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Irish Retail Banks and the Competitiveness Challenge

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Competitiveness at the firm level is about organisational flexibility, cost minimisation and the rate of technological innovation. This article outlines the contours of the competitiveness challenge facing business in a global economy. Its direct and immediate relevance to an Irish retail banking market, which could be described as 'small' by international standards, is that there may be no room for small national firms in the new global market order. Consolidation through mergers and acquisitions is identified as one response to the competitiveness challenge in a new global market order. The topical issue of a merger between AIB and Bank of Ireland, for example, is presented as one possible response to the competitiveness challenge. A merger may have little distortion of competition within the EU. The case is made that there is nothing immutable about the position of our national banks. They could become the target of bigger Continental banks, eager to redeploy their assets for a takeover. An enlightened merger policy would be a measure of antitrust brinkmanship in the evaluation of mergers in the Irish banking sector.

INTRODUCTION

The world economy has changed profoundly; it has become a truly global system. In particular, the international competition for capital has become more intense and this is beginning to exercise a new influence on the design of many corporate policies. Across the world, corporate strategies are increasingly planned and designed to meet the competitiveness challenge, a challenge precipitated by globalisation and by the changing commercial climate in which firms and their management teams operate. A factor that has contributed to fundamental change in banking activity in the global economy, and which continues to do so, is technological innovation.

Competitiveness at the firm level is about organisational flexibility, cost minimisation and the rate of technological innovation. So, in order to meet the competitiveness challenge, Irish and European bank management realise that they must, above all else, reduce

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costs and secure cost leadership in their industry. In this landscape mergers look attractive. Rumours of possible bank mergers are always in the air: Credit Suisse First Boston has been paired with Barclays and Deutsche Bank has been paired with Lloyds TSB by the rumour-mongers in the UK. But now the process is latching on to the Irish banking scene, with speculation as to a likely pairing of AIB and Bank of Ireland. The time may be right for consideration of such a pairing. Not only has banking across Europe changed profoundly over the past ten years or so, but the Irish banking market has changed.

WHAT IS THE COMPETITIVENESS CHALLENGE?

An information and communications technology cycle has exerted its influence on business. It has created a new economic order that is transforming business and the way business is done. There is a 'new economy effect'. It is everywhere, affecting all business activity. For example, it has made possible the automation of all the information and paper processing, record keeping and administrative activities in some businesses, which on some estimates account for 50% of all hours worked. A recent McKinsey report has calculated that a typical European bank could outsource 17%-24% of its cost base, reducing its cost income ratio by between 6% and 9%.[1] A 'new economy effect' could play an integral part in how Irish banking business is conducted and how banking in Ireland is conducted.

Therefore, the part played by 'a new economy effect' in the banking sector will depend, ultimately, on how the management of Irish retail banks respond to the challenge of transforming business. Firm-level competitiveness is first of all a function of the banks' staff and strategies. The strategic response of management to the competitiveness challenge could be measured in terms of a range of 'new economy drivers' such as worker flexibility, social capital and consolidation.[2] The latter could be measured in terms of the extent and scope of co-operation between rival banks. The introduction of the ATM, for example, has helped to erode the geographical links between bank branches and customers. In responding to the challenge, the role of management may be relegated to that of an intermediary in the value chain, eliminating any overhang capacity by ensuring the introduction and harmonisation of new work practices and maximising shareholder value (McNutt, 1994, 1996).

[1] Vide 'Outsourcing to India', special report in *The Economist*, May 5th, 2001.

[2] As outlined in an address by the author to the ISME Annual Conference, May 2001. Social capital as measured by private marginal productivity, includes a deteriorating travel-work environment, imposing heavy short-period costs on an educated workforce. Unless social marginal productivity can be improved, for example, through improvements in public infrastructure or through more flexible working practices, private marginal productivity may have to be sacrificed.

In Ireland, as in most jurisdictions, co-operating or collaborating with rivals would come under the careful scrutiny of national competition agencies. Meetings and negotiations can often be misconstrued as conduits for agreements to fix prices and trading conditions. Negotiation and co-operation is becoming a vital part of the modern banking business as the financial system depends on clearing and settlement operations that require extensive joint venture arrangements.[3]

But what if the two major retail banks, AIB and Bank of Ireland, opted to merge? There would be initial concerns about the levels of concentration in domestic product markets. But market structures are becoming more concentrated. This is neither an Irish, European nor an American phenomenon; rather it is global. It is a natural consequence of growth whether organic or by acquisition.

NO NATIONAL FIRMS

However, it is a challenge for the management of indigenous banks to achieve competitiveness beyond the national or regional level.[4] In doing so, management may attempt to slice up the value chain of their products and services across separate markets. As they do so, traditional criteria focusing on individual characteristics of the firm, for example, the product markets *per se*, are becoming less and less appropriate for strategic analysis. The real yardstick of the competitiveness challenge for management is to understand the integration of corporate strategies with 'the geography' of their business. The strategic issue for both bank management and a national competition agency like the Competition Authority is not a question of Ireland being the geographic scope of banks' activities; rather it is whether the EU has now become the strategic geographic market for business. A merger between the Bank of Ireland and AIB may have little distortion of competition within the EU.

The geographical identity of Irish banks is becoming more and more diffuse because of the increase in cross-border equity, in the cycle of relocation of operations and in the rotation of ownership amongst shareholders. With the apparent 'death of distance' in world markets, access to world markets for EU-based firms is counterbalanced by similar access by their competitors to EU markets.

Banking is a good example of this evolving trend for geographical reach. Both AIB and Bank of Ireland have banking interests beyond Ireland. In recent times ACC has

[3] One of the best examples has seen Barclays and Lloyds TSB, the UK's third and fourth largest banks, pool their cheque processing into a new company controlled by Unisys, in which the two banks have a 24.5% stake.

[4] There are new multilateral structures and processes for regulating world trade and they are gradually replacing traditional national or regional control. Ireland is now part of the euro zone, with no indigenous currency and no independent monetary policy.

become part of the Dutch group Rabobank and Ulster Bank has become part of Royal Bank of Scotland. Consolidation has increased, in many respects, because of the developments at international level where countries, and the firms located in those countries, are becoming more closely identified with regional trading blocks such as Mercosur, the EU, Nafta or APEC. It is more than likely that a non-EU firm would turn to the EU trade area for growth by acquisition. Inevitably, this will trigger competition implications in a domestic setting but assessment of these likely implications should judiciously balance real effects in the home market(s) across all product and geographic markets. The net effect may not be dispositive.

BANKS AND IRISH MERGER ACTIVITY

Irish merger activity has increased and consolidation is fast becoming a prerequisite for the survival of many firms in Ireland. In calendar year 2000, for example, Irish companies spent a record €10.4 billion acquiring 129 companies in both the domestic and international markets.[5] A further 102 transactions had been recorded for which there were no disclosed values. This is almost double the €5.3 billion spent in 1999. However, apart from Irish Permanent and TSB, Bank of Scotland and ICC and Rabobank and ACC, the absence of consolidation in the Irish retail banking market is noteworthy. Indeed there may be a concern with respect to merger law. For example, there may well be a presumption that a merger between the two major retail banks, AIB and Bank of Ireland, could be enjoined on issues of single firm dominance and/or joint dominance as measured by market shares across particular product markets.[6] Such a presumption is based on an over reliance on the market shares-market power axis, which is *passé* in strategic antitrust analysis.

Indeed, the presumption could be challenged in a world where a banking firm's geographical identity is becoming more and more diffuse. A visionary approach to banking mergers would abandon concentration measures and focus on how banks interact as rivals by looking at each other's price changes, taking account of the influence of changes in demand and costs, and of different levels of elasticity in market demand. Although past empirical work using US data supported a link between concentrated local markets and market power, recent research casts doubt on that relationship – Berger et al (2000), Cetorelli (1999), Radecki (1998). In the US, for example, the link has weakened with substantial regulatory changes, which have removed the last barriers standing in the way of nationwide banking there. The

[5] *Vide* CFM Capital Limited 2000 Acquisition Survey, Dublin.

[6] Mergers have the potential to produce two kinds of anti-competitive impact; namely, unilateral effects arising from the merged firm may exercise significantly more single-firm market power than its components each possessed prior to the merger; and co-ordinated effects occurring if a merger enhances the ability of firms to engage in various forms of anti-competitive parallel behaviour.

regulatory changes have substantially widened markets, reduced barriers to entry and contributed to a higher incidence of multi-market contacts among the US banks.

The banking sector is an example of a service industry where traditional demarcations no longer apply. The introduction of technological innovations has loosened the ties between customer and local banks. Geography has dictated that the market for some retail banking products is moving from regional to national and from national to European for other retail products. The pace of movement depends on the product. The market for a limited number of products, such as housing loans and credit cards, may already be European. The market for some other retail products, as well as for products targeted at small and medium-sized business, may remain national in the future. Banking is becoming less local, less regional, less national and more global in scope. National banks in European countries could either enter joint deals with Continental banks or entertain cross-shareholding alliances. In the latter case, management may wish to redeploy assets for a merger or takeover. If the management of the two main Irish banks, AIB and Bank of Ireland, were to aspire to become a force in Europe as the Continent's financial markets consolidate in the emerging euro zone, a merger may be the *sine qua non* of their banks' survival as domestic banks.

A NEW (MERGER) STANDARD

Banks today rarely offer their banking customers one service or product. They offer current and savings accounts, loans and credit, mortgage advice, insurance, pension and share dealing services. While retail banking, as we know it, will remain a core business, some banks are looking to develop pensions and life assurances expertise for market growth. In fact they offer a 'bundle of products'. This strategic approach to product and service has not been fully embraced by the European Commission or national competition agencies. The approach is not dissimilar to an old standard first applied in the US antitrust case, Philadelphia National Bank (1963);[7] that is, the possibility that a bundle of products rather than any one product *per se* may legitimately define the relevant market for merger analysis.

