“Banking and Asset/Liability Management in EC Countries”

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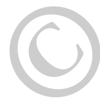
For my individual paper, I plan to analyze the banking system and to take a close look at Asset/Liability Management in EC countries. As an example, I am hoping to learn more about the effects of Central Bank policies on financial institutions’ critical decisions, and to make comparisons (when applicable) between United States and European countries.

The purpose of this project is to get to know Western European countries’ financial institutions -banks, in particular-, and to observe how they are managed in terms of their assets and liabilities. I believe, in a world where globalism became a familiar word for every businessman, this paper will contribute a lot to a potential businessman, myself, whose hometown is not an EC country, but a serious candidate.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1) INTRODUCTION:

Banking systems throughout Europe are in the process of a substantial transformation. The center of the change is European Community (EC) but in the world where we have been stressing the concept of "global economy", this change will surely influence Northern and Eastern Europe, probably North America, and further Japan.

It is therefore necessary to understand the banking system in EC countries, especially in terms of asset/liability management, and regulations. The purpose of this project is to provide an up-to-date research on the aforementioned change.

2) ASSET/LIABILITY MANAGEMENT:

Market developments and competitive pressures have forced European banks to adopt a more formal approach towards asset and liability management, and one result of this has been to increase the importance of banks' treasury departments. Treasury functions developed during the mid-1970s, initially managing the portfolios of short-term assets and later the management of both short-term assets and liabilities. The development and growth of new short-term markets from the mid-1970s onwards encouraged treasury units to trade in instruments from both sides of the balance sheet as well as increasing the proportion of transactions with non-bank clients.

The relative importance of European banks' treasury functions grew markedly during the 1980s as new short-term markets in instruments like FRNs, Euronotes, ECP, swaps, options, futures, and various derivative markets developed. As these markets grew, banking dependence on them increased. The growth of these markets created a broader range of opportunities available to the treasury units through which they could generate arbitrage profits as well as take positions in anticipation of expected changes in interest and exchange rates.

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Throughout Europe the methods adopted by banks to make marginal adjustments to their balance-sheet structures through money-market operations have differed considerably. For example, resort to the bill markets has been widely used in Spain; Eurocurrency market transactions have been most widely used by banks in the Netherlands and France (French banks have traditionally used these markets extensively through the use of swaps for liability management purposes); and raising large direct deposits from customers has been important in Germany, France, the Netherlands, and Ireland. The growth in CD markets has also encouraged banks in most European countries (especially in the United Kingdom) to transact business using these instruments in order to manage their short-term liability positions (Gardener and Molyneux, p.73,75).

a) Risk Management: A critical aspect of asset and liability management is risk management. Efficient asset and liability management procedures should make a bank better able to control and limit risks associated with maturity mismatching, interest-rate gaps, foreign-exchange exposures and so on. Risks that stem from mismatching relate to five main types:

- **Credit risk:** The possibility of default by the counterparty.
- **Market or price risk:** The possibility of a decline in the market value of a financial instrument because of changes in interest rates or exchange rates.
- **Settlement risk:** The risk that arises when a bank pays out funds before it can be sure that it will receive the funds on the due date from the counterparty.
- **Liquidity risk:** The possibility that a tradeable financial instrument may not realize quickly (whenever needed) its full market value.
- **Contingent risk:** Risk associated with the growth of banks' OBS (off-balance-sheet) activities.

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Given the aforementioned risks inherent in banking, it is the aim of asset and liability management to manage these risk exposures so that they are kept within acceptable levels and at the same time help to generate income and maintain profitability (Gardener and Molyneux, p.75).

i) Growth in OBS Activities: The growth in OBS activities has been substantial because in the early 1980s they incurred hardly any extra regulatory costs to the banks. European banks were not required to maintain capital or to hold reserve funds against such activities and risks. These transactions provided a way of retaining customers and market share in an environment of increased competition in mainstream lending markets. Nevertheless, the growth in these transactions reached such proportions by the mid-1980s that it began to stimulate growing supervisory concern in the United States, Europe, and Japan. Regulators began to perceive that these activities were possibly pushing banks' overall risk positions towards unacceptable levels.

