INTERNATIONAL JOURNAL OF BUSINESS, 3(1), 1998 ISSN:1083-4346

The Changing Role of Financial Intermediation in Europe

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After a review of factors such as technology and the related policy toward financial liberalization that has affected financial institutions worldwide, this paper focuses on changes in Continental Europe. We identify and review three driving forces: (a) European integration, (b) the factors that cause a growth of securities markets, and (c) financial innovation. The paper arrives at the conclusion that there will be significant changes in the European financial system in terms of the growth of securities markets but that this growth will center on bank-affiliated institutions who will strengthen their position within national markets. In contrast, there will be relatively little impact via cross-border mergers and acquisitions in the banking sector. Finally, the paper suggests some implications for corporate governance, which will not change unless government policy makes the system of financial intermediation more contestable by outsiders and creates the pre-conditions for an effective corporate control.

I. Introduction: Significance, Background, and Scope

Technological developments and related pervasive effects on the regulatory environment have had a significant impact on financial products, and, especially, the financial institutions and delivery systems worldwide. While the U.S. financial system has already undergone dramatic changes since the early 1980s, and Japan is still in the talking stage, although seriously after announcing "Big Bang" liberalization in the Fall of 1997, in Continental Europe change has arrived with a vengeance in the 1990s.

This survey paper focuses on the changing role of financial intermediation in Continental Europe, primarily by comparison to developments in the Anglo-Saxon world, i.e., the United States and, to some extent, the United Kingdom and Canada. Exploring this issue is particularly timely for essentially three reasons: first, and at the most basic level, since all economic agents are customers of financial institutions in one way or another, they are therefore directly affected by changes in the institutional structure of their financial service providers. Second, the changes in the industry deeply affect managers who must be concerned with strategic decision making under rapidly changing competitive conditions as the survival of their institutions and careers is at stake. Third, and most importantly, the discussion of the comparative performance of various economic systems has shown that financial systems have a pervasive effect on economic performance of various nations through their influence on economic performance via the efficiency of the investment process and corporate governance (for details, see Thakor [24]). Moreover, with the globalization of markets, financial systems do compete head-on, raising serious questions regarding the "best" system and whether and to what extent optimal institutional structures emerge (for details, see Prati and Schinasi [19]).

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Technology had not only an impact on financial institutions and products, it also affected the general trend toward liberalization of regulatory policies in profound ways. While it is difficult to trace all the complex sources of financial market liberalization, there can be no doubt that advances in communications technology played a significant role. It is well known that politicians, members of the bureaucracy, as well as established competitors tend to strongly resist deregulation. Yet, at various degrees and times since the 1970s, liberalization has been a dominant force that shaped financial systems, first of industrialized countries and increasingly of those countries that are now labeled "emerging markets."

A review of the history of the liberalization process in financial markets shows that a large part of the phenomenon has been compelled by the fact that improvements in communication technology allowed at least larger customers increasingly access to alternative markets outside of their own jurisdiction. The concomitant erosion of business opportunities in domestic markets caused the established competitors to try to follow their customers and expand operations abroad. Such attempts, however, created the lever of "reciprocity," where host countries demand, in turn, freedom for their own banks to operate in the other country. As a consequence, this shift in the attitude of existing competitors caused a change in the precarious balance between those who defend the status quo and those who prefer liberalization and it ultimately allowed the latter group to gain the upper hand.

Technology has also changed the cost-revenue structure of delivering financial services. Indeed, as will be shown in more detail below, new and modified financial products have begun to alter the competitive equilibrium among financial institutions.

While technology has impacted financial services worldwide, financial structures in Continental Europe have changed at a much slower pace than in the United States, largely because liberalization has progressed at a slower pace. To wit, exchange and capital controls in most European countries, except Germany and Holland which liberalized external transactions in the early 1960s, were not abolished until the mid and late 1980s. Further, significant sectors of the financial services industry have been in the hands of national or regional governments and, therefore, insulated from competition in the markets for risk capital. In many European countries, controls were maintained over interest rates and the scope of permissible business activities was liberalized only slowly.

However, in the 1990s change arrived in Europe at a rapid pace due to the extension of the European Union "harmonization" rules to services, the rapidly increasing globalization of commercial activities of European corporations, and a host of other events.[1] This paper analyzes the changing role of financial intermediation in Continental Europe. Specifically, after presenting outlines of the current U.S. and European systems in their comparative context, we shall review three driving factors that are shaping financial intermediation in Europe: (1) European integration, (2) factors promoting securities markets, and (3) financial innovation.

We will conclude with an attempt to sketch the outlines of the evolving system of financial intermediation in Continental Europe, particularly the quest for new strategic approaches among financial institutions, and provide an educated guess as to possible implications for corporate governance.

II. Comparative Context

When one endeavors to analytically compare national financial systems, it would be a mistake not to take into account the factors that have historically shaped the various structures, and this is particularly true with respect to a comparison of the United States and Europe. Indeed, for readers who look at this issue from a US perspective, it is useful to be reminded that it is the financial system of the United States that exhibits unique features which can only be explained through its particular historical development (Allen and Gale [2] Chapters 2, 3 and sources cited therein. See also Calomiris [5]).

