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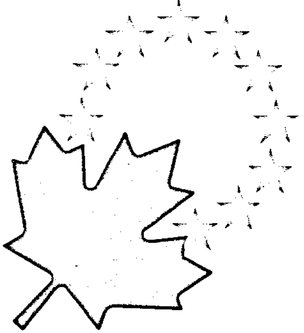
1992 IMPLICATIONS of a SINGLE EUROPEAN MARKET

Financial Services



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1992

IMPLICATIONS
OF A SINGLE EUROPEAN MARKET

FINANCIAL SERVICES

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FOREWORD

The European Community (EC), with a GDP similar to that of the United States, is Canada's second-largest trading partner and source of investment and technology. Canadian companies therefore have a particular interest in the completion of the European Community's internal market. The goal of the Single Market program, or Europe 1992 as it is often called, is the complete removal of barriers to the movement of goods, services, labour and capital within the 12 states of the Community to create a dynamic and rapidly growing market.

External Affairs and International Trade Canada (EAITC) is pleased to present this study as part of a series of reports on the implications of a Single European Market on Canada's trading, investment and technology interests. The areas to be covered by these reports include:

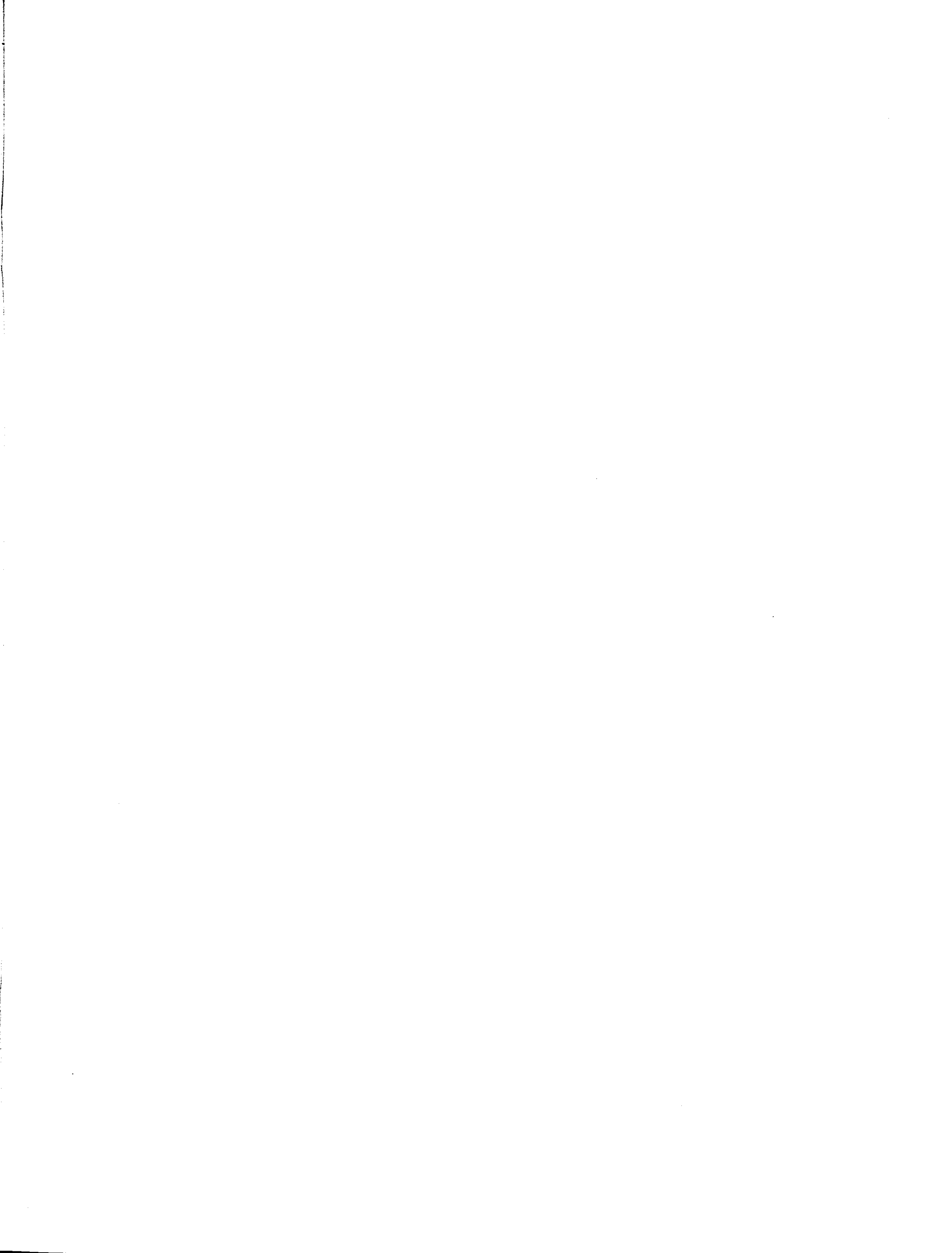
Agriculture and Food Products
Consumer Goods and Cultural Industries
Telecommunications and Computers
Automotive Industry
Minerals and Metals
Forest Products
Defence, Aerospace and Transportation
Specialty Chemical Products, New Materials, Pharmaceuticals and Biotechnology
Industrial Products and Services
Financial Services
Fisheries Products
Professional and Consulting Services — Law and Accounting

These reports, prepared by Raymond Chabot International Inc., BIPE (Bureau d'Informations et de Prévisions Économiques) and Informetrica Ltd., analyse the trends, export impact, competition, investment implications and technological acquisitions arising from the EC Single Market of 1992.

This series of reports complements an earlier study published by EAITC, *1992: Effects on Europe*, which details the major economic and trade effects of the integration. Now in its third printing due to popular demand, the report provides a clear picture of the unification legislation and implementation measures and the general expectations and response of European industry.

Following the publication of these sectoral reports, EAITC will focus on subsectors of Canadian industry in which particular opportunities arise from the Single Market. These studies will go into much more detail on the trade ramifications specific to each subsector.

Together these reports, the overview presented in *Effects on Europe*, the sectoral analyses of this series of studies, and the subsector details of the next phase of Europe 1992 reporting, are not simply an information base for Canadian business people, but can be seen as a call to action. Europe 1992 is happening now. It will affect the way we do business. We have to know about it. And we have to plan to profit from it.



CONTENTS

LIST OF ACRONYMS AND ABBREVIATIONS 7

EXECUTIVE SUMMARY 8

INTRODUCTION 10

1. BACKGROUND AND TRENDS 12

1.1 Canadian Context 12

a) Banks 13
b) Insurance 15

1.2 European Context 19

a) Financial Services other than Insurance 19
b) Insurance 21

2. EUROPE 1992: SECTOR-RELATED CHANGES 24

2.1 Principles of the Single European Act 24

2.2 The Second Banking Directive 24

a) A Single Banking Licence 24
b) Freedom to Provide Cross-Border Services 25
c) Freedom to Extend Services 25
d) Reciprocity 25

2.3 Related Issues 26

a) Solvency and Capital Ratios Directives 26
b) Investment Services Directive 27
c) Free Movement of Capital 27
d) Tax Harmonization 27

2.4 Prospective Changes in Markets 27

2.5 Insurance 28

3. EUROPE 1992: EFFECTS ON CANADA'S FINANCIAL SECTOR 31

3.1 Direct Effects 31

3.2 Indirect Effects 32

4. STRATEGIES 33

4.1 European Strategies 33

a) Cross-Border Acquisitions 33
b) Participation Agreements 35
c) Bank-Insurance Company Alliances 35

4.2 Canadian Strategies 38

a) Product-Driven Strategies 38
b) Investment Products for Individuals 39
c) Europe's Financial Centre? 40

5. OPPORTUNITIES AND RISKS 41

List of Tables

1. The EC, U.S. and Japan: A Statistical Comparison, 1988 10
2. Canadian Bank Assets, 1978-88 14
3. Rate of Return on Average Assets, 1978-88 14
4. Canadian Banking Institutions: Locations and Forms of Operations in Europe, 1988 16
5. Canadian Investment Dealers: Locations and Forms of Operations in Europe, 1988 17
6. Major Canadian Life Insurance Companies: Locations and Forms of Operations in Europe, 1988 18
7. World Banking Markets, 1986 19
8. European Financial Services Statistics, 1987 20
9. European Banking Market Saturation 22
10. Foreign Bank Participation in Major EC Markets, 1987 22
11. Insurance Premiums in Europe, 1986 23
12. Potential Declines in Financial Product Prices after Market Unification 29
13. Cross Border Acquisitions in Europe, 1989 34

List of Figures

1. Mergers and Acquisitions in Europe, 1983-88 36
2. Takeovers in Europe 37

LIST OF ACRONYMS AND ABBREVIATIONS

BENELUX	Union of Belgium, the Netherlands, Luxembourg
BIP	Banque Internationale de Placement
BIS	Bank for International Settlements
BNP	Banque Nationale de Paris
EC	European Community
ECU	European Currency Unit
EFTA	European Free Trade Association
EMS	European Monetary System
EMU	European Monetary Union
FTA	Free Trade Agreement, Canada-U.S.
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
LDC	Less Developed Country
M & A	Mergers and acquisitions
N/A	Not Available
OSFI	Office of Superintendent of Financial Institutions
ROA	Return on assets
ROE	Return on equity
UCITS	Undertakings for Collective Investments in Transferable Securities
VAT	Value-added tax

EXECUTIVE SUMMARY

In 1986, the European Community (EC) embarked on a six-year program to achieve a Single Market. In the financial sector, progress was initially slow but has been accelerating. This key sector has a strong driving effect because it covers all economic sectors and all companies and individuals. The business community has already largely integrated the prospect of a unified market in its strategies. The most visible effect of this is a growing wave of mergers, acquisitions, joint ventures and cross-border co-operation and participation accords sweeping over Europe, following the moves of leading institutions in their respective markets.

The impetus towards a truly integrated market derives from the original approach adopted by EC Member States in the Single European Act. Under the Act, many decisions no longer require unanimity; a qualified majority is sufficient. Emphasis has shifted from detailed harmonization of regulatory systems to mutual recognition of each other's systems. Generally, control of undertakings in each country has been given to the country of origin, which is often best equipped to ensure proper surveillance. A host country now accepts that a company from another EC Member State but established on its territory is governed by the regulations of the home country.

At the same time, the European Commission is preparing a comprehensive set of new regulations — almost 300 Directives to be incorporated by Member States in their legislation. These Directives harmonize key sectors and provide common solutions to complex technical problems.

The unification process requires a reassessment of relations between the EC and the rest of the world, in the new context of a single market, the opening up of Eastern Europe and the rise of Japan and Southeast Asia. EC economic experts and political figures are holding regular high-level meetings to deal with a host of sensitive issues.

In services, a sector of increasing importance, the unified market calls national regulations and protectionism into question. Unification has thus contributed to bringing American and European views closer together in most areas, aided by the liberalization of markets and the new international context.

Fears of a Fortress Europe are fading; liberal ideas are triumphant everywhere; and protectionist tendencies will likely be surmounted by prolonged growth. However, there are still differences over industrial policy and concepts such as the mixed economy, as well as uncertainty over where German unification and the opening up of Eastern Europe may lead.

