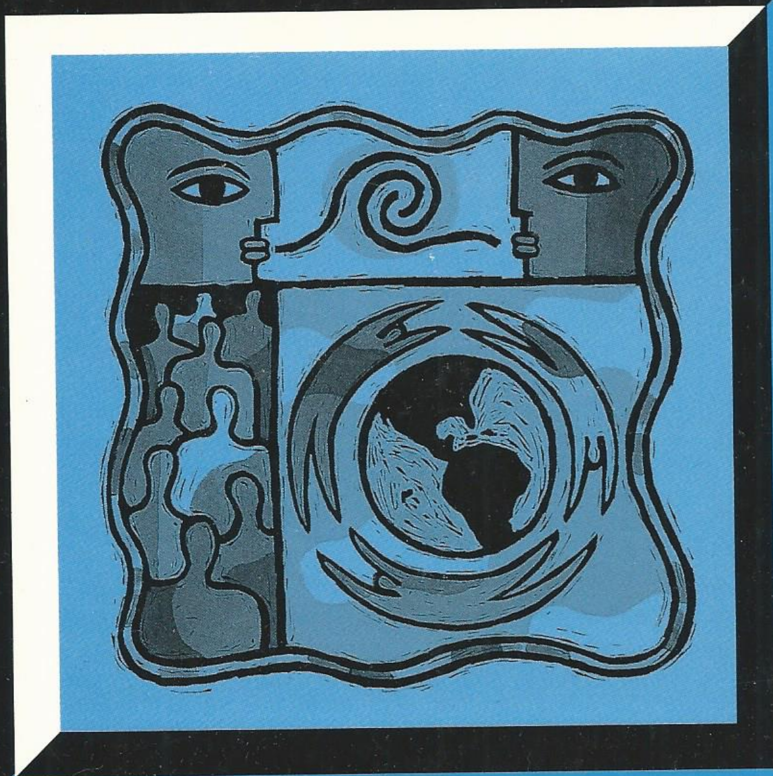
International Risk and Insurance

An Environmental–Managerial Approach



Skipper

CHAPTER

7

INTEGRATION AND GLOBALIZATION OF FINANCIAL SERVICES

Andrew F. Giffin
Tillinghast-Towers Perrin
Bryan Clontz
Boys and Girls Clubs of America

The authors acknowledge with appreciation the helpful comments and suggestions of Jean-Pierre Daniel of CAPA (France), Alan Leach of Datamonitor (UK), Michael White of International Bank Consultants (USA), and Peter R. Wilde of Wilde Associates (USA).

Introduction

Changing customer needs, more knowledgeable and demanding consumers, new technology, liberalization, deregulation, and a combination of other forces are blurring the lines between financial products, institutions, sectors, and countries. Regulators are responding to market pressures by allowing more intersectoral competition. Banks, securities firms, insurance companies, and other financial intermediaries increasingly compete with each other by offering similar products and services and by entry into fields previously reserved for one sector only. At the same time, many traditional financial institutions, products, and service delivery methods are in decline worldwide.

The preceding chapter explored certain elements of financial risk management convergence. This chapter builds on that conceptual discussion by covering financial services integration and globalization. We first examine the scope of financial services and then the factors driving integration and globalization. Next, we consider important international variations in the regulation of financial services. We conclude by exploring the public policy issues associated with financial services integration.

The Scope of Financial Services

The Nature of Financial Services

Financial intermediaries are firms or other operators that bring together the suppliers and users of funds. In economic terms, their outputs include the "manufacture" of financial services, called financial intermediation, and supporting services such as risk assessment, administration, and marketing. Ancillary services such as financial counseling, credit cards, brokerage, trust management, and the like also may be included. A financial intermediary may not actually manufacture (underwrite) all of the financial services that it sells. Some sell (distribute) the services of other firms, as when a bank sells an insurance company's policies.

Most traditional financial intermediaries are engaged in **portfolio intermediation**; that is, issuing a contract (e.g., demand deposit or insurance policy) to suppliers of funds and using the funds to purchase securities or make loans. Expense coverage and profit depend on the **spread** between interest rates earned on the investments and those credited to fund suppliers. More direct, lower-cost forms have replaced much of portfolio intermediation (e.g., mutual funds). This competition has forced many intermediaries to reduce expenses to maintain profit levels. Many also are expanding into related, fee-based services.

Traditionally, financial services have been delivered through financial outlets dedicated primarily to one sector. Even where common ownership existed, institutions remained separate due to regulatory restrictions, tradition, or practical operating considerations. In many contemporary markets, however, the walls of separation are crumbling. This section examines financial services by reviewing their sectoral definitions and functions.

Table 7–1 The World's 25 Largest Commercial Banks
(As of December 31, 1995)

Company (Ranked in Asset Order)	*(in US$ millions) Assets*	*(in US$ millions) Capital*
Sanwa Bank (Japan)	$516,481	$17,926
Deutsche Bank (Germany)	506,291	25,736
Sumitomo Bank (Japan)	504,245	29,879
Dai-Ichi Kangyo (Japan)	496,421	29,197
Sakura Bank (Japan)	487,411	24,859
Fuji Bank (Japan)	470,583	25,640
Mitsubishi Bank (Japan)	469,920	27,859
Crédit Agricole (France)	386,378	25,140
CS Holding Group (Switzerland)	358,513	14,824
Industrial Bank of Japan (Japan)	356,577	19,649
HSBC Holdings (UK)	354,786	32,500
ABN Amro Holding (Netherlands)	341,538	20,865
Dresdner Bank (Germany)	339,442	15,576
Crédit Lyonnais (France)	339,391	19,021
Union Bank of Switzerland (Switzerland)	334,491	23,801
Société Générale (France)	326,034	17,731
Banque Nationale de Paris (France)	325,223	19,676
Industrial and Commercial Bank of China (China)	316,678	10,539
Bank of China (China)	301,368	12,361
Westdeutsche Landesbank (Germany)	296,689	12,422
Commerzbank (Germany)	279,327	14,431
Tokai Bank (Japan)	278,126	13,094
Asahi Bank (Japan)	273,524	14,234
Long-Term Credit Bank (Japan)	273,058	17,268
Barclays (UK)	263,286	17,082

Source: *Institutional Investor*, Aug. 1996, pp. 75–79.

Commercial Banks

Commercial banks are financial intermediaries that take in funds principally as short-term deposits and make them available as personal and commercial loans. Table 7–1 lists the world's 25 largest banks. Japan is home to 10 of the top 25, with France and Germany tying for a distant second with 4 each.

Commercial banks have been established at national and local levels to service businesses and individuals.[1] Thus, they serve as major personal depository and transactional institutions, using personal deposits as a basis for extending business loans.

[1]This section draws on Blommestein (1995).

Banks have added a range of services for business use (e.g., export finance, letters of credit, payroll services, and sometimes securities underwriting) and for personal use (e.g., trust and brokerage services). Many commercial banks formerly relied primarily on local branches for collection of deposits from individual customers. As spread margins declined, local branches were expanded to include a variety of traditional banking and related services, including personal loans, credit cards, and insurance. Through this expansion, banks may generate additional fee and other income to replace declining spread income.

Commercial banks also play a major role in implementing national macroeconomic policy under the supervision of a central bank or other regulatory agencies. They also provide clearing services for various forms of funds transfer. These activities have allowed commercial banks in some countries to dominate the national economy.

A great variety of limited-purpose banks exist worldwide. For example, savings banks are devoted to personal, local community banking services (e.g., personal savings and mortgage lending). Commonly known as **building societies** in the United Kingdom and **thrifts** or **savings and loan associations** in the United States, they are financial intermediaries that operate almost exclusively to loan funds for the purchase of houses and flats. These smaller banks, often with local franchises, contribute to the fragmentation of banking markets.

