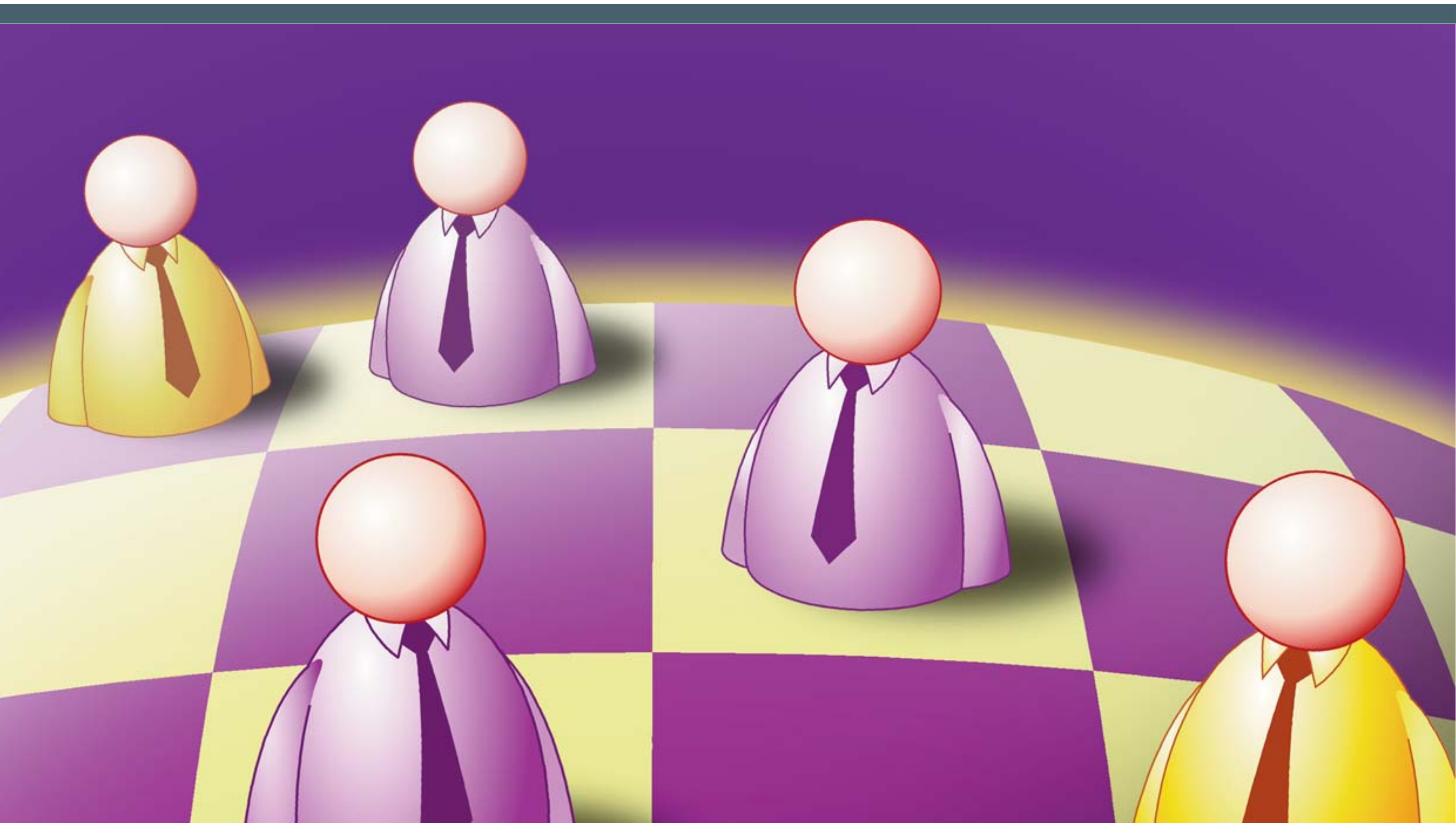

Finance and insurance

Internationalisation of the finance sector: a process under review

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Internationalisation of the economy is an undeniable fact. Many branches, especially within the industrial sector, have increased their international relations in recent years by either selling a part of their output abroad, creating stable cross-border business contacts, setting up an own commercial network or placing production chains outside the country of origin. Reasons to explain this process are mainly based on a considerable reduction of transport costs and improvement of communications, stimulated by technological development playing now a key role. However, from an entrepreneurial point of view, it is obvious that industrial internationalisation has different connotations from those arising from internationalisation of services. Without going too much into detail of possible exceptions, it could be said that industrial internationalisation tends to pose less difficulties.

Benefits of internationalisation of financial services

Just like Ricardo's (1772-1823) findings served to understand and explain the expansion of international trade, internationalisation of finance – i.e. eliminating discrimination between foreign and domestic financial service providers and cross-border barriers to financial service provision – is also the result of a global interest.

As an example of these benefits, the conclusions of a study ordered by the European Commission on potential consequences of integration into such a relevant market like mortgages in the European Union are interesting. The main conclusion is that obstacles restricting cross-border business in the mortgage market – from both the offer and the demand perspective – have an average cost equivalent to 0.7% of the EU GDP (gross domestic product) due to reduced competition and possibilities of choice within the market.

Financial expansion of the last years broke the link between the customer and the broker giving credit and taking the risk in the first instance.

The relation between liberalisation of financial markets and economic development has been widely explored by numerous studies, and there are plenty of countries where liberalisation of financial services has been planned and eventually became the trigger of economic development. The very case of Spain is a good example, with foreign banks allowed to enter after 1978 following a whole range of liberalisation measures to bring about progressive modernisation and efficiency of the Spanish finance system. Although these banks were eventually not especially relevant, it is true that this action and all others taken in that time led to an ongoing modernisation process that improved competitiveness of the domestic finance sector.

