Assurances

Financial Services in the Year 2000: Looking Back on the 1990s

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Volume 59, numéro 3, 1991

URI : https://id.erudit.org/iderudit/1104847ar
DOI : https://doi.org/10.7202/1104847ar

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Éditeur(s)

HEC Montréal

ISSN

0004-6027 (imprimé)
2817-3465 (numérique)

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Résumé de l'article

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*This paper was prepared for the 8th Meeting of the Members' Forum of the Financial Services Research Program established under the auspices of the Conference Board of Canada, held in Ottawa on January 15-16, 1991 on the theme of "Financial Services in the Year 2000."

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Preface

The Canadian financial services industry is preparing for a period of significant adjustment as it looks ahead to the 1990s. The proposed federal financial sector legislation will broaden business powers across all sectors of the industry. Its implementation will intensify domestic competition and will require an in-depth review of historical competitive advantages. Of particular concern is the question of whether size and diversification will provide a decisive advantage over specialized niche players. The adequacy of existing distribution systems in an environment of multi-function institutions is also a key issue for many firms in the industry.

Significant changes are also taking place in the international environment, including the growing fragility of some segments of the U.S. financial system, the restructuring of European financial services as part of the 1992 Program and the retrenchment of Japanese financial institutions. With the emergence of more integrated economic blocks in North America, Europe and East Asia, Canadian financial institutions will need to review the adequacy of their linkages with other financial markets around the world.

At the same time, financial performance is negatively affected by the impact of sustained high interest rates and a deepening recession on the business environment. Tight prudential requirements have strengthened the ability of most Canadian institutions to withstand the shock. Yet, with technology changing rapidly around the world, the need to remain competitive increases the need to modernize existing systems at a time when internai financial resources are generally constrained.

In addressing these issues, financial institutions will need to develop a view of the environment that will emerge in the 1990s. This paper was prepared to stimulate a discussion on the subject at the Members' Forum. The authors fully recognize the risks and the limits of attempting to predict future trends in the present environment of significant international economic, financial and political uncertainty. However, they hope that the more provocative points raised in this "back-cast" of the 1990s will prove useful to participants when looking beyond the very short-term and formulating a longer-term strategy.

Introduction

The Canadian financial services industry has experienced profound transformations during the 1990s. As we move into a new millenium and look back to the period of substantial economic and financial uncertainty experienced early in the decade, the industry has continued to show a remarkable capacity to adjust to a fast changing environment.

The barriers between the various parts of the financial services industry continued to crumble. What has emerged is a dichotomy between large-scale full-service conglomerates and smaller specialized niche players. In retrospect, the fears that this might lead to undue concentration in the financial sector proved largely unfounded. Only a few conglomerates have actually been truly successful. Most others were forced to refocus on their historical core competencies, a process reminiscent of the experience with non-financial conglomerates in the early 1990s.

The Global Environment

Much of what happened during the last decade has been associated with the working out of major economic and financial imbalances accumulated through the 1970s and 1980s. In the wake of the protracted recession of 1991 in key parts of the world, it became increasingly evident that the challenge for policy makers and business executives was to reconcile two seemingly opposite forces. The need for corrective action required much greater *integration* and coordination at the strategic level. At the same time, the need to build flexibility in the economic system and within business corporations required much greater *decentralization* in the decision-making process.

Balancing Integration and Decentralization

The balancing between these two opposite forces was far from easy, but significant progress was achieved through the decade. In the area of international economic relations, despite the collapse of the Uruguay Round early in the decade, integration and decentralization provided a framework to reconcile the basic principles of the GAT I with the emergence of large international trading blocks in North America, Europe and East Asia.

With trade moving more or less freely within each block, the focus has now shifted to developing a common set of rules that would help reduce restrictions on the flow of international investment between regions. The issue has had particular significance for the financial services industry around the world. This facilitated early acceptance between the three emerging trading blocks of the need for a broad-based financial services agreement covering both market access and regulatory harmonization.