The geography of the relevant market is significant to any assessment of likely competition implications. A merger between AIB and Bank of Ireland, for example, may have little distortion of competition within the geographic market of the EU. Views are mixed among European competition agencies concerning banking mergers.[8] For example, there are differing views on whether Internet banking has increased or lowered barriers to entry in retail banking. ATMs, for example, reduce the need to build

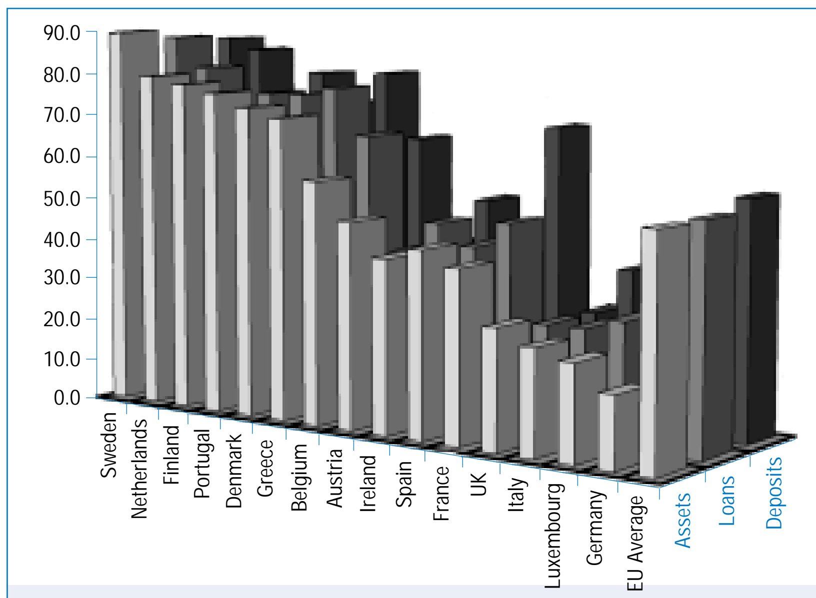
[7] US v Philadelphia National Bank 374 US 321 (1963).
[8] *Vide* OECD *Journal of Competition Law and Policy*, vol 2, no 4, 2000.

additional bank branches while internet banking transcends national and regional boundaries, thus lowering barriers to entry. Therefore the Internet will facilitate real competition in the supply chain of so many 'frozen' products and service markets; that is, markets where innovation and technological advances could release a latent market opportunity affecting both trade and domestic competition.[9]

ARE IRISH BANKS 'SMALL'?

The Irish retail banks could be defined as 'small' relative to their European rivals. An assessment of consolidation in the Irish banking market must be considered in the context of a pan-European banking market. By way of illustration (and before the recent consolidation in the UK and Ireland), the pre-1999 five-firm level of concentration in the banking sector in Ireland could be described as average by European standards.[10] This is illustrated in Figure 1.

FIGURE 1: CONCENTRATION IN BANKING INDUSTRY, PRE-1999



Source: European Central Bank Reports 1997-1999

[9] The concept of frozen markets is introduced in McNutt (2002), *Economics of Public Choice*, Elgar Publishing, UK, pp 310-312.

[10] Concentration is measured as the cumulative percentage share of the five largest banks of total assets/loans/deposits in the national market.

The slow progress of consolidation raises some basic questions about firm dynamics and industry evolution in the Irish retail banking market. In particular, it could facilitate speculation on the manner in which rival (overseas and Continental) banks are likely to enter the Irish retail banking market, grow or stagnate and ultimately survive or exit from the industry in a new economic order. Both the Bank of Scotland and Northern Rock have entered as niche market players and the Royal Bank of Scotland has a footprint through the Ulster Bank. But entry into the Irish banking market by Continental banks such as Deutsche Bank or UBS or Santander Central Hispano through acquisition of an Irish bank remains an option and a credible threat to the Bank of Ireland and AIB.[11] Why?

In banking the nature of mergers and acquisitions is mostly horizontal, aiming at economies of scale, technological synergies, eliminating excess capacity and streamlining innovation strategies and R&D budgets. Competition is more likely to be influenced by technology factors and the threat of competition from new banking sources. Banks have to get better at what they do. Therefore, it is the threat of entry and technological developments that have the potential to substantially change the level of competition in the Irish banking sector. On the one hand, the internet and the advent of electronic banking in the euro zone will free up competition in the EU banking sector. On the other hand, Continental banks will snap up subsidiaries in neighbouring countries and merge across borders and across products and services. It is only a matter of time before the first pan-European bank emerges.[12] Citigroup is often cited as the model of a truly global corporate and investment bank. It is the biggest bank in the world by market capitalisation at $225b. Even Citigroup itself is said to be on the acquisitions trail in Europe.[13]

NICHE PLAYERS VS. 'OVER-BANKED?

Arguably, if national banks exist with market capitalisations below an EU average and if their cost income ratios remain high by international standards, a banking market could be described as 'over-banked'. At present Ireland could be described as 'over-banked' with an extensive branch network. Consolidation will follow the early entry of Bank of Scotland, Royal Bank of Scotland, Rabobank and National Australia Bank. Already, there is some consolidation in the home market: Irish Life & Permanent have acquired TSB. However, it is only a matter of time before the major Continental banks move into the Irish retail banking market. Economies of scale and scope, increased market share,

[11] UBS is the new entity formed between Union Bank of Switzerland and Swiss Bank.
[12] During 2001, Allianz, Germany's largest insurer, acquired Dresdner Bank, Germany's third-largest, in a move to create a European financial services global firm. Dresdner Bank is now part of the Allianz group.
[13] *The Economist*, 'Scent of a Banker' May 4 2002, pp75-6.

international expansion and product diversification will be some of the motives behind the expected surge in consolidation activity.

In the interregnum before the entry of Continental banks, there is likely to be a reduction in the current extensive branch network. The number of branches may decrease but individual branches may expand. The traditional practice of 'lifetime employment' may have discouraged Irish banks from cutting the workforce, and, as a result, the banks are slow to eliminate any overhang capacity. This is in sharp contrast to the policy adopted by some Continental banks. For example, the four big banks in Germany plan to reduce numbers employed and the number of bank branches.[14] Whether a merger occurs or not between AIB and the Bank of Ireland, or between either of them and a third party, some retail branches across Ireland will close and many are likely to be further depersonalised and automated. A change in the deployment and overall profile of bank staff in favour of marketing, IT and more sophisticated value-added services can also be anticipated as electronic banking pervades and there is likely to be increased outsourcing of IT-related activities.[15]

Stylised facts emerging from impressive empirical research, *vide* McCloughan (1995), Geroski (1995), Sutton (1997), Caves (1998) and Agarwal & Audretsch (2001), have been sufficiently compelling as to contradict Gibrats' Law, which assumes that firm growth is independent of size. From the perspective of the two leading retail banks, AIB and Bank of Ireland, their relative performance within a European context may depend on size in the Irish banking market. However, European banks have witnessed higher size thresholds, reflecting the fact that small national banks are finding it difficult to meet the competitiveness challenge. Consequently, rumours of merger activity within the EU banking system are indicative of management intentions to consolidate in the national market or expand their operations into other EU countries.

However, the increasing internationalisation of financial services has accentuated the international dimension to the management of banks. The theory of small firm strategic niches, posited by Caves & Porter (1977) and Porter (1979), argues that by occupying strategic niches, small firms do not need to grow in order to survive. The strategic niche theory further holds that banking firms can remain small by EU and international standards and face no disadvantage with respect to the likelihood of survival in the home market. Empirical evidence across OECD economies to establish robustly the survival rate in the banking sector, whether positive or negative, remains unconvincing.

[14] *Business Week* European Edition 'Titans in Trouble' May 13 2002. The big four, Deutsche Bank, Dresdner Bank, Commerzbank and HypoVereinsbank, plan to reduce the workforce by 10%. The IBOA, for example, have predicted the closure of 100 branches and the loss of 5000 jobs as a result of a AIB/Bank of Ireland merger.

[15] But outsourcing complex services may have flaws: it may be difficult to work out how to split the cost savings and complex contracts often mean the whole arrangement could collapse into legal wrangles.

However, the likelihood of survival depends significantly on the phase of the life cycle of the industry and whether the product market is characterised by technological advances.[16]

CONCLUDING COMMENTS

The landscape of retail banking has changed during the past ten years. The European banking market could be described as dynamic. On the demand side customers have enhanced access to competing suppliers of financial services and increased information on the prices of banking services and products and find it easier to draw comparisons. On the supply side of retail banking, a large branch network is no longer necessary to reach a critical mass of customers. Internet banking and advances in IT may have lowered the barriers to entry into the retail market. This means that small banks and niche institutions can enter and become competitive in the market. Banks that succeeded in the past through a regional strength and presence will come under attack from Continental banks, which are no longer constrained by physical location.[17] As a single financial market starts to take shape in Europe and political resistance to cross-border acquisitions lessens, mergers may become *de rigeur*.

In banking the boundaries between financial and non-financial institutions are likely to diminish and competition from non-financial institutions is likely to intensify. Inevitable branch closures could provide the opportunity to refocus the policy debate on the future of rural banking services in Ireland. With an increasing trend in the movement of services or functions away from the banking business towards other financial and non-financial institutions, potential non-bank competitors, including larger retailers, securities firms, telecommunications companies, insurance companies and software companies could enter the market.[18] The largescale restructuring of the European banking industry inevitably may require changes in the antitrust approach and in banking regulations. These changes should be aimed both at designing a new framework for European banks and at facilitating the completion of a single European banking market.