Some of these thrift institutions are among the largest banks in their markets (e.g., CARIPLO in Italy, La Caixa in Spain). Recently, they began consolidating, forming larger, more powerful banks. In the United Kingdom, the building societies are also consolidating and converting to broader-range banks. Financial services legislation of the mid-1980s in the United Kingdom expanded powers and permitted conversion from mutual to stock forms. One of the largest building societies, Abbey National, converted to a commercial bank and now offers a range of diversified financial services. Through deregulation and expansion, U.S. thrifts suffered a precipitous decline in personal savings due to new competitive factors such as money market mutual funds.

Investment Banks

Investment banks are financial intermediaries that bring together investors with the issuers of securities.[2] They are involved more with direct intermediation than with portfolio intermediation. The world's 25 largest investment banks (securities firms) are shown in Table 7–2. The United States and Japan are each home to nine investment banks with the United Kingdom home to six. Investment banks perform five key functions: underwriting, investing, market making, trading, and custodial servicing.

The underwriting function involves both the packaging and pricing of new debt or equity issues for a government or corporate client. Once packaged, the securities are sold to investors by means of a public or private offering. For this service, the bank can be remunerated in a number of different ways (e.g., best efforts, firm commitment).

The investment function entails managing assets for institutional investors (e.g., pension or mutual funds) or private investors. Institutions and individuals purchase this service

[2]This section draws on Sanders and Walter (1994).

Table 7–2 The World's 25 Largest Investment Banks, 1995

Company (Ranked in Asset Order)	*Total Assets (in US$ millions)*
Salomon (US)	$188,428
Merrill Lynch (US)	175,841
Morgan Stanley (US)	143,451
Nomura Securities (Japan)	124,151
Lehman Brothers Holdings (US)	115,303
Travelers Group (US)	112,093
Daiwa Securities (Japan)	53,637
Paine Webber (US)	45,671
Yamaichi Securities (Japan)	42,215
Nikko Securities (Japan)	36,560
SG Warburg (UK)	32,556
SunAmerica (US)	16,844
Gerrard & National Holdings (UK)	16,274
Kleinwort Benson Group (UK)	14,252
Charles Schwab (US)	10,532
New Japan Securities (Japan)	8,123
Kokusai Securities (Japan)	8,101
Smith New Court (UK)	7,022
Sanyo Securities (Japan)	5,674
Wako Securities (Japan)	5,289
Kankaku Securities (Japan)	5,227
First Marathon (Canada)	4,952
Lazard Frères (UK)	3,553
Quick & Reilly (US)	3,522
King & Shaxson Holdings (UK)	3,420

Source: Worldscope®/Disclosure®, L.L.C.

in the belief that the bank possesses the necessary investment acumen required to outperform benchmark indexes.

The market making and trading functions are similar in that both involve transactions on the secondary market. While market making, the bank acts as either agent or principal. Acting as an agent, the bank is a conduit of a trade, receiving fees or commissions for the service. When a bank assumes the role of the principal, it holds an inventory position in the underlying securities. This is an important distinction from a risk management standpoint because the bank bears the risk of future price fluctuations. The trading function is a permutation of the market-making principal relationship, comprised of complex analyses of various markets (e.g., position and program trading, and pure and risk arbitrage). The custodial function of an investment bank includes services in connection with mergers and acquisitions as well as research and settlement faculties.

Many investment banks have retail subsidiaries (brokerage houses) that service clients through a network of financial consultants (stockbrokers). These vast distribution networks market their companies' products and services primarily to upper-income individuals worldwide.

In the United States, investment and commercial banking were separated by law following the stock market crash of 1929 and the ensuing Depression. This separation was achieved in 1933 through legislation in response to widespread securities manipulations of that era. In most other countries, separation is not mandated, but is practiced through tradition. Recent marketplace developments worldwide have added pressure to eliminate this separation.

Insurance Companies

Earlier chapters discussed the nature of insurance and insurance companies, so our treatment here is minimal. In exchange for a premium, insurance companies allow individuals and businesses to transfer to them the financial consequences of uncertain losses resulting from defined perils.

Life insurance offers payment assurance of a fixed or variable sum in the event of death. Insurance can also serve as a means of savings. In most life insurance markets, the savings aspects of products are more important than the protection components. Nonlife insurance offers protection against property losses, exposure to liability, accidental losses, and a wide range of special exposures. Many insurers are shifting to more direct intermediation forms, such as the issuance of variable (unit trust) products and institutional investments placed in separate accounts.

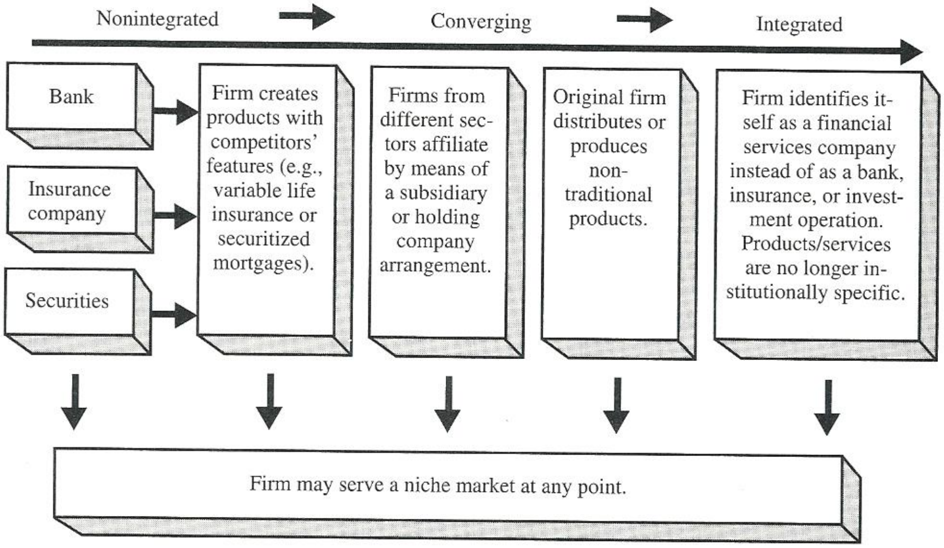
Insurers are important financial intermediaries worldwide. This intermediation infuses significant amounts of capital into both developed and developing countries. The world's 25 largest insurers were shown in Table 4–3 in Chapter 4.

Other Financial Intermediaries

Several other specialized financial intermediaries exist. For example, **credit unions** offer depository and personal loan services, typically at places of employment and for specific geographic groups. **Mortgage banks** provide securities for mortgage funding and package groups of mortgages for subsequent sale.

Mutual funds, known as unit investment trusts in the United Kingdom and UCITS in the European Union (EU), gather funds from investors in exchange for mutual fund shares, investing the money in specified stocks, bonds, government obligations, savings bonds, and other instruments. Mutual fund managers earn revenues as a percentage of managed assets. As previously mentioned, banks earn revenues on the spread between loan interest earned and demand deposit interest paid. Because mutual fund investors assume the risks of return variability and default, the capital cost is approximately one-tenth the cost of managing the spread business of banks and insurers. This is one of the competitive advantages claimed by direct intermediaries because portfolio intermediation involves greater risk and capital cost. Thus, money market mutual funds can offer higher yields than competing bank savings accounts.

FIGURE 7–1
Financial Services Integration Continuum



Financial Services Integration

Financial services integration occurs when financial products and services traditionally associated with one class of financial intermediaries are distributed by another class of financial intermediaries. **Financial services convergence** is the tendency of financial products and services traditionally offered by one sector to take on characteristics traditionally observed with products or services of another financial services sector. Convergence occurs through customer demand across traditional sector lines. Examples include the introduction by insurance companies of variable (unit linked) life and annuity products that contain both insurance and securities features. Another burgeoning area is the banking industry's creation of securitized mortgage and corporate debt portfolios, which involves packaging a group of mortgages or other loans into marketable securities that are sold to investors.