At the same time, the need to establish a reasonably level playing field within each trading block has required greater convergence between member countries in a number of key policy areas, including tax policy, competition policy and bankruptcy legislation. Negotiations in these areas proved to be difficult, with many of the issues being addressed touching on the sensitive chord of national identity.

Integration and decentralization have also led to a major reinterpretation of the whole idea of the Nation State. The process of economic and financial integration in Western Europe reached full maturity in the 1990s and a truly continental economy has now been created with the inclusion of some parts of Eastern Europe and Scandinavia. The building of a wide trading area between North America and the Latin American continent started somewhat later, but the process gathered significant momentum in the wake of the recession and is now coming close to completion. In the old Communist world, massive decentralization of power and authority has led to smaller, much more effective economic and political units grouped under a common federation.

Canada of course remains a common market within a common market, but the process of rearranging the powers of the federal government and what used to be called the provinces has seemed interminable!

Balancing integration and decentralization was also a theme in the business sector. Greater reliance on market forces had been a widespread pattern of the 1970s and the 1980s, with government intervention and state ownership being unwound. This trend was accompanied by waves of mergers, acquisitions and strategic divestitures as corporations around the world attempted to reap the synergies of large and diversified conglomerates.

The process came to an abrupt halt during the protracted recession of 1991 and only those firms which had fondamental unity built around a core competence were able to withstand the shock. The mere collections fell apart, despite the claims that diversification would provide an effective countercyclical protection. And as the rec<?".e11' gathered momentum, the focus turned to finding a better eq 1hbnum between the advantages arising from size and diversification and those associated with specialization.

Adjusting to Past Imbalances

Efforts to unwind the large financial imbalances which had accumulated through the 1970s and 1980s had a significant impact on the economic environment of the past decade. As the world economy moved through the 1991 recession, the fragility of the financial system in several parts of the world and the overextended position of large segments of the business and household sectors l om d as s gnificant threats to the recovery. In a number of countnes, mcluding Canada and the United States, the ability of governments to manage their economies was also severely limited by their large accumulated fiscal deficits.

Ultimately, concerted action through the Group of Seven - subsequently replaced by the G-3 - and through the BIS ensured that the more pessimistic scenarios did not materialize. But reducing the debt overhang proved to be much more painful and protracted thal: had been the case with developing country debt, and recurring penods of slow growth and under employment extended into the second half of the 1990s.

The high y complex business of dealing with global systemic nsk was a m Jor preoccupation throughout this period. Here again, concerted act10n through the BIS proved critical. In many countries, the process le to a much-needed restructuring of supervisory powrs, alon the lines of the reorganization which took place in Canada n the rmd-1980s. For a time, there were also strong pressures to impose a system of market-value accounting. But, with the return to relative price stability later on in the decade, the pressures have progressively diminished.

In retrospect, much of the credit for unwinding the imbalances should probably go to the determined stance of the monetary authorities which played a key role in bolstering the resolve of finance ministers in key parts of the world. Relative price stability has been re-established as a permanent element in our environment, eliminating many of the distortions which had severely impacted on the economic and financial system through the 1970s and 1980s. Nominal interest rates have fallen significantly, contributing in tum to a contraction in both public sector deficits and international payment imbalances. Nevertheless, real interest rates continued to remain at relatively high levels through most of the decade.

The Financial System

Slower Growth than in the 1970s and 1980s

Throughout this period, the Canadian financial services industry has continued to grow rapidly, although less rapidly than in the preceding two decades. Our earlier research had shown that the demand for financial services was income elastic through the 1970s and 1980s, so that the sector grew faster than the economy as a whole. This basic trend was much less apparent during the 1990s.

This was due in part because financial institutions focused increasingly on the need to offer diversified services to their customers rather than on the goal of accumulating assets on their balance sheet. In fact, for most institutions, the growth in fee income has substantially outpaced asset-based income. The unwinding of the large fiscal and financial imbalances in the economy also contributed to a relative contraction in the supply of several financial instruments. Only those institutions whose prime fonction was the accumulation of wealth on account of a third party, such as pension fonds, continued to register sizable asset growth, albeit at a slower pace than in the 1980s.

