Integration across Sectors and Borders – The Scandinavian Experience

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Integration across sectors and borders[1]

Mr Chairman, Ladies and Gentlemen,

Let me first of all thank you for inviting me to address this distinguished audience. The theme of the conference is important and urgent with less than three years left before the main parts of the Financial Services Action Plan shall be implemented.

The topic I was asked to tackle is "Integration of Financial Supervision". I have chosen to look at two types of integration: between industries/sectors and cross borders. As you will see, the first one is not that hot a topic any longer in Scandinavia. It is the latter one that is creating the debate right now and probably even more in the future.

Integration between industries/sectors

In most countries there is a story about the private soldier who asks the sergeant what to do if there is a misfit between the map and reality. The answer is of course that he shall trust the map. This rigid way of looking at life is fortunately rather uncommon these days in the financial industry. When reality changes the map has to follow! This is the way financial supervision as a whole has developed in Scandinavia during the last 10-15 years.

In Sweden, insurance companies started to sell mortgage loans in the late seventies while leasing and and other types of financing activities became popular some years later. The insurance companies were not allowed to engage in other business than insurance so these new activities had to be owned by "friends". The same happened in banking where life insurance was added to the product line in the late 80s. The banks controlled these new life companies but they were not formally part of the bank group. From a consumer perspective one stop shopping sounded like a brilliant idea, especially in the savings products area, so banks, insurance companies, stock brokers and mutual funds managers met somewhere in the middle in what we can call "financial supermarkets". This blurring of the borders between

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various parts of the industry was spurred by deregulation and led to future deregulation aiming at adapting the laws to the new reality.

From an FSA stand point it didn't make much sense any longer to stick to the old model of having separate units for the various subindustries so in the beginning of the 90s the Banking and Insurance supervisions merged. Today all financial activities are supervised by this joint unit. Is this a good or a bad thing?

On a general level one can always go back to the private soldier and the map. It makes sense to have a supervision organized so that it reflects the organization of the industry it is supervising. From an FSA perspective there are some definite advantages:

- You see <u>all</u> the activities that a financial group like Nordea is involved in. It is then easy to get an idea of e.g. the total risk exposure of the group. Before divesting the Danish non-life insurance company Nordea's exposure to insurance risk was pretty high. If you wanted to get a feel for how much beating Nordea could take during an industry downturn it was not enough just to look at the banks of the group. You also had to look at the insurance side. It is easier to make this "global" analysis of a financial group like Nordea if you have all information in house.

- The communications lines tend to get shorter when you do not need to coordinate between different FSA:s. This means that you can react faster if/when you need to take action.

- There are synergies in day-to-day operations meaning that you can stay lean while being very mean, if you see what I mean! Employees can be moved from one area to another by the drop of a hat. A good example of that is the recent problems of the Swedish life insurance industry. Since the situation on the bank side has been relatively calm it has been possible to move accountants, analysts etc. from this side to the life insurance sector where they have been badly needed.

- A bigger and stronger FSA offers more challenges and more interesting career paths for young people. An eternal problem for the FSA in Sweden is to keep talented employees. They tend to end up "on the other side of the fence after having spent a couple of years at the

FSA learning about the industry. This brain drain is costly and can create problems with continuity etc.

- International cooperation and exchange of information and experience is easier when there is only one party per country to talk to.

Before leaving the FSA perspective one observation is that the organization structure of the Swedish FSA is changing. A relatively simple "sub industry" structure has been substituted for a matrix with the "old" industries in the columns and functions/processes in the rows. The matrix is now rapidly tilting meaning that the industries are becoming less important while the functions (e.g. prudential and market conduct supervision) are gaining in importance. This is an effect of the discussion above. It also reflects a change in attitude from rule based to risk based supervision.

From an industry perspective there are also advantages with an integrated FSA:

- It makes life easier when you only have one contact person to deal with on a daily basis. Fewer reports is another positive effect. Last but not least it is ceteris paribus probably cheaper! Since the industry pays for a large part of the FSA operations this is in this context a relevant argument.

- It forces the company, e.g. Nordea, to take a broader perspective. We all know how easy it is to get bogged down into small details thus forgetting the big picture. When a group becomes as large and complex as Nordea relatively few managers have the full picture of e.g. risk exposure. At least this is true during the merger phase that can be pretty long. The FSA then can make sure that the right questions are asked and that they are given enough attention.

In summary, the Swedish and, I dare say, Scandinavian experience of an integrated FSA is very positive. Indeed it is hard to think of better solutions. Going back to e.g.separate FSA:s for banking and insurance is not regarded as a serious alternative. Remember the private soldier! I am not too familiar with the UK experience, but so far the merged/integrated FSA seems to be working all right. I therefore dare to stick out my neck and say that the future belongs to the horizontally integrated FSA.

Cross Border Integration

Word stands against word when if comes to what Mr Monti and his colleagues actually said to FSB/SEB when they wanted to merge a couple of years ago. Still, the interpretation in the Nordic banking community was that domestic mergers of any size can no longer take place in small countries with a high degree of concentration at the outset. The FSB/SEB merger was subsequently called off. The route forward for the industry is cross border through organic growth or MandA. This of course makes sense in a EU where the playing field will become more and more level. It also makes sense that when the industry structure changes the supervision must follow suit.