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Swaps activities tend to be the major OBS component for banks in most European countries, and the largest banks appear to have a substantially greater proportion of their activities dedicated to floating-rate assets business. A breakdown of European banks' OBS exposures would reveal that interest-rate swaps generally constitute a larger proportion, usually accounting for around 60 to 70 per cent of total swaps business (foreign currency swaps making up the remainder). Similarly, interest-rate options and futures activities usually constitute a much larger part of total business compared with currency-related transactions. What is clear from the information available on European banks is that there has been a substantial growth in all these activities during the 1980s (Gardener and Molyneux, p.76-78).

ii) Capital Adequacy and Profits: Capital adequacy is related to a bank's corresponding risk exposure. *Ceteris paribus*, the higher a bank's risk exposure, the more capital is required -balance-sheet ratios have traditionally been used to relate capital to banking riskiness. Supervisors have increasingly required more capital backing during the 1980s as the perceived riskiness of banking business has increased, and capital adequacy is a central issue in most supervisory systems. Banks have generally attempted to operate close

to these standards or to modify them. This action by European banks has not necessarily been directly targeted as direct regulatory avoidance but has been more generally the result of increasing competitive pressures.

As it can be seen in Table 1, capital to asset ratios have increased in all the reported European banking markets. It is also interesting to note the differences that exist in bank capital ratios between different European countries. In 1986, for example, equity to asset ratios ranged from 6.32% in the United Kingdom to lows of 2.51% for Belgian and 2.2% for French banks. These kinds of differences are not only confined to country comparisons. For example, equity to assets ratios for Italy's ten largest banks in 1987 ranged from 12.33% (Istituto Mobiliare) to 1.69% (Banco di Napoli). In the United Kingdom, equity to assets ratios for the ten largest banks ranged between 2.41% (Standard Chartered) and 13.2% (TSB). These kinds of divergences between individual banks are least characteristic in France and Germany where the respective ratios for the top banks are very similar (Gardener and Molyneux, p.78-79).

The on- and off-balance sheet characteristics of West European banks have been subject to unprecedented changes in the last decade. Increased competition in mainstream banking business has continued to promote the use of non-traditional sources of funds, squeezed interest margins (which will be given in details on part "b"), and has also led to the reduction in the overall profitability of many banks.

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The substantial increase in the growth and depth of new financial markets, coupled with balance sheet capital constraints, have encouraged European banks to undertake more formal and complex asset and liability management, and the importance of banks' treasury functions has correspondingly burgeoned. The growth of OBS risk-taking by banks and the related decrease in the transparency of their balance sheets will continue to force them to adopt a more dynamic approach towards capital adequacy. Risk containment will undoubtedly remain a central aspect of capital-adequacy analysis and a major issue for European bankers.

Table 1: Banking rates of return and capital adequacy in selected countries (%).

	Return on assets (average)		Equity/assets	
	1983	1986	1983	1986
Belgium	0.30	0.38	2.34	2.51
France	0.10	0.22	1.78	2.20
Germany	0.51	0.46	3.07	3.57
Italy	0.48	0.69	3.48	4.41
Netherlands	0.21	0.31	2.82	3.37
Spain	0.76	0.89	5.97	5.88
United Kingdom	0.88	0.90	6.24	6.32
Japan	0.15	0.19	2.29	2.22
United States	0.63	0.73	4.62	5.24

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b) Interest Margins and Operating Expenses: One important aspect of asset/liability management is the management of the net interest margin to ensure that its level and riskiness are compatible with the risk/return objectives of the institution (Gardner and Mills, p.13-14).

Table 2 shows evidence of substantial differences in interest margins in the retail market. High margins are observed in Belgium, France, Spain, and the United Kingdom. The joint effect of inflation, higher interest rate, and deposit rate regulation is quite evident in the period 1980-85. Countries with lower margins include Germany, Italy, and the Netherlands. However, the period of 1987-91 is indicative of a convergence process in interest rate margins. Margins are decreasing in the first group of countries, while they are going up in the Netherlands and Germany. This is due to a general movement of deregulation and a convergence of interest rate levels in the European Monetary System (Dermine, p.30).

Table 2: Interest margins and operating expenses.

	Avg. margin on DDs (a)		Avg. margin on Sav. Dep.s		Op. exp. per asset in banks	Op. exp.
	1980-5	1987-91	1980-5	1987-91	(%) (b)	(% of GM)
Belgium	11.2	8.7	5.6	3.9	2.6	0.66
France	11.7	9.7	4.3	5.2	3.2	0.65
Germany	6.5	7.2	2.8	2.2	2.5	0.65
Italy	4.3		3.4		3.0	0.63
Netherlands	5.6	6.8	2.8	4.7	2.5	0.65
Spain	14.5	6.0	10.7	9.0	3.5	0.60
UK	10.8	7.0	2.5	2.0	4.2	0.65
USA	9.0	7.5	1.0	1.0	3.5	0.61
Japan	5.6	5.4	3.8	2.0	1.0	0.61

(a): Current short-term rate minus interest rate paid on deposits.