Without venturing too deeply into the issue of historical causation, it is fair to say that given the unique conditions of the United States, especially its size and the fact that it was populated by immigrants who left their home countries because they did not like many aspects of established order, it is not surprising that the financial system differed from those found in Europe. The U.S. body politic developed early on a strong distrust of powerful financial institutions. Thus, during the 19th century the U.S. banking system evolved in a highly fragmented way, unlike Canada, the United Kingdom, and the countries comprising Continental Europe with their large, nation-wide banks who had "universal" business powers (see Tilly [25]). Individual states in the United States retained a great deal of power on chartering banks, branching powers etc. and the Federal Government, in spite of some attempts, did not play a significant role until much later.

Even the Federal Reserve System, as it emerged in the early 20th century, was de jure very decentralized, although the inherent logic of a national monetary policy ultimately compelled de facto concentration of policy making powers in Washington, D.C., and in New York, for the execution of the policy. The McFadden Act (1926) prohibiting interstate banking as well as the Glass-Steagall Act (1933), which established the strict separation between commercial banking and capital market activities, further weakened the banking system. However, it is often forgotten by casual observers, that the weak and fragments system of commercial banks also brought forth a very competitive sector of investment banks that learned to thrive on "living by their wits instead of other people's deposits."

While we pointed out the contrast between the United States and Europe in terms of historical development of the respective financial systems, this should not leave the impression that the European system of financial intermediation is characterized by a few monolithic financial institutions. Those obviously exist; each of the Continental European countries has a number of universal banks which effectively operate on a national scale. However, overall their market share is by no means dominant, when compared to the United Kingdom or Canada, for example.

Largely because of a reaction against the perceived power, or inadequacies of the large, private universal banks, in each country one finds today a number of publicly owned financial institutions that provide at least sectoral competition. Thus, virtually every Continental European country has an expansive system of savings banks, often owned by regional and municipal entities and cooperative financial institutions owned by their members/customers as well as variety of special purpose financial institutions, frequently owned by national governments.

Furthermore, in each European country there is a financial institution attached to the

Postal System with significant market share in deposits and small money transfers. As a result, in each country there is currently a vibrant public debate which has percolated up to a European-wide level, where powerful constituencies argue that various financial institutions under governmental ownership provide unfair competition for privately owned banks.

Foreign owned institutions do play a role in all European markets, a small role in commercial banking (less than 3 percent), but a significantly more substantial role in investment banking. The structure of financial institutions is further affected by a fundamental regulatory difference between Continental Europe and the United States: in Europe banks are defined as **credit-granting** institutions. In the United States it is **deposit taking** that is the regulatory criterion for a financial intermediary that carries the label "bank" with all its implications for regulation but also implicit or explicit government underwriting of the risk of failure.

The legal definition, of course, has wide-ranging implications with respect to the structure of nonbank financial intermediaries (NBFI's). In the United States, for example, institutions such as the captive finance companies of not only the auto companies but many other industrial enterprises (General Motors Acceptance Corporation, GE Capital, Ford Motor Credit, and many others which often reach the balance sheet size of major commercial banks) play a major role in the financial intermediation. Their role is being played by specialized banks in the European markets. However, the more uniform regulation in Europe has also affected adversely the diversity of products and cost structures, in contrast to the United States.

While public support, and even ownership and sponsorship for financial intermediaries is not unheard of in the United States (to wit, the Farm Credit System, the Federal Home Loan Banks, and Federal Government sponsored mortgage institutions such as Fanny Mae), the extent and role of such institutions is dwarfed by publicly owned banks in various countries on the European continent.

Similar to the United States, Europe has, of course, an extensive sector of insurance companies, both casualty and life. However, there seems to exist a much closer cooperation between insurance companies and banks which goes as far as extensive cross-holdings of equity stakes and the coordination of commercial policies and alliances, culminating in the concept of "ALLFINANZ," i.e., the comprehensive product offerings of the "financial supermarket."

The most significant driver of change in financial intermediation in Europe is European unification, which goes far beyond the general trend toward liberalization of financial markets, referred to in the introduction. From a historical perspective, while exhibiting some common features, European national markets have been characterized by being closely segmented according to national (and to a certain extent even regional) lines. The factors are primarily (a) regulatory regimes imposed by national governments, and (b) different monetary systems. Interestingly, governmental borrowers and large corporate entities had, over the years, managed to escape this segmentation by plugging into the emerging global offshore markets (see Dufey [11]) while medium size enterprises, local and regional governments as well as retail consumer markets remained captives of segmented national markets.

III. European Integration

The state of affairs outlined in the previous section held even after several relatively modest attempts to harmonize regulations affecting financial markets went into effect early on, for example, by the First Banking Directive of 1977, which provided a common legal definition of "credit institution." While the definition comprised commercial banks and some non-bank financial institutions, it definitely left out insurance and securities transactions where vastly different structures among national markets prevented any agreement on a European level. It was not until the “1992 Initiatives,” when the European Commission pushed through a number of specific rules designed to promote financial market integration through harmonization. These regulations comprise three basic principles:

First, EC directives and recommendations establish that **cross-border trade** in banking, securities, and insurance services will have to be **liberalized**. National laws and regulations, to the contrary, must be altered.