The changes taking place in Europe have a definite influence on Canadian financial institutions, which are exposed at the same time to deregulation in both national and international markets. Faced with increased competition, banks feel hampered by regulations that deny them access to some activities, such as underwriting and distributing insurance products. In Europe, universal banking is a tradition; in North America, the process of dismantling the walls between the different pillars of the financial sector is still at an early stage. Some Canadian financial institutions dominate their domestic market and are preparing to maintain this leading position against a strong push from outside competitors. These institutions are also used to a high level of profitability, which will be difficult to match in the highly competitive markets of Europe. Thus priority for these companies is given to national expansion.

Canadian institutions have not reacted specifically to the advent of Europe 1992, but rather to general market conditions influenced by events such as the Canada-U.S. Free Trade Agreement (FTA) and to drastic changes in the Eurodollar markets, in which they were once very active. Deregulation and internationalization have led to reduced margins, which, together with rising costs, have forced companies to focus on a selection of sophisticated services in which Canadian institutions have a particular expertise. Banks and their investment dealer affiliates are specializing in capital market products such as mergers and acquisitions, which are in great demand in Europe. Insurance companies are considering promoting abroad some of the experience and technology developed for products such as mutual funds management and life insurance. In other words, Canadian financial institutions are using a product-by-product approach and have generally preferred to remain independent rather than enter into some form of association with competitors.

Canadian institutions see great potential in Europe, but major moves need time and must be very carefully planned. Their attention is focused primarily on consolidating the domestic market. The U.S. market also offers attractive opportunities for expansion, and techniques and technologies developed in the U.S. market can in turn be exploited in European markets. In the meantime, Europeans are making their move very quickly. Leading institutions are occupying key positions, alliances are being sealed and potential partners are playing musical chairs around the best projects. For Canadian financial institutions, to venture out of the U.K. to the EC frontiers is to face new cultures and unfamiliar markets; but it might also be to prospect rich claims. Are Canadians sufficiently aware that some of their products have great appeal for Europeans? This appeal, coupled with their Canadian advanced marketing know-how, could produce rewarding successes.

INTRODUCTION

The rapidly developing process of creating a unified market in Europe is being closely monitored at every political and economic level. This is to be expected, since the European Community (EC) represents one of the most important economic and financial regions of the industrialized world. The EC's population of 323 million compares with 272 million in North America and 123 million in Japan. The combined GNP of the EC was US$4.7 trillion in 1988, compared to US$5.3 trillion for the United States and Canada, and nearly US$3 trillion for Japan (Table 1). This considerable economic strength is being enhanced by governments lifting the remaining barriers to a unified market and by harmonizing legislation.

Europe 1992 has three objectives. The first is to achieve a free flow of capital; this has almost been accomplished. The second is to have a single market for banking and financial services. The third is a longer-term objective, with wide-ranging implications: to attain economic and monetary union.

These objectives complement one another. A single banking market would make no sense without free movement of capital. At the same time, the Single Market will give a far greater scope to this newfound freedom, and free circulation of capital will make monetary union even more desirable.

These objectives have existed from the inception of the European Community. The difference now is that they are close to being fulfilled.

TABLE 1

The EC, U.S. and Japan: A Statistical Comparison, 1988 (US$)

	European Community	United States	Japan
Gross National Product (billions of dollars)	4 725	4 800	2 850
Population (millions)	325	245	125
Income Per Capita (U.S. dollars)	14 550	19 500	23 100
Merchandise Trade* (billions of dollars)	720	670	380
Merchandise Trade* (per cent of GNP)	24	9	13

Source: Union Bank of Switzerland.

* Sum of exports and imports excluding inter-Community trade.

In the monetary realm, long-standing scepticism is giving way to a growing movement that will vitalize banking and financial activities. This movement involves financial organizations both within Europe and beyond.

The Commission has measured the likely economic impact of a truly unified market in a comprehensive study, known as the *Cecchini Report*. The Report forecasts a GNP increase of between 4 and 7 per cent over several years, raising the average annual growth for EC Member States from the current 2.4 per cent to about 3.8 per cent. Prices could drop by 6 per cent, exports could surge by 10 per cent and between 1.7 and 5 million jobs could be created. However, some commentators feel these forecasts are overly optimistic. On the other hand, recent studies--in particular one by the Centre for Economic Policy, in London--consider the *Cecchini Report* too conservative, underestimating the gains from Europe 1992 by concentrating only on the static effect of removing trade barriers. The dynamic effect, the study concludes, will be felt over the medium term and could produce an increase of between 3.5 and 19.5 per cent in Europe's real standard of living.

Richard B. Baldwin, a Columbia University economist, argues that the EC economic integration will not only boost output by fostering more effective use of existing capital, but will also create an attractive climate for new investment. His calculations indicate that the enhanced growth resulting from accelerated investment could eventually double or triple the initial rise in income produced by the efficiency effects of market integration. Baldwin points out that his predictions are already supported by Europe's current capital spending boom. This is confirmed by figures published by Translink's *European Deal Review*; 117 foreign acquisitions occurred in Europe in the last six months of 1989, amounting to $50 billion, double the total for the first six months. The rapid acceleration of foreign investments as 1992 approaches seems to show a recent perception of the credibility of the EC program, and an acknowledgement of the necessity of attacking this market from the inside. The Americans invested $15.2 billion (27.6 per cent of the total), followed by the French with $10.6 billion and the Germans with $7.3 billion; the Japanese trailed with $1.6 billion, or 3.3 per cent.

What are the main characteristics of this great European market? One of them is size. The volume of bank deposits is comparable to that of the U.S., although stock market capitalization is less. The potential for growth is large. The European banking market is already open, and will become even more so. For example, from 1985 to 1989 the number of banking and financial establishments under foreign control in France rose from 192 to 277; 167 foreign banks now have affiliates or branches in Paris, and the number continues to grow. A similar or even more open situation exists in a number of other Member States.

This banking and financial market will not be fragmented: once approval to operate a bank in the EC has been received, it will be possible to cover the whole market from a single location, under only one controlling agency. Finally, the concept of universal banking is very widespread in Europe, and gives financial organizations considerable flexibility in adapting to changes in the market. The European market will thus become more competitive and more selective.

The next major step after a single market has been created will be monetary union: a single European currency will allow large capital markets to develop. This strong stimulus to economic growth will create a great demand for financial services, and the free flow of capital will create greater competition among financial institutions. This competition will, in turn, permit lower costs.

1. BACKGROUND AND TRENDS

The concept of a unified Europe is not new. In the 1957 Treaty of Rome, the Member States of the EC (six at that time) committed themselves to establishing a common market by abolishing "obstacles to the freedom of movement for persons, services, and capital." This was to occur in stages over the next 12 years; 30 years later, the task is still not complete. However, considerable progress has been made on some fronts — notably in goods — but difficulties remain. In the financial area, these include exchange controls, restrictions on access to stock exchanges, limits on the foreign investments of some kinds of financial institutions, and restrictions on residents taking out insurance policies with companies in a foreign country.

So the completion of the internal market is 20 years late. What has happened to speed up the process, making 1992 a credible deadline?

In 1985, Member States decided to make a fresh start. The Single European Act that took effect in 1987 was designed to give a new impetus to the process of liberalization by offering a new set of principles suitable for attaining unification.

As proposed in the White Paper, *Completing the Internal Market,* the Single European Act abandoned the unanimous vote in favour of a qualified majority system. The new system sidesteps endless negotiations and abuses of right of veto, and facilitates agreement on issues for which Member States must give up a degree of sovereignty.

The EC thus gave itself the means to work efficiently. The European Commission identified regulations requiring amendments in a series of 300 Directives proposed to the Council of Ministers. As of July 1, 1989, more than half had been adopted, and some were at the drafting stage.

Europe 1992 has a direct impact on the Canadian financial sector, specifically on its network in Europe and on operations and services conducted from head offices. This wide-ranging impact dictates a redesign of business strategies to adapt to an increasingly competitive environment and to respond to opportunities.

1.1 Canadian Context

Canada's trade with the EC is not as large as with the U.S., but is nevertheless substantial, particularly in capital flows. A more competitive European business sector will affect the Canadian domestic market, but its chief impact will be on Canada's foreign trade and international financial activities.

In 1988, Canada exported more than C$10 billion in goods to the EC, almost 8 per cent of total exports. In the same year, imports from the EC were worth C$15 billion, 12 per cent of total Canadian imports. Investment flows are even more important. In 1983, Canadians invested $7.9 billion abroad, with 55 per cent going to the U.S. and 22 per cent to the EC. Net portfolio investment abroad by Canadians totalled $1.1 billion, with only 11 per cent going to the EC. Net foreign investment in Canada totalled $4.9 billion, 40 per cent coming from the EC and 19 per cent from the U.S. Net portfolio investments in Canada were $13.8 billion, 33 per cent from the EC and 10 per cent from the U.S. These figures show that Canadians invest primarily in the U.S., whereas an important share of foreign investment in Canada comes from the EC.

The investment flows between Canada and the EC will certainly increase after the combined restructuring resulting from the Canada-U.S. Free Trade Agreement (FTA) and Europe 1992. Canada and the U.S. will form one bloc, the EC and its

European Free Trade Association (EFTA) partners another. A third group is emerging around Japan in the Pacific Rim.

a) Banks

Canadian banks have been reducing their foreign lending. From 1983 to 1987, their foreign assets have decreased from 42.5 per cent of total assets to 39.4 per cent (Table 2). This trend will continue: several major banks have indicated their intention to pull out of commercial banking in Europe and to continue to reduce their lending to less developed countries (LDCs). The main reason for this policy is the better rate of return from domestic assets. As Table 3 shows, profits from foreign assets have recently declined while domestic operations have become more profitable.

One reason for large international financings by Canadian banks in the late 1970s and early 1980s was the need to recycle large amounts of petro-dollars; this compensated for a severely depressed domestic market. The trend is now totally reversed, with a dynamic Canadian market outperforming international operations.

The Regulatory Framework

Canada is justifiably proud of the solidity and stability of its banking and financial system, especially considering the problems currently facing many American banks, and the crisis in the savings and loan sector.

But Canada runs the risk of falling out of step with the rest of the world in how it regulates its financial system, thereby making the Canadian market more vulnerable to international competition and limiting the competitiveness of Canadian institutions in the world market. The past 10 years or so have produced considerable changes in the world of banking and finance, giving rise to some instruments that meet a given need at a given point in time, and then are disposed of. Financial institutions accustomed to stability and permanence must learn to adapt to constant change. European banks are more open to universal banking and are better able to cope with change than their Canadian competitors, who are prohibited from carrying out certain kinds of financial activities. A thorough revision of the Bank Act was announced three years ago but has yet to materialize. Moreover, there is uncertainty as to how far its reforms will go.

Competition is very real in the Canadian financial system. From 1982 to 1988, the banks' share of personal deposits declined from 57 to 51 per cent, and their share of total assets fell from 69 to 61 per cent. Some trust companies are as large as the largest banks. Canadian banks are currently not permitted to engage in fiduciary services, insurance underwriting and distribution, and car leasing. In the meantime, closely held commercial enterprises have taken control of some very large trusts, insurance companies and loan companies. These companies, operating outside the legislation regulating the banks, are able to offer very diversified services.

The big banks and the large trust companies are rendering the same type of services, but the rule restricting shareholder ownership to a maximum of 10 per cent (to prevent takeover by commercial or foreign interests) applies only to banks. Trust companies in Canada can be controlled by a single or a majority shareholder; and most are. They are also open to foreign takeover; the largest, Canada Trust, is in fact controlled by BAT Industries of Great Britain.