The diversification of Canadian corporations into the United States and the fast growing markets of Europe and East Asia contributed to strengthening the demand for corporate financial services, particularly in the area of investment banking. In an environment of trading blocks, most of the large Canadian firms found it essential to establish a commercial presence abroad. They have relied extensively on the support and expertise from those Canadian financial institutions established abroad or from the few large foreign banks established in Canada. Demographic trends also had a positive impact on the demand for household financial services as the needs of an ageing and more affluent population continued to increase rapidly.

Technology kept on revolutionizing the way financial transactions are conducted. Routine operations of finance are becoming decentralized, with information increasingly conveyed from homes, stores and offices through emerging networks of fibre optics. Smart cards have got smarter, and banking machines more sophisticated.

Within individual firms, the heavy investments in system development of the early decade resulted in increased processing capacity through networks of main frame and persona! computers. This has brought about lower operating costs, greater flexibility and profound changes in the structure of management information systems.

With large efficiency gains arising from technology, overall industry employment has remained essentially flat through the decade. There has been a sharp drop in the low value-added occupations in the branches and back offices. Over time, these positions have been replaced by new ones requiring a combination of both financial and systems skills and competition for highly qualified personnel has remained very tense.

International Competltlon

Despite ongoing negotiations on a broad-based agreement on financial services, competition between the major trading blocks continues to be constrained by a variety of barriers. The bulk of the financial business throughout the world is still done by locally-based firms. Foreign-owned firms have been successful niche players but have done less well in the mass retail markets. Sensitive regard to customer needs is a precondition of success, and it seems this can best be done by locally rooted firms, though foreign competition keeps them on their toes.

Our experience in North America illustrates this well. Early in the nineties, Canadian firms were rather successful in building continent-wide enterprises because of the systemic weaknesses of U.S. banks and savings and loans associations. In this they were helped by the continued erosion and ultimate repeal of the Glass-Steagall Act. But just as the U.S. automobile industry fought back foreign competition by improving quality and service, so did their financial institutions. Canadian firms are now having difficulty maintaining their market shares in face of renewed local competition. Similarly, the elimination of the constraints on foreign banks operat-

ing in Canada has not led to a major increase in the Canadian market share of these institutions, except when this was done through acquisition.

With very few exceptions, the experience with truly "global" financial services firms around the world has not been successful in the 1990s. Most Canadian firms have pursued the route of strategic alliances with locally-based financial enterprises established in key foreign markets. These arrangements are proving to be an effective mechanism to meet the needs of customers. However, they remain complex to arrange and several have failed because they did not provide a balanced package of reciprocal benefits to both parties.

Full Service Conglomerates vs Specialized Niche Players

Batancing Size and Diversification Against Specialization

The evolution of the industry into a two-tiered structure, with large full-service financial institutions on the one hand and niche players on the other is a good illustration of how the forces of integration and decentralization have been balanced and reconciled. It has reflected the need to balance the economies of scale and scope with the high levels of service specialists can provide.

Financial conglomerates have been able to implement the complex technology on which modern financial transactions are based. In these new structures, the total financial needs of clients can be addressed in an integrated way. In contrast, small firms have continued to flourish by profitably meeting the needs of special groups and offering services tailored to individual requirements. By not providing the whole range of services to mass markets, they have gained the benefits of nimbleness and flexibility. It is often the smaller firrns who are the innovators.

The distinction between the comparative advantages of the full-service conglomerates and the niche players was best illustrated in the securities industry after the late 1980s. While the big firms were able to meet the needs of most people, smaller and more specialized firms did well in providing the more intensive and customized service required by wealthy and sophisticated investors.

Management Issues

One of the major challenges for the new conglomerates was to integrate the diverse cultures of the old pillars and to build management structures which could deliver the wide range of financial services implied in one-stop shopping. On the whole only a few conglomerates have been truly successful and not all achieved this with equal facility.