Second, the EC 1992 directives introduce a general license, or principle of a "**European passport**" for providers of goods and services. Thus, institutions authorized to operate in one individual EC member country have the right to establish themselves in other countries and operate throughout the community.

Third, while home country authorization and supervision is fundamental, in a number of crucial areas **minimum community standards** will have to be followed by all institutions operating in the EC.

As of 1997, even with the implementation of these important initiatives, European financial markets nevertheless have remained segmented, with national banks retaining their strongholds in providing retail banking services and markets for debt and equity securities maintaining distinctly national characteristics. When it comes to assessing direct forms of intermediation via fixed income and equity markets, the first distinguishing fact when comparing U.S. and the European situation is that institutionally the market in Europe is dominated by universal banks. There are very few merchant banks and those that exist play more the role of specialized boutiques than independent, competitive players as the "bulge bracket" houses such as Merrill Lynch, Morgan Stanley, Goldman Sachs, and others in the United States.

As far as securities markets are concerned, data in Table 1 show that much more financing is done through intermediaries rather than through securities markets. While governments borrow in securities markets extensively, especially at the national level, European private entities tended to finance their activities through bank loans. Obviously, there are significant differences in terms of size: while large companies tend to borrow relatively more in the securities markets and very large companies do so beyond the confines of their national markets, medium size firms and most local government entities stay within their national banking markets. And while it is true that small and medium size firms in the United States also borrow largely from banks (Calomiris [5]), there are significant differences in degree.

If we look at fixed income markets issued by private entities in Europe, the bulk of such paper is issued by financial institutions. Thus, while bonds accounted for less than 6 percent of nonfinancial firms in France and less than 1 percent in Germany, they accounted for just under 20 percent of the total liabilities of U.S. nonfinancial entities. In particular, there is nothing in Europe that resembles the huge commercial paper (CP) market through which many large U.S. companies efficiently satisfy their working capital funding needs. CP markets in Europe have only come into existence in the 1990s and they remained small and fragile.

Table 1
Regional Comparison of Liability Structure (as of year-end 1995)

Country	Population (Mn.)	GDP (US$ Bn.)	Total Assets* (US$ Bn.)	Equity Share (% of Total Assets)	Debt Share (% of Total Assets)	Bank Assets (% of Total Assets)
U.S.	263.3	7253.8	22865.1	30.0	48.1	21.9
Japan	125.2	5114.0	16375.2	22.4	32.5	45.1
EU11**	286.1	6803.9	21084.2	10.1	33.2	56.8

* Assets include bonds, equities, and bank assets. Domestic and international debt securities shown by nationality of issuer.
**Includes Germany, France, Italy, Belgium, Netherlands, Spain, Portugal, Austria, Finland, Ireland, Luxembourg, and Ecu.
Source: "Currency & Bond Market Trends," Merrill Lynch Global Fixed Income Research, September 25, 1997.

It is difficult to come up with easy explanations for this lack of fixed income markets, but one cannot help but recognize that the system of universal banks in Europe internalizes competition between bank loans and commercial paper issuance within the large universal banks, while in the United States they have been institutionally strictly separated and follow quite different competitive dynamics.

As to equities, European securities markets are known for a seeming aversion to equity, both by issuers as well as investors. While part of the bottlenecks are attributable to limitations on the investor's side, there is no doubt that companies often held by families, or other controlling shareholders as well as managers have a strong preference for internal financing because of cost and, more importantly, control reasons. Except for some of the smaller countries such as The Netherlands and Switzerland, the relatively unimportance of the European equity markets are represented by capitalization data as shown in Table 2.

This state of affairs has often been labeled as lack of an "equity culture". On the demand side, households play a very limited role as holders of equity. While the reduction in terms of households holding equities is virtually a worldwide trend, data show that even when indirect holdings via mutual funds and similar structures are taken into account, European investors prefer fixed income assets and funds to equities. While there is some evidence that such behavior may have changed somewhat as of the mid-1990s, the trends are too recent to draw strong inferences. There are many reasons for the traditional aversion of households to invest savings in securities in general, and equities in particular. If one is to dig deep into cultural perceptions, there is the history of two world wars which have wiped out equity values, although fixed income holdings did not fare much better. More difficult to argue, however, is general risk aversion. A detailed look at European financial markets shows that there are significant segments of the saving public that is quite willing to take on highly risky securities in the form of traded derivatives for which retail markets have evolved in Europe to a much greater extent than in the United States, for example. Furthermore, there are surprisingly large "grey" capital markets which seem to produce a never-ending stream of deals that often turn into disastrous experiences for investors.