Another danger arises from the risk of the Canadian market being fragmented as a multiplicity of poorly co-ordinated federal and provincial regulations create confusion, unnecessary costs and inefficiency. The Europeans are not attempting to remove all the differences in the Member States' ways of regulating financial institutions, but they have adopted the principle

TABLE 2

Canadian Bank Assets, 1978-88
($ billions)

Year-end Oct. 31	Canadian Dollar Assets (1)	Foreign Currency Assets (1)	Total	Foreign Currency Assets as Percentage of Total Assets
1978	117.6	62.2	179.8	35
1979	141.7	80.1	221.6	36
1980	166.9	103.0	269.9	38
1981	196.5	141.5	338.0	42
1982	201.2	149.5	350.7	43
1983	198.3	148.4	346.7	43
1984	204.8	171.1	375.9	45
1985	224.3	178.5	402.8	44
1986	237.9	181.6	419.5	43
1987	264.1	171.9	436.0	39
1988	300.6	153.1	453.7	34

Source: Canadian Bankers' Association.

Note: Assets in foreign currency, liabilities and operations abroad do not coincide fully. Only a small percentage of assets of banks in foreign currency and liabilities correspond with their domestic operations.

TABLE 3

Rate of Return on Average Assets, 1978-88
(Percentages)

Year	Domestic	Foreign	Total
1978	0.64	0.66	0.65
1979	0.56	0.71	0.60
1980	0.38	0.78	0.51
1981	0.51	0.68	0.57
1982	0.14	0.52	0.28
1983	0.42	0.26	0.36
1984	0.50	0.31	0.43
1985	0.57	0.41	0.50
1986	0.45	0.47	0.46
1987	0.76	N/A	N/A
1988	0.95	0.32	0.74

Source: Canadian Bankers' Association
N/A: Not available

whereby an institution of a Member State can exercise the same rights in other Member States as those it has in its own country. They have also agreed that the primary responsibility for regulating a financial institution and for guaranteeing solvency lies with the authorities of the country of origin.

Market Factors

Return on equity (ROE) of from 16 to 18 per cent is not unusual for Canadian banks; return on assets (ROA) in the range of 0.7 to 1 per cent is also to be expected. These rates are very high by European standards. For example, Deutsche Bank had a 10.8 per cent ROE and 0.39 per cent ROA in 1988.

The domestic market, being the most profitable, is given first priority in development plans and new investments. Expansion abroad is oriented towards industrialized countries where the level of profitability is similar to Canada — e.g., the U.K. or Australia. In these countries, high interest rates result in a high cost of capital. Capital allocation provides inadequate returns, which dilutes the total profitability and reduces capacity to raise additional capital; competition is fierce for this precious commodity. Financial institutions around the world are looking for large amounts of capital to comply with stringent new solvency and capital ratio requirements, and to finance expansion programs which cash flows are insufficient to cover. Maintaining shareholder fidelity and confidence is a never ending struggle, and is difficult to reconciliate with long-term planning.

The U.S. market is a natural extension for Canadian financial activities in banking, securities transactions and insurance. This is supported by the extent of trade relations between the two countries, developments under the FTA and the opportunity to penetrate a still-fragmented U.S. market. In a depressed market, the U.S. offers attractive buying opportunities for regional banks, savings and loans, and small- to medium-sized insurance companies.

The Bank of Montreal, for example, is transforming itself under new leadership from a global institution to a bank clearly oriented towards North America. Its offshore operations now focus on serving Canadian and U.S. customers and on attracting more North American business. The Bank hopes to increase its U.S. business from 26 per cent of earnings in 1989 to 50 per cent in the coming years.

Canadian Presence in the EC

Canadian financial institutions have a strong presence in Europe (Table 4). Their holdings have for many years been concentrated in the U.K., but in the 1960s and early 1970s expansions were made to both EC and EFTA countries, including France, the Federal Republic of Germany, Switzerland and some of the Scandinavian countries. However, many of these branches and subsidiaries have since the early 1980s been sold or closed, and only a symbolic presence has been maintained in some cities. Staff and assets have been regrouped in London, which thus serves as a European headquarters.

b) Insurance

Canadian life insurance companies have a long tradition of international operations. In 1988, policies amounting to $423 billion covered five million people in more than 20 countries. Canadian companies have assets of $40 billion invested abroad on behalf of policies written in other countries — this represents 34 per cent of the total assets of federally registered Canadian life insurance companies.

At the same time, non-Canadian insurers held 17.7 per cent of the $995 billion of life insurance owned by Canadian residents in 1988. These insurers hold $18 billion in Canada on behalf of policies, and they have invested $32 billion in additional funds in Canada on behalf of their worldwide operations. The market share

TABLE 4

Canadian Banking Institutions:
Locations and Forms of Operations in Europe, 1988

COUNTRY	Bank of Montreal	Bank of Nova Scotia	CIBC Bank	Royal Bank	Toronto Dominion	National Bank	Laurentian Bank	Royal Trustco
Belgium (EC)	B		S	S				
Denmark (EC)								
France (EC)		R	B,S	S		R		
Federal Republic of Germany (EC)	B	B	B,S	S				
Greece (EC)		B		S				
Ireland (EC)		B,S						
Italy (EC)			R	R				
Luxembourg (EC)								S
Netherlands (EC)	S	B	S	S	S	S		S
Portugal (EC)								
Spain (EC)		R	R	B				
Switzerland (EFTA)			R,S,O	S,O			S	
U.K. (EC)S	B,S	B,S	B,S	B,S,O	B,S	X,B,S	S	

Source: External Affairs and International Trade Canada.

B = branch
S = subsidiary
R = representative office
X = regional office
O = other affiliated

EFTA - European Free Trade Association member.
EC - EC member.

TABLE 5

**Canadian Investment Dealers:
Locations and Forms of Operations in Europe, 1988**

COUNTRY	Dominion Securities	Wood Gundy	ScotiaMcLeod	Nesbitt Thomson	Burns Fry	Richardson Greenshields
Belgium (EC)						
Denmark (EC)						
France (EC)	B	B			B,S	
Federal Republic of Germany (EC)						S
Greece (EC)						
Ireland (EC)						
Italy (EC)						
Luxembourg (EC)						
Netherlands (EC)						
Portugal (EC)						
Spain (EC)						
Switzerland (EFTA)	B		B,S	B	B	
U.K. (EC)	B	B	B	S	B	S

Source: External Affairs and International Trade Canada.

B = branch
S = subsidiary
R = representative office
X = regional office
O = other affiliated

EFTA - European Free Trade Association Member.
EC - EC member.

TABLE 6

Major Canadian Life Insurance Companies: Locations and Forms of Operations in Europe, 1988

COUNTRY	Sun Life	Manufacturers	Great West Life	Confederation Life	Mutual Life	Canada Life	London Life	Crown Life	Imperial Life
Belgium (EC)									
Denmark (EC)									
France (EC)									
Federal Republic of Germany (EC)									
Greece (EC)									
Ireland (EC)	B					S			
Italy (EC)									
Luxembourg (EC)									
Netherlands (EC)									
Portugal (EC)									
Spain (EC)									
Switzerland (EFTA)									
U.K. (EC)	S	S		S		S		S	S

Source: External Affairs and International Trade Canada.

B = branch
S = subsidiary
R = representative office
X = regional office
O = other affiliated

EFTA - European Free Trade Association member.
EC - EC member.

held by European worldwide operations. The market share held by European insurers has increased from 2 per cent to 6 per cent since 1940; during the same period, the share held by U.S. insurers has dropped from 31 per cent to 12 per cent.

1.2 European Context

a) Financial Services other than Insurance

EC banks account for 34 per cent of total international world lending, just ahead of the Japanese. The Americans, with 7 per cent, have a smaller share than the German or French banks; in recent years, American banks have been reducing their international business while the Japanese have been expanding rapidly.

As Table 7 shows, Europe has close to 40 per cent of the world's banking market, based on the number of banks included in the top 500, the amount of total assets, and the percentage of total profits. The European market is also characterized by a high degree of concentration. The 25 largest European banks (five each from France, Italy, Spain, the U.K. and the Federal Republic of Germany account for 70 per cent of the total assets of the 2 039 European banks. The five largest banks hold almost 80 per cent of total assets in France, 75 per cent in Spain, and 60 per cent in Italy. These large institutions occupy a strong position in their domestic markets and are well positioned in the other European countries.

At the same time, banks are only part of a financial sector that also includes savings institutions, mortgage finance companies and a variety of specialized institutions. Banks represent 85 per cent of the financial system in the U.K., but only 55 per cent in France and 45 per cent in the Federal Republic of Germany. The non-bank financial sector is structured quite like the banking sector, with a few large institutions dominant in their fields. This means that traditional banking services, securities trading, mortgages, mutual funds and life insurance are distributed through very dense retail networks. The 6 600 bank branches in the Federal Republic of Germany are only a fraction of the 44 000 financial offices covering this country. In Spain, bank branches represent almost half of the 33 000 financial outlets. The U.K., on the other hand, has almost twice as many bank branches as other financial services retail offices (Table 8).

TABLE 7

World Banking Markets, 1986
(US$ billions)

	Banks in Top 500	Pct. of Top 500*	Total Assets (US$)	Pct. of Top 500	Total Profit (US$)	Pct. of Top 500	ROA (%)	ROE (%)
Europe	**203**	**40.6**	**4 047**	**39.3**	**26.9**	**40.6**	**0.69**	**17.6**
Asia	126	25.2	3 345	32.5	15.0	22.7	0.47	17.4
U.S.	110	22.0	2 187	21.2	17.4	26.3	0.80	26.0
Other	61	12.2	717	7.0	6.9	10.4	1.08	10.0
Total	500	100.0	10 296	100.0	66.2	100.0		

Sources: Salomon Brothers Inc. and *The Banker*.
ROA: Return on assets. ROE: Return on equity.
*Ranked by assets by *The Banker*.

TABLE 8

European Financial Services Statistics, 1987
(US$ billions)

	France	Italy	Spain	U.K.	Federal Republic of Germany
General					
Population (millions)	55 379	57 221	38 638	56 900	61 080
Savings as a pct. of income	14	36	N/A	12	11
Banking and financial institutions					
Banks	394	159	138	578	313
Non-bank financial institutions	1 673	950	0	124	4 145
Total financial institutions	2 067	1 109	138	702	4 458
Bank branches	9 917	7 014	16 498	14 300	6 602
Non-bank retail outlets	17 306	8 351	17 046	8 598	37 856
Total retail outlets	27 223	15 365	33 544	22 898	44 458
Population per retail outlet	2 034	3 724	1 152	2 485	1 374
Assets of banking system ($ billions)	861	593	255	1 561	927
Assets of five largest banks as pct. of banking system	79.2	60.4	74.9	35.7	62.0
Assets of financial system ($ billions)	1 571	593	399	1 833	2 076
Assets of banks as a pct. of financial system	54.8	60.4	63.9	85.2	44.7
Profit of banking system ($ billions)	1.80	3.19	2.46	N/A	N/A
Foreign Bank Share of Total Market					
Percentage of assets	17.6	N/A	6.4	61.6	9.1
Equity Markets					
Market capitalization ($ billions)	155	127	72	672	206
Listed issues (in units)	688	211	328	2 656	525
Capitalization of 10 largest stocks as pct. of market capitalization	23	65	50	21	48
Average market capitalization as pct. of GNP	16	16	22	88	16
Debt Markets					
Outstanding public debt issues ($ billions)	75.0	643.0	N/A	236.9	76.3
Outstanding Eurobond issues ($ billions)	59.5	26.2	6.3	68.9	36.9
Fund Management					
Value of mutual funds ($ billions)	204	50.8	3.2	57.9	42.3
Insurance					
Annual life insurance premiums ($ billions)	8 332	968	305	35 860	21 806

Source: Salomon Brothers.
N/A: Not available.