Liberalisation of financial services requires however accurate institutional management, especially of regulation and supervision functions, which can be done by the relevant authorities but also needs to be based on the principles of information transparency in line with the new Basle agreement, so it is the market that provides discipline of institutions to a certain extent.

The financial crisis. Lessons for internationalisation of financial services

This is why we need to learn from the mistakes that led us to a big global crisis of the finance system that burst out in mid 2007 and eventually developed into the first big global economic crisis. This financial crisis has been the result of the combination of a long period of high liquidity in markets and the proliferation of new financial instruments and practices in which risk assessment was done wrongly. These very instruments and practices led to great expansion of financial titles that were after all upheld by financing a basis of physical assets, mainly real estate, that eventually lost their value. All in all, a big mass of real estate had become a big mass of mortgage, which in turn had become by means of complex financial structures an even bigger mass of financial titles that were financed and refinanced without anybody being actually able to know their implicit risk level. So the link broke between the customer and the broker giving credit and taking the risk in the first instance.

Within this scenario, the Lehman Brothers case stands out particularly. That big US-based financial corporation founded in 1850 with an absolutely global business view has been the big loser of the current financial crisis. Lehman Brothers survived the American Civil War, the 1907 banking crisis, the 1929 crash and the hedge funds collapse in 1998 but has been unable to endure the mid-2007 subprime crisis, causing the biggest bankruptcy in history.

So Lehman Brothers is a reference for how the financial sector will need to tackle globalisation. The American company had become a global financial business present in more than forty countries and with over 650 legal entities outside the United States, including subsidiaries in places like the Cayman Islands, the Bermuda Islands, Switzerland, Hong Kong and Singapore, an immense financial conglomerate going far beyond the supervisory reach of the Federal Reserve and US authorities as well as a complex management system that was literally termed a «chaos» in the report analysing how to address the company's winding-up process.

Hedge funds as a paradigm of internationalisation of finance

The concepts of crisis, internationalisation and laxity regarding regulation find their finest paradigm in the business model of hedge funds, free investment funds with a wide variety in operations, investing in debt, stock or commodities, combined with derivatives or short sales.

