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# Convergence in the Financial Services Industry[1]

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## 1. Introduction

The financial services industry is undergoing drastic changes. One of the main challenges for managers of financial institutions as well as for regulators and supervisors is the growing convergence between different sectors within the financial services industry. In this paper, we present some general observations and recommendations. We hope that these recommendations help in fostering innovation and prosperity, without neglecting the important conditions for a stable and reliable financial sector.

This is an important message to both supervisors and regulators in the financial services industry. Optimal regulation and supervision can only be guaranteed if there is a good balance between the measures to guarantee a stable and reliable financial sector on the one hand and the need for safeguarding sufficient competition and innovation on the other. This is not a simple task, especially because there is no single answer to this complex equilibrium. However, adequate regulation and supervision is only possible if there is a clear understanding of the market reality. There, regulators and supervisors will have to accept that they will always "lag behind" business innovations and that market forces will always try to find ways to circumvent (restrictive) legislation. Financial convergence is, as we will show later, a perfect example in this respect.

## 2. Financial convergence takes many different forms

### *Financial convergence and financial conglomerates*

Since the term "financial convergence" is central in this paper, we will outline briefly what we mean by it. We use "financial convergence" as the general term, relating to all types of interfaces between financial suppliers and the demand of all types of financial products and services. Part of the interface is of an institutional nature, and this is where the term "financial conglomerates" pops up. More particularly, we consider a financial conglomerate as a group of enterprises, which is formed by different types of financial institutions (banks, insurance companies and investment institutions). Most of the time, the term "financial conglomerates" is used to denominate groups with both banking and insurance subsidiaries. But in principle, a financial conglomerate can consist of a bank and an investment company (without having an insurance subsidiary). These types of groups are often referred to as "universal banks".

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[1] This paper is based on the report "Convergence in the financial services industry – a report written under the authority of the OECD", by L. Van den Berghe, K. Verweire and S. Carchon, September 1999 (draft version).

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*It is very dangerous to categorize this whole evolution as one standard practice*

One of the most important lessons learned is that it is very dangerous to categorize the whole evolution of financial convergence as one standard practice. The same can be said of financial conglomerates: there does not exist such a thing as "the" financial conglomerate. Both financial convergence as well as financial conglomerates are multidimensional concepts. Therefore, they should be analysed from different angles.

- What are the different types of institutions involved? Do we analyse the increased integration between banking and insurance, or do we focus on the growing competition between insurance companies and pension funds, etc.?
- Which structures are used to create financial conglomerates (networking, distribution agreements, cross-shareholding, parent/subsidiary, holding structure, etc.) and what is the mode of diversification (*de novo* start-up, merger, acquisition, joint venture)?
- What is the level of integration for all the different activities in the value chain. For example, in case of the growing convergence between banking and insurance (and investments), we see that integration between these different sub-industries started mainly at the distribution level, where in the first instance the different financial institutions sold each other's products through their own distribution channels. During the last couple of years, we have also noticed more integration between banking, insurance and investments at the back-office activities. This is especially the case for asset management activities, but there are numerous examples which show that financial conglomerates try to integrate on other levels and activities as well.
- How diversified are the financial conglomerates? Some financial conglomerates combine substantial banking and insurance activities, while for others the diversification strategy is only marginal.

These different questions show that it is not possible to refer to this movement as a uniform, well-defined type of diversification.

*Supervisors should not focus their attention on "distribution" or "cross-selling" nor on "financial conglomerates" alone*

When one talks about convergence in the financial services industry, one often uses terms like "bancassurance", "assurfinance" and financial conglomerates. However, it is our firm belief that the combination of banking and insurance products as is now done through bancassurance and assurfinance is just the first step in a more profound development.

Bancassurance

The majority of the financial players do practise one or other type of cross-selling. The most popular, the bancassurance trend, is where banks sell insurance products. Life insurance products especially have proved to be a great success for bancassurance, as is shown in the Figure 1.

From a statistical perspective it will certainly be necessary to make the distinction between distribution on one's own account (manufactured by the insurance subsidiary or sister company within a financial conglomerate) and pure cross-selling, whereby the bank acts as a distributor for another insurance company. However, for this last type of financial convergence reliable information is completely lacking.