As banks, securities firms, and insurers construct products and offer services that resemble the features of their competitors, product convergence will be an important driving force toward financial services integration. Figure 7–1 illustrates this chain.

Financial Services Consolidation and Globalization

As pressures build for convergence and integration, existing financial institutions link operations.[3] In most countries (e.g., the United Kingdom, Spain, and Singapore), there has been little impediment to common control and direction of different types of financial institutions. In others (e.g., the United States and Japan), however, regulation has restricted

[3]This section draws from Koguchi (1993).

consolidation efforts. Tradition and the limitations of paper processing have tended to maintain the separation even where permitted.

Potentially significant benefits can be derived from consolidation through a more efficient allocation of resources. Consolidation allows for possible economies of scale and scope. These economies, in theory, can be parlayed into increased profitability, primarily from leveraging their respective distribution channels. We cover these benefits in greater detail later in the chapter.

At the same time, many policy makers believe that consolidation and conglomeration will give rise to new public policy issues. Regulation, therefore, is considered essential to safeguard the public against various risks, as discussed in a subsequent section.

Financial Services Conglomerates

We define a **financial services conglomerate** as a firm or group of firms under common control which offers financial services that extend beyond the traditional boundaries of any one sector. The two most commonly discussed arrangements are *bancassurance* and universal banks.

Bancassurance

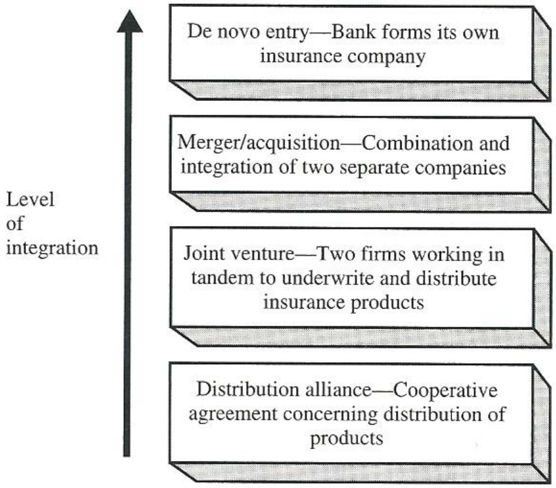
Bancassurance and ***allfinanz*** describe arrangements—that is, de novo, merger/acquisition, joint venture, or marketing alliance (see Figure 7–2)—between banks and insurers for the sale of insurance through banks, wherein insurers are primarily responsible for product manufacturing (production) and banks are primarily responsible for distribution.

Customers continue to discover nontraditional, more efficient ways to achieve savings and protection goals (e.g., money market funds, equity mutual funds, tax-advantaged retirement savings plans). Therefore, banks and insurance companies have reduced their spread margins substantially to compete for savings. In the United States, for example, spreads for banks and life insurers some years ago were in the range of 6 to 7 percent. In recent years, however, competition has reduced spreads to 0 to 2 percent.

Both banks and life insurers have tried to reduce their vulnerability to narrowing margins. Banks have sought more fee business, such as compensation for the sale of mutual funds, life insurance, annuities, and other forms of insurance. Life insurers have expanded into products that shift the investment risk to the customer (e.g., unit linked or variable life). Both intermediaries are trying to leverage major investments in distribution capacity by adding products, including those outside their traditional core. Banks have four primary entry methods into insurance as illustrated in Figure 7–2. Of course, insurers can similarly enter the banking business, although the reverse is the more common. Tables 7–3 to 7–6 profile companies using these methods.

In some cases, banks have garnered significant market shares as a result of windfall situations. In France, for example, favorable tax treatment of certain life insurance products allowed banks to offer simple, tax-advantaged savings products with minimum life contingencies through their own life companies. Crédit Agricole's Predica became France's second largest life insurer in less than 10 years. In Spain, bank sales of life

FIGURE 7–2
Various Insurance Entry Opportunities for Banks



Source: ©Tobias Hoschka. From *Bancassurance in Europe* by Tobias Hoschka. Reprinted with permission of St. Martin's Press, Inc.

insurance prospered as individuals avoided taxation by shifting taxable bank savings funds to tax-favored insurance products. These transfers slowed considerably when Spanish tax authorities enacted similar tax policies for both banking and insurance products. Experiments with bank-based insurance in the United States date back at least to the late 1960s (apart from the specialized savings bank life insurance in the states of Massachusetts, Connecticut, and New York which began in the early 1900s).

Banks have been most effective selling insurance products that are similar to their traditional savings business (e.g., annuities) or that complement other bank products (e.g., mortgage life insurance). They have been much slower to adapt their distribution systems to accommodate more complex combinations of savings and protection. During the 1980s and early 1990s in the United Kingdom, a substantial volume of mortgage endowment products was sold through banks in tandem with interest-only mortgages.

To date, *bancassurance* mainly has involved attempts by the traditional distribution systems of one institution to sell the products of another, mostly banks trying to sell insurance. Banking and insurance have been little changed in this effort. These cross-selling efforts remain far from true integration. Further, despite some spectacular successes, the use of traditional insurance products and sales methods through bank branches has not achieved significant penetration of bank customer bases.

Universal Banks

Although terminology internationally is inconsistent, **universal banks** are financial intermediaries that typically offer commercial and investment banking services plus insurance. The term usually is associated with financial service conglomerates that offer a broader range of services than *bancassurance* firms. Figure 7–3 on page 173 illustrates different approaches to universal banking.

Table 7–3 Selected Bancassurance Distribution Alliances

	Banque Nationale de Paris and UAP	*Dresdner and Allianz*	*Bank of Scotland and Standard Life*
Background	Fourth-largest French bank and largest French insurer	Second-largest German bank and Europe's largest insurer	Regional U.K. bank and second-largest life insurer in United Kingdom
Year and reason for entering alliance	(1989) Bank needed access to technical skills; insurer needed distribution network	(1989) Bank did not want to jeopardize customer relationships; insurer needed distribution network	(1989) Bank needed diversification of income; insurer needed distribution network
Distribution approach	After initial problems, changed distribution to "insurance counters" in branches	Sold by branch staff	Referrals from branch staff to insurance professionals
Compensation structure	Insurance specialists paid on commission	Commissions paid to branch employee	Insurance staff salary-based with incentives; no remuneration paid for referrals
Success of entry	After initial failure, hope for success through new distribution structure	Initially disappointing but now showing promise	Still below expectations

Source: ©Tobias Hoschka. From *Bancassurance in Europe* by Tobias Hoschka. Reprinted with permission of St. Martin's Press Inc.

The structure of universal banks is limited by the home country's legal and accounting standards. Moreover, perception and tradition also play a significant role. For example, the United States historically has made a point of maintaining segregation between commercial and investment banks. Conversely, Switzerland, Italy, Germany, France, Luxembourg, and The Netherlands have long considered the securities business to be a natural banking activity conducted within the bank or through a separate subsidiary. Although universal banking laws permit common ownership and management of traditionally separate financial operations, actual integration remains low.

Financial Services Globalization

Financial services globalization implies that geographical location will have less meaning for financial intermediaries, regulators, and consumers than ever before. While physical barriers will always exist, technological advances and market liberalization have sparked the evolution of what some believe will eventually be a seamless world financial services market.