Table 2
Top International Equity Markets
(Market capitalisation as % of GDP, end of 1996)

Country	Companies listed	Market capitalisation (USD billion)	% of GDP
Spain	387	222.8	41.6
France	702	540.6	38.2
Germany	802	608.3	28.2
Italy	335	236.8	21.5
Netherlands	380	346.1	96.1
United Kingdom	2,091	1,614.1	155.5
EU (15 countries)	6,604	4125.0	52.9
EMU (11 countries)*	3373	2234.0	35.6
Canada	2,383	805.7	152.5
Japan	3,027	5,010.0	119.2
United States**	8,782	7,660.1	110.6

*based on a broad EMU, including southern Europe
*NYSE + NASDAQ
Source: Deutsche Morgan Grenfell, "German Equities," Oct. 1997, p. 11.

Nevertheless, the bulk of household savings goes to banks, some into fixed income securities and little into equities. One of the reasons is effective taxation. By the letter of the law income from securities is subject to taxes, while capital gains for individual investors are largely nontaxed or tax-deferred. In a number of European countries, however, taxpayers largely avoid and indeed evade paying taxes on interest income, either through simple nonreporting of income or by holding securities and bond funds outside of their country of residence, with the most popular locations being Switzerland and Luxembourg.

Will European integration cause significant differences in this respect? While a number of pundits predict a flourishing of equity markets in this new world of a Europe united by a common currency, history counsels caution. The reasons are simply that a common currency has positive effects primarily on fixed-income vehicles, from bank deposits all the way to short-term and longer-term bonds. Equities, representing claims on real business activities, are much less sensitive to nominal changes in the value of currencies: while there is an extensive debate about the suitability of equity investments as a hedge for inflation and currency volatility, the performance of equity markets tends to be inversely correlated to exchange rate changes, especially over longer periods. While we recognize that there are a number of arguments for the relative growth of securities markets in general and equity markets in particular, we believe, as will be shown in the next section, that they largely stem from changes independent of the introduction of a common European currency.[2]

IV. Factors Promoting Securities Markets

While we have looked so far at historical developments and current characteristics of European securities markets in contrast to the United States, this survey would be remiss not to take account of some changes and developments that may profoundly affect securities markets and the nature of financial intermediation in the future. Fundamentally, we see four major forces at work which will affect this particular dimension of financial intermediation. First, there are fiscal policy pressures throughout Continental Europe exacerbated by the political quest for a common currency. Secondly, there are long-term competitive forces impacting on the corporate sector which finds itself inherently tied to the fate, foibles, and fortunes of global markets. Third, there is government reaction to both the on-coming Euro as well as global competition. Fourth, population dynamics impose significant stress on traditional retirement systems and the way they are being financed in Europe. Each of these will be discussed individually below.

The debate and commentaries on European fiscal policy dilemmas abound. In virtually all countries, slow economic growth and the increasingly burdensome demands of the welfare state have put tremendous pressure on fiscal budgets in Europe. Given already high tax rates, the political and economic leeway for further increases in revenues by raising taxes is probably impossible. While these dilemmas are independent of the forthcoming European monetary unification, the advent of the Euro and the need to reasonably comply with the benchmark set by the Maastricht Treaty give these issues a particular urgency.

It is not surprising, therefore, that increased privatization of state-owned enterprises has become a popular means to alleviate fiscal deficits, if only to realize temporary revenues from their sales. For some time there have been debates going on in Europe about the role of the state in various enterprises; and while the resistance to privatization from the political establishment as well as organized labor continues, circumstances have swung the pendulum of public opinion in the direction of a reduced role of the state in commercial enterprise. Much has been accomplished during the 1990s and considerable privatization projects are in the pipeline. However, the impact of privatiation on securities markets is very clear: partially for political reasons, the equity markets have been considerably broadened by placing substantial parts of initial public offerings (IPOs) in the hands of small investors where they were both politically effective and at the same time provided the impetus to strengthen the capital market infrastructures.

As far as the private corporate sector is concerned, many European corporations have recognized that they compete in global markets not only with respect to goods and services but also for risk capital. The price of equity capital is the most important input into the discount rate that determines whether cash flows from new projects are sufficient to add value. Consequently, there is throughout Europe a shift in the pronouncements of top managers toward shareholder value and while one may dismiss some of this talk as self-serving, there is no doubt that management perceives the pressure from competitive capital markets. One has to be blind not to recognize that throughout Europe there are initial signs that companies have become more shareholder friendly in many respects and that the much neglected shareholders is becoming a more important persona in the stakeholder capitalism of Western Europe.

Both the prospective arrival of the common European currency as well as the importance of access to risk capital in a united Europe have compelled governments to change regulations in order to strengthen the infrastructure of their capital markets. Old laws on share repurchases, mutual funds, disclosure regulations, and many other issues are being scrutinized and brought up to date step by step. The reform process is largely driven by the argument that the competition for capital in a Europe with a common currency and harmonized rules on doing business is going to be much fiercer. Meanwhile, traditional securities exchanges pursue new strategies to make themselves more attractive to users, utilizing fully the potential that new technologies offer. Beyond the upgrading of established bourses, one also can observe experiments with new markets to facilitate the access to risk capital for entrepreneurial firms: the Nouveau Marché in France, the Neuer Markt in Germany, and EASDAQ (European Association of Securities Dealers Automated Quotation), a spin-off from the U.S. NASDAQ market.

