Perspectives on Financial Integration and Financial System Architecture in Emerging Markets

by

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Outline

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- Definition
- Classification
- Financial Integrated Products
- Future Trends
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- Financial System Architecture
  - Definition
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Financial Integration

Financial Services Industry Integration:

Any event that joins two or more financial services organizations **OR** combines two or more dimensions of the production or distribution of financial services, within or between traditional financial services sectors.

Traditional Financial Services Sectors include:

Banking

Insurance

Securities

Financial Integration

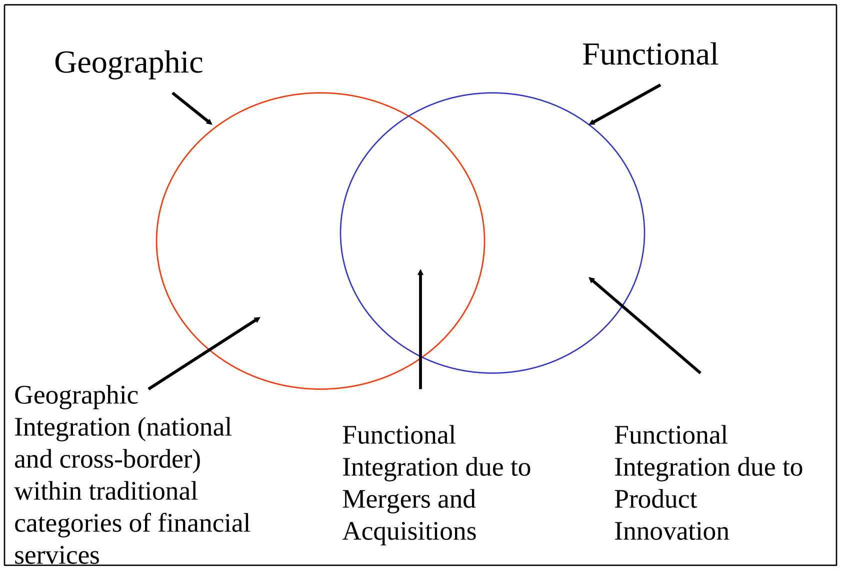
Classification:

I. Geographic Integration

1. National integration of institutions within a single traditional product category (i.e., intra-sector)
2. International (cross-border) integration

II. Functional Integration

- Integration across multiple financial product categories (e.g., bancassurance, universal banking)
- Could be a result of combination of organizations or product innovation.



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Financial Integration

Examples of Functionally Integrated institutions/products include:

- Bancassurance
- Universal Bank
- Asset backed securities
- Mutual fund offerings of banks
- Unit links etc.

The organizational forms of functionally integrated institutions reflect various degrees of integration

e.g., Bancassurance represents low level of integration, and universal bank with high level of integration.

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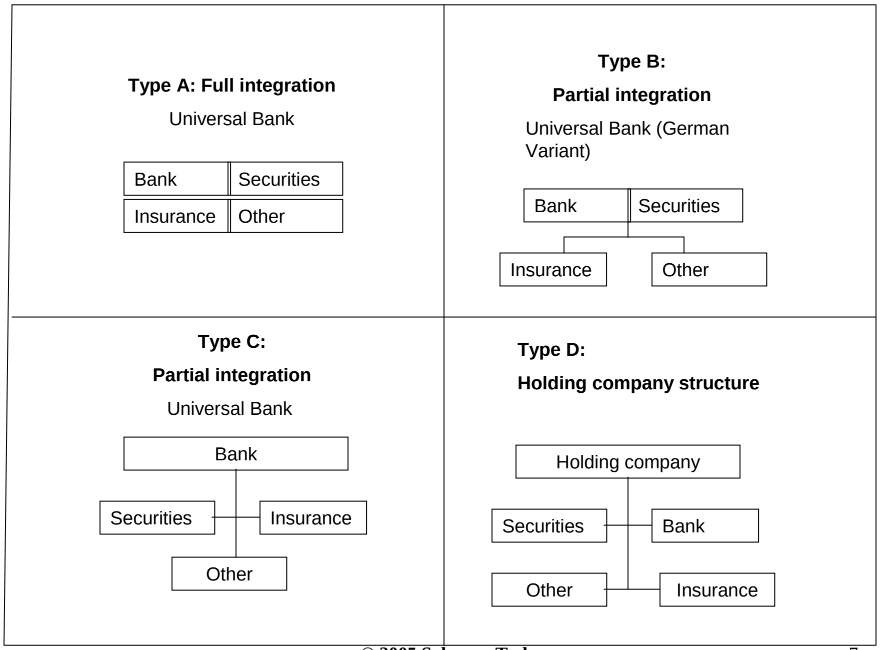

