to take their place. The years 1968-74 are regarded as the phase of deregulation. Fifteen states drastically reduced the regulation intensity of insurance markets. An early recognition system[26] for insolvencies with graded supervisory measures was combined with the

[25] However, nowhere has the same regulation intensity been reached as exists in the Federal Republic of Germany.

[26] Originally the system was called »Early Warning System«, later it was referred to as NAIC Insurance Regulatory Information System (IRIS) where NAIC stood for »National Association of Insurance Commissioners«.

setting-up of so called guarantee funds, i.e. funds to protect against bankruptcy.

The early recognition system is based on eleven solvency indicators (financial ratios)[27] which have to be calculated and presented by each business at the beginning of the year. For each indicator, standard intervals are set. If more than 4 values lie outside these intervals, the indicators and other data of the business concerned are examined in detail. This is done at a conference of state auditors which lasts for about 6 weeks, where those businesses which »came to the attention of the auditors« in the previous year are also monitored. The conference takes place in March. The businesses are analysed and divided into three groups. The first group consists of the financially sound businesses. As explained later, the device of the solvency indicators and their standard intervals guarantee that only a few businesses are allocated to this group. The second group consists of businesses which have to be specifically monitored since sooner or later a precarious situation will arise unless the policy of the business changes. The third group consists of businesses which are in need of immediate regulatory measures. The division into groups is not made available to the public.

The measures for the »rehabilitation« (the French call it redressement) of businesses in group three are neither decided nor carried out by state auditors but by the appropriate supervisory body at state level. The mildest form of intervention is a talk with the management. Intervention can, however, involve a continuous supervision of the business decisions or additional audits. The businesses can be persuaded to use rehabilatation measures through »moral suasion« or by threatening to withdraw the permit/licence.[28] In states with price regulation, higher premiums can be stipulated.

Critics of the American supervisory system claim that a rehabilitation or liquidation in many cases does not succeed because these measures can only be enforced through the courts.[29] The courts first demand total certainty about the financial situation of a business before they make possible the enforcement of the rehabilitation measures or the liquidation demanded by the supervisory body. An overall view[30] of the individual state procedures in the case of rehabilitation or liquidation suggests that enforcement of supervisory measures through the courts does not place too heavy a burden of evidence on the supervisory body. After 1978 the criticisms no longer seem valid, not least because 20 states, at the time, accepted the regulations of the NAIC Insurers Supervision, Rehabilitations and Liquidations Model Act, which allowed for certain rights of intervention for the protection of capital investment before the formal enforcement of the rehabilitation or liquidation through the supervisory body.

The selection criterion for the solvency indicators and the basis for the standard value intervals was the likelihood that a business with anormal values became insolvent in the following years. The IRIS Early Warning System was set up in such a way that it recognises insolvency within one to three years. It seems that the prediction accuracy has worsened over the years. Therefore proposals for improvements were developed in a multitude of studies, mainly through the method of discriminant analysis.[31]

What do the guarantee funds in the USA look like? After the judicial »liquidation order« for an insolvent insurer, the claims of policy holders are met except for a small deductible.[32]

Only in the »workers compensation« insurance is the total claim paid. There is an upper limit, though.[33] The deductible is meant to give insurance purchasers an incentive to look for a sound company. The upper limit does not primarily exist for private clients, having been created for the commercial policy holder; as in other areas, he should check the insurer's solvency before taking out insurance.

There has been a long discussion about whether the funds ought to be raised through annual premiums or whether it is sufficient simply to reallocate the pay-out of funds in proportion to the market share of the business. The supporters of »pre-funding« believed that a reallocation among the surviving businesses would not only be unfair, since healthy businesses would be punished twice (once through the loss of business to price undercutters and again through the reallocation as a consequence of the undercutters' ruin) but that the ex-post reallocation might place such a burden on marginal businesses that they found themselves in financial difficulties. The insurers, among others, vetoed the »pre-funding« proposal. They feared abuse of the fund for the purpose of rehabilitation before »liquidation«. Apart from that it was obvious that in the long run the reallocation would be passed on via higher premiums. Later it became clear that the reallocation on average only accounts for half a promille (over 16 years 0.06 per cent)[34] of premium volume. Only once in 16 years has the average allocation accounted for more than one promille,

[27] The solvency indicators are explained in some detail by Harrington, S. and Danzon, P. (1986).

[28] See Harrington, S., and Danzon, P., (1986), p. 18.

[29] See Bailey, R., (1986), and Bailey, R., (1977).

[30] See Alliance of American Insurance, (1986).

[31] See Pinches, G., and Trischmann, J., (1974), Kramer Capital Consultants, Inc., (1976), Aetna Life and Casualty, (1979), Herschbarger, R., (1979).

[32] Originally a standard $100 was envisaged.

[33] At the beginning of the 1970s it was a standard $300,000.

[34] See Finsinger, J. (1988), Chapter III, Part 5. The data from which this average was calculated are contained in Harrington, S. and Danzon, P. (1986). More recent data could be collected and would not show a significantly different picture.

namely in 1975 (1.03 promille). If, therefore, insurers have been in favour of the ex post allocation and still are, the fairness argument cannot carry great weight.

It was rather experts who had been interested in an »insurance of the insurance« via the »pre-fund« solution. Premiums could have been made to depend on the risks of the individual business.[35] The possibility of »having a free ride« at the expense of healthy businesses could be avoided. The only problem was how to determine the individual insolvency risk. An appropriate number would have to take into account the joint distribution of the losses and capital investment risks as well as of the administrative costs. At present, we do not have the means for this; we could only make the premium dependent on the solvency indicators. That, however, would contradict the principle of insurance insofar as the premiums would be linked to the solvency and thus implicitly to the loss experience that is already taking shape. Such a procedure would burden businesses that are already at risk. On the whole, the danger of attaching the premium to the wrong risk indicators would be great. Consequently, this system might have an effect similar to an inefficient tax on certain business dispositions. If the »pre-fund« were to be organised as a private insurance company, a super-cartel epicentre might develop from it. If it were organised on a statutory basis, the cost-benefit analysis of the »risk-based« premiums could have a negative ending: a lot of bureaucracy with little success.

The United Kingdom

In Britain, the level of intervention is low. Regarding the solvency of the insurer, only the control of market access (minimum capital requirements on the EC pattern) and solvency monitoring by actuaries are relevant.[36] There is no price or profit regulation.

Great Britain can be said to enjoy the least regulated insurance market in Europe. In spite of this, company failures do not strain the guarantee fund. Since 1976 only two allocations of bankruptcy funds have been necessary.[37] The first allocation of £ 1 million was raised in 1990 and amonted to 0.0039 per cent of premiums. The second allocation of £ 37.9 million was raised in 1992 and amounted to 0.1487 per cent of the total premium volume. Most of the time the payments made by the fund are recovered from the liquidation of the assets of the bankrupt company. The conclusion must be that the company failures do not affect more than a negligable fraction of total premium volume.

Guarantee funds in an integrated European market

Some insurers and some policymakers argue that guarantee funds are not compatible with the idea of freedom of services and that companies established in nations with such a fund would be disadvantaged.

Clearly, the impact of guarantee funds depends on how they are designed. Suppose they are designed according to the line of argument presented above, as funds protecting the policy holders of the membership companies financed by ex post levies proportional to premium volume.

It could be argued that insurers who are »covered«[38] enjoy a competitive advantage over those who are not. Thus, British insurers exporting policies to the continent, beginninng as of July 1994 with the third generation of EC Directives taking effect, will be able to advertise this safety-net of which they are part. Perhaps, policy holders concerned about the solvency of their insurers will prefer British insurers. As long as the levies are equally raised on the premiums paid by these out-of-state benificiaries of the freedom of service, it cannot be said that the British policy holders subsidize the export of insurance. However, we could speak of an element of competition between regulatory systems in which the British system confers competitive advantage to its companies. Much can be said in favour of letting regulatory systems compete. Only in this way can consumers choose the system they prefer. The market test is possible. The disadvantage of this competitive solution of course is that the guarantee fund levies would not automatically be shifted to the policy holders.

As an alternative one could consider a rule whereby national governments set up guarantee funds as a national affair. Then, exported insurance contracts would not be covered by the guarantee fund system and consequently all insurance companies would compete on the same level in this respect. The price of exported contracts could be lower by the amount of the levy (which during most years is anyway close to zero). Of course, contracts imported into a market with guarantee funds would be covered and the levies would have to be raised on these imports. However, as pointed out above, solvency regulation must be cautious and failures infrequent if a guararantee fund system is established. Given the principle of home country control, countries with a guarantee fund system could not design the early warning system applying to the foreign companies, because they are

[35] Cummins, J.D., (1988).

[36] A comprehensive description of the British insurance markets and the regulation instruments which are applied is included in Finsinger, J., Hammond, E., and Tapp, J., (1985).

[37] To provide the starting capital, a one-time levy at 0.25 per cent of the premium volume was raised initially, in 1975. See Finsinger, J., Hammond, E., and Tapp, J., (1985), p. 27.

[38] Note the confusion: in practice it is policy holders that are covered.

subject to the solvency rules of their home countries. If substantial differences in the actual practice of solvency control persist across the member countries of the EC and if as a consequence companies in countries with insufficient solvency control become insolvent, policy holders of these insolvent companies in countries with a national gurarantee fund system will be compensated. However, all policy holders of this (host) country will pay the corresponding allocation. Therefore, organizing guarantee funds as a national affair might be criticised as facilitating market entry of unsound foreign competitors. However, if solvency control is enforced in a similar way across Europe, bankruptcies will be similarly infrequent. A case in point is Great Britain, which had the least strict regulatory system in the past and nonetheless negligable guarantee fund levies.

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EEA and Insurance in the EFTA Countries

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Despite recent moves towards deregulation, insurance regulation in EFTA countries is still rather comprehensive. It is also strikingly similar, reflecting a common heritage, that of the German model of material supervision. Insurance markets in EFTA countries are clearly more concentrated than the EU average, while profitability is lower. Especially in the Nordic countries, foreign presence is very limited. The adaptation to EEA legislation in insurance will require regulatory adjustments in every EFTA country. The industry specific costs of adjustment appear to be small in the short run. In the longer run, the markets will undergo substantial structural changes which will put an end to the present similarity of the markets.