Table 9 shows the number of bank branches, assets per employee and population per branch for the EC countries, indicating the density and efficiency of the respective networks. These figures, when taken with those for non-bank financial institutions, suggest that the market is generally saturated.

To penetrate EC markets, Canadian banks must get access to potential customers and create or acquire an effective delivery system for financial services. In retail banking, the best opportunity, measured by assets per branch and population per branch, exists in the U.K., the least heavily banked country, and potentially more attractive than Italy and France, while Spain and Denmark are the most saturated large markets. However, a thorough analysis must include factors not visible in these figures. For example, high interest margins and good profitability in the Spanish market could make it more attractive than the highly competitive U.K. market. Population per bank branch is high in West Germany, but population per outlet of all retail financial outlets is much lower, indicating a dense distribution network. In France and Italy, there is a tradition of state intervention in financial systems, although this is evolving towards more privatization. In both countries, the retail market is dominated by a small number of large commercial banks, making the penetration of these markets quite difficult.

European Networking

Almost all European international banks have a presence of some kind in the London securities market. The large institutions are also present through branches and subsidiaries in the other European financial centres such as Paris, Frankfurt, Milan and Brussels. Statistics from the Bank for International Settlements (BIS) also show that EC banks conduct the large majority of their cross-border business with non-residents from headquarters, rather than from their network of branches and subsidiaries abroad. This indicates that large banks in the EC are highly centralized.

Market Share Gained by Foreign Banks

Because the U.K. market hosts the bulk of foreign banks, it has been most successfully penetrated. One-third of private sector loans are made by foreign banks (Table 10). The *Cecchini Report* showed that commercial loans are more expensive in the U.K. than in other EC countries, and are therefore more profitable. The large percentage of banking assets held by foreign banks also reflects the international role of the "City" in the Euromarkets (Table 10). The same is true for Luxembourg. This country's tax haven status has attracted private banking and Eurocurrency booking. France comes second, with 15.5 per cent of domestic loans made by foreign banks. Because foreign banks specialize in wholesale operations, their lending is essentially corporate financing.

A single market will not be completely achieved by 1992, but by then major obstacles will have been removed, and a daring and comprehensive unification program will be in place. At the moment, a lot remains to be done. Economic and political conditions could change, but momentum is strong for increased monetary collaboration, the creation of a central bank, and of a European monetary union. These issues and their solutions will extend well beyond 1992.

b) Insurance

Fuelled by increases in standards of living, life insurance is growing at a fast rate, particularly in the most developed countries (Table 11). Concerns about the dependability and limits of social security systems are also leading households to build up complementary protection. Accident insurance is growing more slowly, in line with the growth of GNP. Traditionally, insurance has had a high rate of penetration in northern Europe; thus the south offers a better base for expansion.

TABLE 9

European Banking Market Saturation
(US$)

Country	No. of Banks	No. of Branches	Population/ Branch	Assets ($ billions)	Assets per Branch ($ millions)	Assets per Employee ($ millions)
			1986			
Belgium	85	3 646	2 702	108.7	29 813	2.147
Denmark	83	2 131	2 403	25.0	11 732	0.703
France	386	9 917	5 584	282.3	28 466	1.232
Greece	32	1 311	7 605	10.4	7 933	0.286
Ireland	36	675	5 259	14.2	21 096	0.901
Italy	162	5 878	9 735	114.5	19 486	0.597
Luxembourg	127	300	1 230	56.8	189 333	4.745
Netherlands	83	2 500	5 859	110.7	44 280	1.757
Portugal	21	1 215	8 420	15.4	12 642	0.348
Spain	138	16 498	2 342	110.6	6 704	0.702
U.K.	578	14 300	3 979	1 008.2	70 503	2.502
Federal Republic of Germany	308	6 382	9 571	283.5	44 422	1.482
Total	**2 039**	**64 753**	**4 988**	**2 140.4**	**33 054**	**1.496**

Source: European Banking Federation.

TABLE 10

Foreign Bank Participation in Major EC Markets, 1987

	Foreign Banks as a Percentage of Total		
	Bank Assets	Private-Sector Loans	Private-Sector Deposits
France	17.5	15.5	20.0
Spain	6.4	6.2	0.3
United Kingdom	61.6	33.2	21.1
Federal Republic of Germany	9.1	5.1	3.6

N/A: Not available.
Source: National central banks.

TABLE 11

Insurance Premiums in Europe, 1986

Country	Share of European insurance markets (% of EC total)	Premiums per capita (C$)	Premiums as % of the GNP
Germany	32.3	1 172	6
France	19.7	790	4.7
United Kingdom	24.7	968	8.3
Denmark	2.0	891	4.2
Ireland	1.1	738	8.5
Luxembourg	0.1	640	N/A
Belgium	2.7	612	4
Netherlands	6.1	945	5.9
Italy	7.8	302	2.2
Spain	2.8	164	2.2
Greece	0.3	55	1.2
Portugal	0.4	91	N/A

Source: Sigma.

In 1986, the EC ranked second in the world for insurance premiums, with a total of US$183 billion, compared to US$371 billion for the United States. The world's 10 largest companies are all American or Japanese; Allianz, the largest European company, is in 11th place.

A few large companies have a dominant position in the major European countries: Allianz in Germany; National Nederland in the Netherlands; Generali in Italy; and Baltica in Denmark.

The freedom for companies to establish themselves in all Member States has increased, but freedom to offer services remains extremely limited because insurance is closely linked to national legal systems. National legislators justify their intervention in insurance matters by their need to protect consumers. The tax regimes for insurance products and for companies are very different from one EC country to the next.

Harmonization of national tax systems will be very difficult to achieve and has been prudently postponed until conditions are more favourable. At present, insurance policy taxation, contract law and supervisory rules are the domain of individual Member States. Host country regulations mostly prevail; the principle of mutual recognition has received only limited acceptance.

Significant progress has already been achieved in unifying the financial sector. The Directive on Liberalization of Capital Movements, adopted in 1988, set a June 30, 1990, deadline for the removal of restrictions on capital movements for most Member States. The Directive embodies the principle of liberalizing flows of capital to and from third countries as well as within the Community. This is a commitment to an *open* European market.

The EC is now setting up a package of regulations to implement home country control and mutual recognition.

2.1 Principles of the Single European Act

The concept of *home country control* is well adapted to banking, for which regulations tend to concentrate on financial soundness, particularly the adequacy of banks' capital resources, since these guarantee the safety of depositors' money. Under home country control, judgement on the soundness of a bank can only be made by home country authorities who are in a position to assess interrelated factors such as management quality, risk appreciation and control systems. Currently, most EC countries prohibit banks and other financial institutions from offering services unless they are established locally and conform with local regulations.

The second fundamental principle of the Single European Act is *mutual recognition* by EC Member States of each other's systems. The regulations of each country apply to its citizens throughout the EC. This is a totally different approach to decision-making, which previously required all Member States to agree in every detail.

2.2 The Second Banking Directive

The new principles are also the basis of the Second Banking Directive, issued by the European Commission in January 1988. This Directive is the cornerstone of banking regulations; it was approved in December 1989 by the European Parliament, and approval is also expected from the Council of Ministers in the near future. The Directive will take effect on January 1, 1993.

The Second Banking Directive does not differentiate between commercial or investment banks or financial institutions, but rather lists a wide range of financial services delivered by "Credit Institutions": these include lending, leasing, foreign exchange services, financial futures, credit cards, fund management and securities trading.

The main concerns of the Second Banking Directives are outlined below.

a) A Single Banking Licence

The desire for a single banking licence is a consequence of mutual recognition. Once a bank has been authorized in one EC Member State, it will be free to open branches in any other EC country without first obtaining authorization there. Opening branches is now possible in most of the EC countries, but the new system will reduce costs and bureaucracy.

Countries with tough regulations will be pressured to liberalize; competitors from countries governed by less restrictive rules would have an advantage over domestic banks.

A single banking licence could also create anomalies because banks from non-EC countries would be allowed to perform services in the EC not permitted in their home country. For instance, Japanese commercial banks are underwriting corporate bonds in Europe, an activity that Article 65, Japan's equivalent of America's

Glass Steagall Act separating commercial and investment banking, denies them at home.

b) Freedom to Provide Cross-Border Services

With a single licence, banks will be allowed to market their products throughout the EC (without needing affiliates) and to operate under many of the regulations of their home country. This is already often the case, but a host country's authorization requirements can sometimes interfere; exchange controls can restrict deposit-taking or lending. The single licence will enable banks to provide fuller and more flexible services to multinational companies operating throughout the Community. At the same time, technological advances will make it easier to deliver those services from the home base. Cross-border retail banking will also be possible with the new telecommunication technologies. Under the new system, host country control will be limited to "conduct of business" regulations aimed at protecting the public interest.

c) Freedom to Extend Services

Universal banking has long been practised in certain parts of Europe. In addition to traditional commercial banking, banks have taken full advantage of the internationalization of securities markets. Many countries are deregulating their markets to prevent trading of their securities from migrating to larger centres such as London or New York.

Banks will also be able to take advantage of increased internationalization of funds management, and will be able to market their own unit trust or mutual funds throughout the Community. This right derives from the Directive on Undertakings of Collective Investment in Transferable Securities (UCITS), which was to be ratified by EC Member States by October 1989. A mutual fund authorized in one EC country is currently allowed to operate and market in countries that have ratified the Directive.

d) Reciprocity

The wide-ranging right to deliver financial services within the EC will be accompanied by reciprocal access to non-EC countries. The Second Banking Directive provides that a non-EC bank with an *incorporated subsidiary* in a Member State will be granted a single licence on the same basis as an EC bank, and will therefore receive identical treatment.

A non-EC bank with only *a branch* in an EC country will not qualify for a single licence. The activities of such a bank will be restricted to its chosen EC domestic market. The prudent course, therefore, is for non-EC banks that currently have no presence in the EC, or that maintain only a branch or representative office in a Member State, to establish a subsidiary rather than a branch. Leaving such a step until after the Second Banking Directive comes into force may trigger the Directive's reciprocity provisions.

The concept of reciprocity contained in Article 7 of the Directive has contributed to a fear of "Fortress Europe." This issue is largely a matter of interpretation; naturally the conflicting parties have somewhat dramatized their concerns. A more measured approach will no doubt prevail during negotiations. After all, reciprocity provisions will not be retroactive, and non-EC institutions incorporated in the Community before January 1, 1993, (the date of implementation of the Directive) will qualify for the single licence. And those Canadian financial institutions already established in Europe, mostly in London, will benefit from a grandfathering privilege.

In the early drafts of the Second Banking Directive, any request for authorization by a subsidiary of a non-EC institution had to be referred to the Commission, which would decide if the state concerned offered "reciprocal treatment" to EC

banks. If reciprocity was lacking, the application was to be suspended pending negotiations with the concerned country to achieve reciprocity.

The Commission has since made its position more flexible and does not expect treatment of EC institutions in non-EC countries to be equivalent to that granted in the Community to institutions from those countries. Rather, it is now looking for treatment identical to that afforded to nationals of those countries; thus it is requiring only non-discrimination in foreign states. This more workable reciprocity provision will be carried into the Investment Services Directive and the Directives in the insurance field. According to Sir Leon Brittan, EC Commissioner: "We will only seek to hit back if there is in effect national discrimination against us."