George Soros: «Find the trend whose premise is false and then bet against it.»

In fact, the financial crisis properly started in summer 2007 based on the problems that overcame two hedge funds of Bear Stearns, who had much of their investment in high-risk assets. What followed was governmental takeover of Freddie Mac and Fannie Mae mortgage corporations, bankruptcy of Lehman Brothers, acquisition of Merrill Lynch by the Bank of America, rescue of AIG – the biggest insurance company in the US with a big turnover in credit default swaps (CDS) – and bankruptcy of Washington Mutual, the biggest US savings bank. As to the eurozone, the first big victim was Fortis insurance company, which had to be intervened by Belgian, Dutch and Luxembourg authorities as its share value was plummeting. Other companies with major problems following later were Hypo Real Estate Bank, Dexia and ING, just to name some prominent cases.

Investment of sovereign funds often has a long-term perspective and a certain strategic component.

However, regulation of hedge funds has become a controversial matter, proving the difficulties in making headway towards stricter legislation. Their detractors insist in arguing that their great leveraging capacity – allowing them to handle extraordinarily large portfolios – gives them a strong speculative character, causing market instability to the point that they have been compared with a «grasshopper plague». Defenders in turn say that these funds are in no case to be held responsible for any financial crisis but only ultimately show the imbalance created in markets, proving George Soros' maxim: «Find the trend whose premise is false and then bet against it.» Both views are certainly right to a given extent, and the difficulty lies in knowing how to adequately legislate the fine borderline separating them.

And yet, hedge funds are not the only collective investment mode. Investment funds in Spain are certainly a good example for internationalisation of finance within the reach of families and companies, as their way of operating allows them to gather savings of many of them till property reaches a given volume that justifies professional management – often out of an international perspective – through so-called collective investment societies.

A different thing is the perspective of other types of collective investment like sovereign funds. Their origin lies in growing imbalance between countries as to their capacity of financing and generating reserves. A main role is played here by countries wealthy in raw materials – basically oil and gas – like the United Arab Emirates and Russia and with a high export capacity like China. As opposed to hedge funds, investment of these sovereign funds often has a long-term perspective and a certain strategic component.

History and present of internationalisation of the finance sector

Despite increasing internationalisation of financial flows, social perception of financial institutions is that they are still a hardly internationalised industry. After all, streets in our cities are crammed with bank branches with signs of mostly national brands. And it is this reality what eventually pushes the European Commission to work for deeper integration of the finance system, for beyond social perception, the truth is that internationalisation of the finance sector regarding operations with families and companies is far from the standard reached in other business sectors.

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Comparison with the car industry will come in handy here, an especially illustrative landmark considering that the first internationalisation cases of financial services are found one century ago, when Citibank started operating in France (1906), Argentina (1914) and Brazil (1915), virtually the same years in which the big car makers having exploited most the international side of their business were created (Ford Motor Company in 1903 and General Motors in 1908). These first internationalisation cases in the finance sector were soon reinterpreted by Barclays Bank, which in 1925 created its international division by merging the Colonial Bank, the Anglo-Egyptian Bank and the National Bank of South Africa, an initiative that has often been considered the first attempt of creating a bank with a truly global perspective.

The volume of external financing obtained by the Spanish finance sector is more than a quarter of the balance sheet of banks within the finance system.

Despite this start, internationalisation reached one century later by the finance sector is clearly different from what is observed in the car industry, whose business strategy is tackled from a fully global perspective regarding suppliers, manufacturing sites and sales points.