(b): Excludes interbank assets; expenses on non-interbank is calculated as follows: total expenses minus (interbank assets x 1/8%).

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Financial market deregulation is a policy that has been widely supported and widely pursued in Europe. Direct controls on interest rates and on bank lending have been removed in the larger European countries in favor of a more market-led system of credit allocation and greater reliance on market methods of monetary control. A number of smaller countries still rely on direct controls for credit allocation and monetary control. However, even in these countries the monetary authorities have been striving to introduce a more market-oriented and more liberal financial system (Mullineux, p.85).

As has been emphasized in the literature, if non-price competition occurs, it is likely to lead to free services, overbranching, and higher operating expenses. Although it is necessary to be cautious with aggregate data since the structure of bank assets and the size of branches could vary across countries, it

would appear that operating expenses are rather high in Belgium, France, Spain and the United Kingdom, and lower in Italy, Germany and the Netherlands. This corresponds to the high-low margins breakdown.

3) DEPOSIT INSURANCE SYSTEM IN EUROPE:

An important activity of banks is to finance illiquid assets with short-term deposits. This creates the potential risk that savers run to withdraw their funds. A run can be triggered by bad news about the value of bank assets or by any unexplained fear. In both cases there is a cost since illiquid assets may have to be sold at a loss. Moreover, a bank failure could eventually trigger a signal on the solvency of other banks, leading to a systemic crisis. A market failure occurs because a cooperative solution among depositors cannot be enforced. Collectively, there is no incentive to run but individually there is the incentive to be the first in the line to collect the deposit at full face value. It is financing of illiquid assets with short-term deposits and the potential for bank runs which explains the need for public intervention and the establishment of a safety net to guarantee the stability of the financial system.

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Three features of European insurance systems make them unique. The first is that, contrary to the Federal Deposit Insurance Corporation in America, the public is totally ignorant of their existence. Publicity is even forbidden in Germany. The argument seems to be that the announcement of their creation could destabilize the confidence in the banking system. Since deposit insurance systems are unknown and the coverage is small (incomplete in the United Kingdom), they are unlikely to contribute much to stability and one would have to rely on lender of last resort interventions by central banks to ensure stability. Secondly, as shown in Table 3, the coverage is different across countries. This could be destabilizing if depositors start to chase the best coverage. A third feature of European deposit insurance mechanisms is that they cover the deposits of domestic and foreign banks operating locally. This could create potential difficulties. Indeed, any insurance activity requires the monitoring of the risks taken by the insuree, but the principle of home supervision would not allow the control of foreign entities by the domestic deposit insurance agency (Dermine, p.28-29).

Table 3: Deposit insurance systems

Country	Coverage (domestic currency)	Coverage (ECU)
Belgium	BFr 500,000	11,520
France	FFr 400,000	56,980
Germany	30% of equity per deposit	
Italy	L 1 billion (100% for first 200 million and 75% for next 800)	662,000
Netherlands	DFl 40,000	17,167
Spain	Pta 1,500,000	11,536
United Kingdom	75% of deposits up to 20,000 pounds	22,388
Japan	Yen 10,000,000	65,789
United States	$100,000	90,909

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4) A CLOSE LOOK AT BIG ECONOMIES OF EC:

a) Germany: In Germany, banks are permitted to acquire large equity as well as debt holdings in firms and they are allowed to be involved in the management of firms to which they lend.

One potentially important issue in the evaluation of competing financial systems for Europe is associated differences in the importance of market-based credit rationing. In the more bank-oriented system of Germany it might be expected that banks could better monitor, and even control, the activities and performance of their loan customers and thereby reduce the risk of making inefficient rationing decisions, both because the banks have more information about the risks associated with firms' investment projects and because the agency costs arising from conflicts of interest between shareholders and debt holders can be minimized. Where banks have high equity stakes in the firms that they lend to, the distinction between lender and borrower becomes blurred, and therefore the moral hazard reasons for rationing, associated with limited liability, are less prevalent (Mullineux, p.74).

b) France: France is a country that has experienced a very quick phase of innovation and deregulation in the last few years. As far as banking is concerned, branch competition has produced a costly intermediation structure, and freedom of capital flows will force France to reduce taxes on capital income. This will represent a substantial financial burden for the state.