The Commission has indicated it is aiming principally at countries that clearly discriminate against foreign banks, such as Japan, Korea, Brazil and to a lesser extent the United States. Canada is far down on the "hit list."

The Commission will examine national policies in countries such as the United States and Canada and also identify regulations affecting foreign banks that appear to be "burdensome" or "discriminatory." However, a degree of discriminatory treatment may be acceptable for the operations of foreign banks; the Commission's criterion is whether "effective market access" is provided. In the United States, Ron Lindhart at the office that controls the currency admits there may be some areas where the United States will "have to make adjustments." The Japanese, under the threat of reciprocity, have permitted foreign banks to participate in various profitable sectors of Japan's financial markets in return for permission to participate in banking and securities markets in the United States and Europe. Disputes over discriminatory policies will likely lead to negotiations. The industrialized countries are constantly negotiating to resolve differences and to reach harmonization via such arrangements as the FTA and GATT.

The Commission believes that non-discriminatory treatment in foreign states should in practice ensure effective market access to non-EC countries. The Commission's initiatives are directed at achieving a single European market by abolishing existing barriers; it does not want to create new ones. In response to cries of "Fortress Europe," the EC insists on "Partnership Europe." To become a more powerful economic and financial centre, the EC needs to attract as many players as possible.

2.3 Related Issues

As barriers are removed to give access to a unified market, it is necessary to ensure a "level playing field" for competitors. The main inequalities will be corrected through a series of Directives.

a) Solvency and Capital Ratios Directives

The Solvency Ratios Directive must be incorporated into the domestic laws of EC Member States by January 1, 1991. The Own Funds Directive (lists in detail what a bank can include in its calculation of capital), adopted in April 1989, deals with the numerator of the solvency ratio. It harmonizes the composition of a bank's own funds.

These two directives and the Second Banking Directive incorporate the conclusions of the Basle Committee, also known as the Cooke Committee. A minimal solvency ratio of 8 per cent will be mandatory as of January 1, 1993. The harmonization of capital adequacy will not be completed by then; the Basle Committee dealt only with credit risk and did not cover other forms of risk, such as interest rate risk.

A country can impose stricter standards than the agreed minimum, as is the case

with Britain. Canada's Superintendent of Financial Institutions has also given a more stringent interpretation than most countries, stating that provisions for general risk cannot be included in aggregate own funds. Large provisions for loans to less developed countries (LDCs) cannot be included in calculation of Canadian banks' capital, contrary to the practice accepted in the U.S.

b) Investment Services Directive

The Investment Services Directive, now at an early drafting stage, will be the equivalent for investment operations of the Second Directive in the banking field. This Directive is also built around the concept of a single licence. It will be complemented by the Capital Adequacy Directive, which will set the minimum capital acceptable for investment banking activities. There are grey areas when the activities of credit institutions overlap credit and investment banking.

c) Free Movement of Capital

The issue of free movement of capital was resolved by the European Financial Area Directive of June 1988. Most Member States must permit free flow of capital within the EC no later than June 1, 1991. Longer adaptation periods have been granted for some countries.

d) Tax Harmonization

Large differences exist in both the level and structure of taxation across the EC. Harmonization will be difficult because fiscal policies are traditionally an important element of each country's economic and social policies. A directive is at the drafting stage, and negotiations are being pursued to narrow the gap in value-added tax (VAT), and to harmonize policies on withholding tax. Countries such as France and Italy are concerned that the new regulations could facilitate capital flight. Luxembourg, on the other hand, intends to preserve its tax haven system.

2.4 Prospective Changes in Markets

A brief guide produced by three European economic institutes (Bureau d'Informations et de Prévisions Économiques [BIPE], IFO and PROMETEIA) analyses the impact of Europe 1992 on various markets. The guide focuses on six criteria. The first three concern demand and movements of goods, and the last three concern organization of supply:

1) the suppression of border controls and harmonization of indirect taxation (except banking and insurance, sectors for which savings taxation has been taken into account);

2) the harmonization of technical standards;

3) decreased intervention and the opening up of government contracts;

4) increased access to the market for services;

5) freer movement of capital and measures relating to company law; and

6) creation of research and development programs at the European level.

According to this system, the activities most strongly affected will be financial services, the first to feel the effects of the free movement of capital. Industry has been traditionally exposed to international competition, but construction and services generally serve a domestic market, and will thus be more strongly affected by a unified market. Firms with a previously limited horizon will need to look outwards and take advantage of freedom of establishment and free movement of labour and of their new freedom to offer services.

The governing principle of European market integration is to establish at the same time adequate safety and control regulations, as well as a high level of

market transparency. The regulations are in place, but market efficiency and substantial savings as a result of open competition are still some ways off.

The *Cecchini Report* calculated the prices of 16 financial products and then evaluated potential cost reductions due to the creation of a unified market (Table 12). The study took into account that the market will not be totally integrated and that competition is never perfect. A single price would be unlikely to prevail except for services such as foreign exchange. The implied price falls have been halved to compensate for special situations given potential price reduction. The study conceded a 5 per cent margin of error.

In banking, Spain has the highest prices and would thus see the sharpest decline. France and Italy would be moderately affected, while the least impact would be felt in the Benelux countries.

Table 12 shows the large price differences among countries and among the various types of services. As a general rule, prices of products and services for individual customers vary widely compared to those directed to large corporation; products and services directed to the latter are more international and highly competitive. The exceptions usually occur in very protected and regulated markets, such as Spain and Italy, and create inefficiencies and high costs. Market unification is starting to change this.

In the securities sector, the lowest prices are found in the Federal Republic of Germany and the Netherlands. The very low cost of large transactions in London is due to the "Big Bang," the deregulation process and free access to the London market of 1987 and reflects the huge volume of wholesale transactions. Belgium and Italy are heavily dependent on Treasury bonds to finance public debt and are subject to specific regulations. In Spain, the high price of transactions is due to a narrow market.

In the insurance sector, large differences are the consequence of specific regulations. Traditionally, northern Europe has been more open to international competition in financial products, as can be observed in the U.K. and in the Netherlands. In France, insurance products are heavily taxed.

2.5 Insurance

The Commission's objective is for a single insurance licence to enable companies legally established in one Member State to offer the full range of their products in another Member State, just as will be the case with banking.

Freedom to offer services has increased through the Second Non-Life Insurance Directive, covering large industrial and commercial risks, and the Second Life Insurance Directive, covering individuals shopping abroad for the best prices and coverage. Supervision is left to the insurer's country of establishment and control is given to us (home country) on the grounds that consumers are making informed choices and do not need special protection.

The freedom to go abroad for non-life, life insurance and private pension funds will apply to people who buy insurance, not to those who sell it. That leaves out a large part of the insurance industry's distribution system, which sells products directly but also through brokers and other intermediaries. Insurance contracts are more often signed through an active sale by a company agent or broker than through a direct client demand.

Insurance companies have been adapting to market integration by building up European groups large enough to resist competition from major American and Japanese companies, and by creating networks of national companies covering a large perimeter.

TABLE 12

Potential Declines in Financial Product Prices After Market Unification

I. COST OF FINANCIAL PRODUCTS (Percentage differences of prices compared to average of four lowest)	Belg.	F.R.G.	Spain	France	Italy	Lux.	Neth.	U.K.
Banking								
Commercial loans	-5	6	19	-7	9	6	43	46
Consumer credit (4)	-41	136	39	105	121	-27	31	122
Credit cards	79	60	26	-30	89	-12	43	16
Mortgages (5)	31	57	119	79	-4	37	-6	-21
Letters of credit	22	-10	59	-7	9	27	17	8
Foreign exchange drafts	6	31	196	56	24	33	-46	16
Travellers cheques	35	-7	30	39	22	-7	33	-7
Insurance								
Contents and house insurance	-16	3	-4	39	80	57	17	90
Motor insurance	30	15	100	9	148	77	-7	-17
Fire and theft	-9	43	24	153	245	-15	-1	27
Public liability	13	47	60	117	77	10	-16	-7
Term insurance	78	5	37	33	83	66	-9	-30
Securities								
Private equities	36	7	65	-13	-3	7	114	123
Private gilts	14	90	217	22	-63	27	161	36
Institutional equities	26	69	153	-5	47	69	26	-47
Cost of institutional gilts (6)	284	-4	60	57	92	-36	-17	-47
II. POTENTIAL PRICE REDUCTIONS (IN %)								
Banking	15	33	34	25	18	16	10	18
Insurance	31	10	32	24	51	37	1	4
Securities	52	11	44	23	33	9	18	12
Total	23	25	34	24	29	17	9	13
III. PRICE FALLS FOR TOTAL FINANCIAL SERVICES								
Implied potential price fall	23	25	34	24	29	17	9	13
Assumed potential price reduction	11	10	21	12	14	8	4	7
Assumed range of price reductions (7)	6 - 16	5 - 15	16 - 26	7 - 17	9 - 19	3 - 13	1 - 9	2 - 12

Source: Price Waterhouse for the *Cecchini Report*.

Companies wishing to achieve a European scope need to build distribution networks.

As in banking, acquiring existing companies is preferable to the cost and time required to build new networks. The large European companies are rushing to secure strong positions in the key EC markets. Union des Assurances de Paris (UAP) is helping La Royale Belge, the second largest Belgian insurer, to expand through acquisitions in Northern Europe and Scandinavia. UAP is already very active in the Netherlands, and has acquired 32 per cent of Victoire in France, which in turn controls Colonia and is associated with Baltica. UAP is associated with Indosuez and has cross-participations with Banque Nationale de Paris. Allianz of the Federal Republic of Germany has taken over La Protectrice of France. Allianz is also integrating its Canadian arms in London-based Cornhill Insurance, which operates in Canada through four insurance companies. Allianz also owns the RAS group of Milan, which owns Adriatic Insurance of Canada and Canadian Home Assurance Co. Starting January 1, 1991, a new company will hold all the Canadian units.

There is also a far-reaching trend towards diversifying the distribution channels of insurance products through other financial institutions. In France, some 40 per cent of life insurance products are now distributed by large banks. A similar trend is developing in the U.K., and in the Federal Republic of Germany banking and insurance markets are now more permeable to each other.

3. EUROPE 1992: EFFECTS ON CANADA'S FINANCIAL SECTOR

The advent of a truly unified market among the EC countries will be felt around the world. Already the growing interpenetration of economies, the globalization of markets and the development of multinational strategies are penetrating into even well-defended sanctuaries. The financial sector offers the best means for facilitating these exchanges, capital and investment flows. In fact, the unification process would have occurred even without the Single European Act, but at a much slower pace and certainly not to the same extent.

3.1 Direct Effects

Canadian banks have reduced their presence in the EC. They were once very active in Eurodollar syndicated loans and Eurodollar underwriting. In a race to accumulate revenues while paying too little attention to costs, market makers have experienced losses on deals that were too thinly priced. In 1989, Canadian banks and securities firms managed only 2 per cent of Canadian bonds issued in European markets, compared to 6 per cent in the 1970s. The network of local offices has been critically re-examined to determine its raison d'être. The Royal Bank has sold its retail facilities in France, for example, after determining it was serving a purely domestic clientele with no potential synergies with other products or cross-border services. The Toronto Dominion Bank is pulling out of continental Europe where it once held substantial assets. These assets have decreased from 50 per cent to 10 per cent of the bank's total, and in time might totally disappear. The bank has decided that profits from traditional banking activities in some countries of Europe are insufficient to cover the higher cost of capital in Canada. Only countries with high interest rates — i.e, the U.K., Australia, New Zealand and to a lesser degree the U.S. — offer returns that compare with Canada; hence the bank concentrates its European assets in the U.K. domestic market. The new capital adequacy rules dictate reallocating capital to the most profitable areas and focusing on less capital-intensive products.