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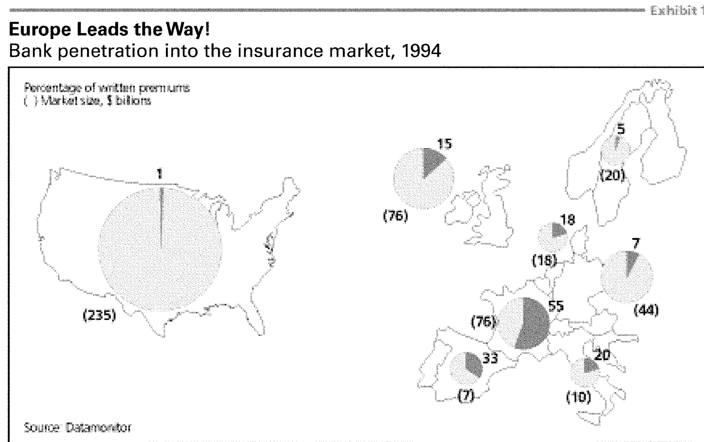


*Source:* Flur, Huston & Lowie (1997).[2]

*Figure 1: Bank penetration into the life insurance market (new life insurance contracts)*

## Assurfinance

The opposite trend of insurers selling financial products is assurfinance. Although insurers have been successful in launching more financially oriented (life) insurance products, it seems that their success in selling pure banking products has been less progressive and successful. Whereas bankers proved to be successful in establishing an insurance company from scratch, this seems a far more difficult route for assurfinance; the only (successful) route in this respect is buying an existing bank.

However, the effect of this financial convergence on the traditional distribution outlets of insurance has been tremendous. Several important consequences are:

- A generalized trend towards multi-channel and multi-distribution has gained a difficult but a certain acceptance; this trend goes beyond the bancassurance movement, because many non-traditional competitors are entering the arena (the same holds for the distribution of bank products);
- Quite a substantial number of these traditional insurance intermediaries, that survived this though competition, developed a new, innovative and offensive strategy in order to create their own competitive advantage.

## More than the retail market alone

Much attention has been given to financial convergence in the retail market. But people from the business sector claim that the current focus on retail market co-operation between

[2] Flur, D. K., Huston, D. and Lowie, L.Y., 1997, "Bancassurance", *The McKinsey Quarterly*, 3, pp. 126–132.

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banks and insurance companies is only the tip of the iceberg. As an example, we see a growing convergence trend underway in U.S. financial markets involving commercial insurance companies, reinsurance companies and leading investment banks. Certainly, this trend is not unique to the U.S. It is, however, beginning to change significantly the very nature of risk management and the methods of financing risk. This trend is driven largely by corporate needs and demands for more effective types of financial protection for a broad range of financial and non-financial risks.

For example, in the U.S., providing financing arrangements for corporate risks is becoming big business in the investment banking industry. Virtually all large investment banks in the U.S. have now developed large risk management divisions that focus on new products that utilize capital market tools for financing a broad array of corporate financial risks. Investments banks, insurance companies, reinsurers and insurance brokers are also coming together to jointly form catastrophic property and liability insurance companies to write high limits of traditional insurance.

## Integrated services: "all finance" and "all care"

Although bancassurance and assurfinance are still two of the most important outcomes of the growing convergence in the financial services industry, we are convinced that this is just the first step in a more profound development. The complementarity in time and space between different financial and insurance products not only creates natural incentives for cross-selling and packaging but also for innovative product integration. Through unbundling (old traditional products) and rebundling (in accordance with the real market needs) new service bundles are created.

The supply of integrated services can be seen as a special application of the more general shift from product-oriented supply to a more client-oriented focus. Strategists often agree that in most markets, and in particular the financial services market, the definition of the core business has traditionally focused on the kind of products offered. But as the product and geographic boundaries disappear, this traditional definition of the core business might not work well any more. Managers of financial institutions should rather adopt a client-oriented (functional) approach, instead of the traditional technical, product-oriented approach. Defining the core business from the perspective of the customer can open a far broader field of services than when one sticks to the pure technical approach or product focus. Figure 2, based on our own market research[3] shows clearly that traditional insurers focus their core business on a very small part of the whole risk management spectrum.