Inevitably, some enterprises diversified too far and were forced to refocus on activities more closely related to their historical core competencies, where synergies were greatest. This has led to a variety of well-publicized divestitures in the second half of the decade and to the emergence of a new industry segmentation, this time based on customer orientation instead of functional specialization. In the process, several highly dynamic mid-size firrns have emerged, some catering exclusively to the business sector while others concentrate exclusively on the household sector.

New patterns of distribution also emerged in the 1990s. The traditional branch was rendered largely obsolete by the technology of electronic seulement. Instead, it has become a place where clients seek advice, choose between new products and carry out major, complex transactions. Because of the persistence of regulatory "Chinese Walls" in information systems, conglomerates have not been able to consolidate their activities around a single distribution network, but have had to maintain different ones to serve different needs.

As regards the niche players, several have continued to maintain their own distribution systems. However, many have found it profitable to rely on outside distributors. This has encouraged a substantial consolidation within the community of deposit brokers, property and casualty insurance agents and mortgage brokers. In many ways, the process was similar to the restructuring of the independent accounting and legal firms throughout the 1970s and 1980s. While there are still some successful independent brokers, most have now joined the large brokerage firms that have emerged over the past decade. These firms are well regulated, they provide a broad range of financial advisory services and offer a broad range of product lines from supplying financial institutions.

Difficult management issues have been involved in pricing the new range of services. With competition and unbundling, clients have been asked to pay fees more closely related to the cost of producing the service, including the costs of the new electronic networks.

Sectoral Issues

Much of the attention in the early years of the decade was focused on the performance of banks, trust companies, securities firms and co-operative credit institutions, reflecting the impact of the recession on their credit ratings. Stringent intervention of the supervisory authorities helped many of the weaker institutions re-establish their position, but several were absorbed by larger financial conglomerates.

In contrast, the life insurance business fared relatively well through this period, continuing to build on the dynamism established through the 1980s. The large life insurance firms have diversified across a wide range of financial services, in effect becoming a key part of the conglomerate universe. Nevertheless, reflecting demographic trends, the life insurance business itself has slowed down in the latter part of the decade. The earlier slowdown in the whole life business has been followed by slower growth in term insurance as the average Canadian feels better protected by pension schemes, RRSPs and RRIFs and by the accumulation of wealth through the pay-down of mortgages and through inheritances. In the process, there has been increased consolidation among the smaller firms in the industry.

Property and casualty companies have had a rockier road to travel. The process of consolidation into a smaller number of more viable firms has been drawn out. The environment emerged as a key issue for the industry with the establishment of environmental "bills of rights" in many provinces, leading to a fondamental reform of tort legislation during the second half of the decade.

The provision of venture capital - providing finance to new businesses and riskier projects - is a continuing concern. There seems to be less willingness to take risks and more emphasis on prudential rules in financial management. We keep on hearing demands for new mechanisms through which venture capital can be provided. The trouble is that no one wants to pay the risk premium.

The Regulatory Environment

Generally speaking, the restructuring of the Canadian financial system worked relatively well. The change was facilitated by the new regulatory regimes introduced early in the decade and reinforced in the mid-decade review when the authorities moved to an integrated legislation under the new Financial Institutions Act.

Regulatory policy has evidently been market driven. The means of achieving the basic objectives of protecting the public have had to be adapted to changes in the marketplace. The move towards fewer, bigger and more diversified firms has altered the nature of the risk and the challenge has been to ensure that sound business practices were maintained within the more complex structure of modern financial conglomerates. This challenge was not specific to Canada and regulators around the world have cooperated actively in developing appropriate safeguards in this area.

Not all institutions were able to adjust to the fast changing environment, but problem areas have been spotted and remedial action taken quickly. Improved supervisory systems put in place a decade ago have proved their worth, and developments in technology also helped. Sorne claims were made against customer protection plans. But the size of the institutions was relatively small and C.D.I.C. was able to reduce its premium rates after building the Insurance Fund to satisfactory levels.