Introduction

The article aims at answering the following questions. Do insurance markets of EFTA countries have common features setting them apart from other insurance markets, in particular those of EU countries? If so, are these features likely to survive, or will they disappear in an integrated insurance market within the European Economic Area? Will the cost of adjustment to a new regulatory standard be particularly high to some EFTA countries, or will it be comparable to that borne by EU countries? The analysis is based on results from an EFTA project dealing with the impact of the liberalization program »EC 1992« on the services sectors (EFTA [1994]). This project constitutes the first attempt to compare the service industries of EFTA countries using a common statistical grid, the scope of EFTA having traditionally been limited to the liberalization of trade in industrial goods. Despite problems of comparability, the data base compiled in the course of this project is rich enough to permit at least some tentative answers to the questions raised at the beginning.

The article is organized as follows. In the next section, the insurance industry will be described in terms of size in order to see whether there are similarities and differences between EFTA and EU countries. The third section will be devoted to an analysis of regulations governing insurance activities, since the structure of the insurance industry cannot be understood without knowing its regulatory framework. Subsequently, developments in the market structure of the sector will be studied in the light of regulation and regulatory change. Much of this regulatory change, however, constitutes an adjustment to the regulatory regime of the EU. Therefore, insights into the relationship between regulation and the structure of the industry can provide some guidance for the future outlook, the latter being provided in the concluding section.

Insurance in the general economy

As far as private insurance is concerned, EFTA countries form two camps. In the Nordic member countries, its contribution to GDP clearly falls short of 1 per cent, whereas it is at least double in the Alpine member countries (Table 1).[1] At least three factors come to mind for explaining this difference. First, since an increase in income tends to result in a more than proportional increase in the demand for insurance, EFTA countries with a high per capita income such as Switzerland should have large insurance markets. However, Austria had the lowest per capita income of all EFTA countries throughout the 1980s. Second, the Alpine EFTA countries export more insurance services than the Nordic ones. Reinsurance services, which could always be exported, account for

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[1] It is common practice to calculate the »insurance density« by comparing premiums written in a country to its Gross Domestic Product (GDP). As shown in Table 1, this indicator ranges between 3.8 per cent (Iceland) and 8.3 per cent (Switzerland). These figures overstate the importance of insurance, however, because the density indicator compares premium income, which is in good part used for claim payments, i.e. redistribution between the fortunate and the less fortunate, with the GDP, which is the total of value added in the economy. The actual contribution of insurance to total value added in the economy is far lower, amounting to a mere 0.8 per cent in Norway and 0.6 per cent in Sweden. Thus, insurance appears to be slightly more important to the Norwegian than to the Swedish economy.

Too much should not be made of these differences, however, because Sweden's labor insurance may well have been counted as social insurance in the OECD statistics, whereas recent developments are about to bring it back into the domain of private insurance. Inclusion of labor insurance would put the Swedish figure at roughly 0.8 per cent of GDP as well.

Table 1 The size of the insurance industry in EFTA countries 1990

Indicator	Austria	Finland	Iceland	Norway	Sweden	Switzerland	EU (examples)
Premiums GDP	4.9 %	6.9 %	3.4 %	5.3 %	5.6 %	8.3 %	2.8 % (I) 10.7 % (UK)
Contribution to GDP	1.7 %	0.7 %	0.6 %	0.8 %	0.6 %	1.7 %	0.5 % (DK) 1.4 % (NL)[a]
Contribution to GDP, banking	5.5 %	4.2 %	6.3 %	3.9 %	4.9 %	7.6 %	2.2 % (DK), 8 % (P)

[a] Data for UK not available.

Sources: Swiss Re (1993), EFTA (1994), OECD National Accounts, and Swiss National Bank, Monthly Bulletin 8/93

some 24 per cent of premiums domestically generated in Austria and Switzerland but only 18 per cent in Norway and Sweden. Third, judging from the case of Sweden, the Nordic EFTA countries seem to have met the increased demand for insurance predominantly by an expansion of their social security systems, whereas this expansion was much less marked in the Alpine EFTA countries (Sigma [11/87], Streissler [1988]).

In spite of the Nordic-Alpine difference, the insurance markets of EFTA countries are more homogeneous in terms of relative size than their EU counterparts. At first sight, this is astonishing because the EU have long had a high degree of trade integration, the share of intra-Community trade in total volume amounting to some 60 per cent (Jacquemin and Sapir [1988]). This high degree of mutual penetration might be expected to apply to private insurance as well, whose non-life part is closely linked to trade. Moreover, the establishment of common EU insurance regulation has been on the European Commission's agenda for twenty years. On the other hand, and especially if Iceland and Luxembourg are disregarded, it becomes clear that the economies of the EFTA countries are much more similar than those of EU countries, both in terms of GDP and GDP per capita (Gardener and Teppett [1992]) and in terms of regulation, as is shown in section 3.

Finally, a comparison with banking is instructive. The banking sector is typically four times larger than insurance in terms of its contribution to GDP (Table 1), a likely consequence of the fact that there is no social banking but a great deal of social insurance. Possibly for the same reason, the homogeneity of Nordic EFTA countries in terms of their banking industries is less marked, with Iceland coming close to Switzerland, where banking is the nation's single most important industry.

Conclusion 1: If measured by its contribution to the Gross Domestic Product, private insurance is a small industry, accounting for less than 1 per cent of GDP in Nordic EFTA countries and less than 2 per cent in the Alpine EFTA.

The smallness of the insurance industry contrasts with its importance for the functioning of an economy. In fact, insurance systematically influences many decisions taken in the economy. Specifically, it permits decision makers to opt for more risky courses of action, e.g. business investments, in return for higher profitability, thus fostering economic growth (Zweifel [1987]).

Regulation of insurance in EFTA countries

When thinking of regulation, it may be helpful to imagine a stylized product cycle. A firm establishes itself, hires workers and other factors of production, launches a product, sells it at a price, pays taxes, and (hopefully) makes a profit. Each stage of this cycle may be subject to regulation, and is indeed so in the case of insurance (Table 2).

Regulation of market access

In all EFTA countries, a license is required for conducting insurance business, the main condition for its granting being a minimum paid-up capital. At the low end of the range, Norway and Sweden require a capital of some ECU 1.4 million, with Norway having an escalator clause for adjustment to inflation (Blixt [1993], Husevåg [1993]). In Sweden, this applies only to general agencies, established by non-resident companies. At the high end, there is Austria with a maximum of ECU 7 million, which however applies to a composite insurer doing business in all lines, reflecting the fact that Austria has not adhered to the »principle of separation« (Brandner [1993]).

Regulation of factor market

In most EFTA countries, but not in Sweden, an insurance company is somewhat restricted in its filling of top management positions in that the chief executive officer generally has to be a national citizen. In Switzerland, hiring restrictions are much more far-reaching

Table 2 Regulation of insurance in EFTA countries 1992

Aspect	Austria	Finland	Iceland	Norway	Sweden	Switzerland
Market access regulation (paid-up capital, ECU mn.)	1 (needs test) (2–7)	1 (n.a.)	1 (n.a.)	1 (1.4–3.6)	1 (1.35)	1 (2.8–5.6)
Factor market regulation	1	1	1	1	1	1 (quota)
Product regulation	1	1	1	1	1	1
Price regulation	1	0	1	0	1 (motor)	1 (motor)
Taxation	1 (discrimin.)	1 (22 %, NL)	1 (exempt)	1	1	1
Use of profits regulation	1	1	1	1	1	1
Supervisory authority	Ministry of finance	Ministry of finance	Ministry of health and insurance	Financial supervisory authority	Financial supervisory authority	Ministry of the interior

Note: 1 = exists.
0 = does not exist.
NL = non-life insurance.

due to the country's foreign labor policy. Allocation of migrant workers is by administrative fiat rather than the market mechanism, with preference given to agriculture, hotels, and hospitals (see Zweifel & Prioni [1993] for details).

Regulation of product

Again, EFTA countries have been sharing much the same philosophy. In particular, life insurance is to be kept separate from non-life insurance, which makes it easier to check the solvency of a company with regard to a given line of business but does not answer the question of how to proceed with a company that is insolvent in line A but very sound in line B. Austrian authorities, while permitting the combination of life and non-life insurance, retain the right to veto a particular combination.

Regulation of price

Here, Finland and Norway differ from the rest of EFTA countries by permitting price competition in general, which of course does not preclude price fixing by associations. Incidentally, Sweden and Switzerland share an especially elaborate scheme for fixing premiums in motor insurance (Blixt [1993]; Zweifel and Kleeb [1993]), which does not square too well with the consumer protection argument for justifying price regulation because this regulation dates from a time when only the rich could afford to own a car.

Regulation through taxation

Especially in the case of life insurance, tax deductibility of premiums paid and taxation of benefits received determine the competitiveness of insurance vis-à-vis banks as intermediaries for old age provision. All EFTA countries grant preferential treatment to life insurance in at least one of the two aspects. In this vein, the full 22 per cent turnover tax is applied to nonlife insurance only in Finland. Austrian authorities even use taxation to discriminate against insurers operating from outside the country, levying a surcharge of 400 per cent on the sales tax applied to the purchase of their policies (Brandner [1993], p. 3).

Regulation of use of profits

Contrary to a »normal« business firm, a private insurance company must not use retained profits for buying assets as it sees fit. The common standard of regulation is to prescribe fixed shares for certain classes of assets, in particular government bonds, serving the interests of the treasury.