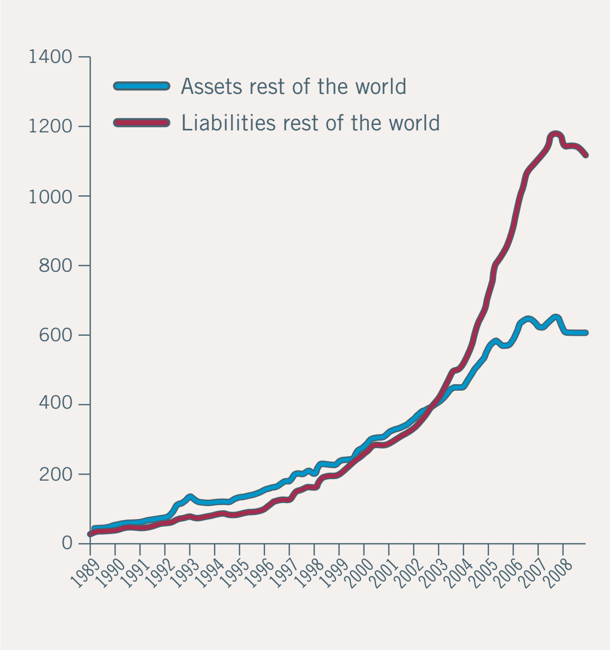
This unfavourable comparison does not mean that change in the finance sector has not accelerated in recent years, although this has not been made very visible in the streets of our towns and cities. Although direct settling of banks outside their domestic markets is the clearest demonstration of internationalisation of finance, it is definitely not the only one. Seizing resources in international markets is also an internationalisation process that has had a strong echo in the Spanish and also the Catalan finance sector.

Just to illustrate this process, the volume of external financing obtained by the Spanish finance sector in the shape of deposits or acquisition of different shares reached 1.2 trillion euros, which is more than a quarter of the balance sheet of banks within the Spanish finance system.

Following the car industry simile, it is as if most car makers had gone international based

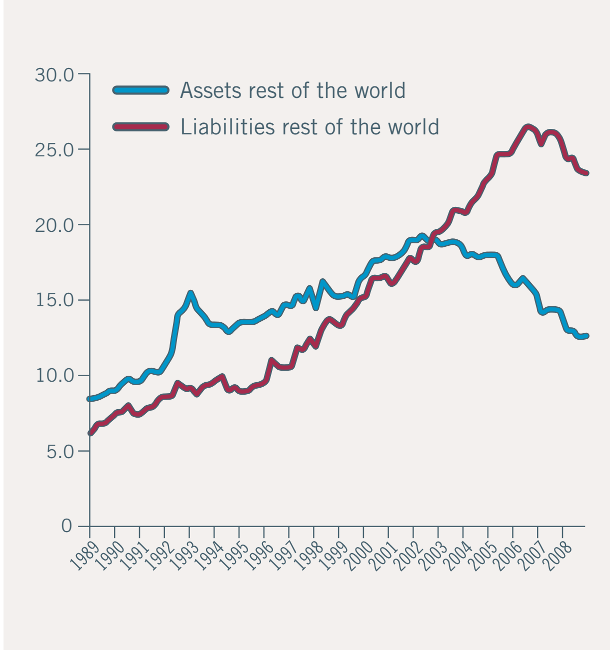
Graph 1a. Assets and liabilities of the rest of the world in the Spanish finance

Billion euros, excluding shares in capital



Graph 1b. Assets and liabilities of the rest of the world in the Spanish finance system

% of total balance sheet, excluding shares in capital



Source: Bank of Spain

▲ The volume of external financing obtained by the Spanish finance sector reached 1.2 trillion euros.

on component supplies while sales are still basically concentrated on the domestic market.

The euro as a potential catalyst for integration of the European system

Just like the creation of a single market in Europe set the basis of a wider market, the introduction of the euro as the single currency enhanced international trade in the eurozone as it eliminated the currency exchange risk in transactions between member countries. However, the euro also brought about a single monetary policy, a key element to the finance sector in the area, which saw its main barrier break up to start a strategy with a pan-European perspective, the ultimate ingredient to facilitate full integration of the European finance system.

According to ECB studies, European integration of financial activity is high in monetary and interbank markets but low in retail banking.

