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## Relevant changes in the character of integration in the financial market

### Abstract

This paper deals with the changes in concentration and integration process on financial market, namely on banking and insurance market. Tendency of banks and insurance companies to develop bancassurance brings synergic effects and intersectorial stabilizer. Citizens of each country have different ideas about the financial products and services. Nevertheless, bancassurance creates a completely new space on the market but it can be expected that its popularity will not grow in the future.

**Keywords:** acquisition and merger, bancassurance, financial supermarkets.

**JEL Classification:** D 40, D810, D820, G 22.

The period of significant volatility in the behavior of financial markets with all its negative consequences often showing a nature of the crisis so characteristic for the end of the last century, was followed at the turn of the millennium for several years by a much quieter period of “great moderation”. This meant a contraction of the spread of economic factors of the developed world, particularly characterized by a significant economic growth with low inflation.

Financial crisis caused by a meltdown of the price bubble in the stock markets in the late ‘90s generated a strong pressure on the global integration of the financial institutions exposed to a highly competitive environment. This process had commenced with increasing cooperation of the banks and insurance companies being then supplemented by other segments of financial services. The turn of the millennium was therefore characterized by gigantic mergers and acquisitions with positive expectations of a further economic growth supported by additional synergistic effects of the product convergence within the framework of intersectorial integration. This process was supposed to contribute to the maintenance of economic stability as well as prosperity in the long term.

Following this development trend meant for the financial institutions at that time to react to the changing requirements of the clientele concerning a higher quality and complexity of the services as well as the new more effective forms of communication (e.g., the sales of the financial services over the phone, use of internet network, etc.), saving time of the clientele. The extraordinary client approaches created then a competitive advantage on the one hand, and also a greater stability and client safety, on the other hand. Consequently, the results of these in many aspects revolutionary processes, have been still today surviving significant changes in relation-

ships of the financial institutions supported by advancing deregulation and possibly conducive taxation environment.

Also, for example, the factors such as compliance rules, off shoring and the measures to stem money laundering, etc., had a positive influence. In the last decade the financial sector had therefore undergone a gradual consolidation and concentration where the dominant players turned out to be small, more concentrated numbers of multifunctional financial groups and financial “supermarkets”.

Consequently, generally speaking, the financial markets institutions, including banks, insurance companies, investment funds and pension funds, in this more complex global environment have become more interrelated, in order to achieve a higher level of competitiveness. By the same token, the traditional clear boundaries of various financial sectors have become obscure, giving a rise to the new integrated subjects – firstly the bank/insurance companies hybrids and then the multifunctional conglomerates with more or less centralized management. The positive potential of this financial strategy included new factors: revenue of conglomerates being diversified, economies of scale, cost reduction, risk diversification, possible tax shield, lower demand for information collection about the clients, lesser requirements concerning the distribution networks, common marketing and more effective product sales, more effective utilization of the manpower as well as work places along with the geographic coverage, and last but not least increasing financial and strategic capacity power of integrated financial institutions.

The more cohesive liaison of the banks and insurance houses, representing the first stage of integration processes was generally predetermined by the fact that in spite of the specifics of each industry, the mutual relationship is rather intertwined. Banks and insurance companies (particularly the life insurance houses) are institutional investors. As far as the banks are concerned, the priority is the capital for-

mation, whereas in the case of insurance companies creation of reserve funds is a secondary consequence of the special insurance services offer. Insurance companies are using banks in the process of premium collections and payment of the insurance compensations.

The banks, on the other hand, are taking business risk insurance covers and often are arranging risk diluting investments of the technical reserves deposits by insurance companies, using suitable instruments at their disposal.

First impulse in the initial phase of integration of the banking houses and insurance companies was a significant change in the clients' investment demand which occurred in the '90s: investors cash savings shifted towards the long-term investments including the life insurance instruments, as an indication of a preference of the latter products over any other assets. Due to the fact that the banking industry has been economically a stronger and more significant partner in the alliance with insurance houses, the obvious similarity of bank-offered and insurance investment products allowed the banks to initiate the change in the investors' preferences thus opening the way for banks to the insurance markets still in the meantime enjoying growth, particularly in the life insurance segment. On top of, that at the turn of the century, the bankers had to face a relative saturation of the retail banking market and therefore a decline of the profit margins together with the rising costs of obtaining the new clientele. The implementation of strategic "bank-insurance" orientation, not excluding the market comparative advantage of a wider spectrum of the offered services, created a room for the cost favorable acquisitions of the new banking clientele from the area of the common business joining insurance companies.

At present, the fast development of life insurance where its products are easily adaptable to bank investment structures has been, apart from the increasing popularity of the long-term investment instruments, fostered by the contemporary grave problems of the Government-funded pension systems. These systems based on the so called "intergeneration solidarity" can hardly cope with the fiscal aspect of a demographic shock reflecting the relatively fast ageing population in the developed countries. In this context life insurance in some countries, with a possible tax-saving benefit represents in line with the market a viable alternative to financing the life of retired population.