General remark

In all, the similarity in regulatory regimes across EFTA countries is striking. This seems to be due to a common underlying philosophy, the so-called risk community model of insurance that has been quite popular in Germany (Eisen, Müller, & Zweifel [1993]). According to the risk community model, insurance is organized as a co-operative association, charging an equitable premium, with the insured in his capacity of member of the collective ultimately assuming risk-bearing responsibility while being subject to special behavioral obligations. By way of contrast, some of the EU countries (such as the United Kingdom) are closer to the competitive entrepreneurial model, according to which insurance companies are in the market for making a profit, a risk is priced in view of its contribution to the portfolio, and the risk-bearing responsibility lies with the owners of the company, with no special obligations falling on the insured. Since the mid-1980, authorities of EFTA countries appear to be moving slowly toward the competitive entrepreneurial model of insurance, following the lead of deregulation in banking.

Once more, differences between the major EU insurance markets are much more marked than between EFTA markets. In particular, the very tight material supervision by German authorities contrasts with the British system of self-regulation through royal actuaries (Finsinger & Pauly [1986]).

Conclusion 2: Despite recent moves toward deregulation, insurance regulation in EFTA countries is still very prevalent, covering all stages of the stylized product cycle. Moreover, it is characterized by a striking degree of similarity, reminiscent of the German model of material supervision.

There is, however, one interesting difference with regard to locus of regulatory control (see last line of Table 2). Whereas the supervision of insurance is in the hands of the Ministry of Finance in the case of Austria and Finland, authority is vested with a Financial Supervisory Authority in Norway and Sweden. In view of the fact that banking and insurance both constitute instruments of portfolio management for households and firms, their traditional separation in terms of regulation seems above all to be a reflection of regulatory convenience in conjunction with adherence to the risk community model of insurance. In the future, joint supervisory authorities may well serve as the vanguards of a more global regulatory approach.

Structure and development of insurance in EFTA countries

Size and structure of a national insurance market can be described by the number of companies and their average size in terms of premiums generated domestically, i.e. excluding affiliates located abroad. Different regulatory policies leave their traces in this regard. For instance, the slow growth of the number of companies in Austria (item No. 1 of Table 3) should not be misinterpreted as a sign of stagnation. Rather, there is less need to found specialized companies when composites may legally be formed. Conversely, Sweden had relatively few companies back in 1980, reflecting the belief of its regulatory authority that size is associated with lower cost per policy; therefore, market entry was discouraged and mergers were permitted to reap these so-called returns to scale (Blixt [1993]). However, this belief did not appear to be too well founded in the light of research (Skogh [1982]). A more condescendent stance of regulators in matters of establishment has since contributed to a marked growth in the number of companies. Moreover, there is no indication that Sweden's companies have become smaller compared to others in the meantime.

This change of policy is also reflected in a decrease in concentration, measured as the share of the leading four companies in total premium volume (item No. 3 of Table 3). With values between 50 per cent (Austria) and 75 per cent (Iceland), EFTA insurance markets are rather concentrated. In the EU, the largest three companies account for 44 per cent of national life premium volume and 29 per cent of non-life premium volume (unweighted national averages, calculated from Dickinson [1992]). A conservative extrapolation from Dickinson's measure to ours yields 59 per cent and 39 per cent for the EU, respectively. Thus, EFTA insurance markets are more concentrated than their EU counterparts. In addition, they are again rather homogeneous in this respect. In life insurance e.g., shares amount to a mere 20 per cent in the United Kingdom but 70 per cent in Greece.

Conclusion 3: EFTA insurance markets are rather similar with regard to number of companies, their size, and degree of concentration. They are clearly more concentrated than the average EU insurance market, which however should not be taken as a sign of competitiveness.

Since the issue of advantages to size (the so-called increasing returns to scale) preoccupies policy makers in the whole EEA, it is interesting to compare the share of the leading four companies in premium volume (item No. 5 of Table 3) with their share in employment (item No. 4). With the important exception of Sweden, premium shares exceed employment shares in the countries for which data are available, which means that the leading companies generate higher premiums per employed person than the rest. It does not mean, however, that they are more efficient, efficiency requiring optimal use of all inputs. Indeed, a recent Swiss study in that regard, using premium volume as output and labor costs, capital costs, and claims payments as inputs and applying Data Envelopment Analysis (Färe, Grosskopf, & Lovell [1983]), failed to indicate increasing returns to scale among the leading Swiss companies during the entire 1980s (Zweifel & Kleeb [1993]).

On the other hand, an industry characterized by a high degree of concentration may still be very competitive, provided newcomers can enter the market at reasonable setup costs. Regulation almost invariably increases these costs, especially for foreign firms. If foreign competitors nevertheless succeed in attaining a nonnegligible market share, then the market evidently is not really closed in spite of concentration and regulation. Table 3 contains some estimates of the share of the premium volume currently accounted for by foreign competitors (item No. 5). Austria stands out with a share of no less than 44 per cent, mainly due to German firms. Similarly, the 12 per cent in the

Table 3 Structure and development of insurance in EFTA countries

Measure	Year	Austria	Finland	Iceland	Norway	Sweden	Switzerland
1. Number of companies	1992	69[a]	57	29	61[a]	82[e]	136
	(1980)	(64)	(n.a.)	(n.a.)	(88)	(55)	(106)
2. Average size mn ECU	1992	105[a]	45[d]	6	84[a,f]	126[e]	150
	(1980)	(42)	(n.a.)	(n.a.)	(26)	(n.a.)	(65)
3. Sales concentration	1992	50 %[a]	55 %[c]	75 %	69 %[a]	61 %	62 %
	(1980)	(55 %)	(n.a.)	(n.a.)	(49 %)	(70 %)[b]	(54 %)
4. Employment concentration	1992	42 %[b]	n.a.	n.a.	n.a.	ca 65 %	50 %
	(1980)	(50 %)	(n.a.)	(n.a.)	(n.a.)	(n.a.)	(38 %)
5. Premium share of foreign firms SF %	1992	44 %[a]	0.2 %	0 %	12 %	2.2 %	6 %
	(1980)	(n.a.)	(n.a.)	(n.a.)	(n.a.)	(ca 1.5 %)	(5 %)
6. Return on assets	1990	1.06 %	n.a.	n.a.	10.1 %[g]	ca 0 %[h]	2.1 %
7. Variance of return	1980–90	0.05	n.a.	n.a.	3.2	n.a.	0.02

Notes: a 1991.
b 1983.
c S5 instead of S4.
d 40 local insurance clubs and 26 foreign firms represented as agents excluded.
e Figure refers only to companies doing nationwide business; in addition, there are 414 local clubs.
f Total premiums rather than domestically generated premiums.
g Life insurance only.
h Non-life insurance only. According to Blixt (1993), the total investment result neutralized technical losses in 1990.

case of Norway can be traced to a neighboring country, Sweden. Foreign competitors are just about absent from the other Nordic EFTA insurance markets, with Switzerland constituting an intermediate case.

Conclusion 4: While the leading insurers in EFTA countries employ fewer persons per unit premium, the issue of whether this transforms into a global cost advantage is not settled. Until this day, the high degree of market concentration has not been neutralized by the presence of foreign competitors in Nordic EFTA countries.

Not much is known about the profitability of insurance companies. From an investor's point of view, return on equity constitutes the indicator of primary interest. However, insurance companies in several EFTA countries will have to increase their equity base in order to conform with EU solvency margins. Thus it seems more appropriate to use return on total assets as the indicator of profitability, since this measure compensates for differences in leverage that would have to disappear before long under the EEA Agreement.

The scanty available information seems to suggest that shareholders in insurance companies may have a high rate of return on their assets only at the price of a good deal of risk. E.g., the figure of 10 per cent shown for Norway in the year 1990 (see item No. 6 of Table 3) was accompanied by a high variance already in the 1980s, a qualification that could only be reinforced in view of the fate of UNI Storebrand, the market leader of Norway. In the wake of heavy losses on its Skandia engagement, UNI Storebrand had to be placed under public administration (Husevåg [1993]).

At the low risk end of the range, the insurance companies of the two Alpine EFTA countries display rates of return of 1 to 2 per cent. This compares rather favorably with banking performance in a sample of OECD countries, where rates of return on total assets invariably fall short of 1 per cent (Wirth [1993]).

Conclusion 5: While the profitability of insurance companies in EFTA countries cannot be compared to that of EU insurance companies, it is somewhat higher than that of banking in a sample of industrialized countries.

Induced regulatory adjustments

In *non-life insurance*, Nordic EFTA countries still have a few legal provisions that are not in line with the relevant EU directives. In Norway, distinctions between large risks and mass risks and between active and passive cross-border sales will have to be dropped because the Third EU Directive permits direct trade in insurance. Under the EEA Agreement, Sweden and Finland will also have to grant EEA-based companies the right of actively marketing their products without the intermediation of a domestic broker or company. In Austria, the needs test for access to the domestic market will have to be formally abolished, authorities having already abstained from its use for several years. In the case of Switzerland, a bilateral Insurance Agreement with the EU came into force in 1993, stipulating full national treatment of EU companies. This Agreement contains very much the same provisions as the EEA Agreement with respect to insurance. However, it still permits prior approval of general terms and conditions, a clause that may be repealed before very long, e.g. in exchange for application of the EU home country rule to Swiss-based companies.

For these adjustments, there is a transition period of several years because implementation of the Third Non-life Directive by the EU is scheduled for the end of 1994, which amounts to a deferral of the original deadline of the »EC 92« program.

In *life insurance*, the Nordic EFTA countries, with the notable exception of Sweden, still prohibit the purchase of life insurance abroad, a relic from the days of foreign exchange controls that recalls the traditionally close connections between the regulation of insurance and general economic policy. Austria will quite likely see its tax surcharge on the sale of policies by non-established foreign companies challenged. Finland, with its pension schemes farmed out to private insurers, may be asked to admit foreign competitors to this market, although these schemes be considered part of social insurance, which is exempted from the EU Directives on Life Insurance, pursuant the 1987 decision of the European Court of Justice.

Conclusion 6: The completion of the »EC 92« program will require some additional regulatory adjustments by every EFTA country. The industry specific costs of adjustment do not appear to be very large at this stage.