This is how this has been seen from the European Central Bank (ECB), where regular monitoring of the degree of integration of financial activity in the eurozone has been done over the last years. ECB papers conclude that integration differs according to the area: it is very high in monetary and interbank markets – with expansion of cross-border transactions clearly above progress observed at international level, stimulated by the single currency – but low in retail banking as it requires personal contact between the bank and the customer, which is difficult to reach if not done by placing the offer directly in third countries.

This conclusion is backed by ECB data highlighting that the rate of assets financial institutions in the eurozone have in other countries within this area is not higher than 20%, a figure that increased only slightly with the introduction of the euro. Besides, this ratio is below 10% in a quarter of eurozone countries and hardly surpasses 20% in most of them (75% of countries have a rate below 25% of assets).

These data are relevant to understand that internationalisation of financial activity within service to families and companies requires after all spatial proximity between offer and demand. Such proximity should be materialised either based on direct settling – opening own branches – of banks in third countries or through merger and acquisition processes of companies already present in target markets.

Regarding the creation of own commercial networks in third countries, data are really modest, which could be reasonable if considering some elements working against it like saturation of financial services, the need of gaining trust of consumers and reaching a minimum critical mass within a relatively short period. The Spanish finance sector is a good example of poor dynamism of this strategy, with international presence through direct establishment having even gone down to only 120 branches in recent years after reaching its peak in the early 1990s with more than 200 branches.

According to this trend, it seems obvious that internationalisation of the world finance sector demands a model based on cross-border mergers and acquisitions. This has in fact been the most common way in the Spanish finance sector, not due to the creation of a single currency area but already much earlier, based on the main banks, when a decided investment policy in the main Latin American countries was started over a decade ago.

In fact, the Spanish finance sector concentrated between 50% and 80% of Spanish foreign direct investment during these years, with total shareholding investment surpassing 160 billion euros in late 2007. This rate is opposed to little foreign direct investment in the finance sector in Spain, which was only about 10% of total foreign direct investment in the last years.

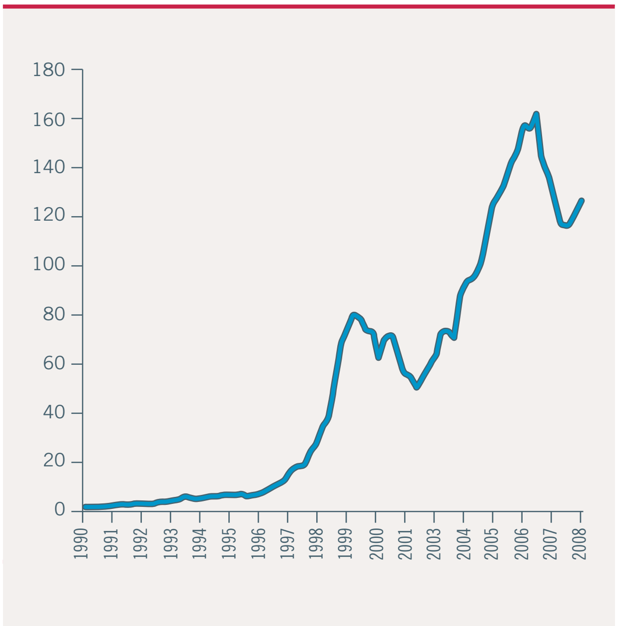
The Latin American venture of big Spanish banks that started in the mid 1990s explains most of this investment. It came in after unsuccessful attempts by American banks, taking a radically different strategy as Spanish banks went from the very beginning for acquiring shares allowing them to take control of already consolidated local banks. This strategy was opposed to that followed by big US banks like Citigroup and Fleet Boston, which opened branches basically aimed at corporate banking and better-off population segments.

Internationalisation of the world finance sector is based on a model of cross-border mergers and acquisitions.