In the global market order there will be closer cooperation between rival banking firms and mergers will become the *sine qua non* of survival in a global banking market. In the specific case of Irish retail banks, increasing internationalisation of financial services has accentuated the international dimension to their regulation and highlights the need for

[16] In the non-banking sector it is really only the small firms occupying a strategic niche in mature high-tech industries that can enjoy the same likelihood of survival as large firms.
[17] The argument is often made that in competitive markets, firms cannot expect to earn excess profits. They actually do in the short term: if, the X-inefficiency costs are abated or if the demand for the product in a (innovative) market in highly inelastic. The former can happen if firms can achieve operational efficiency by relocating or merging.
[18] They have distinct competitive advantage over other new bank entrants in that they possess the physical distribution network, the customers, the advanced IT systems and do not have the problems of having to create a brand name.

an enlightened (national) regulatory standard. The likely adoption by the Competition Authority of a substantial lessening of competition (SLC) standard is encouraging for all companies in Ireland, not just those faced with the competitiveness challenge.[19]

An SLC standard would allow the Authority to be the architect of progress, responding to both the direct, pragmatic requirements of Irish businesses and the long-term challenges emerging from a global market order. An enlightened merger policy would be a mark of antitrust brinkmanship and the application of such a policy to the evaluation of mergers in Ireland, particularly in the evaluation of mergers in the Irish banking sector, would be a progressive move.[20] The policy could be based on less traditional measures of competitive harm and injury without diluting consumer welfare as a primary goal. A merger policy with a focus on innovative competition standards would be a key signal to Irish (bank) management who intend to respond to the competitiveness challenge by consolidating business activities at home.

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[19] As indicated in the Authority's response to the European Commission's *Green Paper on Reform of Merger Regulation* and in an Interview with the Chairman, *The Sunday Times*, April 7, 2002. Check www.tca.ie.

[20] *Vide* the author's Minority Report as Chairman of the Competition Authority in favour of the Coillte/Balcas merger, in *Coillte/Balcas* 1998 available from the Government's publication office, Dublin.

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Ireland and the WTO: Challenges and Opportunities

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Although the World Trade Organisation has not traditionally been a subject of great public interest, a number of circumstances have contributed to increasing the public and business awareness of its important mandate. Among them is the expansion of its scope to cover not only rules on cross-border trade, but on other crucial areas of economic activity: services, intellectual property rights, investment, etc. The work programme agreed to in Doha in 2001, which launches a new cycle of multilateral trade negotiations, is of prime importance to Irish business. The new negotiations will affect areas of particular interest to Ireland, including agriculture, services, industrial tariffs and electronic commerce. The new negotiations will offer the opportunity to move forward and press for Ireland's national interest within the context of its membership of the European Union.

INTRODUCTION

It is not uncommon for the business sector in European Union (EU) countries to be indifferent about developments in the World Trade Organisation (WTO). Indeed, it is difficult to convince business people – even those directly dealing with international trade issues – that the WTO could have even a modicum of importance in their day-to-day business. However, the WTO is becoming increasingly relevant. Not only is it the rules-making body that provides the legal framework for the transaction of international business, it is also the arbiter when these rules are transgressed, apportioning blame and penalty to transgressors.

The most recent example of WTO relevance is the United States' decision to impose tariffs on imported steel, a measure that the EU and other WTO members considered illegal. In response, the EU used the WTO dispute settlement mechanism and notified the WTO of a list of potential US imports that could be subject to retaliatory tariffs if a compensation agreement were not forthcoming or the US did not remove this protective measure.

The importance of the WTO has grown in direct relation to the array of areas it has come to cover, particularly when compared with its predecessor, the General Agreement on Tariffs and Trade (GATT). For over forty years the GATT set the rules for cross-

* The Agency for International Trade Information and Cooperation (AITIC) is a Geneva-based, independent organisation, whose goal is to help less-advantaged countries to benefit from globalisation in general and the multilateral trading system in particular.

border trade. However, with the launch and completion of the Uruguay Round, the areas to which the trade rules applied multilaterally expanded to encompass not only those relating to trade in goods, but also to other spheres that include trade in services, trade-related aspects of intellectual property rights (TRIPS), trade-related investment measures (TRIMS) as well as the integration of important sectors which had remained outside GATT rules, namely agriculture and textiles and clothing. Despite this expansion of multilateral rules on issues of prime economic relevance, a certain indifference to the WTO and the multilateral trading system remained until relatively recently.

Several reasons for this can be advanced, but two stand out. First, the WTO language is extremely legalistic and the issues discussed are too technical for the layman or ordinary businessman to understand. WTO issues are usually left to national negotiators or to international trade lawyers in case of dispute – potential or actual. Secondly, in the context of the EU, the importance of the WTO has been diluted, as its members do not have national negotiating positions in that forum (nor did they in its predecessor, the GATT). It is the European Commission that represents the 15 Members States at the WTO and speaks there with one voice. Of course, EU Members' national positions are put forward at the coordination meetings taking place almost daily in Geneva and in Brussels. In this way the interests of individual EU Members, including those of Ireland, are fed into the EU process. That is why consultations between the business community and the Irish authorities are so important.

In this respect it is worth noting that, although the lion's share of Ireland's trade is with the EU and is not likely to decrease in relative terms, Irish trade with non-EU partners is likely to grow substantially in absolute terms in the future. This has been fully recognised by the Irish Government, which has encouraged consultation with industry regarding the new negotiations taking place in the WTO.[1]

SEATTLE: AN IMPORTANT WATERSHED

Awareness of and interest in the work of the WTO is gradually increasing. It is ironic that one of the factors contributing to this wider interest is the anti-globalisation movement. Numerous non-governmental organisations (NGOs) concerned with third-world poverty, animal, human rights and workers' rights, have launched a vigorous – at times even violent – campaign against the WTO. The organisation has been depicted by many NGOs as the epitome of capitalist exploitation. Two well-known dispute settlement cases brought to the WTO, tuna-dolphin and shrimp-turtle, were cause célèbre for the NGO community, whose best known attempt to block the progress of WTO negotiations occurred at the Third Ministerial Conference in Seattle in 1999. This proved to be an important watershed.

The failure of a Ministerial Conference on trade issues is unusual but not unique.[2] It is important to consider why this happened. A contributing factor to the Seattle fiasco is

[1] The Irish Government established a web site (www. openmarkets.ie) to inform the Irish business community on WTO negotiations and to offer the opportunity to comment on trade issues of relevance to Irish business.
[2] Two other failures included the mid-term review of the Uruguay Round, held in Montreal in 1988; and the Brussels Ministerial in 1990, which was supposed to put an end to this Round.

the relatively recent perception of lobby groups and NGOs that the global trading system is responsible for restricting national government rights to protect health, workers, the environment and consumers. At the same time, their increased ability to attract publicity puts pressure on negotiators. Linkage between such issues as the recognition of labour and environmental standards and trade sanctions has become, as a result, more sensitive and divisive. This points to the need to be clear on the role of NGOs, national governments and the WTO. But the Seattle failure was not due solely to the activities of NGOs. Other elements, further removed from the public eye, had a more direct influence in bringing about the failure of this Ministerial Conference. It is important to briefly mention these as they point to the peculiarities of the WTO system itself.

Organisational and systemic issues proved to be key factors behind the failure in Seattle. The long negotiations on the appointment of the new Director General deflected Geneva officials from the pre-Seattle process. Additionally, it became clear that procedures, which worked in the early days of the GATT and which were designed to enable 30 active members to reach consensual decisions, do not work satisfactorily for a membership of well over 100, the majority of whom are developing countries. This majority was excluded from important restricted meetings in Seattle, in which only a limited number of key players participated. Developing country participation in WTO activities and in the preparations for the Ministerial Conference is in sharp contrast to their relative lack of active participation in the previous rounds of multilateral trade negotiations. Previously only a handful of developing countries had the expertise and interest to try influence the negotiations in accordance with their national objectives. Indeed, developing country participation in the process leading to Seattle, and continuing all the way to Doha, has been unprecedented.

Following a long and difficult process after the Seattle failure, new multilateral negotiations were finally launched at the fourth Ministerial Conference that took place in Doha, Qatar in November 2001. The agenda was expanded further to include other new areas. A number of these had been previously discussed in the WTO context – trade and environment, trade and competition, trade and investment, trade facilitation, transparency in government procurement – but had not yet been negotiated.

THE ROAD TO DOHA

Under the Marrakech Agreement, which established the World Trade Organisation on 1st January 1995, Ministers meet at least every two years as the organisation's top decision-making body. The first Ministerial Conference took place in Singapore in 1996, where a stocktaking exercise was undertaken. The agreed work programme included further work on issues on which agreement was not possible during the Uruguay Round itself (known as the "built-in agenda"). The negotiations on financial services and basic telecommunications were included in this category. More importantly, the built-in agenda contained the mandate for extensive future negotiations, such as those on agriculture and services, which commenced in January 2000.

The second Ministerial Conference in Geneva in 1998 was principally a commemoration of the 50th anniversary of the multilateral trading system. One important outcome was

the Declaration on global electronic commerce, which established a comprehensive work programme to examine all trade-related issues relating to global electronic commerce, taking into account the economic, financial, and development needs of developing countries. The Declaration also agreed that members would continue their current practice of not imposing customs duties on electronic commerce.

The Third Session of the Ministerial Conference, held in Seattle in 1999, was the first to consider the launch of a new round of negotiations. Three main areas were to be discussed: the implementation of the existing agreements and decisions; the built-in agenda, in particular agriculture and services and the "new" issues. Some fundamental differences in approach marred progress in Seattle and remained until they were later partially resolved in Doha. Many developing countries preferred the implementation of the existing agreements to be settled before considering further negotiations; and there were differences between major developed countries on the scope of a new round. The final outcome required trade-offs. The key elements, participants and positions are outlined below.