Table 7–4 Selected Bancassurance Joint Ventures

	Royal Bank of Scotland and Scottish Equitable	*Commerzbank and DBV*	*Midland and Commercial Union*
Background	Sixth-largest U.K. bank and large regional insurer	Third-largest German bank and one of 10 largest insurers	Fourth-largest U.K. bank and 10th-largest U.K. life insurer
Year and reason for entering alliance	(1990) Bank wanted to increase insurance profits; insurer wanted distribution channel	(1989) Bank wanted to become more competitive; insurer wanted to broaden distribution channels	(1987) Bank wanted to become more competitive; insurer wanted portfolio investment
Distribution approach	Simple products sold by branch staff; complicated products sold by specialists	Life insurance sold by bank staff; nonlife sold by DBV specialists	Referrals by bank staff to insurance specialists
Compensation structure	Specialists paid salary plus bonus; branches receive commissions from leads	No incentives for branch staff; specialists receive commissions	No incentive scheme in place
Success of entry	Too early to assess	More successful in life than nonlife	Achieving targeted growth rates, but customer penetration is only 3%

Source: ©Tobias Hoschka. From *Bancassurance in Europe* by Tobias Hoschka. Reprinted with permission of St. Martin's Press Inc.

As with globalization in other sectors, financial services globalization is driven by customer demands for more efficient financial solutions. Some needs are international in nature while others are purely local but involve customers that will accept more efficient foreign substitutes.

Already, companies are no longer limited to their domestic markets for capital or production. With national borders meaning less and less, regulators are working together to address common problems (see Chapter 13). Through this process, consumers can potentially benefit by increases in choice, value, and access.

Technology also facilitates decentralized production. For example, a U.S. health insurer processes claims in Ireland. The Isle of Man serves as the base for a large business in offshore life insurance for expatriates worldwide. The possibilities seem endless, at least as far as technology and logic are concerned.

Forces Driving Financial Services Integration and Globalization

Financial services integration and globalization trends are driven by a myriad of supply and demand forces coupled with changing government attitudes. Each is discussed briefly below.

Table 7–5 Selected Bancassurance Mergers and Acquisitions

	NMB Postbank and NatNed	*Lloyds and Abbey Life*	*Rabobank and Interpolis*
Background	Third-largest Dutch bank and largest Dutch insurer	Third-largest U.K. bank and 15th-largest life insurer	Second-largest Dutch bank and 15th-largest insurer; each cooperatively owned
Year and reason for entering alliance	(1991) Merger; to reap potential benefits of economies of scale and scope	(1985) Acquisition; bank wanted to diversify; insurer needed distribution channel	(1990) Acquisition; both wanted to increase life insurance market share by enhanced synergies
Distribution approach	Mutual cross-selling has started	Branch staff and insurance consultants	Bank-based insurance specialists
Compensation structure	N/A	No payment for bank staff; insurance specialists are commissioned	Bank staff paid salary
Success of entry	Too early to tell	Lloyds very successful; Abbey less so, but synergies are still elusive	Sales disappointing

Source: ©Tobias Hoschka. From *Bancassurance in Europe* by Tobias Hoschka. Reprinted with permission of St. Martin's Press Inc.

Demand Forces

Three categories of demand forces are driving the trends toward integration and globalization: (1) changing buying behaviors, (2) enhanced consumer awareness and expectations, and (3) reduction in employer-provided economic security.

Changing Buying Behaviors

Despite the wide range of demand conditions from country to country, broad worldwide trends are apparent. In life insurance, for example, concerns about premature death have given way to the even greater fear of outliving financial resources. Thus, death-protection products are now experiencing low growth in most developed markets and limited success in developing markets. Even where substantial death protection is sold, increasingly it is separated from the savings component.

This change has exposed the life insurance industry to at least two major problems. First, insurance products designed to respond to the increased demand for retirement savings compete directly with products of other financial institutions. Second, the cost of acquiring and maintaining insurance business is high relative to most other financial substitutes. In many countries, life insurers rely on favorable tax treatment of the savings element to remain competitive. Although these trends are perhaps most evident in markets such as

Table 7–6 Selected Bancassurance De Novo Entries

	TSB	*Crédit Agricole*	*Deutsche Bank*	*Barclays Bank*
Background	Fifth-largest U.K. bank (publicly traded)	Largest French bank (co-ownership)	Largest German bank (publicly traded)	Largest U.K. bank (publicly traded)
Year and reason for entering alliance	(1967) Bank perceived profit potential	(1985) Bank wanted to defend market share	(1989) Bank wanted to defend market share	(1969) Bank wanted to capitalize on potential synergies
Distribution approach	Insurance specialists based in branches	Sales through bank staff	Sales through bank staff	Insurance specialists based in branches
Compensation structure	Salary-based but commissions can double income	Salary with small bonus	Salary only	Specialists primarily commission-based
Success of entry	Highly successful; with insurance profits representing 30% of total financial services	Highly successful; with insurance contributing 15% of gross profits of group	Relatively successful; after only four years is the 15th largest German life insurer	Very successful; with insurance activities contributing 25% of group profits over the last five years

Source: ©Tobias Hoschka. From *Bancassurance in Europe* by Tobias Hoschka. Reprinted with permission of St. Martin's Press Inc.

the United States, the United Kingdom, Canada, and Australia, they are also emerging in continental Europe.

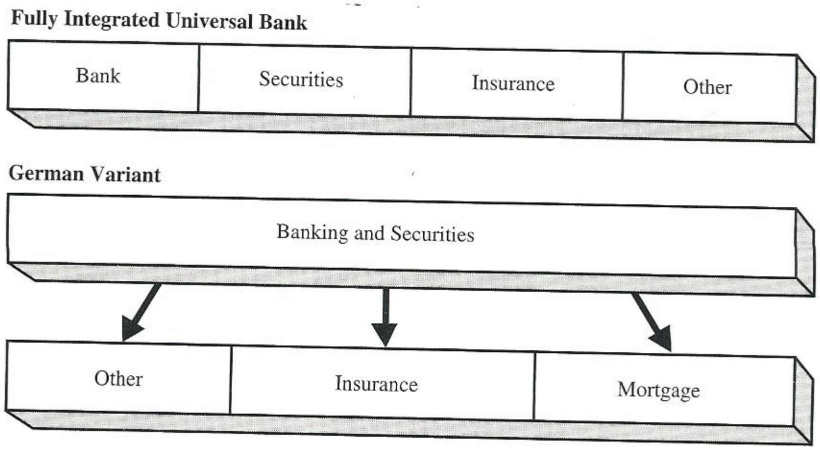
Today, many financial intermediaries encourage customers to compare prices and services and make their own decisions. Customers forced to make their own retirement account choices (due to the growth of employee-directed defined contribution retirement programs) are responding positively to these new approaches. Customer responses then provide a blueprint for effective marketing programs of the future. The features of such programs are highlighted in Box 7–1.

Enhanced Consumer Awareness and Expectations

Beyond changes in customer needs, customer awareness of interest rates and investment yields increased dramatically as many countries experienced periodic high inflation and high interest rates. When life insurance products offered yields close to other available investments, there was little interest in finding alternatives. During periods of high interest rates, as in the United States during the late 1970s and early 1980s, conservatively priced life insurance products did not compete well with alternative, new money savings instruments. Also, new competitors quickly appeared to meet these new demands.

FIGURE 7–3

Different Organizational Structures of Universal Banks



Although increased customer awareness has hit traditional life insurers harder than nonlife insurers, the latter have been far from immune to its effects. Once the province of independent insurance agents and brokers, personal lines customers have made an exodus to direct marketers. In the United Kingdom, new companies such as Direct Line, Churchill, and others have taken a large portion of the motor insurance market through targeted underwriting and direct response techniques (i.e., telephone, direct mail). In the United States, personal lines market share continues to move toward direct writers with tied agents (e.g., State Farm, Allstate, Farmers). Selected direct response companies have been quite successful as well (e.g., USAA and GEICO).