The goals pursued by big Spanish banks entering this market were manifold. On the one hand, they wanted to follow the big Spanish industrial groups that were then deploying an internationalisation strategy (e.g. telecommunications companies and power utilities). On the other, it was growth expectations provided by this strategy allowing to enlarge markets and deploy that growth potential expected in that economic area. There were also higher margins while Spain was experiencing increasing competition and margin reduction following the derogation in 1992 of the rule limiting expansion of savings banks outside their home region.

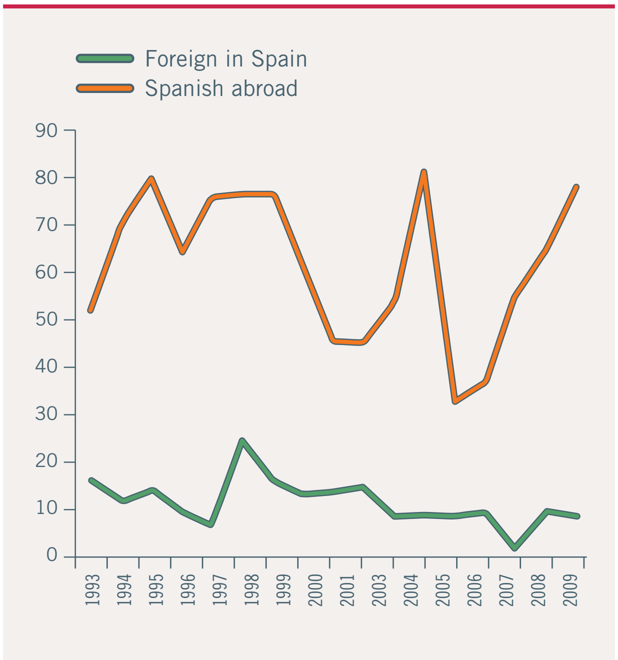
***Graph 2a.* Shareholding Investment of Spanish financial institutions in the rest of the world**

Billion euros



***Graph 2b.* Foreign direct investment in the finance sector**

% of total



Source: Bank of Spain

▲ The Spanish finance sector concentrates between 50% and 80% of Spanish FDI. Financial FDI in Spain is 10% of total FDI.

This process came together with implementation of several economic reforms in different Latin American countries that were precisely aimed at opening their banking systems to foreign investment in order to improve their efficiency.

Strategies implemented by each Spanish bank had their own individual specificities, which may illustrate possible future internationalisation models. In general terms, it could be said that Banco Santander envisaged internationalisation by acquiring majority shares ensuring full control over management, which often eventually led to create a single brand. On the other side, the BBV (merger with Argentaria was only completed in 1999, some years after initiating the internationalisation process) strategy aimed at having first minority shares in order to seek cooperation with local partners.

Finally, Banco Central Hispano – which completed its merger with Banco Santander also in 1999 – followed a strategy rather aimed at creating joint ventures with local partners.

As opposed to what had probably been expected, the number of cross-border merger and acquisition agreements within Europe has even reduced.

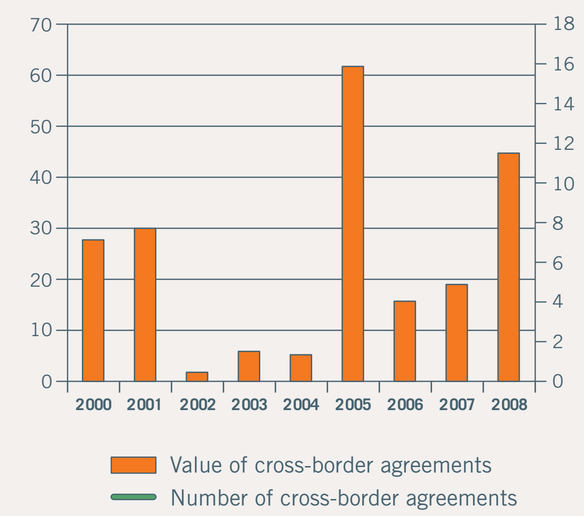
In the case of savings banks, internationalisation was burdened by limitations to expanding outside the own region until 1992. Within the context in which big Spanish banks were looking to Latin America, savings banks still had hardly any possibility of expanding beyond their local borders. In fact, this situation reached a grotesque highlight when "la Caixa" started opening branches in France in 1988 while still having restrictions to do so in the rest of Spain. Things eventually came to reasonable terms and savings banks were able to start their own expansion process beyond their own region, spreading first all over Spain while leaving expansion abroad for a later stage as it seemed beyond logic to go to new markets with domestic expansion still to be completed.