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Financial Integration

Current trends in Financial integration

- National integration more significant than cross-border integration in the developed world (see Table on M &A activities in 1985-97 below)
- Within-product category integration is more frequent and important than cross-product (i.e., functional) integration
- Overall, financial services integration is the rule and will continue to fundamentally change the landscape of the industry. The distinctions among the traditional banking, securities and insurance products are getting increasingly blurred as a result of deregulation, globalization and product innovation.

Values of Target Institutions in M&A Activity in Financial Services from 1985–97

Panel A: Domestic M&As — Target Institution

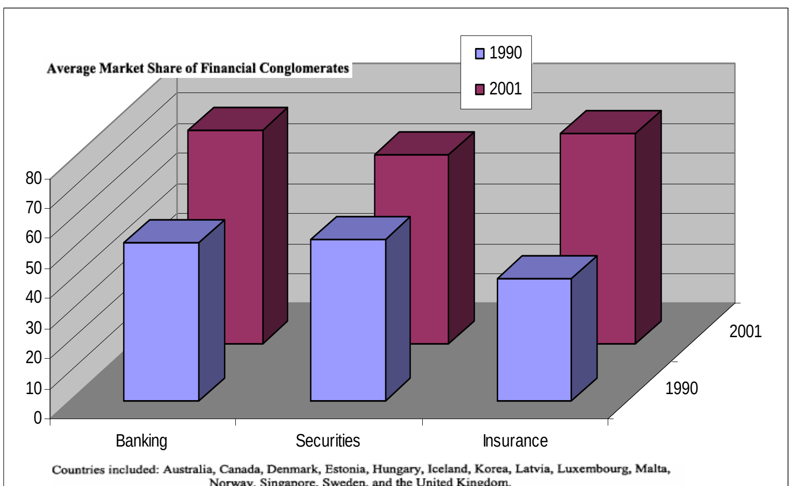
Acquiring Institution	U.S. Banks	U.S. Securities	U.S. Insurance	Europe Banks	Europe Securities	Europe Insurance
Commercial Banks	241 (51.8%)	15 (3.2%)	0.2 (0.1%)	89 (36.0%)	9 (3.6%)	20 (8.1%)
Securities Firms	6 (1.2%)	74 (15.9%)	27 (5.8%)	23 (9.3%)	19 (7.7%)	24 (9.7%)
Insurance Companies	0.3 (0.1%)	14 (3.0%)	88 (18.9%)	11 (4.5%)	6 (2.4%)	46 (18.6%)

Panel B: International M&As — Target Institution

Acquiring Institution	U.S. Banks	U.S. Securities	U.S. Insurance	Europe Banks	Europe Securities	Europe Insurance
Commercial Banks	9.5 (13.6%)	4.4 (6.3%)	0.2 (0.3%)	29.5 (16.0%)	13.0 (7.1%)	0.7 (0.4%)
Securities Firms	3.0 (4.3%)	14.7 (21.0%)	7.7 (11.0%)	19.9 (10.8%)	21.7 (11.8%)	14.0 (7.6%)
Insurance Companies	0.6 (0.8%)	3.9 (5.6%)	25.9 (37.1%)	12.2 (6.6%)	3.4 (1.8%)	69.7 (37.9%)

Sources: DeLong, Smith, and Walter (1998); Berger, Demsetz, and Strahan (1999); and Securities Data Company. The main number shown in each entry is the sum of the equity values (in billions of U.S. dollars) of the target institutions. The number in parentheses is the percentage of the total (these sum to 100 for each 3 × 3 matrix).