Reduction in Employer-Provided Economic Security

As employers have faced increased costs of providing defined benefit retirement programs and other traditional employee benefits, they have sought lower and more predictable costs through defined contribution programs. In a defined contribution pension plan, the employer contributes a certain amount with no guarantee of future benefits and no assurance that the contributions will provide sufficient retirement income. Each employee determines what investment vehicles will represent the best mix of capital preservation and yield, and what personal supplemental savings will be required to meet retirement income needs.

The global movement toward more individual responsibility will continue to shift the retirement savings burden to individuals. Sales and administrative cost differences will receive even greater attention. For example, when offered life insurance where the returns and costs are often difficult to assess, customers will continue to opt for less complex, alternative products where these factors can be determined (e.g., mutual funds, insurance bonds). This trend will put more pressure on life companies to provide higher returns, lower costs, and more understandable products. Simultaneously, the shift of responsibility from government to citizens and from the employer to the employee expands the demand for individual financial services worldwide, forcing financial firms to offer additional, but different, products to meet the burgeoning need.

Box 7–1

Effective Marketing Programs in the Future

Customer Needs and Preferences

The obvious beginning point for meeting the needs of emerging financial service markets is information on customer behavior and preferences. This is commonly accepted by insurers and banks today, but the implementation of programs based on customer behavior is frequently ineffective. What does the customer want and how does he or she want it delivered?

By examining buying behavior, we can determine what is motivating change. This information provides the basic guide to future product design; that is, which of the various product management skills possessed by life insurers or banks are likely to respond to the customer's view of needs? How do individuals with various financial needs respond to particular investment policies that form the basis for mutual fund compositions? What form will effective financial planning take for individuals with different objectives and preferences?

Segmentation by Buying Behavior

Customers can be segmented by a combination of factors. Needs, identified through market research, provide the primary basis. By further identifying the "need states" of customers, firms can address needs from the customer's point of view. Need states identify customer motivations about specific events (e.g., attitudes about death that influence purchase of death protection, attitudes about risk that influence investment purchases), confirmed by buying behavior.

Customer Life and Calendar Trigger Events

Many financial intermediaries have used particular life and calendar events to gain customer attention to particular needs that might be served by their proprietary or brokered products. For instance, the birth of a child, house purchase, inheritance, contract anniversary dates, impending school and college expenses, and other events tend to bring particular kinds of needs to the customer's attention.

As with segmentation, identification of trigger events is likely to reveal needs beyond those for which the primary product may be best suited. Many banks have used this concept to offer customers additional related products beyond the initial mortgage, such as homeowners insurance and mortgage term life insurance.

Supply Forces

Pressure on traditional financial institutions, products, and delivery systems has come not only from customers. New financial service providers have taken advantage of the change in consumer demand and have established strong positions in the marketplace. In the United States, securities brokers broadened their appeal beyond investors with high net worth who are active in the stock and bond markets, by providing discount brokerage, cash management accounts, mutual funds, asset management accounts, insurance, and related financial products. Many mutual funds, once relying on brokers to sell their products, now do their own marketing. In addition to taking a larger share of the personal savings market through sales to individuals, U.S. mutual fund managers have extended their role in corporate 401k asset management (individualized retirement accounts through employers) to a major market share in 401k administration. They have moved from solely a money management concentration to a customer service focus.

Similar developments have occurred elsewhere. The *bancassurance* movement has taken hold in much of Europe and Australia. To a greater degree, banks are developing broad financial services programs in Mexico, Argentina, Brazil, and other Latin American countries. Likewise, mutual fund sales personnel in Italy (e.g., at Fideuram, Mediolanum) account for a growing share of life insurance sales. Several supply forces are driving these trends, among them distribution inefficiencies, economies of scale, and economies of scope.

Distribution Inefficiencies

As distinctions between institutions, products, and delivery channels blur, consumers can more easily and directly compare them. When life insurance was a distinct product acquired from a distinct set of institutions through a distinct delivery system, insurers could focus their concerns on what their competitors were doing. Industry traditions and practices limited the comparison requirements and also limited their practical ability to innovate. Banks faced similar situations, particularly savings institutions limited to individual deposits and mortgage lending.

Today the services of life insurance companies, banks, retirement companies, and others are much less distinct. Property and casualty companies offer few alternatives to insurance for covering motor, household, and other personal risks, but innovative methods of risk assessment, underwriting, and management have provided opportunities for new and existing players.

Cost comparisons among retail financial service products pose a variety of problems (e.g., relevant durations, allocation of costs, product mixes, value of benefits), but even when these variations are considered, traditional life insurance and bank deposits appear to be the high-cost alternatives (see Table 7–7). Customers are changing their buying behavior to favor financial products that they believe offer greater value; for example, they favor money market mutual funds over bank deposits, and mutual funds over life insurance.

These comparisons illustrate the problem traditional life insurers face in these new market conditions. The high relative cost structure in traditional life insurance is dictated by the traditional selling requirements. The high cost of life insurance distribution is a common problem worldwide because traditional agency sales methods continue as the dominant method of individual life delivery.

Bancassurance is becoming the distribution method of choice in much of Europe for six distinctive reasons:

1. Brand image and enhanced customer management.
2. Some efficient lead generation.
3. Improved sales productivity.
4. Financial products to satisfy customer needs.
5. Use of technology.
6. Low expense ratios.

Table 7–7 Estimated Transaction Costs of Competing Savings Media
(As a Level Percentage of Premium or Other Payment)

	Life Insurance	*Annuity*	*Bank CD*	*Loaded Mutual Fund*
Acquisition costs	20–30%	2–7%	N/A	2–6%
Maintenance costs	7–12	1–2	10–20%	3–5
Capital costs	5–8	5–8	10–14	1
Total	32–50%	8–17%	20–34%	6–12%

Source: Tillinghast-Towers Perrin.

Table 7–8 Expense and Profitability Ratios of French Life Insurers by Type of Company

	1992	*1993*	*1994*
Expense Ratios			
Private companies	15.8%	14.2%	12.6%
Mutual companies	12.9	11.9	9.7
Foreign companies	20.5	19.6	18.1
Bank-owned companies	4.3	4.6	4.5
All companies	11.7%	10.5%	9.3%
Profitability Ratios			
Private companies	–2.2%	–2.0%	–1.9%
Mutual companies	–1.6	–2.6	–1.3
Foreign companies	–0.2	–0.7	–2.0
Bank-owned companies	2.1	1.3	2.5
All companies	–0.6%	–0.8%	–0.2%

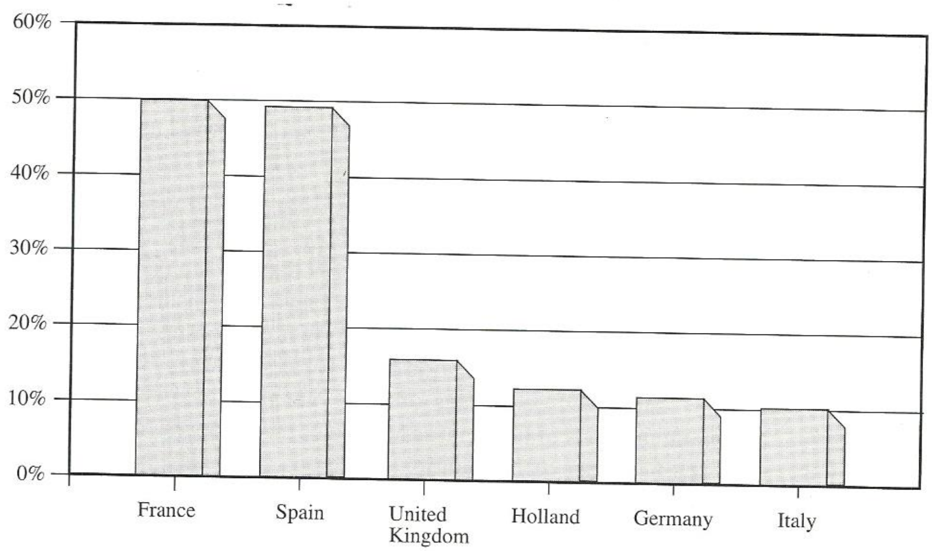
Expense ratio = Commission and expenses / gross premium income.
Profitability ratio = Operating profit / gross premium income.
Source: *Datamonitor European Insurance Database*, 1997.