Profitability is no longer being considered globally, but rather product by product to determine which activities should be developed or abandoned. Securities firms as well as banks are now selecting the niches where they are most competitive and the corresponding products that best fit their expertise.

One of the most important niches is mergers and acquisitions (M & A), for which the single market will create unlimited opportunities. The number of M & A deals is almost doubling from year to year as barriers are lifted and companies restructure in anticipation of 1992. Many small- and medium-sized companies are facing transfer problems; aging owners must organize their succession. Scores of others that lack the resources to keep up with the competition and are unable to raise additional capital must either merge or face a slow death.

North American financial institutions have a recognized expertise in M & A, particularly in very large deals. M & A deals present many advantages. They are conducted by small teams of highly skilled individuals, advising and arranging complex operations for large fees. They do not freeze any capital, and can lead downstream to very profitable financings. This is an area of natural synergy between Canadian banks and their recently acquired investment dealer subsidiaries.

Private banking is receiving renewed attention because of the constant rise in living standards, the growing number of wealthy individuals and the fast growth of savings and insurance products in Europe. The Royal Bank employs a large percentage of its staff in Europe in private banking. Royal Trust is developing

a global strategy largely anchored in the EC, Switzerland and offshore centres. The elimination of exchange controls will give a great advantage to banks able to serve this rewarding market.

Europeans are leading the way in the integration of banks and insurance. France has the most experience in "bank-insurance," and these marriages work in several ways. Some banks are now operators of insurance companies; others have chosen to create their own affiliates, particularly for life insurance which can be as much a savings as a protection instrument depending on regulations and the kind of product. Canadian banks would like to enter this field but first need clear Canadian legislation that reflects the new economic realities.

Fund management is another area of Canadian expertise applied to large pension funds, units trusts and mutual funds. Canadian techniques and software for administering large numbers of accounts, and Canadian methods of financial analysis, are very efficient. They could easily be adapted to European markets and marketed as a high-quality service.

Mutual funds authorized in one EC country will be allowed to be marketed in all EC countries, according to the Directive on Undertaking for Collective Investments in Transferable Securities (UCITS). Mutual funds have had impressive growth in the EC, primarily in heavily regulated countries, such as Italy or Spain, that offer a limited selection of savings products. In the past, foreign exchange controls limited the development of internationally diversified funds; the removal of these barriers is creating a big demand. The traditional local suppliers, often with limited experience, would be open to associating with foreign partners to market international funds.

3.2 Indirect Effects

Pushed by the restructuring taking place in the EC, leading European financial institutions will become strong competitors. They will be better armed to defend their domestic market and to expand to other Member States, as well as becoming more aggressive on the world market. Apart from the limited number of truly global banks, major banks will tend to become large regional banks. The EC is reshaping Europe, and the Canada-U.S. Free Trade Agreement is having a similar effect back home. Canadian institutions are adapting their strategies to the opening of this vast market with its access to large resources. Large corporations are also growing to continental dimensions and requesting extended services. These new risks will need to be carefully assessed.

To continue to develop, Canada needs a large inflow of foreign investment. Federal and provincial bonds are well accepted in Europe, and large amounts of equity are raised through the sale of Canadian stocks for the development of natural resources. The new prospects offered by countries such as Spain, Portugal and Greece might divert part of these flows from Canada, not to mention the large investments that will be needed to rebuild the economies of Eastern Europe. Innovative ways need to be found to keep attracting investments to North America. Clearly, Canadian financial institutions in Europe are in the best position to promote Canada in the EC.

4. STRATEGIES

Despite uncertainties about some of the deep changes under way, European unification is rapidly taking shape. Far-reaching decisions make unification increasingly irreversible. European businesses are involved in a wave of mergers and acquisitions -- some of them hostile takeovers, uncommon in Europe until recently. The mergers take place in every economic sector and their number is growing fast. In 1985, among the top 1 000 European companies there were 140 "national" mergers, achieved to consolidate core markets before expanding to other European countries. In both 1987 and 1988, there were 225 national mergers. Spanish banks provide a good example of this regrouping. For example, Banco de Viscaya and Banco de Bilbao, regional banks of similar size, have formed Banco Bilbao Viscaya, a new entity of international stature. At the same time, cross-border deals targeted on Spain have more than doubled, from less than 50 in 1986, to well over 100 in both 1987 and 1988 (Table 13).

Managers know they cannot wait for every detail of new business opportunities before they respond to competition. It might still be too early to develop precise strategic plans, but an overall goal must be set now.

4.1 European Strategies

a) Cross-Border Acquisitions

Very few banks around the world have chosen to be truly "global," offering a full range of products through a very large network and dealing with a clientele ranging from top-ranking corporations to individual customers. Wholesale banking is not viable if it focuses exclusively on lending (because margins on loans to large companies are excessively competitive. Lending must be coupled with corporate finance products that generate fees and commissions.) Retail banking is profitable when it can combine high-margin products, such as consumer lending, with low-cost deposits, with additional profits coming from funding treasury mismatch. Branch networks are necessary for distributing retail products; attempts to develop new retail facilities are too costly and time consuming. Thus the only sensible way to gain new distribution capabilities is to buy an existing network.

A handful of European banks have clearly indicated their desire to build a significant presence in other major EC Member States. The most visible moves have been made by Deutsche Bank, which is aggressively engaged in a buying spree across Europe. Deutsche Bank has acquired the subsidiary of Bank of America in Italy; Banco Commercial Atlantico in Spain; Morgan Grenfell in the U.K.; and is searching for an acquisition in France. The large French banks are also developing a very coherent network. After two acquisitions, Crédit Lyonnais is a major player in the Benelux countries and participates in Italy with Credito Bergamasco. Banque Nationale de Paris is consolidating its banking and insurance presence in the major European countries. The large British banks are well established across Europe, and are expanding. Barclays has entered Spain, and Lloyds Bank and Midland Bank have made acquisitions in the Federal Republic of Germany.

These highly publicized deals are limited in number because there are few large, profitable and reasonably priced targets. Hostile takeovers are still rare in the financial sector, and foreigners could probably not take control of a major local institution against political opposition. Local governments are encouraging consolidation of the important players in their domestic markets in preference to outsiders. Potential candidates for takeover, being in short supply, might prove very expensive, limiting returns for a long time. Some past cases of foreign

TABLE 13

Cross Border Acquisitions in Europe, 1989

Target nations	C$ million	Total No. of deals
U.K.	30 913	238
Federal Republic of Germany	8 279	216
France	7 780	191
Italy	5 975	104
Spain	3 899	128
Netherlands	2 730	99
Belgium	1 863	62
Sweden	1 104	35
Denmark	787	35

Acquiring nations	C$ million	Total No. of deals
U.S.	20 014	185
France	14 027	168
Federal Republic of Germany	9 638	128
U.K.	7 992	282
Italy	2 437	52
Japan	2 147	55
Sweden	2 002	121
Belgium	1 473	28
Switzerland	1 342	83

Source: Translink's *European Deal Review.*

Note: These tables include acquisitions made in European nations by U.S. and Japanese companies.

acquisitions in Europe and North America have turned into very costly mistakes because of mismatches in cultures and management styles and an incorrect perception of the market.

At the same time, local banks are keeping a strong hold on their markets and are rapidly diversifying their products. This creates excellent opportunities for foreign banks to create joint ventures to distribute specialized products to local banks, who are eager to offer new products to their clientele, particularly the more demanding younger generation.

The different approaches adopted by the three largest German banks to broaden their European coverage are typical of the strategies being used.

Deutsche Bank is developing a strategy of "Allfinanz," offering a wide range of financial services under one roof. In addition to acquiring banks, it is invading the insurance sector, breaking an old tacit agreement not to infringe on insurer's territory.

Dresdner Bank is much more selective. It has acquired a third of Banque

Internationale de Placements (BIP), one of the leaders in treasury management and arbitrage market in France. Dresdner is reinforcing its strength in sectors where it is performing best, such as foreign exchange and capital markets products. At the same time, Dresdner has bought the treasury activities of Elders Finance Group and counter-attacked Deutsche Bank in the insurance business by signing exclusive marketing deals with leading German insurers.

The third bank, Commerzbank, is looking for small stakes in similar European institutions. Its "Europartners" include Banco di Roma, Banco Hispano Americano and Crédit Lyonnais.

Acquisitions will probably multiply in the years to come, but mergers can fall through. The Government of Spain tried to assemble the two largest banks in the country, Banco Espanol de Credito (Banesto) and Banco Central S.A. For whatever reasons, the deal collapsed. The case of Amro Bank in the Netherlands and Generale Bank in Belgium is also instructive. This highly publicized deal, which would have created a single transnational operation through several stages, was abandoned at an early stage. The two banks will retain some cross shareholding and will continue to co-operate, but this arrangement falls short of the ambition to build one of the largest banks in Europe. Yet the merger of these two banks initially looked very promising. Of similar size, they are located in neighbouring countries with similar cultures and languages. They would have gained clear benefits in linking their distribution capabilities in securities, in research, in mergers and acquisitions and in combined overseas networks; in the end, these benefits were not enough to close a deal.

b) Participation Agreements

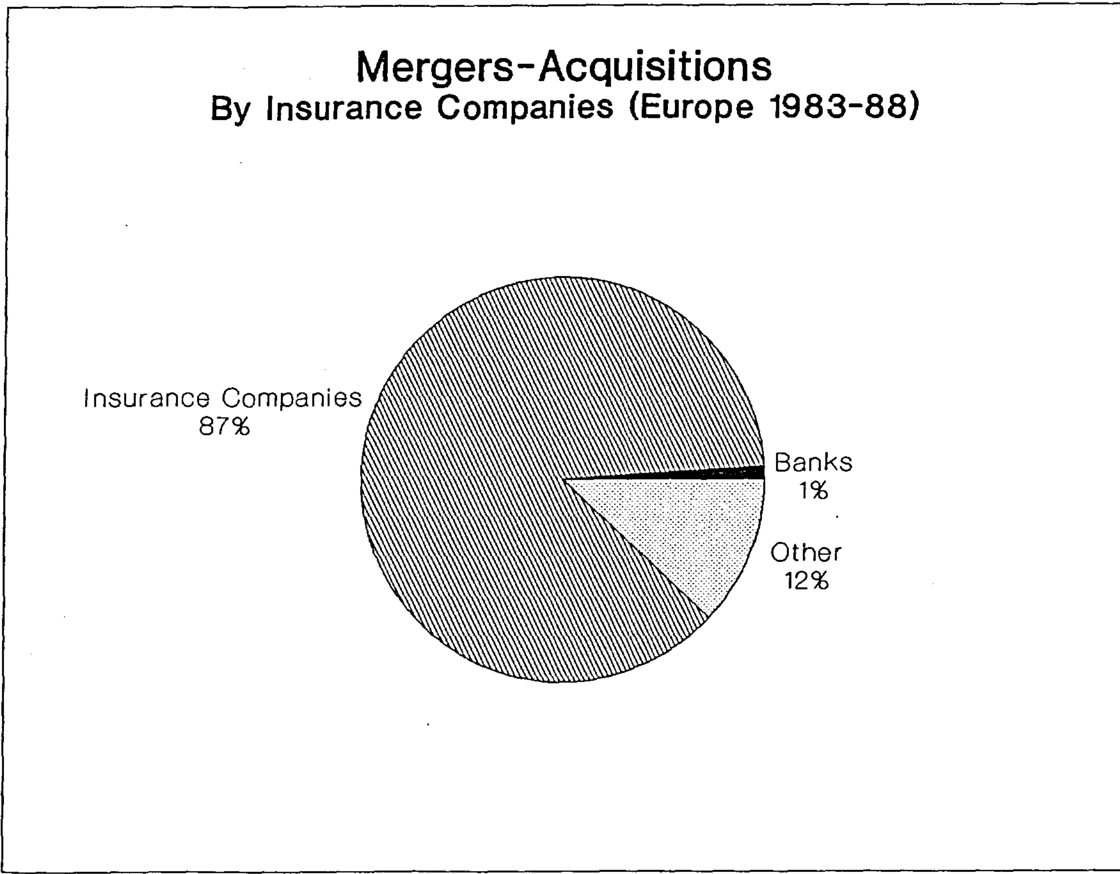
There is a general trend in European financial services toward consolidation through loose confederations. Alliances, co-operation agreements and cross participations have proven more flexible than full mergers. These confederations can involve two or more partners from the same or different sectors--i.e., banks and insurance companies. An interesting arrangement occurs when a group of middle-sized banks from different EC Member States agrees to exchanging cross-shareholding in order to gain access to new markets by trading matching products and distribution strengths. This type of arrangement also provides additional friendly shareholders and increased equity. Banco Santander in Spain is associated with Hambros in London, and Instituto Bancario Italiano is associated with Crédit du Nord Belge for some private banking products and with Noble Lowndes and Metropolitan Life of New York for mutual funds' administration and life insurance products.