Last but not least, securities markets are affected by population trends which, together with fiscal tensions, prompt reform of public retirement systems. Unlike in the United States and the United Kingdom where equity markets, including markets for venture capital, get major support from pension funds managed by independent entities, these vehicles hardly exist on the European Continent. As supported by data in Table 3, the pension system is largely based on Social Security pensions that, just like in the United States, are unfunded and supported on a pay-as-you-go basis by levies imposed on current workers.

Unlike in the United States, however, where Social Security only provides for a minimum standard of living, European retirements provide quite generous benefits, including relatively early retirement (e.g., 55 in southern Europe) and benefit levels that endeavor to provide somewhere between 50-70 percent at workers' last income level. With population trends in Europe declining for some time, the burden of paying for such pensions has reached magnitudes (see Table 4) where employment costs become so high that they significantly contribute (a) to high unemployment and (b) to a significant underground, off-the-book economy. Both phenomena cause higher costs for the remaining sectors of the economy and most countries find themselves in a vicious cycle which, given the population dynamics, can only deteriorate in the future.

Table 3
European Pension Systems and Financial Markets

	Funded Private and Public Pension Schemes (as % of GDP)	Inclusive Life Insurance
United States	54	NA
United Kingdom	73	144
Netherlands	84	129
Italy	6	14
France	5	32
Germany	7	29

Source: Euromoney Suppl., The 1997 Guide to Preparing for EMU, May 1997, p. 22.

Furthermore, the extent to which public Social Security pensions are supplemented by employer retirement schemes, such pension arrangements in the past simply represented general corporate obligations, largely off the balance sheet of enterprises and while they may have contributed to social peace, they also contributed to the ossification of industrial and commercial structures, because to wind up unprofitable enterprises, even though privately owned, with significant labor forces becomes politically impossible. Thus, in contrast to the United States where pension funds represent a major source of demand for securities, particularly equities, such entities are almost totally lacking in Europe and reform efforts are underway in every European country. Such measures, however, take time and we would expect few short-term effects from such measures, although in the medium and longer term there is definitely the potential for significant change.

Table 4
Elderly Dependency Ratio
(Number of Persons Aged 65 and Over as Percentage of the People Aged 25-59)

	1990	**2020**
Austria	24%	33%
Belgium	31%	43%
Denmark	33%	45%
Finland	27%	48%
France	30%	43%
Germany	29%	40%
Ireland	28%	38%
Italy	30%	45%
Netherlands	26%	40%
Portugal	29%	37%

Spain	30%	38%
Sweden	38%	48%
United Kingdom	34%	40%
United States	27%	36%
Japan	24%	55%

Source: Dermine, "Finanzmarkt und Portfolio Management," Jan. 11, 1997, no. 2, p. 146.

Nevertheless, the current debate on pension reform often overlooks another dimension when comparing the structure of financial intermediation with that in the United States; specifically, who will actually run these pension funds? We will address that issue in the concluding section.

V. The Impact of Financial Innovation

As pointed out previously, information and communication technology had a profound effect on the financial industry worldwide, spawning a process of financial innovation. The concept of financial innovation raises two interrelated questions: first, what is the essence of financial innovation and second, are there regularities in this process or is it a random occurrence?

Financial innovation is not easy to define with precision and therefore it is not surprising that its origins are shrouded in the fog of financial history. However, it is fair to say that in the beginning of the 1970s in the United States a number of circumstances coincided that made possible a significant change in the rate at which new financial instruments, techniques and products appeared in the markets worldwide. The 1970s were a time where external events, such as the "oil shock" and the demise of the Bretton Wood system of fixed exchange rates, brought about a period of heightened volatility in financial markets. Furthermore, more investors and business firms had become exposed to fluctuating market rates, largely because they had started to expand their interests heavily across borders. Simultaneously, technology had advanced to the point where inexpensive computing power had become widespread, communications technology improved significantly, and, last but not least, some significant advances were made in financial economics in terms of contingent claims theory and financial modeling in general.

Coming from the United States and London, this change in financial markets began to take roots in Continental Europe in the 1980s and financial markets have never been the same since. Among other manifestations, these developments led to the establishment of new specialized exchanges in Chicago, New York, and London (LIFFE) and, soon after, on the Continent in Frankfurt, Paris, and Amsterdam. In addition, over-the-counter markets for many of these products started to take off.

What actually is financial innovation? Many critical observers point out correctly that the basic functions of the financial system have not changed: namely, to move funds over space, i.e., facilitate payments, to move funds over time, i.e., extend and receive credit, and to reallocate risks. Thus, every financial system continues to perform these basic functions. What has changed, however, is **how** these tasks are being done.