As to the substance of the negotiations, there was mounting evidence in the period between Seattle and Doha that many key delegations would attempt to negotiate the outcome of a new round as distinct from just its parameters. Furthermore, many developing countries were setting particularly strong demands – which is not surprising given the poor results of the Uruguay Round from their point of view. Also, the US and EU stances were in marked contrast to one another: the former opting to be selective on the scope of a new round, whereas the EU favoured an all-embracing approach in order to find sufficient trade-offs in exchange for furthering the reform process in agriculture.

DEVELOPING COUNTRIES' CONCERNS

As stated, developing countries became key players in Doha and put forward their positions forcefully. Yet, these countries often lack the financial and human resources to meet their commitments under the more complex agreements and believe that the developed countries have failed to implement the agreements in a way that would benefit their trade. They point to the special and differential provisions for developing countries, which are sometimes specific – for example, allowing longer transition periods or weaker commitments – but can also sometimes be too vague. Developing countries have sought to make the special and differential treatment provisions more precise, effective and operational by transforming them from "best endeavour" clauses to mandatory provisions.

Similarly, developing countries considered that their market-access expectations had not been met in the Agriculture Agreement and the Textile and Clothing Agreement. Lower agriculture tariffs and more generous tariff quota systems were sought; and in textiles and clothing, the more meaningful removal of quotas. Developing countries also felt excluded from the creation of international standards under the sanitary and phytosanitary[3] measures and technical barriers to trade agreements, yet were often expected to comply with standards that go beyond their technical ability and financial capacity.

[3] Often referred to as "quarantine meaures", these are border controls to protect human, animal or plant life and health.

EU INTERESTS

The EU was principal among those with a comprehensive agenda in Doha. Its negotiating mandate included the so-called "Singapore issues"- namely, investment and competition, trade facilitation, transparency in government procurement – which the EU saw as being in the interests of both developed and developing countries.[4] Trade and environment also featured on its agenda, as did clarification of the multilateral environmental agreements (MEAs), the scope for use of labelling schemes and the application of the precautionary principle.[5]

The EU was also open to negotiating antidumping and subsidies. To seek support from developing countries on these issues, the EU was flexible and sympathetic on some of the implementation issues on which the former were *demandeurs*, including extension of the TRIPS Agreement to cover geographical indications other than wines and spirits, the relationship between TRIPS and the Convention on Biological Diversity, the question of traditional knowledge, TRIPS and public health and the review of the Dispute Settlement Understanding. The EU was also receptive to a review of the special and differential treatment provisions to make them more operational.

US INTERESTS

The US interest in a new round was less pronounced than that of the EU. Its main interests were market access, transparency in government procurement and the revision of the dispute settlement rules. On the question of implementation, the US (together with Canada), was opposed to changes to the Agreement on Textiles and Clothing, as the implementation schedule had already been approved by Congress and was part of US law. Together with a host of other WTO members, the US was in favour of negotiating reductions in fishing subsidies, but showed a marked reluctance to enter negotiations on investment and competition. At the same time, a number of developing countries – notably Colombia and Chile – supported the inclusion of investment. Opposition to the inclusion of competition came from other WTO members, including developing countries such as Brazil, Chile, India, Pakistan, Indonesia, Singapore, Ghana, South Africa, Trinidad and Tobago, feeling as they did that they lacked the relevant legal and administrative structures and capacity to support full competition.

SECTORS OF IMPORTANCE TO IRELAND IN THE DOHA WORK PROGRAMME

It is undeniable that the agreement reached in Doha was a major success at a particularly difficult international juncture. Circumstances made it imperative that the divisiveness that had marked the road to Doha gave way to agreement on the following contentious issues:

- the crisis post September 11th, which called for a show of solidarity in view of the fragile international security situation;

[4] Stemming from the EU Commission Paper on strategy for a new WTO Round (Note for the attention of the 133 Committee, 13 December 2000).

[5] Defined in the Rio Declaration: where there are threats of serious or irreversible damage, lack of full scientific certainty shall not be used as a reason for postponing measures to prevent environmental degradation.

- the slowdown in the world economy; and
- the need to demonstrate the credibility of the multilateral trading system after the failure in Seattle.

The Doha work programme is presented in three important documents: the Ministerial Declaration, which set the parameters and areas of the new negotiations; the Decision on Implementation-Related Issues and Concerns and the Declaration on the TRIPS Agreement and Public Health. Although not all members were satisfied with the outcome, there is sufficient in the work programme to allow new negotiations to get underway. Developing countries succeeded in winning acceptance of a number of their proposals, at least in part, although there is still much work to be done to fully satisfy certain of their demands on implementation, special and differential treatment and TRIPS and public health. The programme is vast and the difficulties in reaching agreements have quickly become apparent.

Several of the agenda items are of major importance to Ireland. The key export sectors of relevance include chemical and pharmaceutical products, information and communication technology and food and drink. Thus, certain areas of the new negotiations should be of major and direct concern to Irish business: agriculture, services, electronic commerce and industrial tariffs. Other cross-cutting issues are also of prime importance, such as investment, competition, transparency in government procurement and trade facilitation. Although not included in the work programme, the Information Technology Agreement, a tariff-cutting mechanism on information technology products concluded at the Singapore Ministerial Conference in 1996, is also worthy of note.

AGRICULTURE

Just as it proved to be one of the principal stumbling blocks to successful negotiations during the Uruguay Round, agriculture continues to be the subject of wide divisions: that is, as between the agriculture exporters – US and the Cairns Group – who seek a more ambitious mandate than the existing one on Article 20 of the Agreement on Agriculture; and the EU supported by Norway, Japan, Switzerland and Korea, for whom the 'multi-functionality' of agriculture is paramount.

Discussions prior to and during Seattle centred on whether Article 20 was a sufficient basis for the new negotiations. Those seeking further liberalisation sought a more detailed and ample mandate for targeted reforms and firmer deadlines. In the end, the Doha mandate agreed to build on the work that had been initiated in 2000 and to continue the reform programme. Also, it committed members to comprehensive negotiations aimed at "substantial improvements on market access, reductions of – with a view to phasing out – all forms of export subsidies and substantial reductions in trade-distorting domestic support". The mandate also allows for special and differential treatment of developing countries to be an integral part of the negotiations.

TRADE IN SERVICES

The General Agreement on Trade in Services (GATS) provided for negotiations to reopen on the further liberalisation of international trade in services in 2000. All the

WTO members have made specific commitments in this regard. In accordance with Article XIX of the GATS, these specific commitments were negotiated either during the Uruguay Round, during subsequent additional negotiations carried out in some sectors – like basic telecommunications or financial services – or indeed, for the most recent members, during the actual accession process. Negotiating these specific commitments has enabled all members to modulate not only their level of obligation sector by sector, but also the mode of supply for each service concerned, including their determining which restrictions governing market access and national treatment to retain.[6] Within the framework of these negotiations the following aspects have been considered for inclusion:

- improved commitments in respect of the "movement of natural persons", which refers to the entry and temporary stay of persons for the purpose of providing a service;
- rules dealing with subsidies, government procurement and safeguards;
- rules dealing with such matters as the qualifications and licensing requirements for foreign service providers, with a view to preventing unnecessary barriers to trade;
- commitments in respect of maritime transport, including access to port facilities and auxiliary services; and
- an annex in the interests of developing countries on tourism.

ELECTRONIC COMMERCE

At the time of the Uruguay Round, the theme of electronic commerce was just emerging. It was too new to be put on the multilateral trade negotiations agenda. Issues directly related to electronic commerce first appeared at the WTO Conference, held in Singapore in 1996, where the Ministerial Declaration on Trade in Information Technology was adopted. This declaration, also known as the Information Technology Agreement (ITA), provides for the liberalisation of international trade with regard to a number of products essential for electronic commerce by the year 2000. Since 1997, when the Agreement came into force, it has provided for the reduction of customs duties on computers and telecommunications equipment, for example. Although not all members have adhered to it, the commitments undertaken under the Agreement in the WTO are on a most favoured nation basis; thus, benefits accrue to all other WTO members. Consultations have taken place on the expansion of the list of products subject to duty reductions/elimination and also on the need to address non-tariff measures. However, progress on these issues has not taken place and no agreement has been reached on adding products to the original list.

A programme on electronic commerce was launched as a result of the Second Ministerial Conference in Geneva in 1998.[7] The WTO General Council mandated for the issues to be analysed by four relevant bodies: namely, the Council for Trade in Services, the Council for Trade in Goods, the Council for TRIPS and the Committee for

[6] Indeed, this agreement distinguishes between cross-border trade ('mode 1'), consumption abroad ('mode 2'), commercial presence ('mode 3') and the movement of natural persons ('mode 4').
[7] In Paragraph 1.3 of the work programme: "the term 'electronic commerce' is understood to mean the production, distribution, marketing, sale or delivery of goods and services by electronic means".

Trade and Development. Prior to Seattle every one of these committees had submitted the conclusions of their respective discussions to the General Council. Since then, several WTO seminars have taken place regarding e-commerce, most recently in April 2002. The Doha Declaration endorses the work carried out so far and mandates the General Council to consider institutional arrangements for continuing with the work programme and states that the practice of not imposing tariffs on electronic transmissions will continue until the fifth Ministerial Conference.