Although the tendencies are not yet completely clear in practice, we see the following options for further integration:

- *All finance*, in the direction of personal financial planning (retail market) and employee benefits (commercial market). This is an option followed by a large number of insurance companies. However, it is not always clear whether insurance companies are in the best position to offer such solutions. For example, in case of employee benefits, it might be that human resources consultants have developed more competencies than the traditional insurance companies in this respect.

[3] Van den Berghe, L.A.A. and Baeten, X., 1996, "Risico, beleggen, sparen, verzekeren en zorg; Survey in the Dutch Market", Research Project, Erasmus University, Rotterdam and The Vlerick School of Management, Gent.

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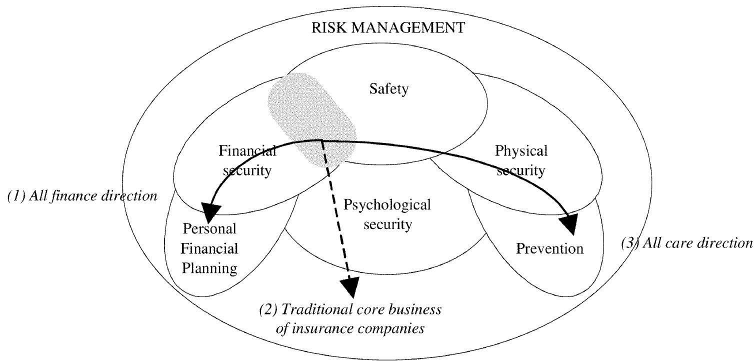


*Figure 2: Insurers' core business from a broader perspective*

- *All care*, in the direction of family risk management (retail market) and integrated or holistic risk management (commercial market). Here too, we see a broadening of the scope of the insurance company, e.g. by offering laundry, catering and home care services.

Similar arguments can be forwarded with regard to the banking industry. Robert Merton has published an article [4] where he suggested that a functional approach may provide a more useful organizing perspective than an institutional approach, especially in an environment of rapid technological change and movements towards increasingly global connections among financial markets.

Based on the fact that this integration can lead to a net advantage for customers and suppliers (economies of scope) we stated that far more integration can and probably will be fostered in the financial sector. In this respect we do believe the following expression: "l'appétit vient en mangeant" or "appetite comes with eating". We believe that the fragmentation of traditional financial suppliers is part of a transition to more efficient arrangements. A functional approach may provide a more useful organizing perspective than an institutional approach, especially in an environment of rapid technological change and movements towards increasingly global connections among financial markets.

Examples of potentially far-reaching integration are to be found in the following areas:

- asset liability management;
- integrated (holistic) risk management;
- alternative risk transfer;
- personal financial planning;
- employee benefits;
- back-office integration and integration on information and communication technology.

[4] Merton, R.C., 1990, "The Financial System and Economic Performance", *Journal of Financial Services Research*, pp. 263–300.

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Financial conglomerates and integrated financial services

Although the formation of financial conglomerates can lead to better conditions for integration, it is certainly no guarantee that (only) this route leads to the supply of integrated financial services. Before financial conglomerates can deliver really integrated products, they must be able to co-ordinate all different activities, from the different back offices over the different front offices. This is a very difficult task, not only from an implementation point of view, but also because of potential conflicts of interest.

On the other hand, one could say that one does not need an integrated group of financial suppliers to offer integrated products. If distribution will be able to offer client-oriented financial services from different financial services providers, they might evolve towards important players in the financial sector.

Pension funds and financial convergence

Almost all of the previous analyses and conclusions also hold for the increasing interface between pension funds, insurance companies and other financial institutions. Two opposing converging trends occur: the pension funds entering the insurance and other financial markets at the one hand, and the insurers and other financial institutions entering the pension market.

- The inroads made by pension funds into the financial sector are based on the same principles of the financial convergence trend: shifting to a functional and client-oriented approach, whereby bundling and unbundling must lead to integrated employee benefits (collective base) and even personal benefits (individual base). In fact they look for service bundles, starting to integrate the so-called first, second and third pillars of the pension system. The core business of pension funds is however also changing because of other factors: the need for flexibility, clear communication on future pension benefits, etc. Instead of being pure administrators of collective pension provisions, modern pension funds want to position themselves as competitive financial service firms. The most important difference is that most pension funds, and especially the largest ones, are not private companies, but operate in a somewhat different (protected?) market environment.
- As governments cut back on social security provisions, the provision of many benefits shifts to the employer (either on a mandatory or incentive base), or even to the individual. The transition from an unfunded to a funded pension scheme creates an enormous potential for (life) insurance companies, ranging from a doubling or tripling of the market volume (according to the degree of accumulated savings). This can lead to new financial developments. We believe that this trend will affect the competitive position of all market players not only pension funds and insurers, but also banks and asset managers.