The technique of financial innovation is quite straight-forward: in its essence, it consists of the "unbundling" (stripping) and "bundling" (rebuilding) of various contractual elements that are contained in traditional financial products. Thus, a "plain vanilla" term loan may consist of contracts extending a commitment to lend funds for a specified time, involving the absorption of credit risk, interest rate risk, options on interest rates, as well as options on the value of the debtor's assets, etc. The separation of each individual element has permitted transactors to price and hedge each risk separately; thus, increasing liquidity, reducing transactions costs for users, and flexibility by facilitating the rebuilding, or "financial engineering," of contracts tailor-made to the specific needs of a market participant. Primarily, the process allows minimizing risks and features that market participants do not want in traditional products, which are really complex bundles of contracts. The mere process of generating new instruments within a relatively short period is a fascinating one and there have been a number of attempts to distill some of the regularities out of these developments, indeed there seems to be a life cycle model that explains this process. Franke [13] distinguishes four distinct facets of the process. First is the **innovation** per se, which not only comprises the original abstract idea but the packaging, hedging, and legal research that is necessary to create a new financial instrument. Early innovators will try these products out and for most people they will be quite pleased.

However, since there is hardly any legal protection for financial innovations, it is attractive for other institutions to **imitate** products and techniques, particularly if they appear to be successful. Typically, imitators have a cost advantage and will offer their products at lower prices. This increase in volume facilitates risk management, which further drives down the prices and costs. Unique in the life cycle of financial innovation is stage 3, which has been labelled **demystification**: the improvement in customers' understanding of the components of a new instrument reducing the technological gap between the producer, typically a financial institution, and its customers. The final life cycle for financial products is **standardized mass production**, which arises when knowledge has been widely diffused among banks and customers.

There is no doubt that this model of a life cycle of financial institutions makes sense of a number of observed phenomena, but it is surely a simplification, like all models. In particular, cycles of various products seem to vary greatly in length. For example, some new products have taken off and then disappeared very quickly, never to be seen again. Others, such as markets for swaps, for instance, have exhibited continued growth, although at time-varying rates.

Such observations suggest that there is more at stake here than just a cyclical phenomenon driven by institutional learning. Derivatives are uniquely suited arbitrage instruments. In fact, much of the cyclical nature of financial innovation can be explained by looking at the role of dynamic market imperfections. As discrepancies in markets open up ("windows" in the investment banker's parlance), an incentive is provided for institutions to create, to market, and to use new financial products. The very fact of the arbitrage, however, will tend to close the window of opportunity, until new shocks occur in other markets that open up new windows, providing opportunities for either the same or, more often, differently structured financial innovations.

A similar way of looking at this phenomenon is to borrow from the marketing concept of "experience goods." Such products reveal their quality and performance only after they have been tested under a variety of states and market conditions. As technical know-how has spread in the financial community and as the (sometimes unpleasant) experiences by various institutions with certain instruments became well publicized, many of these products have gone through something that appears to resemble a life cycle.

While one can quibble with the precision of the life cycle theory, it points to one important fact: production of these products involves considerable investment, both intellectual as well as in organizational assets. First, it requires a fair amount of talent, both in terms of financial engineering, mathematics, knowledge of systems technology, and legal know-how. Since the creation of most of these innovative products is concerned with the managing of specific risks, appropriate hedging operations have to be established. This process alone can be very expensive. To illustrate: any institution that intends to offer option products on foreign exchange rates or interest rates in major currencies in what are now-a-days 24 hour markets has to establish effectively three dealer operations around the globe in order to cover all time zones in order to perform the continuous, or dynamic hedging operations to eliminate directional (delta) and reduce volatility (gamma) risks. Each of these operations has to be fully staffed with dealers, information technology specialists, legal advisors, and sales people because to run trading operations for hedging purposes only without the natural off-sets that come with a "deal flow" from customers is too expensive. Last but not least, such operations require substantial risk capital which tends to be expensive.

What this example points to is the increasing "institutionalization" or intermediation of financial markets. Few individuals or even corporate financial executives have the time and the resources to keep track of ever more complex products and arrangements. Thus, financial innovation supports the trend toward the increasing intermediation of financial flows that we can be observed in mature markets throughout the world.

VI. Outlook and Conclusion

On the basis of the considerations presented so far, we would venture essentially the following conclusions. First, because of the increasing complexity of financial products, Europe will continue on the same a trend that can be observed worldwide: increasingly channeling of financial flows through various intermediaries. Second, among these intermediaries, a greater proportion of funds will be channeled through "direct intermediaries," i.e., those without equity. Third, unlike in the United States, there are indications that in Europe virtually all financial channels will be bank affiliated, i.e., there will be much less diversity among financial service providers. Along these lines, the role of cross-border service providers will be limited to wholesale markets, as is the case already. Last but not least, the impact on corporate governance, seen purely from the perspective of changes in the financial system, will be quite limited.[3]

With respect to policy, these conclusions imply that governments must be very conscious of promoting open markets, both with regard to permitting entry to nontraditional suppliers of financial services as well as to attracting service providers from abroad. The objectives of making financial markets contestable implies further trade-offs between the intent to assuring consumer safety and the (unintended?) effect of protecting the competitive position of established institutions.