As stated, Conclusion 6 entails a certain risk of understatement. As described in national studies (Blixt [1993], Husevåg [1993]), regulation of insurance interacts quite closely with taxation. Especially life insurance written by a foreign company can be used as a vehicle of tax avoidance, which is of particular importance in the Nordic countries with high marginal tax rates on income. Prior to the EEA Agreement, a government was able to deregulate insurance while having an eye on its domestic tax base. Under the EEA Agreement, home country control takes precedence, enabling foreign insurance companies to act as conduits for capital movements. On a longer run, it may thus be the domestic system of taxation and even social security that has to be adjusted to increased foreign competition rather than the other way round. This also means that the cost of adjustment to be borne might be substantially higher than estimated on the basis of a purely sectoral analysis.

Outlook

Until recently, only *reinsurance* was an internationally traded commodity. The successful completion of the Uruguay Round of the GATT prepares also the ground for global liberalization of *non-life insurance*. This adds to the European integration of insurance within the EEA. Long-run trends emanating from increased economic integration might however take some time to evolve, for several reasons.

First, the freedom of direct cross-border trade is not yet established in the Uruguay Round of the GATT, causing only competition among EEA-based companies to intensify at first. Yet there is no reason why Japanese and U.S. insurers should not follow the lead of their banks before long. In this context, it should be recalled that among the 30 major insurers worldwide, 11 are Japanese (Sigma [1/1992]). Second, even intra-EEA competition will not pick up as quickly as originally envisaged. The group exemptions from the anti-cartel provisions of the EEC Treaty by the European Commission (European Commission, 1993) in fact amounts to a partial delegation of regulatory authority to national associations, who will tend to protect their domestic markets (Eisen, Müller & Zweifel [1990]). Of course, these endeavors will not have the same impact as the previous public regulation, but they can be counted on to slow down the process of mutual market penetration – at an increased cost of adjustment later on.

Barriers to trade are less artificial in the domain of *life insurance*. For some time to come, provision for old age etc. will continue to be provided by social security, whose volume is at least four times as large in Switzerland and may even be seven times as large in Nordic EFTA countries (Blixt [1993]). This implies that private insurance policies must be tailor-made to fill in the gaps left open by social security. For example, some countries impose larger reductions of pension benefits on workers opting for early retirement than others, creating a market for complementary life insurance that is particularly flexible in the time domain. These same differences will hinder the marketing of all-EEA life insurance products in the near future, preventing the new opportunities for direct cross-border trade to fully materialize in the short run. In the more distant future, possible reforms of the social security systems might enlarge the scope for private insurance and enhance the structural effects of integration.

Some of the similarity between EFTA insurance markets will be lost in the longer run. As the experience of the EU suggests, economic integration will serve to accentuate rather than diminish sectoral differences due to the workings of the law of comparative advantage. The enlargement of markets will permit countries such as Austria and possibly Sweden to specialize even more strongly in the provision of financial services in general and insurance in particular. Countries remaining outside the EEA Agreement will have to strive hard to develop a regulatory regime that lowers the cost of doing business sufficiently to render their markets attractive nevertheless. In all, the Nordic EFTA countries will have to bear somewhat larger adjustment costs than the Alpine ones, not least because of their higher level of taxation, but this cost will still be small compared to that falling on some EU countries such as Italy.

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EEA and Swedish Insurance – the Main Impacts

EVA BLIXT*

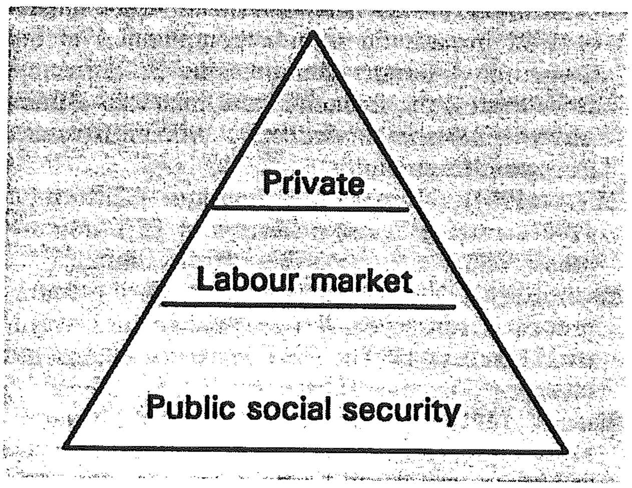
A process of deregulating the Swedish insurance market since the late 1980s, together with the adaptation to the EEA legal system, is affecting the conditions for Swedish insurance companies. The barriers to entering the Swedish market will be subject to withering forces. The immediate effect on market structure is unlikely to be entry by large numbers of companies. Instead, competitive pressure will increase and induce the existing companies to adopt a more competitive behaviour. In the longer run, entry is likely to be more pronounced, leading to structural changes in the insurance market.

Introduction

The legal conditions for the Swedish insurance market will change dramatically in the 1990s, going from a heavily regulated market in the early 1980s, via a partial deregulation in the late 1980s, to an almost totally changed legal framework due to adaptation to the EEA legislation from January 1, 1995. This article provides a broad overview of these legal changes as well as other driving forces, and of their consequences for the Swedish insurance market.

The next section deals with the deregulation process and the main structural changes in the 1980s. Thereafter the necessary adjustments to EEA legislation are outlined. In the final sections an attempt is made to identify emerging trends for the insurance market in the 1990s.

Figure 1 The framework of Swedish insurance



Deregulation and structural changes in the 1980s

Broadly speaking, the Swedish insurance market consists of three sectors, to be compared with the EC's »three pillar system« for life insurance.

The first sector is the public social security system, which includes, among others, old age pension, sickness benefits and unemployment schemes. All public insurance services are organised as »pay-as-you-go« systems.

The second sector is labour market insurance, which provides virtually all employees with benefits supplementary to public insurance such as pension, group life, sickness and industrial injury benefits. These insurance benefits are agreed upon by the parties on the labour market and administered by labour market insurance companies.

The third sector, private insurance, consists of life and non-life insurance as well as reinsurance. The market is dominated by a few large nation-wide groups, each of which handles all kinds of private insurance. Besides these national groups, there is a large number of small local companies. Both private and labour market insurance operate according to the »premium reserve principle«.

In the 1980s, the relative size of the three sectors hardly changed, with over 80 per cent covered by public insurances. The analysis in the following concentrates on the second and third sectors, unless indicated otherwise.

The markets for labour and private insurance, being subject to a comprehensive regulatory system that encouraged co-operation among companies, were shielded by rather efficient barriers to entry in the 1980s. These barriers, being higher for life insurance than for non-life insurance, led to an oligopolistic market structure with rather homogeneous prod-

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ucts. A notable exemption was reinsurance, which was practically unregulated and already then internationally traded.

In the 1980s some barriers were lowered, both legal and other more implicit barriers. Initial deregulatory moves came in the first half of the 1980s, with some amendments to the Insurance Business Act. The deregulation then gained momentum around the turn of the decade, aiming at a more competitive market, partly in view of a possible future EC membership. Most important was the abolition of a needs test in 1985, which tended to lower the regulatory barrier and paved the way for new companies, both Swedish and foreign, and the introduction of unit-linked insurance in 1990.

As a result the number of Swedish nation-wide (both life and non-life) companies increased sharply, from 53 in 1985 to 89 in 1992, including seven unit-linked companies, which illustrates the earlier conserving effects of the legal system.

The rules concerning access for foreign companies were hardly altered during this period. At the outset, the regulatory framework in that regard had a superficially liberal appearance. Foreigners were allowed to acquire domestic companies or establish general agents, provided they deposited securities with a Swedish bank. Cross-border trade was also seemingly open, Swedish citizens being free to buy foreign policies on their own initiative.

Nevertheless, the incentive to acquire Swedish companies was low, since domestic life insurance companies were not allowed to distribute profits. In addition, a majority of the domestic companies, both life and non-life, were mutual, not being for sale due to their associative statues. Also, foreign companies were not allowed to establish branches or actively to market their products from abroad.

As a consequence, foreign presence remained limited throughout the 1980s. The total number of foreign companies today is 14 (twelve general agents and two subsidiaries) compared with 15 in 1980. All are non-life insurance companies, and their market share fluctuates around 2.5 per cent, increasingly held by EC companies during the 1980s.

Adjustments to EEA legislation

The forthcoming EEA integration will bring increased opportunities to trade insurance cross-border as well as increased opportunities for establishment from abroad. In particular, the EC's principles of home country control, single licence, mutual recognition and harmonisation of essential rules will have to be applied. In order to identify the full range of adjustments that are needed in Swedish legislation and regulation to adapt them to the emerging EEA legal system for insurance, the present account starts from the situation on January 1, 1990.

Some EEA legislation has already been incorporated into Swedish law since that date. The 1990 Insurance Brokers Act incorporated national provisions for insurance brokers. Unit-linked insurance was also introduced in 1990. The three Directives on civil liability in respect to motor vehicles have been largely implemented by amending the Motor Traffic Damage Act. A general bill covering all the Directives that are part of the EEA Agreement is due to be passed by Parliament in 1994. This bill and other forthcoming legal changes imply a far-reaching reform of Swedish insurance legislation, although still not providing all the necessary adjustments to EC legislation.

Single licence and home country control. Authorisation of insurance companies within the EEA will be governed by the principle of a single licence. This will permit an insurance company to do business throughout Western Europe, under either the right of establishment or the freedom to provide services cross-border. An insurance company still has to obtain authorisation in the EEA state which is its home country. But branches and agencies of authorised companies are treated as integrated parts of those companies and may be established throughout the EEA without a separate licence. In accordance with the principle of mutual recognition, it will also be possible to sell insurance in another EEA country without establishment, that is, to carry out cross-border trade.

Under the Swedish provisions, an authorisation is granted provided the planned activity is not deemed to be incompatible with a sound development of the insurance system. As this rule cannot be said to exclude some assessment of need, it will probably have to be modified to comply with the EC's fundamental principle of freedom of establishment. Moreover, in 1990, establishment from abroad was allowed only in the form of subsidiaries and general agents (Table 1). The Act concerning the right of foreign insurance companies to conduct insurance business in Sweden therefore has to be amended so that companies in the EEA countries do not face more stringent requirements than Swedish companies.