INDUSTRIAL TARIFFS AND OTHER ISSUES

As to industrial tariffs, the centrepiece of the trading system since its inception, the Doha Declaration seeks the reduction or elimination of tariff peaks, high tariffs, tariff escalation and of non-tariff barriers, taking account of the needs of developing countries. Although most developed countries have low tariff averages and developing countries have reduced their own tariff levels through eight rounds of negotiations, those that remain are some of the most difficult items under negotiation. The difficulties are illustrated by the fact that negotiations have stalled due to conflicting views on deadlines for deciding on negotiating modalities.

Inclusion of the Singapore issues (see “EU Interests” earlier) in the Doha work programme met with stern opposition from developing countries. Furthermore, while the Doha Declaration includes recognition of developing country needs and provision of technical assistance on these issues, their opposition has delayed formal negotiations until after the fifth Ministerial Conference – to be held in Cancun, Mexico in September 2003 – when a decision on the “modalities” of negotiations will be taken by “explicit consensus”.[8]

Thus, it seems that deciding the modalities for negotiations will take up most of the preparatory work on the Singapore issues until the next Ministerial Conference. Of these, the more managable should be trade faciliatation – the simplification and harmonisation of trade procedures – because it does not involve specific commitments on liberalisation. Several developed WTO members proposed it as a subject for negotiation, as an agreement on trade facilitation would reduce administrative barriers to imports and exports. However, developing country members favoured guidelines rather than a formal agreement, as they were reluctant to include it as part of the new negotiations out of concern that abiding by the trade facilitation rules would be subject to dispute settlement. They argue that making trade facilitation mandatory would put them in a difficult position given their institutional, technological and infrastructural weakness. Similar arguments would apply to other issues, including the relationship between trade and investment, trade and competition and transparency in government procurement.

CONCLUSIONS

While clearly ambitious, the Doha work programme came at a critical time for the WTO, as the Seattle failure had badly bruised its credibility. But, in contrast to the Punta del Este Declaration which had launched the previous round of negotiations and had set a

[8] In WTO parlance modalities are the methods under which negotiations take place.

well-defined deadline of four years for the conclusion of negotiations – although it took four years longer than foreseen – the Doha Declaration is full of ambiguities. A prime example is its use of hazy language to refer to the lack of consistency regarding deadlines. To a degree this is understandable, given that the Declaration was adopted under undue pressure, given the time constraints that applied – it was agreed to a full day later than foreseen – and given the need to overcome at all costs the "Seattle syndrome". However, the Doha Declaration also opens the door to numerous interpretations. This presents both challenges and opportunities for countries seeking to benefit from, and to defend their national interests in, the forthcoming multilateral trade negotiations.

In the vast number of issues to be negotiated it is vitally important for WTO members to define their priorities so as not to spread themselves too thinly. For Ireland in particular it would be important to gauge which of the issues are of prime interest to the business community. As the country does not directly partake in the negotiations, its national position will have to be included in the EU's negotiating agenda. The opportunities are vast. Further liberalisation of trade in services, further reduction of industrial tariffs and a more liberal multilateral trading regime for information communication technology would be a plus for Irish industry and overall economic growth. It is in the hands of business and government to take full advantage of the negotiations that have been launched.

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Efficiency and Competition in European Banking

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Whereas the European wholesale banking market has seen a marked increase in competition, a single competitive retail banking market remains a long way off. This can be seen from the very large efficiency differences between the banking markets of EU Member States. Going forward, the most crucial consideration for the competitiveness and survival of Europe's banks lies in choosing the correct strategy for restructuring, cost reduction and efficiency – a strategy clearly evident in the Nordic countries. Likely future developments will include a pronounced increase in competition, a narrowing of efficiency differences, a rapid decline in numbers of personnel and branches and many more mergers and acquisitions.

INTRODUCTION

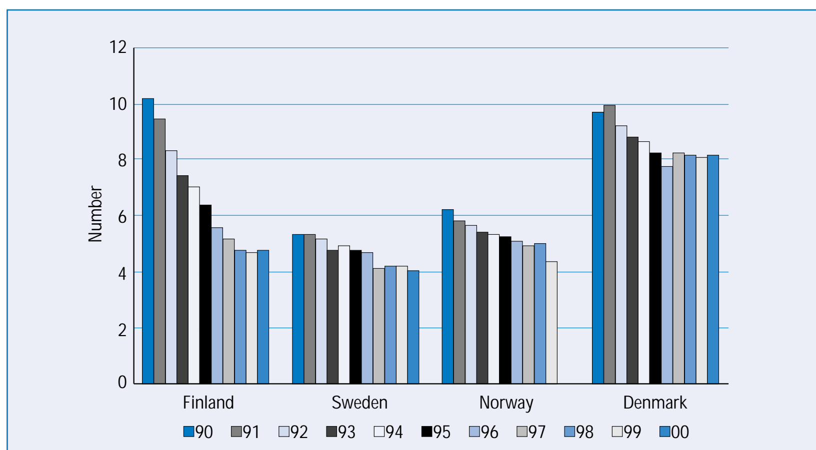
In recent years, and especially since the advent of Economic and Monetary Union (EMU), the changing nature of the financial services sector has become a growing focus of policy interest, public debate and academic study. Deregulation, internationalisation and technological development have changed the environment in which banks and other financial intermediaries operate. It has been suggested that EMU will introduce a 'regime shift' that will strengthen the underlying trends affecting longer-term prospects for the European banking industry. The main effect will be to increase competition in the different market segments. Monetary union will also increase the depth of the securities markets and hence provide new challenges to banks and possibly bring further progress in disintermediation and market concentration.

This rapidly changing environment brings increasing pressure for restructuring in the European retail (universal) banking industry. It has often been argued that there is much overcapacity and inefficiency in the banking sectors. Although competition is increasing, overcapacity and inefficiencies have not yet been eliminated and there remains enormous potential, indeed need, for capacity reduction. Efficiency differences are large, both across banking sectors of different countries and between banks within a given country. The adoption of new technology has been slow (except in Scandinavia) but is now advancing rapidly.

THE NORDIC EXPERIENCE

Financial market liberalisation was accomplished for the most part in the 1980s in the Nordic area. Prior to that, and with the exception of Denmark, the degree of regulation had been extensive. Overcapacity in banking in terms of numbers of branches and employees had gradually built up over time such that the banking sectors had generally become quite inefficient – see Figures 1 and 2. Overcapacity and inefficiencies can be estimated to have been about at the same level as in other EU countries, although Swedish banks were somewhat more efficient.

FIGURE 1: NUMBER OF BANK EMPLOYEES PER 1000 INHABITANTS IN THE NORDIC COUNTRIES

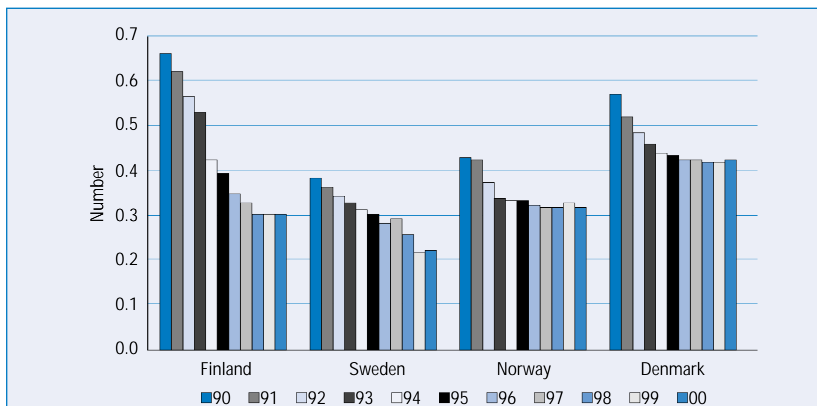


Source: National central banks

Favourable macroeconomic development and deregulation of credit markets induced a rapid increase in lending in the latter half of the 1980s. The stock of bank credit doubled in the course of a few years. A 'bubble type' economy developed, especially in Finland, Norway and Sweden. When they occurred, the economic downturn and currency crises led to severe banking crises in all three countries and to a lesser extent in Denmark. Huge amounts of public finance were extended to the banking sectors – amounting to an estimated 7% of GDP in the case of Finland.

These severe crises provided a strong impetus for banks to restructure, cut costs and generally to increase efficiency. Moreover, the adoption of new technologies was stepped up so that existing distribution channels (branches and personnel) could be scaled down. The use of new technologies (internet, PCs, telephone/GSM etc) is today much more intensive in the Nordic banking system than in other European countries and around the world generally.

FIGURE 2: NUMBER OF BANK BRANCHES PER 1000 INHABITANTS IN THE NORDIC COUNTRIES



Source: National central banks

Thus, since the early 1990s, Nordic banks have coped well with the adjustment process of restructuring and cost cutting. This process impacted significantly not just on the various interest groups of each bank – such as management, personnel and shareholders - but also on the regulatory authorities, customers and trade unions. Other European banks were not compelled to adjust early on in this way and thus have not learned how to handle capacity reductions and restructuring. This is probably one of the major reasons why the other European countries have been slower to restructure and eliminate overcapacity.

The restructuring process of the 1990s gave rise to mergers in the main, but also to acquisitions, alliances and certain other types of affiliation or cooperative arrangement. For the decade as a whole a total of 100 restructurings took place and this pattern has continued into the new millenium. As can be seen from Table 1, the total number of banks declined by about 56% between 1985 and 2000.

TABLE 1: NUMBER OF BANKS IN NORDIC COUNTRIES, 1985-2000

	1985	2000
Finland	654	347
Denmark	166	102
Norway	150	99
Sweden	543	117
Total	1,513	665

Source: National Central Banks.

Consolidation is expected to continue in the Nordic area so that the number of banks will decline further. All large Nordic banks have indicated that they regard the whole Nordic area as the home market and a number have extended their activity to non-Nordic countries such as the Baltic area, Poland, Germany and Russia.