The last capital control (namely, that French residents cannot open an account abroad or lend in francs to non-residents) was removed by July 1990. Following this, non-interest-bearing demand deposits still represent a large share of money holdings; people do not easily change banks and concentrate all their assets in the same one. It is clear that at present only the customers of a given bank invest in its equity or in its initial funds.

A major feature of the structure of bank balance sheets is the fact that the apparent interest rate on bank assets is indexed much more on market interest rates than on the apparent interest rate on bank liabilities. This is due to the importance of non-interest-bearing demand deposits. This means that the French banking sector benefits substantially from interest rate increases, but that its exposure to interest rate risk is very large. The second interesting point is that French banks have limited holdings of securities (T-bills or bonds), which makes the implementation of open-market procedures very difficult for the monetary authorities.

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The existing econometric results show that the returns to scale are very close to unity. This implies that no large movement of concentration is to be expected in the French banking sector. However, the measure of production seems rather unsatisfactory in these studies and the actual degree of returns to scale by type of activity is quite uncertain (Dermine, p.238-239).

c) United Kingdom: The relationship between financial institutions and firms in the United Kingdom is a much more arm's length one. In particular, commercial banks cannot hold large equity stakes in firms on their own account and have less direct involvement in the management of firms (Mullineux, p.74).

The 1986 Financial Services Act (FSA) introduced a comprehensive system of regulating financial services in the United Kingdom that had not previously existed. It contained rules relating to the activities of investment businesses that distinguished financial services from most other sectors of the British economy.

One justification that may be sought for the regulation of this but not other sectors of the economy is that investors are at greater risk than consumers of other products. Why then has an extensive system of regulation been imposed on investment managers but not on builders?

An obvious answer comes from comparing investment managers with banks, not builders. Banks are vulnerable to risks of runs and the concern exists that runs could spread through a banking system in a contagious manner. The regulation of banks is therefore justified by the systemic risks to which the banking system is liable (Dermine, p.43).

5) WHAT HAS BEEN HAPPENING IN EUROPE RECENTLY?

The European Union's executive body called for legislation on cross-border banking, rejecting banks' proposals for a voluntary charter. The decision reflects the EU Commission's frustration with banks' performance in handling money transfers. The EU also said it would clarify competition rules on banks' cooperation in setting maximum fees. This is aimed at making it easier for banks to set up cross-border payment systems (Wall Street Journal, October 20, 1994, A19).

Bundesbank Vice President, Johann Wilhelm Gaddum, said it is less likely for the central bank to decrease the interest rates because of the inflation fears in global financial markets. The current discount rate is 4.5% while the Lombard rate is 6.0% (Wall Street Journal, September 15, 1994, A10). As we know from our bank simulation (SBG), a very significant part of a bank's assets is its investment on bonds. A decrease in interest rates would increase the value of German banks' bond portfolio. Accordingly, there is yet no need for German banks to reconsider their bond portfolio.

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To answer increasing competition, Deutsche Bank -the biggest bank in Germany- announced it would move its international investment-bank operations to London. Other major German banks realized that they cannot just concentrate on German markets if they want to compete internationally. Currently, foreign banks, U.S. and British institutions in particular, control 45% of the business done on the German options and futures exchange, and about 30% of trades on the Frankfurt stock exchange.

The strategy of Deutsche Bank is to use its primacy at home to establish a foothold in other European countries. Once it found enough French customers for German bonds, for example, it began offering them French government bonds as well (Wall Street Journal, November 2, 1994, A7).

6) CONCLUSION:

The increasing competition, without any question, has a great impact on European banks. Increased number of free-services, reduced amount of fee charges, branch competition (overbranching) are just some examples of recent pressures on EC countries' bank managers. Recently, the spread of so-called banks, mainly because of the above reasons, have been showing a downwards trend.

One of the changes in Europe is the deregulation process which started in the United Kingdom in the mid- to late 1960s. The limitations on commercial banks have been decreasing in the last three decades. While the idea of deregulation started in strong economies like the United Kingdom and France, it also affected smaller countries like Portugal, Ireland, and Greece. The latter countries' regulators now have been considering deregulation more than ever. The ongoing changes in the EC banking should be followed closely especially by U.S. bank managers as they are likely to supplement domestic pressures for reform in the USA.

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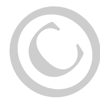

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