In 1990, cross-border trade was still restricted in that, without an establishment or co-operation with a broker or a Swedish insurance company, foreign companies could not actively market their policies in Sweden. In the EEA the insurance companies will be free to market their policies cross-border, as will be the case in the EC from mid July, 1994.

As said above, the EEA introduces the principle that participating countries recognise each other's regulations. At present, the supervision of all insurance business in Sweden is carried out by the Financial Supervisory Authority. Foreign subsidiaries and general agents will continue to be supervised by this authority. Under EEA rules, however, the home

Table 1 Access to the Swedish Insurance market

	January 1 1990	In the EEA
1. Establishment through:		
General agent*	Yes	Yes
Subsidiary	Yes	Yes
Branch	No	Yes
Agency*	No	Yes
2. Cross-border trade	Yes**	Yes

* An agency is a general representative permanently resident in a host country. A general agent, under Swedish law, is an agency that is required to deposit a guarantee. In the EEA, no distinction will be made between a general agent and an agency.

** Passively, i.e. without active marketing. Otherwise through brokers or intermediating Swedish companies.

country authorities supervise branches and agencies of their insurance companies and thus supersede the Swedish authorities. In the forthcoming legal framework, the Swedish supervisory authorities will accordingly play a subsidiary role as regards those affiliates.

Minimum harmonisation of essential rules. To avoid negative effects of applying the principles of single licence and home country control, such as »competition through rules«, the EC legislation contains provisions on minimum prudential standards for the scope and size of technical provisions, investment rules for those provisions, solvency margins, and guarantee funds. These rules apply to both life and non-life insurance companies.

Technical provisions in the EC include every form of bonus to which the insured is entitled. The Swedish definition of technical provisions includes only vested bonuses. In order to comply with EC standards, technical provisions in Swedish life insurance companies may have to encompass the allocated bonuses.[1]

Investment rules for technical provisions in the EC concern diversification, spread, localisation of assets and currency matching. The basic rule prescribes that the mix of asset categories must match the maturity profile and other undertakings of the insurance business. To satisfy this principle, almost all kinds of asset are accepted as cover for the technical provisions, provided they give good risk diversification.

In 1990, the Swedish legislation had no rules for matching or for risk diversification. For Swedish insurance companies only some categories of asset were permitted for covering technical provisions. An adjustment to EC rules will mean allowing new types of asset such as shares and foreign investments of all categories. The investment rules for life insurance companies will be more liberal[2] and more oriented toward risk management. For non-life insurance companies, these legal changes mean more regulation. The only investment rule that applied to them in 1990 was the five per cent rule, which limited an insurance company's ownership in another insurance company to five per cent of the total voting rights.

The EEA investment rules also prescribe caps on shares for a particular asset category and propose limits to the size of holdings in one entity or in a certain asset. The above-mentioned liberalisation will to some extent balance these caps. In 1990, no such restrictions existed in the Swedish legislation. One of the EEA caps concerns insurance companies' large exposures to mortgage bonds issued by housing finance institutions and some Swedish insurance companies will exceed the cap. The EC has, however, agreed to a transitional period up to January 1, 2000.

Assets must also be localised within the EEA and the national legislator is forbidden to specify in which EEA country to localise them. In addition, rules for currency matching and localisation of assets apply.[3] Swedish life insurance companies were prohibited from investing in foreign assets in 1990, with the exception of assets covering commitments in foreign currency. In the new regime, assets covering the technical provisions can be located anywhere in the EEA.

Solvency margin is defined in the EEA as a margin that an insurance company must maintain to provide against business fluctuations. The directives contain detailed regulations for the calculation of the margin, which varies with the nature and extent of the insurance business. The margin consists of paid-up share capital, retained profits and free reserves. With the present definition of technical provisions, Swedish companies have no difficulty in meeting this requirement. With the forthcoming redefinition of the technical provisions (i.e. larger provisions and thus smaller free reserves), difficulties may arise, at least in a transitional period.

The *guarantee fund* represents a minimum capitalisation requirement that insurance companies must possess before obtaining authorisation to conduct business. If this fund falls short of a minimum requirement, it constitutes a signal to the supervisory authorities to intervene. Introducing this rule in Swedish legislation will facilitate the Swedish supervisory authority's control of solvency.

[1] If so, the technical provisions would then amount to 90-95 per cent of the official balances of the life insurance companies, compared to roughly 65 per cent in 1990. For non-life insurance companies, they would include about 60 per cent of the balances.

[2] At least for the part of assets assigned to the technical provisions, according to the traditional Swedish legislation.

[3] Not more than 20 per cent of technical provisions may be placed in currencies other than the currency in which the commitment is to be met.

Factors affecting developments in the 1990s

An attempt will be made to identify the effects of West European integration on the structure of the Swedish insurance industry. The adaptation to the EC's legislative framework is, of course, only one of several influences on the industry. The account therefore opens with a brief look at the broader group of driving forces, namely socio-economic developments and legislative changes in general. As a rule, their effects on market structure are not possible to describe separately as they affect each other as well as the structure.

Considerable *demographic changes* are foreseen in Sweden, as in most EEA countries, including a significant increase in the retired relative to the working population over the coming decades. Social security reforms can also be expected, with the result that some administrative systems are transferred either to the parties on the labour market or to the insurance companies.

Economic development affects insurance companies in several ways. The recession that began in 1989, for instance, has slowed the growth of premium income compared with the early 1980s and impaired returns on assets. Together with the financial crisis, this has contributed to low insurance profits. In the years ahead it seems likely that the economic recovery, instead of accelerating into another prolonged boom, will resume the historical pattern of milder ups and downs. This will put increasing demands on asset management, since mistakes will not be disguised by rising asset prices as readily as in the 1980s, prior to the recession.

Adaptation to EC legislation is likely to contribute to increased internationalisation in the 1990s. In particular, the EEA Treaty reduces barriers to entry for both foreign companies in Sweden and Swedish companies abroad. The EEA drive towards a single licence is likely to accelerate the pace of change. The insurance industry can be expected to review its policies and strategies in the light of new opportunities of operating throughout the EEA and the threat from increased competition. In addition, the adoption of the EC's prudential standards will have an impact on asset management in the companies.

Domestic legal changes in the Swedish legal framework are already taking place and will no doubt continue, particularly in response to the above-mentioned demographic trends. In addition, the deregulation process will continue to affect insurance companies. In a more deregulated environment, as in the United Kingdom, the industry's profitability has fallen in some cases to levels only one-third of the profits earned in a regulated environment, as in Germany (Mutch, [1993]). Insurance companies are increasingly aware of the new environment they are likely to face and have begun restructuring operations, e.g. by cutting operating expenses in order to maintain profitability.

Among domestic legal changes affecting the industry are also the authorities' ambition to open the pension savings market to banks and mutual funds, which will have substantial impacts on the life insurance markets. Moreover, there are effects of possible changes in tax rules for Swedish insurance companies, such as taxation of returns on pension retirement schemes and capital policies.

Emerging trends

Given these factors affecting the development of the insurance industry, future trends can be discerned. These trends will be discussed under three headings: contestability, market structure, and opportunities.

Contestability.[4] In the 1990s, further deregulation, related directly or indirectly to EEA adaptation and to other foreseen changes in the legal system, is likely to continue lowering the barriers to entry. This process had already started in the late 1980s. With this adaptation, it will be easier to trade cross-border. More cost-effective means to establish a presence on the Swedish market are also being introduced in the EEA context. In addition, the EC legislation does not, in general, permit agreements that reduce competition. In the long run this is likely to have a considerable impact on the domestic Swedish insurance market.

EEA integration will afford opportunities to trade insurance cross-border, since it will allow active marketing in Sweden by non-resident companies. At least in the short run, non-life mass risks will no doubt continue to be traded mainly locally, influenced by local differences in legal systems, different currencies, buying preferences, and other remaining barriers favouring domestic suppliers. However, cross-border trade is likely to increase concerning risks that require less administration and claims adjustments, like standardised policies in life insurance and large, commercial risks in non-life insurance.

In this context, differences in tax systems are affecting Swedish life insurance companies in competition with foreign companies' cross-border sales. In several EEA countries, taxes on the return on assets allocated for life insurance are considerably lower than in Sweden. The Swedish tax system may lead to a continued reduction of demand for capital policies (policies without favourable tax treatment, see below) offered by domestic companies. This trend was already evident in the late 1980s and is likely to be reinforced. »Competition through taxation« may

[4] See Baumol et al. [1982] for a presentation of this concept.

eventually lead the authorities to lower the tax on returns on assets reserved for capital policies.

This would reinforce the competitiveness of Swedish life insurance companies at home as well as abroad (through cross-border trade). In contrast to this, tax deductibility for premiums for retirement pension schemes paid to resident companies (policies with favourable tax treatment) has the effect of sheltering life insurance companies in Sweden from competition from cross-border trade, even though the returns on assets reserved for this kind of policy are taxed at 10 per cent. This element of the tax system, being compatible with the EEA Agreement, is expected to remain.

The increased cross-border trade in large commercial risks has to been seen in the light of looser ties between commercial customers and domestic insurance companies. These customers are already looking more actively for the best alternative among a broader range of suppliers. Liberalised in July 1991, industrial insurance in the EC has displayed an increasing price competition. After joining the EEA, the Swedish industrial insurers may increasingly be subject to this harsher competition as well.

The EEA Agreement also implies increased opportunities for direct investment from abroad. The principle of a single licence does away with the need for authorisation when establishing branches. This principle also renders it unnecessary to deposit funds when entering the market with a general agent, from an EEA country. Indeed, the concept of general agent is likely to disappear, arising anew in the form of agencies proper.

Acquisitions of existing Swedish firms from abroad would, however, continue to be of little interest as long as the Swedish articles of association and the principle of no dividends remain unchallenged. At present, with the exception of unit-linked companies, Swedish life insurance companies are not allowed to pay out any dividends to the shareholders regardless of the form of organisation. Introducing the solvency and asset management rules prescribed in the EEA legal system and an abolition of the prohibition to pay out profits would open the way for profit-making stock companies, possibly leading some Swedish companies to become incorporated in the true sense of the word. This might induce acquisitions or mergers, e.g. to cover the North European market with larger groups with a presence throughout the region.