The Nordic banking market has become highly concentrated. Three large banks alone now account for over 80% of Nordic countries' bank assets. Nonetheless, competition has increased and will increase further because of increasing cross-border competition and the use of new technology in selling financial services on-line across borders. In Finland, for example, the market share of small banks has increased in recent years. Foreign, non-Nordic banks have a very small market share in the Nordic area (about 3% of retail business). However, there is already evidence in the corporate, insurance and mortgage credit business of increased competition through on-line, cross-border selling of financial products.

The overall situation in the Nordic banking sector is today quite favourable. Efficiency has increased significantly and is now well above the EU average. The reduction in personnel and branches has amounted to about 30%. In Finland the figure is about 50%– clearly the largest percentage reduction for the OECD area. Even absolute levels of operating costs have declined, although much upward pressure on costs remains. Nordic banks' profitability and solvency have been very strong since the mid-1990s and higher on average than in the EU area as a whole.

It is notable that this adjustment process has been successfully confronted by a variety of types of bank corporate governance; namely, in the commercial, cooperative and savings bank sectors. The situation as regards profitability, solvency, efficiency and use of new technology is quite similar across these three sectors. That said, the increase in efficiency has been much greater for large banks than for the small cooperative and savings banks.

MAIN DEVELOPMENTS IN EUROPEAN BANKING

The European financial markets, including significantly the banking markets, have over the last decade embarked on a permanent and highly dynamic transformation process. It should be noted that the basic idea behind European integration was to create a single market across all sectors and it was anticipated that this would increase competition and efficiency and bring benefits to Europe's citizens and firms.[1] As

[1] See the Cecchini Report, 1988.

reported in its recent Financial Market Action Plan, the EU Commission is now working to speed up this process out of concern about the slowness of progress towards single financial markets - especially in retail banking. This should in turn accelerate harmonisation of EU regulation and supervision of financial markets.

Since the introduction of the euro the concept of a single money market has gained momentum. The short-term money market is already now highly homogeneous, as can be seen from the negligible differences in overnight euro interest rates. Even the three-month interest rates are similar. Long-term government bond rates have also converged rapidly, although small differences continue to reflect differences in liquidity and sovereign risk.

While the European bond market received a boost from the launch of the euro in non-cash form on 1st January 1999, it is still far less homogeneous than the US bond market. The role of government bonds is expected to decline as government borrowing decreases, but the corporate and mortgage bond markets are developing rapidly. Europe will also gradually develop its own low-rated (junk) bond market.

European equity markets have grown in recent years and the volume of international transactions is expanding. There are about 35 exchanges in Europe at present, but consolidation is inevitable and pan-European exchanges (or a single exchange) are only a matter of time.

However, many obstacles still stand in the way of single financial markets. These include differences in taxation, market conventions, accounting, governance, regulations and generally in the infrastructure of financial markets. Of course, cultural and political attitudes also play an important role. The Commission's Financial Market Action Plan is aimed at eliminating or mitigating these obstacles.

INFRASTRUCTURE AND PROFITABILITY

At the outset of the 1990s, following extensive deregulation, the EU banking markets generally resembled the Nordic markets, as described earlier. The main difference was that there had been no economy-wide banking crises in the core European countries, although some large banks such as Credit Lyonnais, Banesto, Banco di Napoli were facing severe problems. Overcapacity right across Europe remained the legacy of a long era of regulation. Nonetheless, numbers of personnel and branches continued to increase up to the mid-1990s in most countries. Restructuring started quite slowly in the core European countries but progressed rapidly throughout the 1990s. The number of credit institutions began to decline somewhat in the late 1980s, especially among small banks.

Somewhat surprisingly, there is still no pan-European bank. In retail banking cross-border transactions account for only 1% of total volumes; while in wholesale banking such transactions have increased rapidly during the 1990s. Mergers have thus far been mainly domestic. The tendency seems to be to first create national giants before entering into cross-border mergers. It has been argued that the current phase of local consolidation – of increasingly large domestic retail banking mergers – is set to wind down. Some banks have chosen the strategy of entering into cross-border retail business via the internet rather than by merging or developing branch networks.

Tables 2-4 show the development during the 1990s of banks, branches and employees in the EU. The picture is one of rapid decline in the number of banks, together with a levelling off around 1996/7 in branch and employee numbers followed by a slow decline. As indicated earlier in Figures 1-2, the pattern in the corresponding Nordic figures was noticeably different.

TABLE 2: TOTAL NUMBER OF BANKS IN 15 EU COUNTRIES

	1990	1993	1995	1996	1997	1998
Savings banks	1,650	1,270	1,120	1,060	1,010	991
Cooperative banks	10,600	9,600	5,640	5,600	5,100	5,010
Commercial banks	2,390	2,600	2,640	2,700	2,710	2,712
Total	14,640	13,470	9,400	9,360	8,820	8,713

Source: European Central Bank and Bank of Finland

TABLE 3: TOTAL NUMBER OF BANK BRANCHES IN 15 EU COUNTRIES

	1990	1993	1995	1996	1997	1999
Savings banks	58,790	57,885	56,020	54,670	54,650	53,710
Cooperative banks	51,490	49,060	52,300	56,020	56,000	55,100
Commercial banks	78,820	95,960	95,880	96,570	96,500	95,700
Total	189,100	202,905	204,200	207,260	207,150	204,510

Source: European Central Bank and Bank of Finland

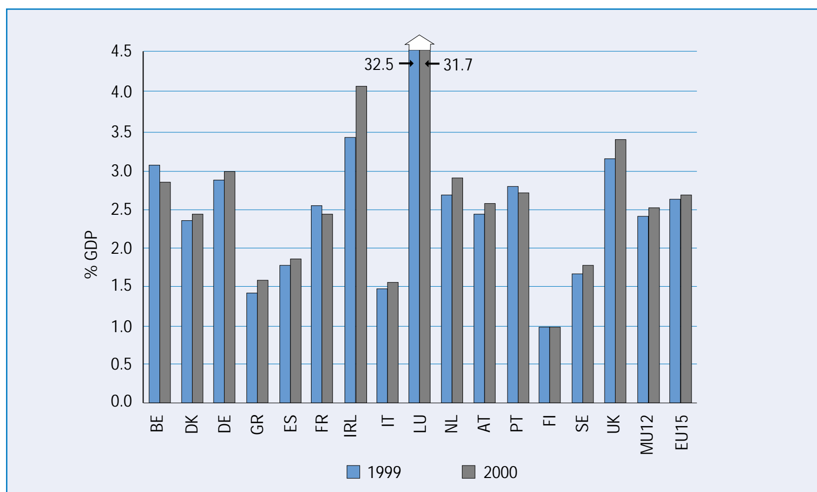
TABLE 4: TOTAL NUMBER OF BANK EMPLOYEES IN 15 EU COUNTRIES

	1992	1993	1995	1996	1997	1999
Savings banks	640,000	639,000	682,400	748,500	740,000	731,000
Cooperative banks	419,200	392,000	398,400	501,500	500,000	492,200
Commercial banks	1,733,400	1,746,000	1,719,300	1,713,800	1,700,000	1,680,000
Total	2,792,600	2,777,700	2,800,100	2,963,800	2,940,000	2,903,000

Source: European Central Bank and Bank of Finland

The relative importance of banking sectors is very different across EU countries. Figure 3 shows the ratio of banking assets to GDP for a range of countries. This is seen to vary widely with Finland at the bottom of the range and Ireland close to the top of the range – apart that is from Luxembourg, the clear front runner.

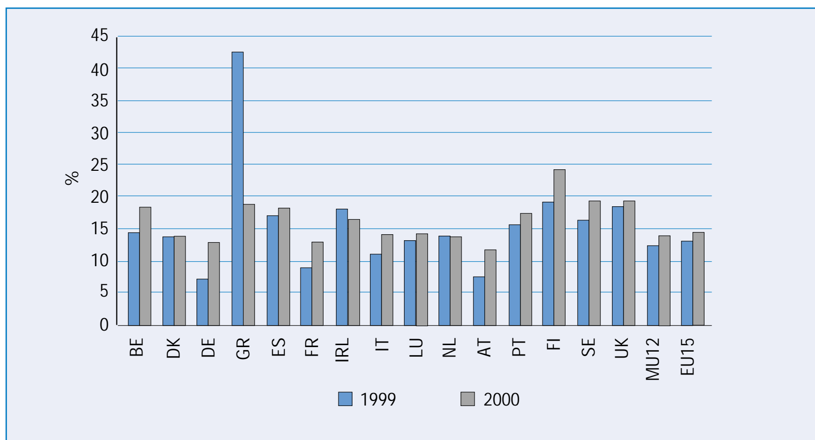
FIGURE 3: TOTAL ASSETS OF CREDIT INSTITUTIONS AS A PERCENTAGE OF GDP



Source: ECB and Bank of Finland

In recent years EU banks' profitability has generally been only satisfactory (see Figure 4) and in 2001 – and continuing into this year – profitability has declined. Different statistical sources give somewhat different results as regards cross-country comparisons. The average rate of return for EU banks stands at about 15%, which is clearly lower than in the Finland and Sweden – both of which have achieved approximately 20% return on equity capital. In 2001 and the first quarter of 2002 profitability has declined in the EU as a whole to 11% and in Finland and Sweden to about 15%.