A. Increasing Intermediation

For decades, financial market studies have shown that in all industrialized countries there is an increasing trend toward channeling funds from savers to investors via various financial intermediaries. Many factors contribute to this trend, including the greater variety and complexity of financial instruments and products, which was pointed out above, and the need for increased hedging, diversification, and risk management in general, which can be done much more efficiently through financial institutions (see Allen and Gale [1] and Rajan [20]). There are also some indications that Europe, as elsewhere, is moving toward an increasing securitization of claims, simply because of the fact that securities are more liquid and most people value liquidity. The growth of commercial paper and note markets, which are now accessible to larger companies -- both "on-shore," i.e., in national markets, as well as "off-shore" – provides strong evidence for this movement. There is also some data emerging that observed differences in the relative importance of bond financing vs. bank loan financing between U.S. and European corporations will be narrowed by a move toward Anglo-Saxon financing patterns. Furthermore, the securitization of illiquid loans that began with the mortgage markets in the United States many years ago, and comprising now all kinds of loans and claims, is rapidly reaching Europe.[4]

In contrast to the United States, the institutional structure in Europe will almost entirely be bank based. There is little reason to expect that Europe will experience the dramatic changes that occurred in the United States where, within a span of a few years, obscure regional banks turned into nation-wide top-tier players (e.g., Nation's Bank), and where the nonbank finance companies, mentioned earlier, play significant roles in the financial market place. The same holds with respect to new entrants into the financial services business by entrepreneurs from nonfinancial backgrounds which, on the basis of technological advances, have gained significant market positions in the financial services industry (for example, see Schwab, Accutrade, E-trade, and others). In Germany, by comparison, almost all the new discount brokers, called "direkt banks," are, without fail, subsidiaries of established commercial universal banks. More importantly, virtually all the mutual fund business on the Continent is firmly in the hands of bank affiliated asset managers. The vast population of independent money management companies in the United States, such as Fidelity, Vanguard, Templeton, and others, to which one has to count the large state government pension funds with their corporate governance agendas, do not exist in Europe, where all significant money management companies are simply affiliates of major universal banks, typically wholly-owned subsidiaries.

B. Contestability of Markets: Foreign Investment

The emerging common European market for services, including financial services, and a the arrival of a common currency, might lead to the conclusion that the position of established financial institutions will be challenged by cross-border competition. So far, there is little evidence of this. Indeed, trends in the pattern of restructuring in the financial services industry that were reported for the 1980s and early 1990s in previous studies (e.g. Dufey and

Yeung [10]) have accelerated in the mid-1990s: cross-border bank mergers and acquisitions are far and few in-between and are dwarfed by intra-market mergers and consolidations. This movement is affecting all European markets and as of late, especially Germany, whose unique structure of financial intermediation had proved resistant to merger activity for a long time (see data in Table 5).

The phenomenon of relative lack of cross-border merger and acquisition activity in banking can be explained quite well with an application of foreign direct investment theory. An acquiring institution needs to have a sufficiently large advantage that allows it to overcome handicaps, given the fact that (a) the foreign acquirer has to pay more than the domestic seller and, by implication, other domestic purchasers are valuing the assets of an existing institution, and further (b) that certain categories of foreigners' operating expenses tend to be higher because of the additional cost of running and controlling operations at a distance, including the cost of expatriate management, coping with nationalism and similar factors. Beyond possessing a sufficiently powerful competitive advantage, it must be sustainable over the long run.

Unlike in the United States where bank mergers tend to yield economies of scale and scope in relatively homogeneous markets even across state lines, in Europe different tax systems, rules on collateralization, bankruptcy laws, and other legal factors, as well as language and cultural issues, make foreign direct investment in banking a very costly and risky undertaking. In commercial banking -- unlike investment banking and to a certain extent insurance -- market shares of foreign owned institutions have remained in all European markets at 3 percent or less and there has been very little change over the years (Dufey and Yeung [10]).

Table 5
Domestic Mergers in Europe[1]

Belgium	1992	CGER-AG (fortis)
	1995	Fortis-SNCI
	1995	KB-Bank van Roeselaere
Denmark	1990	Den Danske Bank Unibank (Privatbanken, Sparekassen, Andelsbanken)
Finland	1995	KOP-Union Bank of Finaland (Merita Bank)
France	1996	Crédit Agricole-Indosuez
Germany	1989	LB Stuttgart - Badische Kommunale Landesbank
	1991	SüdwestLB erwirbt 10% an LB RheinlandPfalz, 12,5% an der LB Schleswig-Holstein und 25% an der LB Sachsen
	1994	Berliner Bank B Landesbank Berlin - Berliner Hypotheken- und Pfandbriefbank
	1996	Braunschweig.-Hannoversche Hypothekenbank - Berliner Hypotheken- und Pfandbriefbank
	1998	Bankgesellschaft Berlin B Norddeutsche Landesbank

Italy	1992	Banca di roma (Banco di Roma, Cassa di Risparmio di Roma, Banco di Santo Spirito)
		IMI B CriploSan Paolo-Crediop
	1995	Credito Romagnolo (Rolo) B Credit Italiano
Netherlands	1990	ABN - AMRO
	1991	NMB-PostBank-ING
Portugal	1995	BCP-BPA
Spain	1988	BBV (Banco de Vizcaya-Banco de Bilbao)
	1989	Caja de Barcelona-La Caixa
	1992	Banco Central-Banco Hispano
	1994	Santander-Banesto
Sweden	1993	Nordbanken-Gota Bank
Switzerland	1993	CS-Volksbank

[1]Not complete. For illustration only. Source: Dermine [7], p. 146, and author's data.