Contemporary globalized financial world is offering at the moment an alternative strategy of enhanced insurance cover by the intersectorial risk diversification. For commercial insurance companies tied up at

the moment in the problems associated with the natural disasters, climate changes, computer piracy, diseases, e.g. SARS, BSE, etc., this means a possibility of transformation of various risks beyond the perimeter of insurance industry, to the area of banking and, for example, with the use of instruments such as derivatives, to the whole entity of financial markets.

From all points of view, a very cohesive cooperation with a subsequent strategic alliance of the banks and insurance companies was at this stage of development a logical step leading finally to creation of the multifunctional financial conglomerates where the client has an opportunity to obtain the whole spectrum of financial services including not only traditional bank deposits or several credit products, but also various investment as well as insurance products. The offer of such cross functional packages makes it possible to enhance the client loyalty and with relatively low costs to obtain additional information about the clientele to further the customer/product focus.

Table 1. % bank-insurance share of insurance products sold in selected European countries (year 2006)

	Non-life insurance	Life insurance
Great Britain	10	20,3
France	9	64
Germany	12	24,8
Italy	1,7	59
Spain	7,1	71,8
Belgium	6,1	48
Portugal	10	88,3
Poland	0,6	14,4
Turkey	10	23

Source: Insurance regulators; insurance associations; Axco; LIMRA; Swiss Re estimates. Bancassurance: emerging trends, opportunities and challenges, Sigma No.5/2007.

In respect of the two different segments of the insurance market, i.e. life insurance and other insurance, the former is more typical for a distribution of the relevant products through the bank-insurance market approach (see Table 1). At the same time, it is possible to see a significantly different distribution through the bank across different countries. However, it is possible to see stagnation and/or a small decline of the trend, particularly in the countries with a large share of life insurance product sales through the banks.

In the meantime, however, we have to realize that the trend of intersectorial integration and its phenomena has already passed its peak. Economic development of the recent years being followed by the contemporary subprime mortgage financial crises originated in the US and having the global reach

raises doubts about the capability to sustain and manage the long-term stability and prosperity as well as a continuity of integration processes. The gradual reduction of space for opportunities in terms of a number of acquisition targets in the past decade was another reason for this development. Acquisition strategies oriented across-the-border on the potential of emerging markets might have problems. Placement of capital surpluses by the banks can face obstacles in the form of local regulations. Further to that, some of the mergers of the banks and insurance companies had not been successful even in the “bullish” period causing some evaporation of optimism and sobering up in the subsequent time.

Among the well-known cases of unsuccessful fusions of the banks and insurance companies were the acquisition of the Dresdner Bank by Allianz Insurance where the bank has caused a loss situation, then in 1997 Credit Suisse merging with insurance house Winterthur and fusion of Citibank with Insurance company Travellers. This third merger occurred in 1998 creating the largest bank-insurance conglomerate Citigroup intending to explore the synergistic effects of intersectorial integration. However, after only three years, during the times of various catastrophic events, including 11th September, etc., the Travellers&Casualty subsidiary dealing with other insurance, as many other similar, even renowned houses in the field, was jettisoned.

Four years later then, after the sale of the life insurance business with a small loss, the Citigroup conglomerate collapsed. The explanation stated the colossus to be effectively unmanageable.

Besides the profit fall was soon reported by the second largest bank-insurance conglomerate Credit Suisse-Winterthur which also operated in the Czech Republic. One of the reasons seemed to be orientation on the already saturated insurance markets in Germany and Switzerland. The insurance part of the whole business

had been on sale since 2004, finally being acquired only last year by French insurance interest AXA.

These unsuccessful ventures only confirm the already early stated problems with harmonization of activities with regard to the banking and insurance processes, with the aim to overcome a possible lack of effectiveness, particularly in case of a large scale of operations. It also appears that the savings due to the economies of scale from insurance transactions are rather small. The strong competition is also forcing the price decline regardless the size and organizational structure of a financial subject. Price is therefore not a decisive parameter in the clientele’s decision making.

In the context of integration the area of other insurance business has appeared to be a problem right from the beginning. The factors such as the math/statistical problems of computing models, different organizational culture, difficulties to integrate majority of other insurance products into the bank-insurance strategy (with the exception of simple products, e.g. covering accidents, traveling, etc.) determined since the early stages only the specialized life insurance houses as suitable for integration with the banks. The framework of other insurance products should therefore remain outside the conglomerate strategies. In our opinion, a further problem influencing the integration trend lies in the flexibility of change in insurance packages to be tailored to the clients needs. A standard package often includes services which a client does not need even though he is paying for them. The loss of fiduciary contact with the insurance broker and a switch to competition on the client’s part can be the consequence. Although the “tailor-made” products do not conform to the bank-insurance strategies of the service providers, they are favored by the large group of more affluent clientele preferring more sophisticated and cost effective products. This, of course, opens an opportunity window for independent financial advisers, small operators acting as personal brokers being capable of conforming more to the market demand.