As Table 7–8 shows, bank-based distribution of insurance in France, for example, involves considerably lower expense rates and higher profitability than domestic or foreign life insurers.

Figure 7–4 shows the market shares for bank life insurance in selected EU countries in 1994. Given that most of these markets had only nominal bank-based insurance activity a decade ago, these numbers take on added significance. Bank-based sales of annuities in the United States also have grown rapidly, accounting for almost 20 percent of the U.S. market. In Australia, bank life insurance marketing programs often operate at about one-third the distribution cost of the traditional agency field force. These differences reflect

FIGURE 7–4

Bank's Share of Life and Pension Premiums (1994)



Source: *Insurance Fact Book 1995,* Tillinghast/MPC Publications.

variations in distribution methods, customer affinity, and cost allocation within integrated financial service providers. In addition, many banks have offered less complex retirement savings insurance products that are more akin to their traditional products than to traditional life insurance.

Economies of Scale

Anecdotal evidence supports the belief that financial service conglomerates enjoy certain *economies of scale*—the notion that at some level of output, production and operation efficiencies will create lower per unit cost. Empirical evidence in support of this belief, however, is sparse, primarily because of data limitations. (The problem to date is that we have inferior proxies for the outputs of banks and insurers, and we can only approximately classify and account for attendant expenses.)

Basic financial service operations are similar from country to country. Much of the product development process—gathering market information, pricing procedures, underwriting risk analysis, distribution expenses, and so forth—is the same. Similarly, different distribution channels exist from country to country, but the same basic processes are applied worldwide. Administration involves a particularly high degree of consistency, depending on the basics of product design. Other operating requirements, such as customer service, financial reporting, investment management, and general management, all have broadly similar requirements.

As markets open, opportunity will increase to leverage these basic processes across a broader scale of business. At the wholesale level, the emergence of a global capital market has created many new scale and possibly intermarket arbitrage opportunities. In retail markets, advances in technology have made the mortgage and credit card processing businesses subject to continuing economies of scale. Even within single countries, we find companies seeking larger scale in operations to compete more effectively.

Economies of Scope

Frequently, financial intermediaries offer a broad variety of products and services to capitalize on potential *economies of scope*—the notion that a wide range of products can be sold at a lower cost through one outlet than if each product were sold separately. Empirical evidence supports such claims for banks and insurers. While research has not been extended to integrated conglomerates, firsthand observations indicate specific efficiencies of scope (e.g., low distribution costs for *bancassurance*).

However, economies of scope are not always achieved in *bancassurance* or other combinations of financial service sales unless operating methods change. Bank agents who sell insurance using traditional methods fail to take advantage of scope potential. Perhaps new marketing programs with packaged insurance and banking services could offer significant scope advantages.

The Importance of Tradition and Corporate Culture

Not all factors encourage integration. Insurance, banking, securities, and other financial sectors have long been separated by law, tradition, and practical operational considerations. Although all financial intermediaries can be described in terms of four primary functions—underwriting, intermediation, administration, and origination—each has different requirements. Their traditional "paper-processing" environments made those differences much more important.

With technological advances, many of the practical reasons for separation are disappearing. Customer demand is leading to reductions in legal separation, but different traditions and corporate cultures (i.e., a system of shared values, beliefs, and habits within organizations) remain formidable barriers to meaningful integration. These differences are clearly apparent when traditional products and distribution methods of one sector are partnered with those of another. Second generation integration programs begin the process by adopting neither sector's traditions and culture, trying instead to establish a combined approach from the start. Cultural adaptation remains the most significant obstacle to integration.

Political and Governmental Forces

Several political and governmental forces are combining to promote the trend toward integration and globalization in financial services. Of course, government influences both the demand for and supply of financial service products; in this sense, we could have covered its influence above. By separating the discussion, however, we intend to clarify how political forces and government continue to play important roles in this evolution.

Reduction in the Role of Government

Many governments face mounting costs in meeting social program entitlements for retirement and health benefits (see Chapters 15, 21, and 22). Although voters often favor continuation of high benefit levels, they resist the tax increases required to maintain them as the population ages. Even in countries with traditionally strong social programs (e.g., France and Italy), benefit levels have been reduced gradually.

As governments reduce their roles in the provision of individual economic security, the private market will provide products and services to meet this emerging need. Governments often encourage such de facto privatization efforts by providing tax advantages for private-sector products. In France, the retirement administrators (Caisses de Retraite) have added voluntary supplementary products. New legislation in Italy provides for additional private pension arrangements, and the U.K. government encourages holders of state pensions to seek private alternatives.

Demand and Supply Factors Influencing Government Regulation

Government policy toward financial services is driven in part by taxation and retirement savings objectives. Policy also is influenced by changes in market behavior. The demand and supply influences previously identified have encouraged governments to reduce the artificial barriers between financial services sectors and between countries.

As financial service customers become more aware of the costs and benefits of financial products, they will continue to put more pressure on governments to expand disclosure requirements and policing authority. The U.K. Financial Services Act of 1986, for example, requires sales staff to disclose their exclusive relationship with one provider or be prepared to demonstrate their complete independence. Further, they are required to determine their customers' situation ("know your customer") and offer the best product available to meet their needs ("best advice"). The act also mandated sales compensation disclosure, a requirement also laid down in Australia. In the United States, the focus has been on enforcement of new and existing prohibitions against misrepresentation through insurance regulatory actions and private lawsuits.

Liberalization

Countries increasingly are opening their markets to foreign financial services firms. Liberalization brings greater competition and innovation. At the same time, liberalization promotes financial services integration and, by definition, globalization.

We also are witnessing a growing trend toward regional liberalization (see Chapter 13). Regional trading arrangements can increase opportunities for exploiting the demand and supply trends toward globalization. For example, the European Union (EU) has opted to apply the more liberal approaches of the United Kingdom and The Netherlands over the more restrictive German approaches. The Association of Southeast Asian Nations (ASEAN), the Southern Cone Common Market (MERCUSOR),[4] the North American Free

[4]The members of MERCOSUR are Argentina, Brazil, Paraguay, and Uruguay.

Trade Agreement (NAFTA), and other regional trade agreements promise easier market access and less restrictive national operations. The World Trade Organization may facilitate reduction in trade barriers that limit financial service movements across borders.

Regulation of Financial Services Conglomerates Worldwide

Regulatory Overview

Financial services are subject to intensive regulation worldwide. The objectives of government are to (1) protect the consumer, (2) maintain adequate competition, and (3) ensure the stability of the financial system, thereby protecting the economy as a whole. Tables 7–9 and 7–10 provide an overview of the regulations of selected countries regarding permissible bank activities and investments. The following discussion provides an examination of selected markets and describes some of the key public policy issues associated with integration.

European Union

Prior to the formation of the EU, each member country maintained its own regulatory system for financial services. Most permitted active participation by foreign firms, but retained significant advantages for domestic firms. As discussed in Chapter 13, the financial services directives mandate certain changes to conform to an EU model. In general, the directives require each member to permit companies licensed in member countries to conduct business within its borders with minimal restriction. This regulatory requirement has encouraged companies to increase cross-border activity. Most participants, however, find that some form of local presence is required to attract the business of local residents.