FIGURE 4: RETURN ON EQUITY, END OF YEARS 1999 AND 2000 (2000 FIGURES FROM LARGEST BANKS)



Source: ECB, Bloomberg and banks' annual reports

NEW TECHNOLOGY

New information technology presents both an opportunity and a threat to the financial services industry. It provides enormous efficiencies in transaction costs and offers new ways for financial companies to reach a broader range of clients. At the same time customers can obtain much higher quality services than with the more traditional distribution channels. On the other hand, new technologies – especially the internet and mobile phones (soon also jointly) – are rearranging the whole landscape for financial service providers. Many internet-only financial companies are likely to be established and these could be highly competitive vis-à-vis traditional banks.

Technological developments in information collection, storage, processing, transmission and distribution will influence all aspects of banking activity, impacting in two principal ways: by reducing costs and by modifying the channels through which customers have access to banks' services and products. One of the most important strategic choices for banks today is to decide how to use the new technologies in their product development and distribution processes. Major business opportunities are offered because:

- the cost per transaction can be significantly reduced;
- new marketing and transaction instruments for increasing market share become available;
- more efficient means become available for processing information related to the needs and habits of customers;

- the possibilities improve to diversify into new business areas and to become 'service aggregators';
- improved tools are introduced for banks' internal information management and risk control.

At the same time banks also face a number new strategic challenges and even threats as follows:

- remote banking may in the longer run be transformed from supplementary to core services, which could bring enormous pressure to downsize existing branch networks;
- customer loyalty may decrease rapidly as information on financial service prices becomes fully transparent and it becomes easier to change service suppliers;
- competition within the banking sector and from non-bank financial companies intensifies.

However, in light of recent experience it can generally be argued that the internet has not yet strongly affected the core profits or competitive positions of traditional banks in that they have succeeded in competing against 'pure play' internet banks. In fact, many pure internet banks have been bought by incumbent established banks, as is the case also in the United States. For the present, the integrated bank model appears to be the most viable.[2]

SINGLE MARKET, EFFICIENCY AND COMPETITION

The EU's single market programme is primarily designed to integrate financial service markets and to facilitate cross-border trade in financial services. In particular, it seeks to internationalise the provision of financial services by facilitating cross-border establishment of financial firms, especially in the areas where banking services have traditionally been supplied to customers by domestic banks. Such services comprise a wide range of retail banking products. These services and products were generally regarded as the least integrated and least internationalised across the EU financial sectors. This is in contrast to wholesale services provided to large corporations and financial institutions, which are typically integrated on a global scale already.

The single financial market implies both freedom to trade and freedom of location for firms in the EU area. This means that there should be no regulations that compromise consumer choice as between buying financial products and services from domestic institutions, foreign institutions located in the consumer's country or on a cross-border basis. However, in reality long-standing economic and market barriers can have a significant effect on the integration of EU financial markets.

[2] See also Moody's 2001.

According to the Cecchini report (1988), elimination of the remaining cross-border barriers should lead to a reduction of costs, which can then be translated into a widening of profit margins, a lowering of prices, or a combination of both. The Cecchini study laid great emphasis on scope and scale economies. The study argued that in financial markets actual firm size is significantly smaller than the optimal efficient scale size.

The main objective of the Cecchini study - and the related background Price Waterhouse study – was to estimate the impact of the single market programme on the financial services sectors in eight EU countries, assuming the law of one price. The estimated gains resulting from price reductions amount to 0.7% of GDP. These studies have provoked much criticism: some arguing that the estimated impact is too low, some that it is too high.

The key issue as regards the single market philosophy is that competition will increase; hence the assumption of the law of one price. But prices of similar products are equal and given to the firm only in pure competition, which cannot be attained in the real world of imperfections and uncertainty. These issues have generated increased interest in the efficiency of banks. Under perfect competition, the less efficient banks are driven out of the market and the surviving banks are equally efficient. If efficiency differences between banks are large, competition will be imperfect and will lead to general overcapacity.

Discussion of efficiency and competition and the related issue of overcapacity has actively engaged regulators and the banking community. Economic research in Europe has also focused on these questions to an increasing extent. US research on efficiency and competition in banking has a long history and a firm basis.

The theoretical concepts of economies of scale and scope have recently found their way into practical discussions in the banking community. Economies of scale obtain if output increases while total costs increase less than proportionately. Economies of scope obtain if the cost of producing joint outputs (products) is less than the cost of producing outputs separately. A multiproduct firm (a bank) may achieve cost reductions via economies of both scope and scale.

The results of cost studies on European banking markets suggest the presence of economies of scale, although there is no consensus as to the level of output at which these economies are exhausted.[3] The implication of these results is that the average bank size should increase in the EU area.

[3] See Molyneux, Altunbas and Gardener 1997 for a summary of European research.

The concept of economies of scope has not been as frequently analysed and therefore it is difficult to draw general conclusions.[4] Overall, empirical findings on economics of scale and scope in banking provide stronger evidence for scale economies. It also appears that there are potential cost gains from altering scale via internal growth or merger activity, which may be important in the European context. This is in line with the observed behaviour of European banks. Banks throughout Europe have focused strongly on improving cost income ratios. Cost reduction and revenue improvement are currently among the major challenges and targets being addressed by bank management.

STRATEGIC AND MANAGEMENT FACTORS

In recent years the emphasis in European and US banking research has gradually shifted from scale and scope economies towards technical and allocative efficiency. Managerial and organisational abilities to decide on input and output that minimises costs or maximises profits is referred to as X-inefficiency. Various theoretical and empirical methods have been used to estimate X-inefficiency. Inefficiency is typically measured as the deviation of costs from the so-called efficient frontier, that is, the estimated level of costs under optimal behaviour.[5]

Usually a distinction is made between two components of banking efficiency. Technical efficiency refers to a bank's ability to achieve maximum output from given inputs, while allocative efficiency refers to its ability to use the inputs optimally. These two measures can be combined to obtain a measure of total economic efficiency. If costs are substituted for output, the total measure is cost efficiency. Very few studies exist comparing these two types of efficiency for banking sectors in European countries. A summary of research results is presented in Molyneux et al (1997) and in Bikker (1999).

The main finding of these studies is that differences in managerial ability to control costs or maximise revenues seem to be greater than the cost effects of the choice of scale (size) or scope of production (product mix). Thus a bank's success depends on the quality of its management! However, no consensus has been reached on the average level of X-inefficiency for the European banking industry. Inefficiencies seem to vary widely across countries but also between different types of banking groups, such as commercial, savings and cooperative banks. The variation between individual banks is of course the greatest of all.

In summary, it can be said that European banking research on the issues of efficiency and optimal size and scope has produced mixed results. Nonetheless, some general

[4] See Molyneux et al.
[5] See Molyneux et al and Bikker 1999.

and significant conclusions can be drawn on the basis of these studies. First, there seems to be at least some room for size increases among European banks. Secondly, the product/service range probably should be widened. Thirdly, there are large inefficiencies in the European banking sectors, on average in the range of 20% to 30%. Finally, the efficiency differences across European banks are very substantial. In effect, these results indicate that the single banking market is still far from being realised and that there is in fact limited competition in the European retail (universal) banking markets. The results also support the view that strategic and managerial factors are decisive for a bank's success.

SOME SIMPLE INDICATORS OF EFFICIENCY AND OVERCAPACITY

The investigation of efficiency and competition referred to above was based on a scientific and research-based approach to banking behaviour. In practice, efficiency is often estimated using simple ratios or indicators involving banks' income, profits and balance sheet statistics. Such ratios are widely used by banking analysts working with regulators, banks, banking journals and rating agencies. A typical list includes the cost income ratio, interest rate margin, labour cost share, labour costs as a percentage of balance sheet total, labour costs as a percentage of total capital, branch numbers per capita, index of concentration and index of competition.

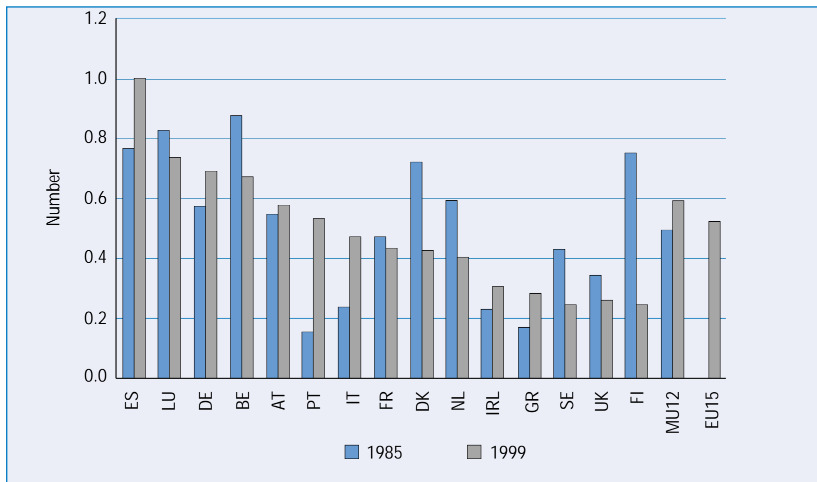
The use of such variables to measure efficiency, competition and overcapacity has also been criticised by economists and others. Sometimes it is not possible to ascertain a priori the true significance of the ratio.[6] For example, does an increase in the cost income ratio imply an increase or decrease in efficiency? The common assumption is that a lower ratio indicates more efficient behaviour.

Figures 5-7 provide some of the Bank's own ratio estimates of efficiency. Figures 5 and 6 show bank branches and employment per capita in various countries and country groups. The figures clearly reveal large differences between countries. Both number of branches and employees per capita are clearly lower for the Nordic area than for other EU countries. Ireland also has very low values; that is, high efficiency. A sharply declining trend is also discernible for the Nordic area.

The most widely used proxy variable for efficiency is banks' cost income ratio. Figure 7 presents this ratio for European banks. Large country differences can again be observed. The ratio is clearly lower for the Nordic area – and indeed for Ireland – than for other European countries. However, the ratio for Denmark is clearly higher than for Finland and Sweden.