Table 2. Changes in bancassurance penetration since 2000

	Life insurance		Non-life insurance	
	Current penetration	Changes since 2000	Current penetration	Changes since 2000
North America	low	↗	low	↗
Latin America	low to medium	↑	low	↑
Continental Europe	high	↔	low	↗
CEE	low	↑	low	↔
Japan	low	↑	low	↑
Asia ex Japan	low to medium	↑	low	↔
Middle East	insignificant	↔	insignificant	↔
Africa	low	↔	low	↔
Oceania	high	↔	low	↗

Note: Bancassurance penetration differs among markets within each region. The above is a stylized summary of regional trends. Source: Bancassurance: emerging trends, opportunities and challenges, Sigma No.5/2007.

Financial turbulence of the end of '90 being followed by the contemporary crisis in the financial markets most certainly calls for a more effective, Government-led legal/economic framework of regulation and control with the aim to increase as well as maintain market stability, client safety and reduction of the so called information asymmetry. At the same time it is necessary to react within this framework to the latest trends such as the consequences of mergers and acquisitions as well as the intersectorial integration, in particular. From this point of view we believe that the regulation-orientated projects Basel for banking and Solvency for insurance determine more rigorously the requirements of the capital adequacy for banking and insurance operations, new quality of handling the business risk of banks and insurance companies, together with a set of rules improving the transparency as well as reducing the information exchange asymmetry between the banks, insurance companies and their clients. The quality of regulation improvement in the capital markets in the European Economic Space is expected from the system of regulation Miffed aiming to complete the process of creating the unified, robust and competitive European market for investment services to react to the capital market new changes/innovations and to secure adequate protection of investors. Nevertheless, the critics of the project consider the market being "overregulated".

Recent "creative accounting"-driven scandals create a need of stable and comparable accounting methods according to application of the rules IFSR. Since the projects are prepared by various teams using different methodologies, the process naturally generates inconsistencies. An example is a definition of the term "risk". The science understands decisions in the risk circumstances as an uncertain situation when the probabilities of an event are known apriori (e.g., a toss of the dice).

Although the economic and human activities are usually missing the attribute of knowledge apriori, the term "risk" is used due course of rigorous research in fundamentally more complex economic processes and activities, offering no unique or certain results, without respect to any forward aimed probabilistic assessment thus lacking the correct methodological foundation.

This situation enters IASB with its own definition of the terms "financial risk" and "insurance risk".

In spite of the fact that the points of view are only of a preliminary nature, still subject to a possible change, the consequences of the standards hitherto applied could turn out to be very serious in the life insurance computations. The IFRS standards' im-

plementation has not been so far compulsory; consider along the line of IASB definitions the life investment or some life capital insurance covers as investment contracts as opposed to insurance contracts as such. These instruments are therefore escaping any "conservative" supervision of the insurance business. The preliminary and/or even contradictory accounting definitions might lead then their authors to conclusions with serious consequences for classification of some economic and financial outcomes and categories. Example is the typical life insurance cover for a contracted period which hardly fits the created definition of insurance contract.

However, in this context it is possible to say that the regulation process-orientated projects Basel and Solvency II belong to the best worked out ones in their fields.

The subprime mortgage debacle complemented by the Collateral Debt Obligation (CDO) crisis gradually spreading from the US since 2007 raised naturally the question of effectiveness of regulation process concerning the reckless and irresponsible advancing of loans to the mortgagors of doubtful financial solvency. Further, the case of Société Générale revealed a lack of internal control leading to a fraudulent behavior of an employee which caused exposure ranking in tens of billions EUR, far exceeding the bank's net worth, when finally the hardly hit bank had to write off EUR 5bn as a consequence of impact of the commencing world financial crisis.

Nevertheless, the subtle yet cardinal question is whether or not the even very well worked out projects such as Basel II, being concerned with management of the credit, operational as well as the total risks, are capable of stopping the destructive turbulence in the financial markets.

Financier George Soros calls it "casino in the whole planet"! Right or wrong?

## Conclusion

It is difficult to disagree with the prognoses of some experts that the next trend in our environment will scale down the variety of portfolio instruments of the institutional investors who will concentrate on the supply of homogeneous products offered by an array of specialized financial institutions. In other words, a higher focus is expected on the "core business" using more outsourcing to cover the other activities. The high degree of using life insurance in the rich economies means a possible decline of the demand in these areas. The opposite might be true in the economies with a low level of life insurance.

The contemporary globalized world is bringing the time/space compression of economic events which modifies the content of traditional economic categories and develops new trends together with their very fast changes. The trend of intersectorial integration in the framework of mergers and acquisitions commencing in the '90s is currently undergoing serious corrections.

What we mean is firstly, the sobering process of the acquisition bidders due to the shrinking space of suitable opportunities and secondly, the set of factors mentioned in this paper which in our opinion will act against any further massive continuation of the intersectorial integration and concentration trends in the financial markets as in the past.

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