Financial Integration



Source : Martinez and Rose (2003)

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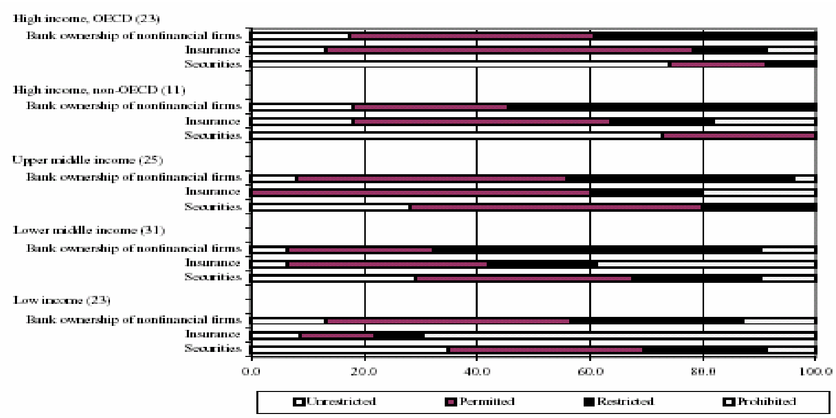
Financial Integration

- Data is not available on the significance of financial integration in Emerging economies
- However, from the indirect evidence, based on data on bank regulations
  - A significant number of countries (in all income groups) allow joint banking, insurance and securities activities. (see Table below)
- In East Asia, regulations in almost all countries allow joint banking, insurance and securities activities.
- Although at early stage, financial integration in Indonesia is getting significant. (e.g., by 2003, at least 10 banks offer bancassurance; 15 banks offer mutual funds; and 85% of mutual funds are sold via banks (Siregar & James(2004))

Distribution of 123 countries by degree of restrictiveness of regulatory restrictions on bank activities and the mixing of banking and commerce (in percent)



Note: Unrestricted = full range of activities can be conducted in the bank/bank may own 100 percent of equity.
Permitted = full range of activities can be conducted, but all or some must be conducted in subsidiaries/bank may own 100 percent of equity but ownership is limited based on bank's equity capital.
Restricted = less than full range of activities can be conducted in the bank or subsidiaries/bank can only acquire less than 100 percent of equity.
Prohibited = activity cannot be conducted in either the bank or subsidiaries/no equity investment allowed.

Source of basic data: Bank Regulation and Supervision Database, World Bank (2001).

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Permissible Activities for Banking Organizations in Various Financial Centers

(Directly or Thru Subsidiaries of the Bank)

Country	Securities[1]	Insurance[2]	Real Estate[3]	Bank Investment in Industrial Firms[4]
Indonesia	Permitted	Permitted	Not permitted	Not permitted
Malaysia	Permitted	Permitted	N/A	Permitted but Restricted
The Philippines	Permitted for both Universal and Commercial Banks with limitations	Permitted for both Universal and Commercial Banks with limitations	Permitted with limitations for Universal banks only	Permitted with limitations for Universal banks only
Thailand	Permitted	Permitted	Permitted	Permitted but Restricted
Singapore	Banks may hold equity participation in stockbrokering firms with MAS approval	Locally incorporated banks may own insurance companies with MAS approval	Limited in the aggregate to 20% of bank's capital	Interests in the excess of 10%, or that give the bank significant influence over the management of a company, require regulatory approval. In addition, a bank may not invest more than 2% of its capital funds in any individual firm.

Source: Siregar & James (2004)

Financial Integration

Future Trends and Major Factors driving financial integration:

- Deregulation and Liberalization
  - More and more countries, particularly emerging economies, are removing regulatory barriers
  - Deregulation is major driver behind national integration, and functional integration within countries.