## 3. Financial convergence is here to stay and supervisors cannot and must not prevent this

In the 1980s we started scientific research to investigate the drivers behind the financial convergence trends. The hypothesis analysed started from the idea that this trend was only beneficial for the suppliers and that in fact, it was for them a fancy way of selling their diversification strategy to the public. The main conclusion of this research was that financial convergence offered a number of advantages as well as some disadvantages. For some consumer segments the balance was towards the advantages so they favoured this movement. Others were more pessimistic about the outcome of this evolution in the financial sector. In

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follow-up research in the 1990s, it became clear that the camp of the believers had grown and that more integration into the direction of all finance and all care could shift the balance considerably in favour of this financial convergence.

Looking at the market scene today, we can state that one or other form of financial convergence can be witnessed in many, if not all, developed markets. It is striking to observe that even the strongest opponents of financial convergence accept that this trend is irreversible. An even stronger proof of the fact that financial convergence has gained acceptance is that specialist insurers are starting to apply the formerly suspect bancassurance in their own business. Other manifestations of growing market acceptance can be found in the "neighbouring" markets: for example, the sectoral agreements on labour conditions are shifting more and more into the direction of convergence (to an integrated base either per sector or per company). Also in the field of education, programmes emerge which increasingly focus on this convergence aspect.

This convergence trend is not peculiar to the financial sector alone. In fact one can state that financial convergence is embedded in a much wider trend towards integrated services. In an effort to offer convenience and switch from mass production to customization and individualization, bundling and unbundling becomes necessary.

The reaction of many of the supervisory authorities has been very market-friendly in that they allowed this convergence to happen. Notable exceptions that tried to restrict the playing field of the financial firms, like the U.S., show that market innovation always finds a way around strict regulations:

- Look, for example, at the establishment of "near-banks" to cope with the strict limitations on interest payments by banks in the U.S.;
- It is clear that the same circumventing movement could well evolve in other directions as well; for example, in regulating intermediaries one will always have to cope with the famous Internet; the same could be the case by strictly regulating insurers or pension funds, whereby self-insurance or alternative risk transfer could offer a way around;
- There are a number of examples showing how the strict limitations in the U.S. on financial convergence have been bypassed by U.S. banks (e.g. by establishing distribution alliances, investment in insurance companies through venture capital subsidiaries, credit relationships, etc.).

This does not mean, however, that there is no further need for regulation or supervision; on the contrary even, as will be shown in the next point. But in order to develop adequate regulation and supervision, it is necessary to have a look at the advantages and disadvantages of financial convergence.

## 4. Financial convergence creates many opportunities and advantages but can also create extra risks and disadvantages

Financial convergence hides advantages as well as disadvantages. At the outset, the general feeling of critique against diversification of business firms certainly influenced the sceptical evaluation of many types of financial convergence. Economic research and literature showed that – at least in the manufacturing industries – the large conglomerates, built up in the 1950s and 1960s, destroyed shareholder value in subsequent years. Therefore, it was not surprising that quite a number of large conglomerates have been refocusing on their core business by either down-scaling or even by breaking up in the last decades. Despite the negative connotations of diversification in the business world, a more positive attitude is

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prevailing nowadays in the financial services industry. The main idea is that diversification in the financial services industry is more of the related form. With related diversification, there is more potential for synergies at different levels of the value chain, and more operational integration instead of mere "portfolio diversification".

In order to detect the potential advantages and disadvantages of this financial convergence, we look at three different levels:

- the consumer level;
- the market level;
- the macro level.

*The consumer level*

The question whether convergence in the financial services industry is beneficial to consumers is a central element in the whole discussion on financial convergence. There is, however, no simple and straightforward answer to this question. It depends on the personal needs and attitudes of the customers, whether the balance will strike in a positive or negative sense. Some customer segments prefer comfort and convenience and accept that this raises the need for detailed private information to be given to one supplier or that this can lead to tied-in sales. Other customers will sympathize with financial convergence because cross-selling can lead to price discounts, which they prefer above all. Other customers will be convinced that they do not need the patronage of a one-stop seller or an integrated service provider, but prefer shopping around themselves.