In countries such as Germany, where regulation has been strict, non-German companies must demonstrate that they provide the kind of financial strength that Germans could rely upon under the prior regulatory system. In more open markets such as the United Kingdom, foreign companies must demonstrate both financial strength and attention to product design and value that is demanded in that market. Although the EU directives have now been in force for several years, the shape of both market participation and national regulations is still in flux. EU countries uniformly permit financial services firms in one sector to own firms from other sectors. Following a somewhat liberal approach, they permit joint marketing alliances but generally bar joint production of insurance and banking services unless the firm uses a holding company structure.

Japan

For many years, Japanese financial markets have been subjected to strict control. In 1996, the life insurance and general insurance sectors were permitted to enter each other's markets through subsidiary companies. In the future, banks are expected to be allowed to enter

Table 7–9 International Banking Regulations in Selected Countries

Country	*Securities*	*Insurance*	*Real Estate*	*Bank Investments in Industrial Firms*	*Industrial Firms' Investment in Banks*
Belgium	Unlimited; some activities through subsidiaries	Unlimited through subsidiaries	Limited to bank holding companies	Single shareholding may not exceed 10% of bank's own funds, and aggregate holdings may not exceed 35% of bank's funds	Unlimited, but subject to previous approval of authorities
Canada	Unlimited through subsidiaries	Ownership permitted; joint marketing limited	Unlimited through subsidiaries	Permitted to hold up to 10% interests, with aggregate holding not to exceed 70% of bank's capital	Permitted to hold up to 10% interests
France	Unlimited	Unlimited through subsidiaries	Unlimited	Permitted with regulatory approval of interests in excess of 10%	Not prohibited, but investments are generally not made
Germany	Unlimited	Unlimited through subsidiaries	Permitted subject to bank capital; unlimited through subsidiaries	Limited to 15% of bank's capital; in aggregate limited to 60% of bank's capital	Permitted subject to regulatory consent based on the suitability of the shareholder
Italy	Unlimited, but not permitted to operate directly on the stock exchange	Limited to 10% of own funds for each insurance company and a 20% aggregate investment	Limited to bank holding companies	Not permitted	Permitted up to 15% of shares of the bank, subject to approval of the Bank of Italy
Japan	Permitted through subsidiaries; banks allowed to own more than 50% of a security's subsidiary	Not permitted	Limited to bank holding companies	Limited to holding a 5% interest	Permitted, provided total investment does not exceed investing firm's capital or net assets
Netherlands	Unlimited	Unlimited through subsidiaries	Unlimited	Subject to regulatory approval for voting shares in excess of 10%	Subject to regulatory approval for voting shares in excess of 5%
Sweden	Unlimited	Unlimited	Limited to bank holding companies	Limited	Not prohibited, but are generally not made
Switzerland	Unlimited	Unlimited through subsidiaries	Unlimited	Unlimited	Not prohibited, but are generally not made
United Kingdom	Unlimited, usually through subsidiaries	Unlimited through subsidiaries	Unlimited	Permitted subject to permission from the Bank of England	No prohibition contained in the Banking Act of 1987
United States	Limited, through affiliates	Highly restricted with various exceptions	Generally limited to bank holding company	Permitted to hold up to 5% of voting shares through holding company	Permitted to make noncontrolling investments up to 25% of voting shares

Source: Modified from *Thompson's International Banking Register*. (1993), pp. 6–9.

Table 7–10 **OECD Member Country Limitations Relative to Direct Production and Distribution**

	Direct Production		Direct Distribution	
Member Countries	*By a Bank of an Insurance Product*	*By an Insurer of a Banking Product*	*By a Bank of an Insurance Product*	*By an Insurer of a Banking Product*
Australia	F	F(x)	A	F(x)
Austria	F	F(x)	A	F(x)
Belgium	F	F(x)	A	F(x)
Canada	F	F(x)	L	F(x)
Denmark	F	F(x)	A	A
Finland	F	F(x)	L	F(x)
France	F	F(x)	A	L
Germany	F	F(x)	A	F(x)
Greece	E	F(x)	L	F(x)
Iceland	F	F(x)	A	F(x)
Ireland	E	F(x)	A	F(x)
Italy	F[1]	F(x)	A	F(x)[2]
Japan	F	F(x)	F	L
Luxembourg	F	F(x)	L	F(x)
Netherlands	F	F(x)	A	F(x)
New Zealand	NA	NA	NA	NA
Norway	F	F(x)	A	F(x)
Portugal	F	F(x)	L[3]	F(x)
Spain	F	F(x)	L	F(x)
Sweden	F	F(x)	A	L
Switzerland	F	F(x)	A	A
Turkey	E	F(x)	A	F(x)
United Kingdom	F	F(x)	A	L
United States	E	F(x)	L	F(x)

Legend
A = Allowed
E = Exceptions
F = Forbidden
F(x) = Forbidden in principle, with exceptions
L = Limited
NA = Not available

Notes: [1]With the exception of Banca Nazionale delle Comunicazioni.
[2]Restrictions do not apply to intermediaries.
[3]Regulations distinguish between insurance intermediaries and insurance companies.
Source: K. Koguchi, *Financial Conglomerates* (Paris: OECD, 1993).

insurance markets through subsidiaries. Outside pressure has encouraged a gradual admission of foreign companies, with operations confined to particular sectors, and within sectors to specific activities.

The Japanese regulatory environment is supplemented by various local traditions. The close association between regulatory agencies and the industries they regulate assures regular consultation on policy change. Affiliations of companies in many sectors within *keiretsu* groups provide preferential advantages, creating barriers to entry for those outside the group. Thus, even as the intra- and intersector barriers to financial service participation are lowered, limitations from traditional ways of conducting business will slow the rate of change.

The Japanese Ministry of Finance regulates both insurance and banking. The insurance sector reports to the banking division within the ministry. The regulatory system emphasizes the financial stability of insurers over other factors. Therefore, limited competition and circumscribed insurance products are preferred, even though this may result in higher insurance premiums for consumers and lower dividends for stockholders.

North America

Canada

Prior to the 1990s, Canada's financial services industry was largely segmented between banks, trust companies, life insurers, and securities dealers. Today, due to limited deregulation, insurers own the majority of trust companies and the large Canadian banks control the securities business. Legislation in 1992 allowed banks to acquire insurers, and vice versa, with the restriction that they not use their customer databases to market insurance. Banks, seeking to integrate their operations, supported legislation in 1996 that would have eliminated this marketing obstacle. Although unsuccessful, the legislation reformed past marketing regulations more in the banks' favor. If banks were to be able to operate with fewer marketing constraints, some observers believe that the "big five" banks, representing 80 percent of the market, might exhibit oligopolistic market power. Even so, many expect that these limitations on information sharing will be removed shortly.

United States

The foundation of U.S. banking and securities regulation has its roots in the Great Depression of the 1930s. During that volatile time, the government imposed rigid guidelines for the separation of commercial and investment banking activities through the Glass-Steagall Act of 1933.

Legal battles and recent limited legislative modifications have significantly mitigated the act's original breadth. Regulators have been drawn into a battle on two fronts. The banks fought on one flank while individual states fought from the other. About one-half of the states currently allow more liberal business operations than the Glass-Steagall Act stipulates.

The insurance activities of banks were expressly limited by federal legislation through the Bank Holding Company Act of 1956. This act and the National Bank Act of 1916 permitted narrow exceptions: Banks in towns of less than 5,000 could sell insurance and all banks could sell bank-related insurance products (e.g., credit life and health). Analogous to securities regulation, the states expanded the authority of state-chartered banks to sell insurance, so that 27 states have allowed state-chartered banks to sell insurance in one form or another by 1996. A 1996 decision by the U.S. Supreme Court ruled that state laws could not interfere with federal law permitting banks to sell insurance from small towns (under 5,000), even if their marketing activities extended to larger towns and cities. This decision, coupled with an earlier one allowing federally chartered banks to sell annuities, suggests a trend toward de facto integration in the United States. Even so, the wide variation in federal and state laws, regulations, and regulatory agencies has produced a conflicting picture of new powers and complexity.