However, as opposed to what had probably been expected, the number of cross-border merger and acquisition agreements within Europe has even reduced, and they only occasionally amounted to a relevant portion of overall mergers and acquisitions completed in the EU-27. The exceptions were 2005 with the first big cross-border merger within the eurozone involving German HVB and Italian Unicredit and 2008, when ABN Amro was bought by a European consortium including the Royal Bank of Scotland, Fortis and Banco Santander. Apart from these two years, cross-border mergers and acquisitions amounted to hardly 20% of total agreements completed in the European Union, a relatively poor figure compared with expectations.

Within the internationalisation process of the Spanish finance system, the Banco Santander case takes a relevant position. After consolidating its establishment in Latin America, it set its focus decidedly on Europe, especially the

Graph 3. Banking mergers and acquisitions in the eurozone

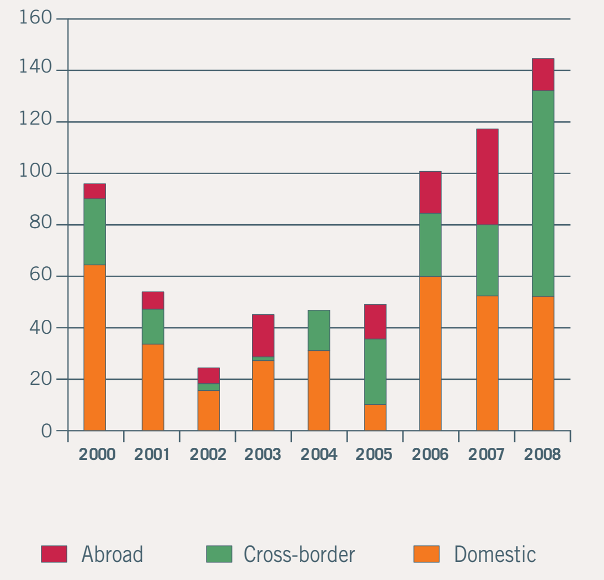
% of total mergers and acquisitions (left axis) and absolute figures (right axis)



Source: ECB, based on Zephyr, Bureau Van Dijk

Graph 4. Banking mergers and acquisitions in the European Union

Transactions in trillion euros



Note: Includes control shares like minority shares but not all agreements. Domestic mergers and acquisitions are the ones completed within one same country; cross-border refers to transactions within the EU-27 involving a non-domestic bank; abroad refers to mergers and acquisitions of banks outside the EU-27 by EU banks.

Source: ECB, based on Zephyr, Bureau Van Dijk.

▲ Cross-border mergers and acquisitions amount to hardly 20% of total agreements in the European Union.

United Kingdom, where it first bought Abbey in 2004 before completing the process in 2009 with the acquisition of Alliance & Leicester (A&L) and the distribution and business channels of Bradford & Bingley. This made Banco Santander the second largest bank in the British market as to mortgage volume and the third in private deposit volume as well as the international bank with most branches in the world. Banco Santander thus became a good example of internationalisation with a global strategic view, which shows in facts as straightforward as its policy of operating with its brand in all markets it is present in.

Bancassurance, an opportunity for internationalisation

The bancassurance business, i.e. commercialising insurances through bank branches, has been playing an increasingly important role over the last years. This combined service came up strongly in Spain during the 1990s, partly due to growth expectations created by pension funds and retirement plans. Synergies between typical banking products and these new ones from insurance quickly materialised, so financial institutions started commercialising them through their wide distribution network. The market share reached by bancassurance operators is representative of the success of this model, which concentrates more than two thirds of life assurances.