The very successful Compagnie Bancaire of France is promoting foreign products such as Merrill Lynch Cash Management Accounts. It is specializing by product groups and building new distribution channels with associated banks for life insurance; with retailers for consumer credit; and with direct mail companies for savings accounts. It has also entered the British mortgage market by acquiring Commercial Credit Services Holdings and has created a joint leasing venture in Belgium.

c) Bank-Insurance Company Alliances

The financial sector is preparing for 1992 through alliances of bankers and insurers across Europe. This development is apparent in the Federal Republic of Germany. France, in turn, has promoted very intricate co-ownership arrangements between the large public sector banking and insurance firms. In cross-border transactions, Banque Indosuez, which has taken over the Victoire Group, the big French insurer which has a majority stake in Colonia, Germany's second biggest insurance group. Indosuez has also signed a pact of co-operation with View Rotterdam into Netherlands and with Baltica Holdings, a Danish insurance and finance company, adding Scandinavia to a

FIGURE 1



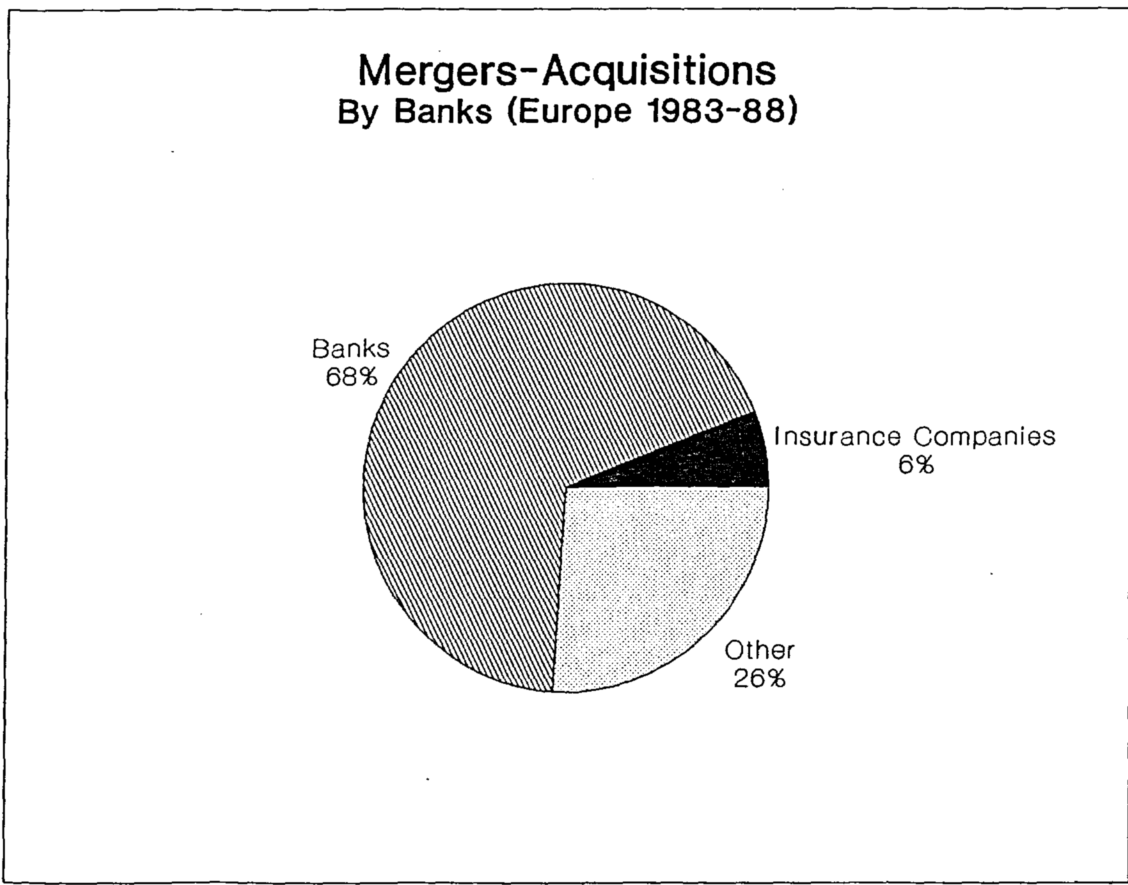
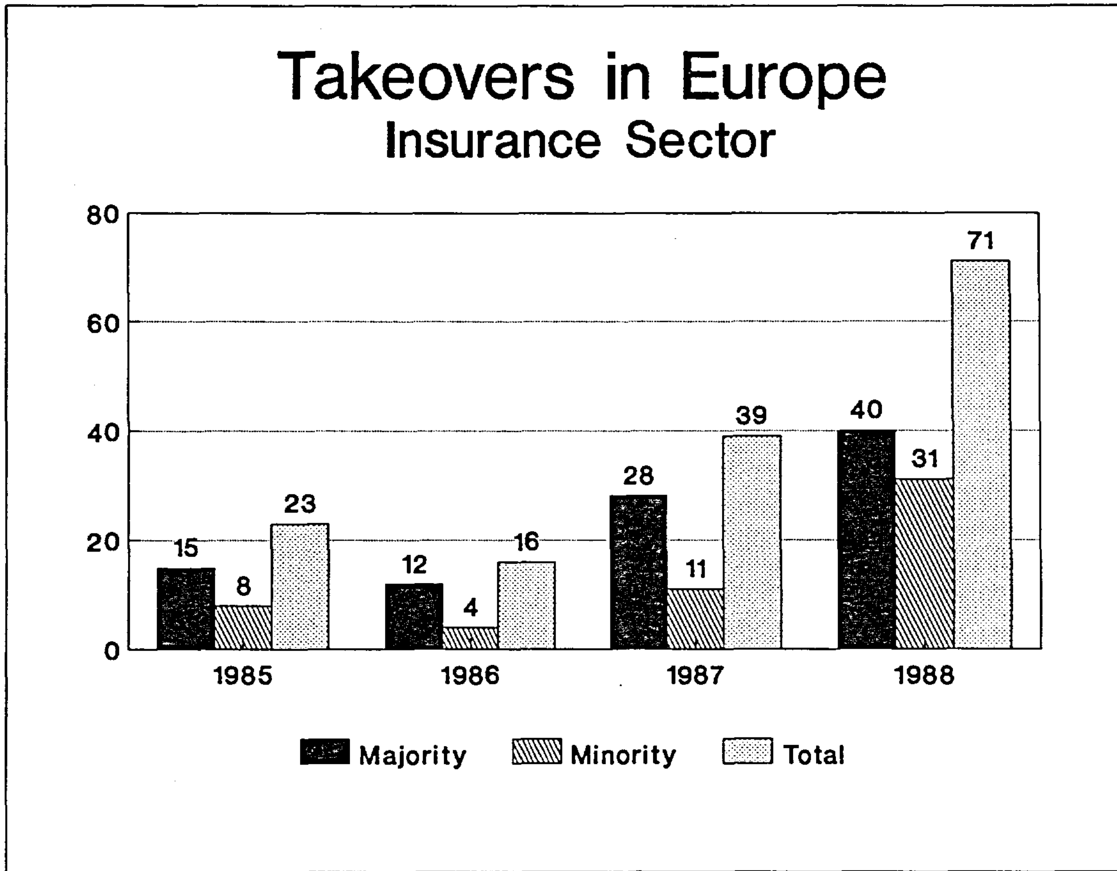
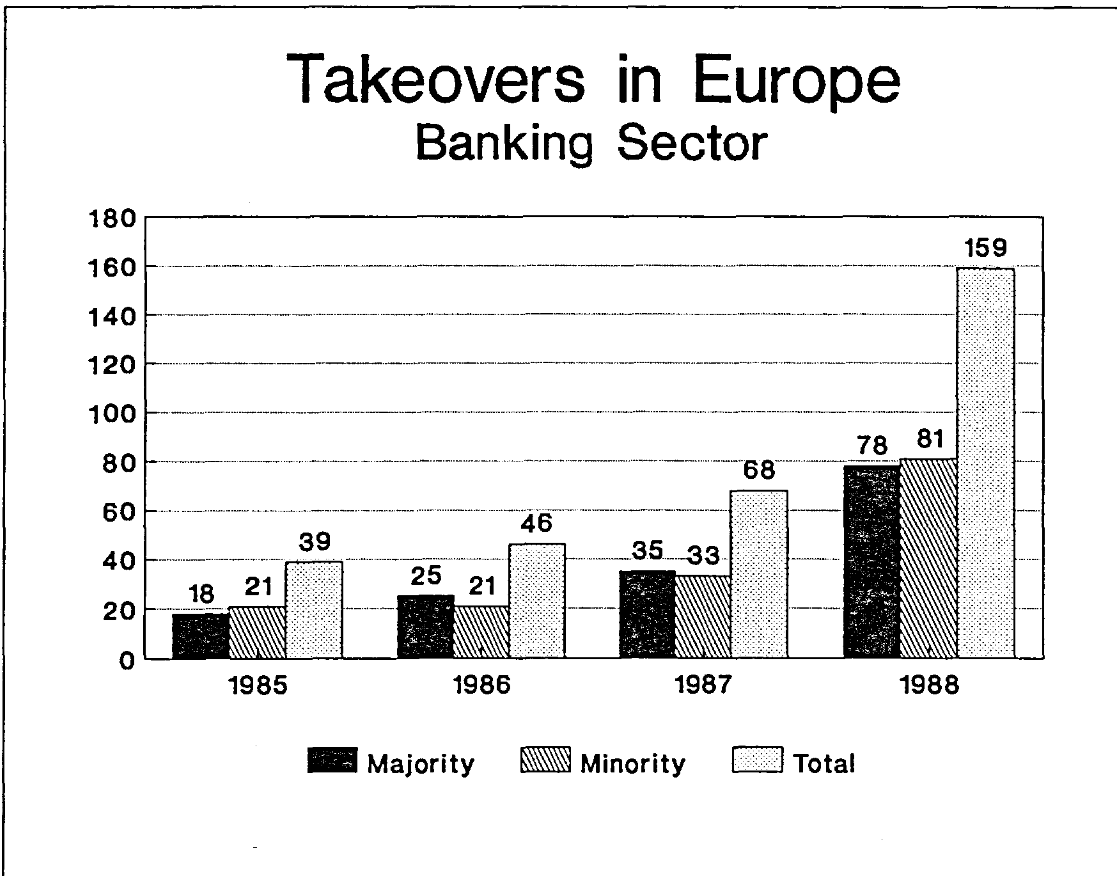


FIGURE 2





network that already covers all the EC countries.