Affecting the desirability of establishment in Sweden would also be a possible extension, to resident branches, of the deductibility of premiums paid for retirement pension schemes. If so, branches might become a prominent way of organising the provision of life insurance services from abroad, supplementing to some extent the cross-border trade and the intermediating functions of agencies, brokers and claim adjusters.

Other factors tend to reduce barriers to, above all, domestic entry. These include the abolition of the needs test, the introduction of unit-linked insurance and the opening up of the market for pension savings to banks and mutual funds, all of which represents a changed supervisory attitude to competitiveness in the industry. The authorities are also trying to increase transparency by facilitating the comparison of performance between Swedish insurance companies. As of 1993, Swedish insurance companies are thus obliged to publish solvency information at regular intervals.

Until recently, only pension retirement schemes provided by life insurance companies were tax deductible, which was a competitive advantage compared to other financial institutions in Sweden, as well as to foreign insurance companies. From January 1994, the deductibility is extended to pension savings schemes (capitalisation products) offered by banks, funds or securities brokers. This faces Swedish life insurance companies with keener competition from non-insurance companies for the long-term savings in pension insurance. Although the overall market potential can be expected to grow with this reform, one can foresee increased pressure on the underwriting results for life insurance companies.

To sum up, the barriers to entering the Swedish insurance market will be subject to a multitude of withering forces. The immediate effect is unlikely to be entry by a large number of contestants. Instead, at least in the short run, there will be an increased awareness of this threat among the Swedish companies, inducing them to adopt more competitive behaviour. In the longer run, entry is likely to occur, with intensified cross-border trade and competition. This will eventually lead to structural changes, through market exit, mergers, acquisitions, etc. Thus, lower barriers pave the way for new configurations on the insurance markets. The full scope of these future events is naturally obscure but an effort is made below to identify some developments that seem plausible in the light of past experience and the new opportunities and pressures discussed above.

Market structure. An important consideration concerning future changes is the insight that the insurance market will not develop uniformly over the short and long term, the various segments being subject in different ways to changed contestability and to new market opportunities.

Substantial changes in the *life insurance market* can be expected within the next few years. The introduction of pension savings in banks and mutual funds on the insurance market implies an expansion of pension saving mainly in the direction of bank deposits or managed funds, to the detriment of traditional pension insurance and partly that of unit-linked insurance. The Swedish market for capital insurance might continue to shrink through increased cross-border trade, due to tax differentials and modes for tax evasion. In the longer run, some establishment of foreign life insurance firms seems likely, especially if tax deductibility of premiums paid to retirement pension schemes is extended to branches of foreign companies.

The Swedish *non-life market for mass risks* is more mature than the Swedish life insurance market. Incentives for entry by foreign companies do not seem to be strong. The Swedish general public will continue to buy Swedish non-life insurance products, since neither tax nor other incentives seem to give a strong impetus to cross-border trade, particularly as brand loyalty still is considerable.

The *market for large risks* is already subject to strong competition and rather internationalised. This, together with the industrial customers' efforts to find »alternative coverages« like self-insurance, pools, and captives, is likely to lead to a smaller market segment for the existing domestic insurance companies, possibly even forcing some of them to exit the market.

For the *reinsurance market*, the adaptation to EC legislation will not involve any changes. As reinsurance has always been internationally traded, this market will be much less affected than life and non-life insurance.

As a consequence of increased cross-border trade, insurance companies can be expected to enlarge their *co-operation with brokers* to reach larger groups of customers and lower distribution costs. Brokers are also likely to receive more requests from customers to find the most suitable insurance policy within the EEA. Thus, brokers will play an important role for the internationalisation of the market. Increased cross-border trade also raises the issue of claim adjustments, since policies sold cross-border usually require settlement of the claims in the policy holder's country of residence. Therefore, we are likely to see the *establishment of independent resident claim adjusters*; this need is probably enhanced by non-life customers' preferences for domestic contacts in this regard.

The *major nation-wide insurance companies* will not stand idly by as their business is being dispersed in the wind of change. The diminishing returns on assets during the recession and financial crisis, together with the competition from unit-linked funds and, soon, the pension saving schemes in credit institutions, are causing companies to increase the transparency of and improve the methods for asset management. One can also expect continuing efforts to increase the overall efficiency of those companies.

In this context, the introduction of EEA rules prescribing diversification of assets covering the technical provisions may lead to increased flexibility in the composition of assets. At the same time, the »free funds« with an unregulated composition, are likely to become smaller. The improved conditions for appropriate asset management are likely to put insurance companies in a better position to compete with banks and fund managers.

As one result, the management of risks can be expected to become more comprehensive, with increased attention to various market and credit risks inherent in the companies' assets, in addition to the insurance risks traditionally monitored by actuaries. A continued slimming of administrative expenses can also be foreseen in order to maintain competitiveness.

As to business strategies, earlier, more active efforts by the large insurance companies (i.e. groups) to diversify into other segments of the financial market from 1991, by acquiring banks, finance companies and other institutions, have come to nought during the recession and financial crises. Instead, a more defensive form of financial broadening can be seen in response to increased competition in the pension market. The larger insurance companies will strive for special solutions to consolidate their earlier acquisitions and to face the competition from credit institutions. For instance, some insurance companies have recently started a bank so as to be in a position to participate in the market for pension savings.

A possible threat to these larger companies would be increased competition from companies concentrating on specific market segments or niches, such as a particular product, customer group, or distribution channel. Recent analysis reveals that most of the top-performing companies in the EC are »niche companies« (Mutch, [1993]); these companies have lower cost structures than the larger entities, because they concentrate on the most profitable market segments. The large Swedish companies seem to be burdened by the size and complexity of their business activities. This posed no threat to their viability in the former regulated system but could be a competitive drawback in the new business environment. One can foresee efforts by some of the large companies to »mirror« the behaviour of niche companies by weeding out relatively unprofitable product segments and reorganising themselves into »multi-niche companies«.

Opportunities. Of this long list of possible outcomes, almost all seem to point to increasing competitive pressure on the existing companies. At the same time, the future offers these companies new possibilities.

The EEA Agreement affords Swedish companies greater opportunities of establishing operations abroad or selling policies cross-border. Most of the Swedish companies seem, at present, to be concentrating on the domestic market, although a few companies may go on expanding on the international market through their existing subsidiaries. In the longer run, it is not unlikely that Swedish companies will again seek to expand abroad, as they began to do before the financial crisis.

Another opportunity is opened by the demographic changes and reforms of the social security system. It is now generally recognised that the existing public pension and health insurance schemes, together with other public insurances, are an increasing burden on the public budget and will have to be reformed in the near future. Old age pension as well as other public insurance services are likely to be partly transformed into private solutions.

We may thus witness a supply-driven shift of responsibility away from public insurance towards private schemes with private insurance increasingly encroaching on the public territory. In addition, increasing uncertainty about the future of public systems is already tending to boost the demand for supplementary private insurance as well as private savings. All in all, it can be expected that the potential for products providing retirement income will grow substantially for life and labour market insurance companies.

This reform will result in an increased market potential, to be realised by the insurance companies. This might also result in a greater number and variety of enterprises, both life as well as labour market insurance companies. Thus, the future insurance system might change in shape and public and private insurance become more equal in importance.

Conclusions

The 1990s will lead to both new opportunities and increased competitive pressures, with a changed market structure as a result. A reformed social security system is likely to lead to new business opportunities for the Swedish nation-wide insurance companies, both life and non-life as well as labour market insurance companies. At the same time, barriers to entering the Swedish market are being lowered, through adaptation to EC legislation and domestic legal changes. Swedish companies are likely to meet more competition from abroad even in the short run. Contestability from domestic credit institutions will also grow after the recent introduction of tax deductible pension schemes. This will tend to force the existing companies to adopt more competitive behaviour, thereby further weakening the traditional co-operation among firms in Sweden.

The lower barriers to entry will pave the way for new configurations on the insurance market. New contestants in the form of banks, have entered the pension market. Also, if the deductibility of pension insurance premiums is extended to foreign branches, foreign life insurance companies may well establish in Sweden for the first time. In the light of increased cross-border trade, there might be an increased demand for brokers as well as for independent claim adjusters.

The large insurance groups will not be inactive during this process. They are likely to reduce operating costs and also to increase the transparency of policy conditions and asset management, the latter encouraged by new investment rules. These new rules might also pave the way for better risk management, which would strengthen the competitiveness of these insurance companies against new pension market contestants such as credit institutions. In addition, some large insurance groups are starting banks to further improve their position relative to these institutions on the pension saving market.

There is also likely to be room for niche companies specialising in specific market segments, which poses an additional threat to the larger companies. The latter may then try to react by rethinking their product strategies and even possibly by reorganising into »multi-niche« companies.

Over time, the EEA Treaty will open up the markets in other countries, since the Directives and the increasing mobility of people within the EEA will make it possible to market standard policies over a wider group of countries. This, together with a necessary recovery after the financial crisis, could rekindle strategies for internationalisation in the large insurance groups.

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The Future of the Swedish Insurance Industry – Structural Changes and the Regulatory System

GÖRAN T. HÄGG AND GÖRAN SKOGH*

As a result of adaptation to the EEA legal system governing insurance, regulation and supervision by the Swedish authorities will become less geared towards preventing insolvencies in insurance companies and more towards identifying and administer them. Structural changes in the industry are expected to be extensive, especially in consumer insurance that is not yet internationalised. The Swedish insurance industry is not altogether prepared for the new conditions and might run into difficulties during the restructuring process.

Introduction

This paper analyses the expected impact of European integration on the Swedish insurance industry. In the following section we briefly present the former and prevalent Swedish regulatory system. Then we discuss the expected changes in the regulatory system and, in the fourth section, the expected institutional transformations. Finally the comparative advantage of the Swedish industry is analysed.