- Globalization and increased international capital flows
  - The driving factor for cross border integration

- Product innovation and technological change
  - The key factor behind functional integration. The proliferation of new products that cross traditional product lines are blurring the distinctions of traditional categories.

Financial Integration

Integrated Products and Economic Performance

How do we measure performance?

Traditional Yardsticks of performance includes the degree of:

- Scale Economies
- Scope Economies
- X-efficiency

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Financial Integration

Evidence

The literature does not provide clear consensus about the value of integration

- Berger (2000), reviewing the extant literature, concludes that

  (1) there might be great POTENTIAL for scale, scope and efficiency gains from financial integration, BUT

  (2) the actual realized gain is MINIMAL because of organizational diseconomies associated with operating and monitoring such organizations.

- In addition, in non-finance industries, conglomerate firms, on average, destroy value (relative to focused firms).

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Financial Integration

However, it could be that these traditional measures of performance may not capture the full benefits of integration.

- The benefits from integration would include
  - Risk diversification benefits not adequately captured by these measures, and
  - The strategic, forward-looking diversification of managerial capabilities and product offerings.
    - In the fast-changing evolution of the industry, it is difficult to predict which product offerings or distribution systems will dominate in the future.
    - Product integration provides firms to be present in the market segments that could emerge in the future.
- These and other benefits may not be captured by the measures.

Financial System Architecture

Theme: Financial integration may serve a transitional phase in the evolution of a nation's financial system from relational (i.e., bank –based) to arms –length (i.e., capital market –based) financial system.

Financial Architecture: the degree to which the financial system of a country is relatively bank or market oriented.

Bank – Based Financial Systems:
e.g., Germany, Japan

Market – Based Financial Systems:
e.g., U.S., U.K

Financial System Architecture

- The financial systems of emerging market economies tend to be bank dominated, and for good reason.
- There has been a long debate on the relative merits of bank or market based systems:

Arguments in Favor of <u>Market-based systems</u> include:
- Capital markets better for encouraging and funding innovation
- Markets better at diversifying and managing risk

Arguments in favor of <u>Bank-based systems</u> include:
- Banks are good monitors, and are able to identify good projects
- Banks allow stage-financing, encouraging risky investments

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Financial System Architecture

Which one is better? Relative Performance:

- One system is NOT universally superior to the other.
- It depends on a number of country-specific factors:

1. The degree of institutional development/contractual environment in the country (Tadesse (2002))
    - Bank-based systems outperform market-based systems in countries with weak institutional environment
    - Market-based systems fare better in countries with strong contractual environment (see Table below)

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Financial System Architecture

2. The extent of moral hazard (agency problems) in the economy (Tadesse (2002))
   - Bank-based systems outperform market-based systems in economies dominated by small firms.
   - Market-based systems outperform bank-based systems in countries dominated by large firms
3. The industrial structure of the country (Tadesse(2005a)
   - Bank-based systems promote growth in economies characterized by traditional, standardized, non-complex industries
   - Market-based systems perform better in countries dominated by complex, knowledge-based industries

Financial System Architecture

- These country-factors (i.e., weak institutions, severe moral hazard and non-complex technologies) are mostly characteristics of EMERGING economies
- Thus, it can be argued that bank-based financial system architecture is <u>more</u> fitting to Emerging economies
  - Emerging economies supported by bank-based financial systems outperform those with market-based systems,
  - On the other hand, developed economies supported by market-based financial systems outperform those based on banks (see Table below).