This partnership could serve as a model for other small companies struggling to protect their large shares of the domestic market from bigger foreign competitors. Through the deal, Baltica is reaching three objectives in one shot. It is gaining access to a pan-European network through which it can offer a full range of insurance services to Danish corporate customers as they expand abroad. The link with Indosuez also promises to facilitate access to capital markets, allowing Baltica to grow as a specialized Danish merchant bank. And lastly, Baltica is now protected against a hostile takeover and gains a capital injection.

4.2 Canadian Strategies

Canadian financial institutions have a realistic approach to Europe 1992. They recognize that it creates great opportunities, but they also appreciate the risks and dangers associated with markets in turmoil. Canadian banks have also recently been opening their market to foreign competitors. They have adapted to this challenge by developing new products and adjusting their relationship with customers to defend their domestic market share, and they now expect European countries such as Italy and Spain to show similar resilience in defending their turf.

There are 450 foreign banks in London -- some say for 450 different reasons. They are there essentially to build an international base in the largest markets, to recycle domestic capital outflow, to follow multinational customers abroad, to trade domestic currency on an international market and to enter fields that are closed at home. All these same reasons apply to Canadian institutions, which are much better positioned in some areas than many of their international competitors.

a) Product-Driven Strategies

As we saw earlier, it is difficult and expensive for a non-EC financial institution to take control of a large network of branches and subsidiaries covering one or more EC Member States. Thus Canadian banks are focusing on products in which they have expertise. These products can be promoted from a central base by small teams of highly skilled and mobile specialists. Canadian banks do not pretend to provide global banking, but do intend to continue offering their international customers key services. The Royal Bank, for example, is one of the most active operators in London in foreign exchange and treasury functions.

London plays a central role in Europe's market for M & A. Canadian banks are developing investment banking experience in London and in association with recently acquired investment dealer subsidiaries. The biggest players in the market are the American and British banks. The largest and most complex deals have been arranged by the Americans: Goldman Sachs, First Boston and Salomon Brothers advised the Spanish banks on their rationalization; the restructuring of Montedison and ENI and the creation of Enimont in Italy was conducted by Morgan Stanley and Goldman Sachs; Merrill Lynch advised the Flick brothers in their successful assault on Feldmuehle Nobel, which was advised in its turn by Morgan Stanley. Some European banks are also emerging as strong players -- e.g. Amro, Dresdner, Lazard and Crédit Commercial de France. There are few billion dollar deals, but plenty of smaller ones. Canadian banks fit in this market and are advising foreign companies wishing to make small acquisitions on the local market as well as local target companies facing an uncertain future after 1992. About 70 per cent of takeover deals do not succeed, making good financial advice extremely important.

The Bank of Nova Scotia specializes in very tough deals requiring a great deal of research and innovation. The bank developed its expertise and trained its

teams of specialists in the U.S. market and then transferred some of these specialists to Europe. ScotiaMcLeod in Paris focuses on France. The Canadian Imperial Bank of Commerce is trying to unify its approach to business across Europe, but still treats each market according to its characteristics. In France, it views M & A as a way to develop commercial lending, and not only as a purely merchant banking service.

Generally speaking, Canadian banks have pulled out of corporate lending, which has become too competitive and thus unprofitable. These banks are concentrating on corporate finance products, now well developed in the U.K. market and gaining acceptance in continental Europe. The banks gained their experience in this field largely in the U.S., where they have to compete with large American commercial and investment banks. They are very familiar with risk management tools such as interest rate and currency swaps, options, futures which are being used more and more often. These products are now conquering new markets in southern Europe.

Canadians are specialists in specific activities such as mining and development of new technologies -- i.e, cable television. This experience has created niches for specialized lending. A large portion of the Canadian economy is based on natural resources, forestry, mining, oil and gas, and Canadian banks and securities companies are leaders in financing these activities. These companies manage energy loans and gold loans, for which they find a very active international market in London.

One of the principal reasons for Canadian brokerage houses and banks to be established in Europe is to promote and sell Canadian equities and bonds. The Second Banking Directive and the Investment Services Directive should create new ways to penetrate long-protected local markets, especially since it will be possible to operate in some EC countries without first establishing a local presence.

The Canadian securities industry can also promote the quality of its North American research on securities, which is based on a profound knowledge of corporations. From this base, Canadian researchers move to the larger context of economic sectors, a process called *bottom up* analysis. The European approach starts from a macroeconomic study and then selects the most promising industries to look for specific stocks: this approach is called *top down* analysis.

b) Investment Products for Individuals

Access to distribution networks is essential for private banking. Canadian institutions do not control these networks and cannot expect a significant direct penetration. On the other hand, they could market some products through mail and advertising.

The National Bank of Canada has chosen to form very close reciprocal banking relationships with EC domestic banks to service each other's customers. Royal Trust is increasing its presence in private banking across Europe. In the insurance industry, the Desjardins group has signed an agreement with Confédération Nationale du Crédit Mutuel de France, also a co-operative movement. The two groups plan to collaborate on several types of activities and to assist each other in the other's market.

Several Canadian life insurance companies operate in the U.K. market and are considering using this as a beachhead for penetrating continental Europe. Head Offices often give their local delegates the responsibility of building a strategy; these delegates are in a position to assess the differences in culture, to establish priorities and to detect opportunities.

In line with its traditions, the life insurance industry is a strong supporter of unrestricted right of access and establishment, of commercial presence in all countries, and of eliminating barriers to

trade (as is evident in its support of the FTA and GATT negotiations). Life insurers thus view favourably the changes in Europe that permit market access subject to the regulations of the home country.

Most EC Member States have built a comprehensive social security system, reducing the need for citizens to get personal coverage. However, the growing fear that these systems will eventually be unable to provide an adequate level of protection has given rise to a tremendous demand for insurance and pension products, from protection to savings. Italy and Spain are the most promising countries, with an expected growth rate in insurance products of 20 to 30 per cent for the next five years. France also offers very good growth potential.

Takeovers have occurred only among leading institutions. At a lower level, co-operation agreements and joint ventures are more feasible. Situated between the powerful groups and the very small companies (which are often well encroached in a very local market), are a large number of medium-sized insurance companies that will have difficulties coping with increased competition. Many will have to find allies and associates to gain access to new and more sophisticated products. Canadian insurance companies have remarkable experience, both in life insurance and pension products, but do not have distribution networks to sell these products. They could negotiate an agreement with local institutions anxious to have access to sophisticated services. The Canadian companies would receive commissions while avoiding the expenses, risks and delays of building a distribution network.

Canadian experience could also be valuable in the management of mutual funds. France has the largest number of mutual funds; corporations and pension funds use these to invest very large amounts. Because of French regulations, 72 per cent of assets are invested in bonds and a small percentage in international funds. However, tax incentive programs similar to Canadian tax saving regimes will now be open to international diversification, which should enhance their performance. Italy and Spain are becoming large markets for foreign products because local mutual funds are not able to satisfy the growing demand. Luxembourg and London shelter many mutual funds, Luxembourg because of its status as a tax haven inside the EC, and London because the City offers unequalled numbers of highly skilled professionals at all levels of the securities industry, from analysts to traders.

The EC is a large potential market for international products complementing local mutual funds. Success will come from focusing efforts on wealthy, sophisticated and more demanding international investors. The reputations of Canadian companies and their track records are strong marketing tools for penetrating this market.

c) Europe's Financial Centre?

Competition to be considered the EC financial centre is fierce among major cities. London has a major advantage, given the traditional power of the "City," but is handicapped by a weak U.K. economy compared to the Federal Republic of Germany, France and Italy. Frankfurt and Paris are taking a lot of activities out of London, but are not yet serious rivals. Regulations, taxation and economics will have their influence in the years to come, and each of the three cities will develop its specialization.

5. OPPORTUNITIES AND RISKS

The management challenges of Europe 1992 are complex and profound, but in essence they are no different from the North American problems of globalization, increased competition and accelerating technology. Europe's euphoria may subside as the opening of long-protected markets leads to casualties. Canadians are closely monitoring the European situation but have not yet taken a leading role. The market is very pragmatic; so should the players be.

Canadian financial institutions should not neglect their role in Europe despite the pre-eminent role of the domestic market in expansion plans, and despite the opportunities currently available in the U.S. market. The EC market will likely achieve an increasingly prominent position, whereas the U.S. market remains fragmented. The EC offers a choice locale for the most up-to-date techniques, and new products are constantly entering markets there. Competition may be fierce and returns sometimes uncertain, but major institutions must maintain a significant presence there. The Chase Manhattan Bank, after selling its branch network in the Netherlands and Belgium to Crédit Lyonnais in 1987, is coming back to these countries to develop M & A. North American institutions can also gain experience in the EC with products they are not allowed to trade at home, preparing them for changes in legislation.

The Toronto Dominion Bank has taken a leading position in selling insurance products in anticipation of reformed financial regulations. Elaborated to cope with crises, these regulations have lost their significance. American brokers, accustomed to relentlessly fighting the commercial banks' encroachment on their exclusive investment banking territory, are now taking a much softer stand. The Canadian Imperial Bank of Commerce (CIBC), the Toronto Dominion Bank, and the Royal Bank are already seeking licences to deal in U.S. securities now that restrictions on commercial banks operating in the U.S. are being eased.

Economic conditions can change very rapidly. Financial institutions are familiar with the cycles that regularly affect their business. Variations in interest rates between countries are having an impact on currency rates, pushing companies to diversify internationally. For example, the earnings of the American automobile industry in Europe are a major contribution to consolidated revenues even though its production there is considerably smaller than in the U.S. Because of their European affiliates, General Motors and Ford had relatively limited drops in 1989 profits; Chrysler, with no presence in Europe, experienced a free fall in profits in 1989.

In summary, the European market unification will have far reaching effects, although these are difficult to predict. Canadian companies that start working now will be able to choose solid partners for joint ventures; attractive candidates will become increasingly elusive as more deals are sealed. Many recent joint ventures, new holding companies or partly owned subsidiaries have been set up not with cash but with an exchange of shares or transfer of assets. This strategy permits recapitalisation and also increases equity funds.

Many commentaries on Europe 1992 have focused on concerns over reciprocity. However, the grandfathering clause that will apply to Canadian financial institutions in Europe makes this concern irrelevant. The real question is the future position of North American financial institutions in Europe.

Canadian financial institutions have lost ground in the EC, despite their mastering of new financial techniques and technologies. However, a lack of distribution networks can be compensated for by Canadian expertise in direct marketing, with supports such as credit cards and mailing campaigns, which should be sufficient to increase market share.

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