All these arguments show that one of the most important tasks of financial services companies is to gain an in-depth knowledge of the needs and profitability of each of its customers. A Lafferty study[5] showed that many providers are still a long way from reaching this goal: few executives are very confident that their current approach is meeting the evolving needs of their customers. The survey showed that a mere 19 per cent said they were highly confident that they were successfully locking-in customers across a range of products, and only 20 per cent were highly confident that they could customize products as required. According to the Lafferty study, one of the main problems in this respect is in integrating the various databases in order to gain a view of the total relationship with each customer. Here, financial institutions are also hampered by privacy issues. Indeed, they are not allowed to use information they have gathered on the banking side for the insurance part of their businesses. It is clear that this will remain a major issue for financial services providers.

Consumer protection arguments must therefore be treated with care. Not all consumers have the same attitude towards financial convergence nor do they all have the same need for protection. Supervisors will have to address the potential disadvantages in a flexible way, without killing the flexibility and innovation in this industry. Risks that will have to be tackled by supervisors are, for example, conflicts of interests, abuse of power, tied-in sales, etc.

*The market level*

On the market level financial convergence will certainly need to be tested against competitive criteria. The impact of the financial convergence on the level of competition

[5] Corcoran, S., 1999, *Bank-insurance Mergers: Synergies or Sham?* Dublin: Lafferty Publications Ltd.

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cannot, however, be analysed without taking into consideration the effect of the changed regulatory environment. Indeed, there is a continuous interaction between (de) regulation, market conduct and competition.

A number of studies have investigated the implications of the changes in the regulatory environment for the financial services industry in general. One of the main issues that has been raised is that we are moving from an industry-based competition to a product-based competition, i.e. more and more financial institutions are being allowed to offer complementary or competing products, that were originally restricted to neighbouring financial sectors. This leads to a blurring of the boundaries between the different sub-sectors of the financial system and to the formation of financial conglomerates. In the United States, the House of Representatives have recently passed legislation that would eliminate regulatory barriers and allow federal regulators to engage in product-based rather than industry-based regulation. As the FTC states:

> One of the implications of product-based competition is that, while there is a trend toward greater consolidation within the traditional financial services industry, there has been growth in the number of firms outside that industry that provide financial services and products. Opening up markets to new firms has the potential to result in increased competition, but it may also lead to competitive scenarios that are unfamiliar to traditional regulators.[6]

These new forms of competition and regulation will have serious consequences for the players in the financial services industry as well as for regulators and supervisors.

*The macro level*

The question of whether there are advantages or disadvantages associated with financial convergence and the accompanying deregulation has been investigated in detail. The main conclusion of these studies is that financial deregulation has led to considerable benefits analogous to those flowing from deregulation in other sectors. Deregulation, both directly and through the increased competition it has spurred, has raised productivity and quality and lowered prices for the services provided by the financial sector itself. The allocation of resources throughout the economy, and therefore overall economic efficiency, have been improved by the removal of regulation-imposed distortions in the allocation and pricing of credit.

In addition to these improvements, financial deregulation has had important broader consequences for financial and macro-economic behaviour that reflect the central role of the financial system in economic decisions and which enter into overall assessments of the efficacy of deregulation. While clearly beneficial in important respects these changes have complicated the functioning of key economic policies, at least temporarily. The changes have also been associated with a number of economic problems (e.g. wide swings in financial market prices, credit market booms, international debt crises, etc.) that raise questions about the risks of the financial deregulation process. However, these problems do not seem to be an inherent feature of the liberalization process, but more the result of its interaction with other economic problems and distortions which were present as liberalization was occurring. These

[6] Federal Trade Commission (3 June 1998), "The Effect of Consolidation on the State of Competition in the Financial Services Industry", p. 9.

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experiences underscore the importance of key linkages between macro-economic, financial and other policies for the relative success of the financial deregulation process.