Public Policy Issues in Financial Services Integration

The trend toward financial services integration has given rise to several concerns by policy makers. We highlight the concerns below.

Contagion

The risk of **contagion** (financial infection) refers to the exposure (or damage) a tainted activity or component might inflict upon the financial services conglomerate. A bank, for example, may have a property and casualty subsidiary that has experienced enormous losses. The bank transfers significant amounts of capital to the insurer, thereby placing the group as a whole at risk. This transaction may be completely transparent or accomplished surreptitiously, depending on management's objectives (e.g., off-market or intragroup transactions).

Although no one questions the possibility of financial contagion within a financial services conglomerate, financial conglomeration could lead to greater diversification. If true, this theoretically should lower overall firm risk, not increase it.

Information disclosure and analysis by customers, intermediaries, rating agencies, and governments have been suggested as a means of controlling the contagion exposure. Many observers believe, however, that a completely different approach is necessary, whereby deposit insurance is privatized and regulation focuses on a narrow range of financial services activities.

Transparency

Transparency is concerned with the assurance that accurate information needed by customers, intermediaries, rating agencies, and governments will be readily available. To assume that customers have the time or the resources to perform due diligence on a financial conglomerate is unrealistic.

Traditional financial measures of strength focused on balance sheets. So long as there was enough unrestricted capital to meet contingencies, organizations were deemed safe. Although this approach may have worked reasonably well when institutions stayed within sectoral boundaries and like institutions were roughly comparable, the new world of mixed services requires a broader consideration of factors (e.g., competitive position).

Management Responsibility

Management responsibility is concerned with the possibility that managers may compromise their entity's sound operation in favor of the conglomerate's fiscal health (e.g., through unwise loans to connected parties). Where a financial services group is regulated functionally, how can each sector's regulator be assured that managers will fulfill their responsibility to meet regulatory requirements given other interests within the group?

Financial service regulators have struggled with this problem for many years as regulated units have become part of broadly based financial and commercial groups. Although there are serious analysis and enforcement limitations on regulatory agencies, some believe the solution is to include a broad obligation to disclose major intragroup transactions. Disclosure would entail transactions that affect the regulated entity or the basic integrity of the regulated unit's assets and operating capacity. At a minimum, these data should constitute a prerequisite for continuing authority to operate.

Double Gearing

Double gearing exists when a company uses the capital of subsidiaries to meet its own solvency requirements. This double counting acts to artificially inflate the conglomerate's capital adequacy. Supervision becomes more complex if certain operations within the conglomerate are unregulated.

Clear, uniform accounting standards and requirements are necessary to identify double gearing. Issues related to appropriate disclosure and the appropriate locus of regulatory responsibility must be resolved.

Market Power

Market power relates to the ability of one or a few sectorally dominant firms (e.g., through oligopoly or monopoly) to influence market prices. A highly concentrated market or the existence of vertical agreements may lead to market power that hinders market efficiency. Many countries have granted regulators supervisory powers over mergers and acquisitions to curtail such risk.

In the past, traditional indicators have proven effective for sectoral analysis. After the introduction of integrated financial services, however, the supervisory function has become arduous. Moreover, with the exponential growth of cross-border trade and foreign penetration into domestic markets, globalization may well thwart any domestic concentration of power.

We have seen significant concentration of market shares, particularly among traditional banks and insurance companies, in many major markets. Simultaneously, we have seen considerable new entry. When a subsidiary, such as Predica, can enter the life insurance market in France and become a leading company in a few years, the risk of oligopoly or monopoly power seems limited.

Overall, the trends toward cross-sector and cross-border entry (and new technologies) would seem to reduce the potential for concentration of market power. Most countries will retain antimonopoly authorities to protect against the rare cases of potentially sustainable market control combinations. Openness and rapid change in financial services markets are likely to preserve strong competitive forces.

Conflicts of Interest

The potential for **conflict of interest** exists when a financial institution offers multiple financial services and promotes proprietary products through coercion or other power for the organization's benefit over the best interest of the customer. In the United States particularly, some have argued that banks should not be permitted to sell insurance because they may make the availability of other products conditional on the customer's purchase of insurance.

Most financial services regulatory systems prohibit tying the purchase of one product to another, although discounts are permitted for joint purchase. As with prior points, some believe information disclosure and competitor exploitation of potential abuses may avoid such conflicts.

Regulatory Arbitrage

Regulatory arbitrage is the tendency of financial services conglomerates to shift activities or positions within the group to avoid certain regulations in whole or in part. For example, a conglomerate might shift the production and sale of a particular savings product to its insurance company if insurance regulation were judged less intrusive than banking regulation. In the absence of comprehensive cross-sector and international regulatory harmonization, opportunities for such arbitrage will always exist. To control this practice, some believe sectoral regulators should engage in extensive cross-sector information sharing. Internationally, regulators of multinational financial services firms also could engage in informational reciprocity with trading partners to identify possible distress situations. The possibility of regulatory arbitrage encourages cross-sectoral and international regulatory harmonization.

Conclusion

We have attempted to convey some of the broad movements shaping global financial services markets. The trends toward globalization and integration of financial services seem likely to accelerate. Continuing technological advances will further increase information availability and transaction speed. These will give customers more options and a better ability to determine product and service value and differences, with reduced requirements for face-to-face contact.

Marketplace influences, such as increasing responsibility for retirement income by individuals, provide the impetus for customers to increase their demands for information and convenient service without consideration for traditional sector boundaries. These non-traditional activities are giving rise to numerous public policy concerns which regulators must address. Traditional institutions will adapt through specialization or integration or risk losing market share to those that do adapt. Through this evolution, barriers between financial service firms will continue to fall.

Discussion Questions

1. If *bancassurance* becomes a globally accepted method of insurance distribution, are consumers more likely to be helped or harmed? How would your answer differ if the same question were asked about a perfectly competitive market compared with an oligopolistic market?
2. From a strictly marketing perspective, what role might culture play in the process of financial services globalization? As the vice president of marketing for a global conglomerate, how might you overcome these challenges?
3. Speculate about the degree to which each of the following market segments would be affected (either positively or negatively) if financial services competition were dominated by financial service conglomerates: low-income, middle-income, and upper-income.
4. What are some of the political ramifications of financial services globalization? As the financial services regulation czar for the European Union, list the three most pressing challenges you would have to overcome. How would you accomplish each?
5. Choose any two public policy issues. Argue either for integration, citing potential solutions, or against integration, citing reasons why the issue cannot be overcome.
6. If full integration were permitted tomorrow in your country, how would the financial landscape look 1, 10, and 25 years from now? What would be the impact on the national economy? Consumers?

References

Blommestein, H. J. "Structural Changes in Financial Markets: Overview of Trends and Prospects." Chap. 1 in *OECD Documents: The New Financial Landscape—Forces Shaping the Revolution in Banking, Risk Management and Capital Markets*. Paris: OECD, 1995.

Koguchi, K. *Financial Conglomerates*. Paris: OECD, 1993.

Saunders, A., and I. Walter. *Universal Banking in the United States: What Could We Gain? What Could We Lose?* New York: Oxford University Press, 1994.

INTERNATIONAL RISK AND INSURANCE

An Environmental–Managerial Approach

SKIPPER

CHAPTER 7 INTEGRATION AND GLOBALIZATION OF FINANCIAL SERVICES

Andrew F. Giffin
Tillinghast-Towers Perrin
Bryan Clontz
Boys and Girls Clubs of America

The authors acknowledge with appreciation the helpful comments and suggestions of Jean-Pierre Daniel of CAPA (France), Alan Leach of Datamonitor (UK), Michael White of International Bank Consultants (USA), and Peter R. Wilde of Wilde Associates (USA).