The Swedish regulatory tradition

The Swedish tradition in regulating the insurance industry is similar to that of Germany. The Supervisory Board has had a strong position. The aim of the regulation has been to maintain market stability, consumer protection and market efficiency, as conceived by the authorities.[1] At an early stage, priority was given to market stability and consumer protection at the expense of market efficiency.[2] The main measures included solvency control, narrow limits for new products and prevention of extensive structural market changes.[3]

The regulations can be classified in codified rules, guiding principles and self-regulation. *Codified rules*, such as the statutory rules in the *Insurance Business Act*, cover business restrictions, rules of establishment and regulations on prices, products, investment and solvency.[4]

The implementation of the codified rules has traditionally been based on practice and *guiding principles*. The guiding principles, which express regulatory intentions and govern overall regulatory policy, have been said to agree with the codified rules.[5] Likewise, self-regulation was accepted as long as it was in harmony with the principles.[6] Hence, regulation is actually more comprehensive than the codified rules would suggest.

The guiding principles gave far-reaching authority to the Supervisory Board. The Board had a broad set of instruments to prevent insolvencies and bankruptcies. It had authority to intervene on vague grounds concerning a variety of variables, such as the size of the company, trends outside and inside the company, foreign business, stock of debts and assets, reinsurance, solvency, contracts, premium calculations and dividends to customers.[7]

The power wielded by the Board may, however, be questioned. The rules were vague and thus difficult to interpret.[8] Far-reaching regulation requires substantial information – information that the Supervisory Board did not possess. Lack of information made the

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[1] See for example SOU 1991:2, p. 16.

[2] See for example Gabrielsson, (1987) p. 11.

[3] The objective of market efficiency was embodied in the guiding principle of reasonable prices. The principle was an expression of the belief that the supervisory agency was able to supervise and steer the pricing process of the insurance contracts in the interest of the consumers. See for example SOU 1946:34, p. 35; regeringens prop. 1948:50, p. 248; and SOU 1986:8. The principle was later extended to comprise reasonable contract terms, SOU 1961:11, p. 336.

[4] The codified regulation is described by Skogh (1986), and Blixt (1993).

[5] For a brief survey, see Blixt (1993).

[6] See for example Skogh and Samuelsson (1985).

[7] See SOU 1986:8, pp. 195–202.

[8] Examples are the principle of need and the principle of reasonable prices. See SOU 1983:5 and SOU 1986:8.

supervisors dependent on co-operation with the industry, with a risk of them becoming more or less captured by the industry's interests. For instance, the industry's preference for limits to entry and for a peaceful market also became the interest of the board.[9] This tendency was reinforced by the conceived main task of the board to maintain consumer confidence in the market.[10] Uniform products and stable growth thus became a common interest for the industry and the Board.

One consequence of regulation was concentration. Today, a few large insurers dominate the Swedish market. The market share of foreign insurers diminished during the post-war period from around 10 per cent to 2 per cent today. Another effect of the regulation was uniform products and vertically integrated distribution. Independent brokers were not permitted until 1988. Administrative costs appear large by international comparison.[11] The efforts to obtain a stable market were successful, however. for decades there were no bankruptcies in Sweden.[12]

The future regulation

Sweden has, under the EEA treaty, to abide by the EU rules, including minimal solvency rules, a single licence system with the right of free entry, home-country control and the right of free cross-border provision of service. A certain amount of self-regulation will also be permitted within the EEA. The group exemption from the EC treaty 85(1) grants the industry an opportunity to co-operate on premium tariffs, statistics, standard policy conditions, common coverage of certain types of risks and common rules on testing and acceptance of security devices.

Other principles will presumably soon be established. One is on *portfolio diversification* applied to assets of the technical provisions. Another principle may be one of *internal control*, aimed at strengthening the responsibility of board-members. Such a principle may also be used to increase the responsibility of actuaries and auditors regarding the timely reporting of mismanagement. A third principle may be a *principle of disclosure and responsibility* that would require companies to present information in a form that policy-holders, brokers, other companies and supervising authorities could evaluate.

Adapting to EEA rules

Adapting to the European legislation gives rise to considerable changes in relation to Swedish standards, affecting the role of the Swedish regulatory body. The position of the current supervisor – Finansinspektionen – will be weakened. It may become harder to control the industry in detail before financial distress or insolvencies appear. It will not be possible for the supervisor to adhere to the traditional use of the guiding principles, developed and interpreted in close connection with the industry.[13]

The home-country principle makes it possible, within limits, to maintain Swedish standards of solvency, business separation, reasonable contract terms and claims adjustments for firms based in Sweden. However, the opportunity to maintain anti-competitive regulatory practice is strongly limited, for at least two reasons. First, if the regulation is considered to conflict with the EU rules on competition, action may be taken in the EU Commission or the EU court. Second, the regulatory practices may harm the Swedish industry's ability to compete relative to foreign insurers.

Some supervision specifically directed to domestic insurers may, however, still be used to strengthen their competitive position. For instance, guiding principles may be used in a way that increases the credibility of the domestic insurance industry. This could be done, for example, through larger solvency requirements than the minimum EU standard.[14] Public control of contract terms as well as of claim settlements may also be used to increase the trust of Swedish consumers in Swedish firms.

Consequences for regulation

The market will not forgive mismanagement, misguided strategy and investment, insufficient internal control, excessively optimistic business strategies or unduly risky asset strategies when the protective regulation is suspended. The ongoing deregulation of the Swedish economy has already resulted in bankruptcies, primarily related to the financial crisis. Three credit insurers have gone bankrupt recently. Bankruptcies will also be probable in the future, both by Swedish and foreign insurers. Dynamic efficiency

[9] See Skogh (1982).

[10] See for example SOU 1991:2, p. 22.

[11] See Finsinger & Pauly (1986).

[12] Bankruptcies have not been common in Sweden during the twentieth century. Only one life-insurance giver, Kronan, fell in 1913. The bankruptcy was caused by high administration costs, adventurous real estate business and internal schisms, Bergander (1967), p. 361; and Englund (1982), pp. 56–57 and p. 60. Several life insurance companies were in financial difficulties during the first half of the 1930s, but were saved by support from the remaining life insurance providers co-ordinated by the Supervisory Board, Grip (1987) pp. 59–71.

[13] It is now apparant that a critical discussion of several of the guiding principles is in the offing. For example the official report from Försäkringsutredningen would like to repeal the principle of sound development of the insurance market (SOU 1991:89, pp. 194–199). It also argues that solvency control should be restricted to the minimal rules of the EC directives, (pp. 154–162). However, in the view of the minister of finance, it is possible to maintain more restricted rules and a more extended solvency regulation than the EC rules demand (Prop 1992/93:257, pp. 116–118).

[14] Equity that generates yields is a cheap way to increase the insurance companies' ability to survive different types of crises.

requires new firms, mergers, closures and sometimes bankruptcies.

It is not in the interest of the consumers that public authorities strive to prevent bankruptcies entirely. As long as customers' claims are covered by the assets of the firm, insolvency is not usually a problem for the insured.[15] The coming EU rules will normally be sufficient to guarantee claims of policy holders.

Nevertheless, there are situations where regulations may fail to protect the policy holders. One such instance is misleading information, frauds and other crimes. Rules concerning disclosure of information will not eliminate the problem of delayed dissolution of insolvent firms.[16] Financial problems may be hidden for a long time by companies in the hope that the problems will be solved. The willingness to increase risk-taking tends also to grow during times of financial distress.[17] These problems should, therefore, not be underestimated. The experience with insolvencies that harm the policy holders shows that the cause is often mismanagement together with misleading information or criminal behaviour.[18] It is, therefore, most important that the national control and supervisory systems are organised efficiently.

Another reason why the policy holders' claims cannot always be protected is the case of large dependent risks. As far as the liabilities of the insurer are concerned, the problem is normally solved by diversification of the portfolio, and by reinsurance. Undiversified risks on the asset side may, however, cause serious solvency problems due to, e.g., national or international crises. For instance, the market value of the insurers' assets was greatly reduced in Sweden in the early 1990s due to sudden structural changes in the economy. The recent recovery appears to have solved this problem.

Regulation cannot protect policy holders from losses during serious financial crises, war or political disorder. The primary task for the supervisory agency is therefore to maintain the credibility of the insurance business under relatively normal economic conditions. That can be done reasonably well by implementing the EU system of regulation, by information collection and by the control of crime, i.e., mostly by *ex post* reactions to insolvencies – including reconstruction of businesses in financial distress.

[15] In mutual firms where the policy holder is also an owner, the situation is, of course, different.

[16] See »O'Sullivan« (1993) regarding the problems of auditing insurance companies in Great Britain.

[17] See Scott (1989) concerning the bankruptcies of the Saving & Loan banks during the 1980s.

[18] See for example Finsinger et. al. (1985), pp. 153–161; and Scott (1989). The bankruptcy of the credit insurance company Njord is a Swedish example of possible crimes that have preceded bankruptcy, SOU 1992:30.

The future insurance market will be more complex and dynamic, with more entries and exits. While the former supervisory process aimed to *anticipate and prevent insolvencies*, the emphasis in the future will rather be to identify fraudulent behaviour and to *administer insolvencies*. The main assignment will, to some extent, shift from ex ante control to reactive interventions concerning problems that have arisen in the industry.

Institutional aspects of insurance

The Swedish, as well as the European, insurance industry is facing important structural changes, due to EU regulation, the financial revolution and new information technology. All these changes tend to result in a more competitive market. Competition will increase for most mass-risks, i.e. consumer insurance. Large industrial risks, as well as reinsurance, are already competitive and international. The discussion in the following will concentrate on consumer insurance. Prior to assessing the industry's ability to adapt to the new environment, some institutional aspects of insurance are discussed in the present chapter.

Business lines

Mergers of banks and insurance firms, as well as the formation of financial »super markets« or »Allfinanz«, have initiated a debate on the viability of various separated business lines. We believe that traditional areas of business, such as property, liability and life insurance, will continue to exist.[19] Banks, guarantors and credit insurers will maintain their specialised interest in business risks, while property and liability insurers will concentrate on accident risks.