It is clear that insurers' growing emphasis on financial products will bring them more into the picture when setting monetary policy as well. On the other hand the banking business is shifting much of its attention from the traditional intermediation to the more fee-based services, consulting and financial engineering. This certainly influences the role of the financial markets as against that of the financial intermediaries. The new role played by financial conglomerates is another aspect that deserves attention, because this evolution is certainly not neutral from a risk perspective. Although supervisors have feared that conglomerates created extra risk, our research[7] showed that the risk profile of financial conglomerates is better than that of specialized suppliers (specialized banks and specialized insurance companies).

## 5. Implications of financial convergence for supervision and regulation

Although financial convergence and in particular financial conglomerates are well underway, up to now few initiatives have been taken towards legislation on financial conglomerates. Indeed, most national regulatory and supervisory systems are structured on the basis of the traditional boundaries between banks, insurance companies, pension funds and investment firms (the so-called vertical division of activities). The evolution of the market in the direction of financial conglomerates, all finance, packaged solutions, integrated product development etc. leads to the further blurring of the traditional boundaries (the so-called horizontal integration and product clustering). All these trends require more attention to be paid to the supervision of these financial conglomerates. This raises the question whether current legal solutions and structures are adapted to the new wave in the financial sector.

One observation is that given the diversity of the sectoral regulation and supervision, it is hard to create a level playing field. Therefore, the main question for supervisors and regulators becomes: "What rules help to create a level playing field without limiting the innovation and expansion of the financial sector?"

In the modern financial markets of today, the main difficulties for supervisors can be summarized as follows:

- The supervision and most of the regulation has a sectoral focus. This can be observed when analysing the solvency rules (different approaches for defining the required solvency capital and the solvency fund) and the institutions under supervision (consolidated group level versus business unit level); also the philosophy on regulation and supervision differs quite substantially.
- This institutional approach proved to be a good solution as long as the sectoral barriers remained stable. Once the barriers started to blur, supervisors had to collaborate more intensively. The solution was mainly sought in the direction of solo-plus supervision.
- This solution presupposed a clear division of tasks; such a division was (sometimes) based on the typology in mixed financial conglomerates, besides banking and insurance conglomerates. Such an approach supposes that a clear distinction can be made between

[7] Verweire, K. , 1999, "Performance Consequences of Financial Conglomeration with an Empirical in Belgium and the Netherlands", doctoral thesis. Amsterdam: Thesis Publishers Amsterdam.

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these three types of conglomerates. However, the current approach is certainly debatable in a number of respects.

Up to now, most attention has been devoted to the question of reconciling the sectoral regulatory and supervisory approach with the creation of financial conglomerates. The solution has mainly been sought in solo-plus supervision. However, this solo-plus supervision is probably only a temporary solution. The more financial convergence is evolving into the direction of integrated services, the more important the "plus" will have to be, creating the danger of double supervision.

Trying to resolve this difficult issue by establishing a separate regulatory system and supervision for financial conglomerates is only part of the potential answer to this challenge. For example, supervision is directed mainly at the legal entities; business innovation leads more and more to a shift away from these legal entities into networks and joint venture agreements. The shift from product-oriented competition to customer orientation needs bundling and unbundling and leads to the creation of "supply-chain management" where the emphasis is no longer on legal entities but on organizational and strategic networks. This general trend affects the supervisors in the financial sector more than in any other sector, because it is mainly in the financial sector that business regulation and supervision exist to such an extent. Furthermore, the new competition is certainly not restricted to traditional suppliers in the financial services industry: the toughest competition comes from outsiders.

Of course, the supervisory and regulatory solutions will also be dependent upon other factors. One important aspect is the level of development of the financial sector in a country. The less markets are developed, the more the balance will shift towards regulations and *a priori* supervision. The more markets become mature, the more *a priori* supervision is replaced with *a posteriori* control and disclosure. In an information age, disclosure must be the cornerstone of all supervisory mechanisms. Such a system is only viable if sufficient and clear information is available.

Given the many dimensions of financial convergence, a better view on the types of convergence, the degree of integration and the products involved is more than necessary. Unfortunately this is completely lacking today. This is harmful for a better understanding of the financial sector from a supervisory perspective as well as from a research perspective. We therefore hope that academic institutions, regulatory authorities and supra-national organizations will collaborate to find a way to bring about a better disclosure of this financial convergence in all its aspects.

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