Today, the main principle for supervision is home country control. This is a concept well suited for a situation where e.g. a big German bank expands outside Germany in an organic way through establishing small (in relation to the parent!) subsidiaries/branches. But take Nordea as a contrast. In little more than two years the merger between Merita and Nordbanken creating MeritaNordbanken and the subsequent merger with Unidanmark and acquisition of Christiania Bank created a group, Nordeathat by IMF in a recent paper is called an LCFI (Large Complex Financial Institution). Nordea at the beginning was active in most areas of the financial market (since then non-life insurance has been divested) and in each of the four Nordic countries the company could be regarded as systematically important. This of course made Nordea an immediate headache for the four FSA:s. IMF (ibid) describes the FSA situation in the following way: “The key supervisory challenge is to ensure that all LCFI operations relevant for assessing group wide risk are covered, taking due account of the interactions among various risks, business areas and regions. The additional regulatory and supervisory challenges posted by LCFI:s include: (i) the systematic risk potential owing to their major role in payment and settlement systems; (ii) the complexity which, inter alia makes liquidity problems harder to distinguish from solvency problems, hampering early detection of insolvency, which makes the assignment of crisis management responsibilities and eventual work-outs or winding-ups more difficult”. No wonder that the representatives from the FSA:s looked a bit worried when I and our chief legal counsel a couple of days before announcing the MNB/Unidenmark merger informed them about our plans. The FSA: s there and then decided to form a “Nordic team” for cooperation when it came to practical matters but also for discussion of more principal issues. Let me briefly go through some of the experiences so far from this cooperation. I do it from a Nordea perspective.

On a principal level supervision is probably the same in most Western countries. On a practical level there are differences due to history, traditions etc. In the beginning the “Nordic team” worked like clock work but the more practical problems it had to solve the more the differences between the four FSAs shone through. It also became clear that some of the principal problems pointed at in e.g. the IMF-report were not that easy to solve. Here different attitudes became important. In Denmark, e.g. the legal framework is rather strict and inflexible giving the flexible and market oriented managers at the FSA little room for manouvre. In Finland on the other hand, the framework is reasonably flexible but the application, at least in the banking area, is perceived to be rather strict and formalistic. A strive for consensus meant that the discussions could be very long, sometimes leaving Nordea in a “decision vacuum”.
The FSA:s also have different views on reporting, how close they want to follow Nordea etc. This has emerged over time probably as a result of better understanding of what kind of creature Nordea is. It can also be a result of Nordea’s legal structure. The parent company is a Swedish holding company that owns a bank group where the parent is domiciled in Finland, an insurance group where the parent is domiciled in Denmark and so on. Anyway, from Nordea’s perspective the time spent in contact, one way or the other with the FAS:s is steadily increasing. There is of course a cost attached to this. Now Nordea has decided to change its legal structure into a one bank structure with branches in the other countries, which is likely to change this situation considerably over time.

The Nordea team has no “real” leader although a director from the Swedish FSA serves as an informal chairperson. No big deal but there is also a hidden agenda. If you give one FSA the role of lead supervisor the other ones are afraid that they over time will loose competence and control. If you hand over responsibility to a lead supervisor before you have enough experience of how that concept works you may end up in trouble! “When the shit hits the fan, everybody gets a tan” as the saying goes. On the other hand it is not self evident that the role of lead supervisor is something to strive for. You will have to take on extra costs for coordination etc. and who shall pay for that? And if something in Nordea goes wrong there must be clear mandates and routines in order to avoid that important matters fall between the chairs. And who shall be “the lender of last resort”? Many questions waiting for answers.

I hope that the discussions so far has shown that there is a need for integration between FSA:s cross border and not only inside FSA:s. So how do we achieve that? The easy way out is to say that at the end of the day European financial services markets will be integrated to a level where we only need one FSA. In a recent article in the Economist (Feb. 15, 2003) you can read why this nice vision will stay a nice vision! So what are the alternatives? Here is a suggestion for you to critisize:

- Create a central unit somewhere in the EU context with the task of creating a framework and some policies for European FSA:s. Here initiatives like the Lamfalussy report and the recent EMAC and Eurofin reports can be discussed and converted into guidelines. Yes, I know that this may sound like mission impossible, especially against what I have said above about the Nordic problems of reaching consensus. But if you stick to frameworks and policies and leave the implementation and thus practical supervision to local FSA:s it is at least worth discussing!

- Develop the concept of "lead FSA". The division of labour between leader and followers, reporting standards etc. are important matters to sort out. The IMF report (ibid) ends with a laundry list of items that fall under this heading. One can probably learn from how the concept of home country control has developed over the years. One can also hopefully learn from the Nordic experience.

<u>End remarks</u>

Letting changes in the market govern how to develop financial supervision and the organizing of FSA:s, isn't that like letting the tail wave the dog? Yes and no. It is up to the politicians to set the rules of the game but as society changes the rules must and will be adapted. When the consumer benefit increases with one stop shopping of financial services, industry will follow even if it means finding ways around the existing legal framework. Adapting the framework (although with lags in order to avoid jumping into the wrong barrel!), is thus the only way forward. A consequence is that you must make sure that you at every given point of time have a supervision system that can handle what is going on in the market place. Thus integration, at least to me and my former colleagues in Nordea, becomes a central concept.

References

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