However, it needs to be said that most of this business model emerged out of the creation of insurance subsidiaries of banks specialising in life assurances, which produced a certain atomisation of the sector, as opposed to the profile of insurance companies offering non-life products (car insurance, home insurance, etc.), which tended to concentrate heavily and often reach a strong international business perspective. In contrast to what is occurring in the banking sector, the Spanish insurance branch is dominated by names like Allianz, Zurich, Axa, Generali, Fortis and Aegon, which indicates a clear international component. This range of companies is to be completed with Mapfre, the Spanish domestic market leader, though also present in 42 countries, where it concentrates up to 50% of its business.

Future perspectives point towards a new step in developing bancassurance, thus creating an increasing market share of this business model within non-life insurance, which amounted to less than 10% of the total business in 2009. However, as opposed to what occurred in life assurances, the trend indicates that here it will be based on business models emerging from cooperation between already consolidated banks and insurance companies, either on the basis of distribution agreements, strategic partnerships or joint ventures or creating financial service groups.

Future perspectives point towards a new step in developing bancassurance within non-life insurance, which can enhance internationalisation of banking.

This new development perspective of bancassurance can definitely enhance internationalisation of banking, taking advantage of the benefits of wide commercial networks of banks and savings banks and the international perspective reached by the insurance business.

Future challenges

According to this analysis, it can be said that the degree of internationalisation of the finance sector at global and even European level is far from expectations created over the last years. The introduction of the euro and the implementation of a single monetary policy were certainly assumed as the beginning of an intensive, promising internationalisation process in the finance business, which however is far from reality in some areas.

This does not exclude that internationalisation of monetary markets has been especially relevant, after all a reflection of increasing imbalance occurring between countries with financing capacity and those with financing needs. Just to illustrate it, aggregated current account deficit of countries with a negative balance sheet amounted to 654 trillion dollars in 2002, this figure reaching more than double in 2007, close to 1.5 quadrillion dollars, and surpassing 1.6 quadrillion in 2008. This involves a growing international flow of funds from countries with a higher savings capacity – mainly China, Japan, Germany, Saudi Arabia, Russia and Switzerland – to those with major financing needs, the most relevant including the US, Spain, the UK, Australia, Italy, France and Greece. The outburst of the economic and financial crisis turned this trend upside down, so aggregated current account deficit was below a quadrillion dollars in 2009, almost a 40% reduction within one year.

After almost three years it is quite obvious that the crisis cannot be interpreted as a sort of break that will allow to retake the development created in financial markets in the first years of this century once it is over. We rather need to think that the current crisis will open a new period in the finance system with substantially different characteristics from the models that have been in place so far, and this will also affect internationalisation.

Regarding internationalisation of business with families and companies, data show that progress made so far in this area is very far from expectations raised some years ago. Nevertheless, institutions with a pan-European view may probably become more relevant in years to come, competing with banks characterised by focusing rather on the national market. Interaction between and coexistence of both strategies will in any case unleash a trend towards standardisation of financial products and services at European level.

Progress in internationalisation of the finance system will hardly be possible if challenges from the lessons taught by the current crisis are not tackled, which will require to deepen into legislation and supervision of the finance business. It will thus be inevitable to introduce stricter rules for operations off the balance sheet of banks, include more stringent liquidity rules, regulate measures aimed at reducing procyclicity of the finance business, increase capital requirements, strengthen internal risk control rules and review the mark-to-market assessment principles, among many other things.

Also, it seems obvious that participation of the Spanish finance system in the next internationalisation phases will strongly depend on how the already initiated restructuring and rationalisation process of the domestic system develops, mainly regarding savings banks.

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Notes

1. London Economics (2005). *The Costs and Benefits of Integration of EU Mortgage Markets*. European Commission, DG Internal Market and Services.