Financial System Architecture

Industrial Output Growth in 36 countries during 1980-95

Institutional Development	Bank-Based Countries	Market-Based Countries	Difference
Institutionally Developed	0.8 %	**3.7 %**	-2.9%
Institutionally Underdeveloped	**6.3 %**	0.5 %	5.8%

Source: Tadesse (2002)

Industrial Output Growth in 36 countries during 1980-95

	Bank-Based Countries	Market-Based Countries	Difference
Developed Countries	0.7 %	**2.2 %**	-1.5%
Emerging Countries	**5.48 %**	2.46 %	3.02%

Source: Tadesse (2002)

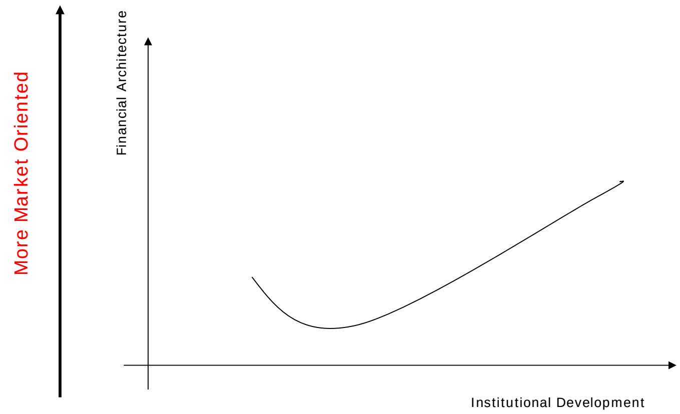
Financial System Architecture

- Transition from bank-based to market based systems

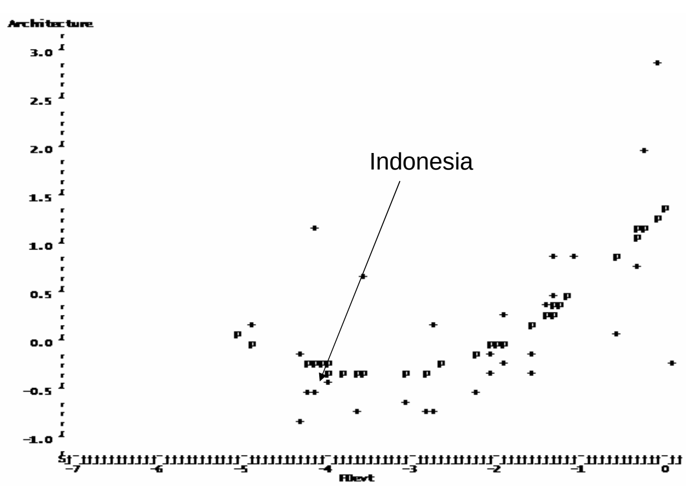
  In Tadesse (2005b), I develop a theory of transition based on institutional development and economic complexity.

  - As institutions improve (stronger legal infrastructure, transparency etc.), financial systems evolve from one based on relations to one based on arms-length transactions.
  - Starting from a situation of complete institutional underdevelopment, as institutions develop, initially, the banking system deepens (the system becomes more bank-oriented) until a point beyond which markets displace relationship-financing.

Financial System Architecture and Institutional Development



Financial System Architecture and Institutional Development



Plot of actual value of architecture '+'

Plot of predicted value of architecture 'p'

Financial System Architecture

- Financial Integration and Financial System Transition
  - Financial integration involves a blending of relational contracts (or activities) with market-based contracts (or activities).
  - As such, financial integration may represent the transitional phase of the financial system from relational to more arms-length form.
  - It may represent that threshold point where market-based structure is about to supplant the relatively bank-dominated system of emerging economies.

Concluding Remarks

- Financial integration is a global phenomenon that is and will be reshaping the landscape of the financial services industry in emerging markets.
- The forces of deregulation, globalization and rapid technological progress will continue to foster greater integration in both products and organizations within the financial sector.
- Financial System Architectures range from the most relation-based, centered around bank financing, to the most arms-length based (capital-markets-based) systems
- The financial system architecture of most emerging economies tend to be relatively bank-centered.

Concluding Remarks

- This is dictated by (and compatible with) their level of institutional development.
- However, as the institutional environment improves over time, the financial system would move to more market-oriented system.
- Financial integration may represent this transition phase in the transformation of the financial system of the emerging economies from the opaque and rigid system of relation-based financing to the transparent and flexible system of arms-length financing.

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