In stark contrast, foreign investment banks in all European markets have achieved substantial market shares, ranging from 20 to over 50 percent, depending on the specific business segments. It is interesting to note that all these foreign investment banks in European markets are essentially U.S. institutions, while European institutions are struggling and their cross-border role in other European markets, apart from their home market, tends to be minor, largely relegated to assisting corporate clients from their home markets.

Obviously this raises the question why American investment banks have performed so well. They have clearly no advantages in terms of cost of establishing themselves or conducting on-going business. For the most part they tend to grow de novo -- and their cost disadvantage of doing business from a distance in a politically difficult environment tends to be no better than their cousins in commercial banking. The difference in the performance between the U.S. investment and commercial banks stems from the nature of their competitive advantage: the unique capability of investment banks which is largely based on their internal culture developed in the unique environment in which they grew up in the United States under Glass-Steagall. Forced to make their money in underwriting, securities research, trading and funds management, they developed unique risk taking and risk control cultures where, to simplify somewhat, highly specialized and energetic professionals work long hours, receiving huge incentive compensation when times are good but are relentlessly laid off when overcapacity develops in their peculiar segment of the market.

Indeed, European universal commercial banks (Swiss, Germans, and Dutch in particular), after failing to develop such investment banking capabilities in-house, have tried to acquire them by purchasing Angelo-Saxon merchant banks in London and now-a-days even smaller houses in the United States, especially in the funds management area, trying to combine their capital strength as large commercial banks with the unique entrepreneurial culture of Anglo-Saxon investment houses. This mixing of cultures makes for a very precarious equilibrium and the period is too short to predict whether these experiments in business strategies will succeed. Part of the problem for any observer is the fact that these strategies have not been tested in periods of sustained down markets.

C. Implications for Corporate Governance

With the linkages among various major economies increasing, comparative studies of financial systems have focused attention on issues of corporate governance with its key challenge of how to channel savings from the financial market place into optimal investments within business enterprises (for recent reviews see Schleifer and Vishny [21] and Berglöf [4]). The debate has been largely concerned with the incentive mechanism that induces managers to realign their own interests with those of various providers of capital and other "stakeholders." [5]

Here is not the place to resolve these complex issues but to present some thoughts on how changes in financial intermediation in Europe might affect prevailing prototypes of corporate governance: the Anglo-Saxon one, based on relatively well developed securities markets, and the European system, based on the power of financial institutions. The conventional view is that the bank-based system of corporate governance is either superior, or flawed, since banks must resolve the conflict between the interests of creditors vs. shareholders by finding solutions that are either optimal, or sub-optimal, depending on the attitude of the writer relative to the power of banks in general. Not surprising, this somewhat simplified view of corporate governance has been challenged in many ways. Schmidt and Tyrell [22] in a thorough analysis of the literature and the data presented therein cast doubt on many of the factual bases on which the conventional wisdom rests. Accordingly, what really matters is whether corporate governance is determined by outsiders (providers of equity) or insiders (management, employees, banks and other creditors, other allied businesses, or governments).

These considerations put the question squarely: in whose interest is control exercised? And it is at that point where changes in financial intermediation become relevant. "How important is equity?" and "how are shareholders represented?" become the crucial questions.

When reviewing the changes in financial intermediation in Europe, the increasing role of equity capital promises significant change, a perspective focused on by Anglo-Saxon commentators. However, there are several factors that cast doubt on such outcomes. First, as pointed out above, there is no indication whatsoever that the interests of equity holders will be represented effectively by bank-affiliated intermediaries. Furthermore, as European economies have matured with fewer high-growth opportunities available, an even higher percentage of business investment will be financed internally, thus decreasing the influence of banks and strengthening the influence of management and other inside stakeholders.

In conclusion, there may well be changes in corporate governance in Europe, but one should not expect these changes to come from changes in the system of financial intermediation. All of these considerations put particular emphasis on public policy if one wants to bring about significant change in corporate governance in Europe (see on this point the paper by U. Hommel in this volume of the journal). What is needed in particular are rules that make it easier for new entrants into the business of financial intermediation, particularly the securities business. Most importantly what is needed are rules facilitating a market for corporate control. Whether the European body politic is ready to accept such radical changes with their implications for possible disruptions and change, is a question that goes far beyond this paper.

NOTES

1. While national financial systems among Continental Europe have a number of commonalities and basic features which are the subject of this paper, significant national differences have always existed and will be given short shrift.
2. For a different perspective see Deutsche Morgan Grenfell [8] and Prati and Schinasi [19].
3. This, of course, is not to say that other forces will not bring about changes in corporate governance.
4. Admittedly with some government help through the Congressional-sponsored financing institutions, such as Fannie Mae and Freddie Mac.
5. Like so many times before, this debate has precursors in the discussion regarding the resolution of "agency issues" and appropriate corporate objectives.

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