The mid-decade revision to the financial sector legislation proved to be easier than was the case in the late 1980s. By then, most institutions were prepared for the removal of the ban on the retailing of insurance by deposit-taking institutions. For a time, the debate over commercial linkages was reactivated when the authorities moved to integrate large segments of the Investment Companies Act into the Financial Institutions Act. In keeping with developments elsewhere in the world, the authorities have been reluctant to relax existing restrictions on upstream commercial ownership. However, in response to market developments, the rules goveming the downstream ownership of commercial enterprises by financial conglomerates have been substantially liberalized.

Challenges Ahead

As the financial system moves out of the turbulent 1990s, policymakers and industry executives continue to face tough challenges. The decade was one of substantial restructuring, and safety and soundness remained at the center of the latest round of discussions on revisions to the Financial Institutions Act. At the same rime, there are many familiar issues carried over in one form or another from the early 1990s.

For instance, the question of whether size can provide a decisive competitive advantage has gained renewed prominence with the prospect for an early agreement on the North American Monetary Union and the creation of a common currency area. Despite their favorable performance, many of the smaller specialized financial institutions in Canada are concemed that the agreement will severely affect their chances for survival in the new environment. Severa! large conglomerates are also concemed that they have not reached the necessary "critical mass" and breadth of operations required to compete against their U.S. counterpart.

Technological innovation and the adequacy of distribution mechanisms remain key issues for the industry and policymakers. The complexity of modem automated processing and telecommunication systems and the potential for major disruptions have been a source of growing concem to the authorities through the 1990s. Thanks to the pioneering work of the G-30, stringent guidelines now govem the safety of seulement and clearing systems around the world. Prudential standards goveming interna! systems and backup facilities have also become an integral part of our Financial Institutions Act. In order to meet the increasingly tough requirements established in Canada and abroad, Canadian financial institutions now allocate a substantially larger proportion of their operating budgets to technology development and maintenance.

At the same time, the regulatory "Chinese Walls" which continue to apply to the internai information systems of financial institutions are a source of substantial inefficiencies. Clearly, the protection of privacy remains a prominent public policy issue. However, the less stringent requirements applying to the large brokerage and financial planning firms have allowed them to make significant inroads into the market for advisory services to household customers. By drawing on the potential of 21st century technology, they can offer their customers a much more integrated approach to the management of their financial position. In this area, policymakers will therefore continue to face difficult trade-offs between industry efficiency and privacy protection.

Regulatory harmonization is another important issue that has been carried forward from the early 1990s. Domestically, the process is now largely behind us but financial services proved to be a major issue in the tough Constitutional negotiations which took place around the middle of the decade. The agreement that was reached in this area is another illustration of the delicate balancing of integration and decentralization. It led to the implementation of an integrated financial institutions legislation both at the federal level and in each of the regional jurisdictions. With a broadly consistent framework established across the country, variations have now been made possible on the basis of the "home jurisdiction" principle.

International discussions over harmonization across countries have been much more protracted. This has been a difficult issue in the negotiations over the creation of a North American Monetary Union. Significant differences still exist around the negotiating table and the question of whether diversification should be allowed to take place through branch operations rather than through dedicated subsidiaries remains a significant point of contention. Substantial differences also remain in the negotiations between North America, Europe and East Asia. Indeed, while a basic agreement over market access has been reached relatively quickly, little progress has been accomplished to date in reducing those regulatory differences which act as powerful barriers to foreign competition.

These are only a few of the issues confronting the industry today. We have now safely moved through the last evening of 1999 and the dire predictions of collapse have not materialized. Many of the tough challenges encountered during the last decade have been successfully addressed but several are still around and have become more deeply entrenched. One of them is the sense of global limits imposed by ever strengthening concerns over the environment and the need to secure stable supplies of energy and resources. Perhaps equally important in an environment of slower growth is the fairness by which the benefits of growth are redistributed globally. As we look ahead to the brave new world of the 21st century, Canadians - and with them also the international community - remain confronted with these two fondamental issues.