One reason for this division of labour is that accident risks differ from business risks. By insuring a large number of similar low probability events, the insurer obtains information about actuarial relations between damages, presence of safety devices, levels of deductibles, and costs of various claim settlement procedures. Accident risks involving water, storm, traffic, and fire have much in common, and their claims-adjustment procedures are similar. The common features and similarities in risk assessment and claim adjustment are important sources of economies of scale. It is often advantageous for the insurer to transact a whole bundle of contingencies by the purchase of a single property and liability policy. These circumstances indicate that property and liability insurance will remain a specific line of business in insurance.

[19] See Skogh (1991).

Similar arguments apply for life insurance. The stable nature of mortality and disability risks makes actuarial information mainly a public good. One obstacle in the assessment of mortality rates is the fact that the insured often knows more than the insurer does about his/her own health status. This informational asymmetry increases when the insured is older. As long as the insured is relatively young, expected claims may be calculated from observable factors such as age, sex, health, etc., which explains why most life-insurance and pension schemes are based on long-term contracts. Claim settlement is simple relative to property and liability insurance – there are usually no question about whether a person is dead or has reached a certain age. The life-insurance policy's character of a long-term contract contributes to the accumulation of large funds. The life-insurance firm, or fund, is usually a mutual institution. One explanation is the problem of estimating the long-term value of the assets. A system with stock companies and nominally fixed life-insurance contracts would result in large insolvency risks, as well as very large potential profits. Therefore, the risks are shared by the policy holders.[20]

The characteristics of business risks, accident risks and risks of life and death thus indicate that the areas of credit, property, liability and life insurance will persist. This is supported by the fact that these specialities exist in all market-oriented systems, independent of the regulatory system in specific countries.

Integrated or separated production of services?

In the typical Swedish insurance firm all activities from risk assessment, contract design, marketing and distribution to administration of funds and claims settlement are performed within the company. The services could be separated, of course, and executed by independent producers. Risk calculation and design of contracts could be executed by one firm, settlement of claims by a second, distribution and marketing by a third, fund administration by a fourth and the bearing of the risk by a fifth party. Economies may be exploited by contract. For example, reinsurance represents a well-established method of utilising the economies of pooling and brokers separate the distribution from the insurer. Hence, survival on a competitive market is not necessarily a question of comprehensive provision, but rather a matter of co-operation, services, cost-efficiency and channels of distribution.

We expect some integrated firms to break up in the future. One reason is that regulation does not favour them anymore. Another is that splitting up the insurance business will simplify cross-country services. Albeit, the saying »business is local« is relevant in marketing. Local information is also important in the settlement of claims. Risk calculation, design of mass contracts, the administration of the funds, and the bearing of risks can, on the other hand, be executed internationally.

Brokers and agents will open the national market to foreign companies, and Europe to domestic companies. The industry no longer has full control over the distribution channels. In addition to own distribution channels, there are brokers, banks, retailers, labour unions and others. This gives European companies the possibility to sell mass risks, both within the property-liability and the life area, via brokers, organisations, retailers, national insurance companies and banks. It may be argued that the Swedish customers are conservative and will thus remain loyal to the Swedish firms. If so, European companies may co-operate with Swedish insurers, or purchase established domestic companies.[21] Hence, it is not necessary for foreign firms to establish their own expensive distribution networks on the Swedish market, and vice versa.

Adaptation to the new environment

The former regulatory process had created and underpinned a structure of the industry that now appears to be inefficient.[22] Administrative costs are relatively high. marketing and distribution are expensive. The ability to adapt to new needs, to innovate and to increase productivity has been curtailed. The new environment with price and product competition is still relatively unfamiliar to most of the established industry.[23]

The view prevailing until recently was that insurance is a mature industry with limited options to innovate. For many years, market growth came from the increase in wealth and the demographic structure. Fine-tuning of large-scale distribution of mass insurance was regarded as a main source of further success. However, the recent changes should be sufficient to support the opposite view, i.e., that the structure of the industry will change and develop rapidly. Indeed, the insurance industry is still a young business – many risks are still uninsured.

The view of insurance as a mature business may be a sign of the industry's inability to anticipate future possibilities and future threats. Thus, it is unlikely

[20] This is also the case for unit-linked insurance, where the policy holder owns shares of the fund.

[21] See for example Woolcock et. al. (1991), pp. 92–93.

[22] See Roos et. al. (1980); Rinsinger (1989): and Rinsinger & Schmidt (1993).

[23] A sign of this is that the established companies on the Swedish insurance markets lose market share to both independent brokers, foreign insurers, banks and newly established specialised insurance companies.

that the established industry will be in the forefront of this structural development. The change will presumably be initiated by other financial intermediaries and from foreign insurance companies utilising cross-border services. Moreover, firms outside the industry will develop insurance, or insurance-like products. Risk management and captives are already established mainly by outsiders. Prepaid services like health care, or plumbing and leasing contracts including insurance are already in the market. The established insurers have not offset lost market shares with new products. For instance, banks have been more successful in distributing insurance services than insurers' have been in selling bank services.

The Swedish insurance industry has the advantage of a well-established domestic reputation. Insurance is a trust-sensitive form of contract.[24] It is, of course, difficult to forecast the ability of foreign insurers to establish a similar trustworthiness in Sweden. However, if credibility can be tied to domestic brokers or distribution networks, it will be easier to outweigh the advantage of the Swedish industry.

What are the main issues?

We have painted a picture of an increasing number of foreign insurers in Sweden. Swedish insurers will also be more involved in international affairs. The reinsurance business, the insurance of large risks and the capital market are already largely international. Financial administration and claim settlement services may be farmed out to some extent. We also expect firms that are traditionally external to the insurance industry to take over parts of the business. The tendency to distribute via banks, real estate agents, brokers, etc. will continue. Other industries will also be providing insurance, or insurance-like services, such as risk and captive management, pension fund administration and prepaid services like health care and car finance. Note that the specialisation of the insurers along the business lines of property and liability, credit and life insurance will remain because of the difference in the insured risks, as explained above.

These developments will on the whole benefit customers. Nevertheless, along the way there will be financial difficulties, insolvencies and bankruptcies, due to competition, mismanagement, failed strategies and crime. Provided that the regulators are able carefully to monitor developments, this will not be a major problem for the customers in ordinary times. Bankruptcies, including losses to policy holders caused by major financial or political crises cannot, however, be fully eliminated by regulation.

It is in the nature of internationalisation to reduce national regulatory power. The Swedish government will have to adjust taxation to international levels, and supervision will have to submit to international standards. The loss of power may for political reasons be negative *per se*. However, from an economic point of view, nationalism has no specific value.

The demand for insurance will presumably increase. Unloading some of the public sector's »overload« will create a large potential for insurance business as a substitute and complement to social security. Innovations may also open up new areas of demand. Hence we expect an increasing insurance business in Sweden, supplied by Swedish and international insurers in complex networks.

What really matters from a Swedish economic point of view is the extent to which the demand for insurance services will be met in Sweden. Will Sweden be a net importer or exporter of insurance services? Will the insurance business flourish in Sweden or will we be an European backwater?

One argument in favour of the Swedish industry is that specific local information is important and that the Swedish public is conservative and not easily won-over by foreigners. This may be true, but only temporarily. Foreign insurers may overcome the resistance by using Swedish distribution channels. In the long run, price and service differentials will become known, and demand for specifically Swedish insurance will decline.

Another argument is that the long tradition of co-operation between the industry and the Supervisory Board has maintained credibility for firms with home-country regulation in Sweden. A counter-argument is, of course, that Swedish regulations cannot continue to maintain this co-operation without conflicting with the EC rules, which would result in complaints from foreign insurers, and corrective measures from Brussels.

A third argument is that the industry's labour force is skilled and well prepared for the future. That may be true of specific employees, especially those that have been active on the international market, but not in general. The industry has for decades mainly recruited personnel directly from high-school (except for lawyers and a few engineers, actuaries and economists). Training is mainly internal. Such a system may create loyal employees with a knowledge based on the older generation's experience. It does not, however, encourage creative experimentation and development of new products. This, as well as the long regulatory tradition, could have led to the view that insurance is a mature business. Innovations in risk management, captives, unit-linked insurance, etc. have usually originated outside the insurance industry.

The winners on the future market will not base their success solely on cost-efficiency and specialisation. They will also build on knowledge, competence and creativity. An open international mind and under-

[24] See Hägg (1993).

standing of customers' needs and expectations will be essential. Training in business administration, financial economics, contractual economics and law will also be of importance. In Sweden, however, there is no training at university level directed towards future or current employees in the insurance industry (except for actuarial science and law). There is nothing compared to, for instance, the specific university training for the agricultural and engineering sectors or the university education and research in the fields of construction, architecture and real estate. Moreover, the research and development units in the large insurance firms are rather samll compared with similar units in, for instance, the manufacturing, health-care, pharmaceutical and weapons industries or in banking.

Conclusions

The Swedish regulatory system is now changing from substantial national regulation to a more deregulated system that is common to all EEA-countries. The structural changes will be extensive, especially for consumer insurance that is not yet internationalised. The all-inclusive insurance firm, comprising distribution, risk assessment, fund administration and claims adjustment, will tend to split into components of a contractual network, parts of which might be international. However, we expect the business areas of property, liability, life and credit insurance to remain as basic areas. The influence of the Swedish regulators will diminish and to a large degree change from *ex ante* anticipation and preventive regulation, to *ex post* regulation. The future monitoring of the industry will mainly be directed towards the identification of misleading information, fraudulent management and the administration of insolvencies.

The Swedish insurance industry is poorly prepared for the new situation. We argue that the future insurance industry will be knowledge-intensive. Traditionally, however, the industry has recruited personnel without higher education. Insurance training is mainly internal. The system has fostered loyal and able employees, but has failed to encourage the development of new businesses. Research and development are lacking. We therefore foresee that difficulties lie ahead for the Swedish insurance industry.

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