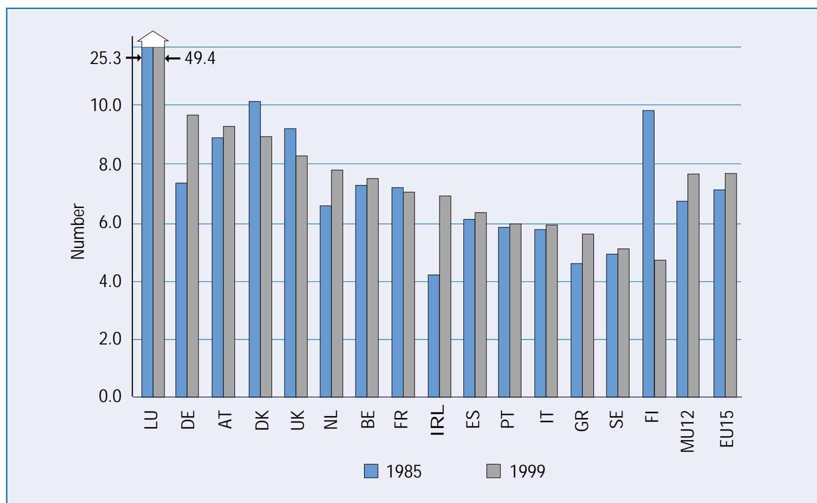
[6] See Bikker, 1999.

FIGURE 5: NO. OF LOCAL UNITS (BRANCHES) OF CREDIT INSTITUTIONS, PER 1000 INHABITANTS, 1985 AND 1999



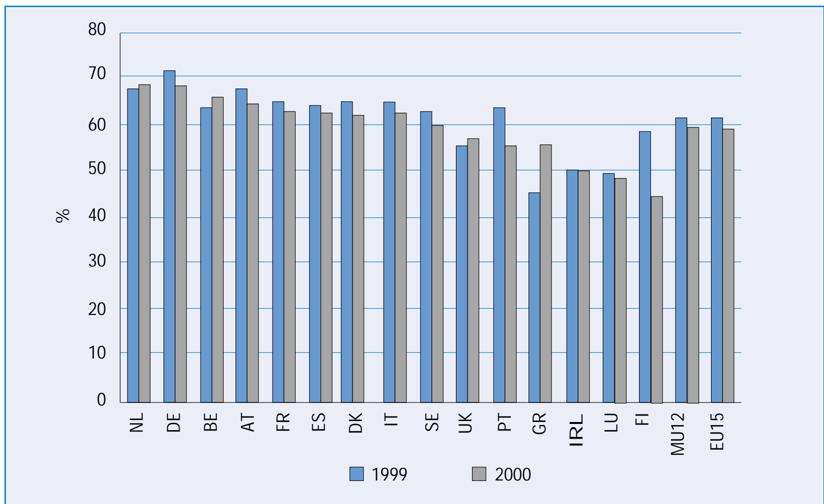
Source: Bank of Finland

FIGURE 6: NO. OF EMPLOYESS OF CREDIT INSTITUTIONS, PER 1000 INHABITANTS, 1985 AND 1999



Source: Bank of Finland

FIGURE 7: COST INCOME RATIO, 1999 AND 2000



Source: ECB and Bank of Finland

In summary, it can be said that various proxies for efficiency produce somewhat different country rankings. Nonetheless, a few general conclusions can be drawn. First, banking efficiency in the Nordic countries and Ireland is clearly higher than in other European countries. Secondly, country differences in efficiency are quite large. Thirdly, efficiency has improved over time. These indicative calculations imply that European banking sectors are marked by inefficiency and that competition cannot be very intense. The results also imply that large overcapacity prevails in the European banking markets.[7]

POTENTIAL FOR REDUCING CAPACITY IN EUROPE: A SIMPLE SCENARIO

On the basis of the banking research findings and the indicative calculations presented earlier, a simple scenario is outlined here for future numbers of bank branches and employees in the EU area. Nordic banking sector developments are used as a reference point.

The decline in Nordic personnel and branches during the latter half of the 1990s was 30% on average. In Finland the decrease was of the order of 50%. Inefficiency estimates indicate potential for an increase in efficiency across the EU of about 20% to 30%, which would be in line with the Nordic cost reductions. The overcapacity and

[7] See De Bandt 1998, Davies and Salo 1998.

efficiency situation was estimated to be at approximately the same level in the Nordic area and the rest of Europe at the outset of the 1990s.

Tables 3 and 4 presented total numbers of EU bank branches and employees in 1999. Since then, these numbers have declined only slightly. In the Nordic countries, it took five to seven years to achieve the capacity reductions. Hence, it is assumed that to achieve a similar reduction in other European countries will take between five and ten years (mean of seven years). Table 5 shows the combined number of bank employees and branches for the 15 EU countries in 1997 and an estimate for 2007. Since further capacity reductions are expected to take place also in the Nordic are, combined EU figures are used.

TABLE 5: TOTAL BANK BRANCHES AND EMPLOYEES IN 15 EU COUNTRIES IN 1997 AND 2007 (EST.)

	1999	2007
Branches	204,500	140,000
Employment	2,903,000	2,050,000

This simple scenario for EU banks' total branch and staff reductions may seem dramatic. But it is possible that even larger reductions can be achieved if new information technology is adopted rapidly and because the recent merger wave can be expected to continue. The need for capacity reductions is obvious, as the Nordic experience shows.

CONCLUSIONS

This article has assessed the relative importance of various factors that are stimulating changes in EU banking structure and performance. It is argued that the euro will introduce a 'regime shift' that will strengthen the underlying trends affecting the longer-run prospects for the European banking industry. The other factors at play include liberalisation, internationalisation, new technology, disintermediation and concentration. The most significant impact will be to increase competition in the banking and other financial markets.

The single banking market is still a long way off, especially for retail banking. This can be seen from the very large efficiency differences between EU banking markets. Hence, there is much room for competition to increase further, which would enable a

narrowing of efficiency differences. Overcapacity is a serious problem. New information technologies will enable reductions in both personnel and branches. If new distribution channels (internet, mobile phone, etc) are widely adopted while the old traditional network remains, inefficiency and high costs will create increasing problems in respect of banks' profitability and solvency.

Efficiency is today's primary issue for European banks. Research results indicate that efficiency improvements can be obtained through various strategies and means, such as:

- taking advantage of economies of scale and scope, which may imply mergers and other alliances;
- improving technical and allocative efficiency;
- adoption of new information technologies to achieve production and cost efficiencies;
- improving managerial and organisational skills.

But the most crucial consideration for the competitiveness and survival of European banks lies in choosing the correct strategy for restructuring, cost reduction and efficiency improvements.

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Evolution of the Asset Distribution of Irish Pension Funds

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This article reviews trends in Irish pension assets over the last decade and longer in a national and international context, based largely on the annual surveys of the Irish Association of Pension Funds. It chronicles the growth of pension assets at a real rate of 17% per year over the last quarter century, taking them from being a relatively modest form of savings in the economy to now amounting to over 60% of GNP. Most of the growth over the last decade is attributed to the performance of the underlying investments rather than the flow of new savings. The distribution of the assets is shown to be predominately equity-based and markedly internationally orientated, with a significant shift occurring from Irish assets (mostly from fixed interest but partly from domestic equities) to overseas equities. By end-2000, two-thirds of the estimated €52.6 billion in Irish pension assets were invested in overseas securities, up from one quarter a decade earlier.

INTRODUCTION

Financial assets managed by long-term institutional investors in the OECD countries increased from US$13.5 trillion at the end of 1990 to US$30.6 trillion at the end of 1998 – a growth rate of 11% p.a.[1]. This is considerably higher than nominal GNP growth of the world economy. Ireland is the only OECD country that does not participate in the cited survey but it is possible to piece together a picture of the growth of investible funds in Ireland from several other sources.

For instance, the Irish Association of Investment Managers (IAIM) have conducted an annual survey of the principal, Irish long-term investing institutions since 1995. They report an increase of funds under management of 17% per year, from €33.7 billion to €75.1 billion between the end of 1995 and the end of 2000.[2] Of this sum, pension-motivated savings represent 64% of all such long-term savings. The trend, evident over the last five years, has been for Irish pension assets to grow at a faster rate than other forms of savings – with pension money increasing as a share of total long-term savings from 57% at the end of 1995 to 64% by end-2000.

* This article is based on a report, Irish Pension Funds: Size, Growth, and Composition of Assets, commissioned by the Irish Association of Pension Funds (IAPF). The author is grateful to the IAPF for permission to develop this article from the report and to John Feely, Chairman of the IAPF, and Professor Gerard Hughes of the ESRI for valuable comments.

[1] Figures are from the OECD's Institutional Investors, Statistical Yearbook 2000. The institutional investors surveyed comprise pension funds, insurance companies, investment companies (i.e., unit trusts and investment trusts), and others (e.g., charitable foundations and endowments).

[2] The annual survey, Assets Under Management, is available at www.iaim.ie. The figures quoted relate to assets managed by Irish institutions on behalf of Irish residents (this represents just under 40% of the assets managed by such institutions at the end of 2000).

Irish pension money managed by Irish financial institutions amounted to €48.3 billion at the end of 2000, according to the IAIM. A somewhat more complete estimate of Irish pension assets, including assets managed by non-Irish financial institutions, has been made annually since 1987 by the Irish Association of Pension Funds (IAPF). The IAPF put the value of Irish pension assets at €52.6 billion at the end of 2000.[3] While being the most complete available, this survey inevitably misses out some schemes and some scheme assets.

The annual IAPF surveys therefore provide a unique guide to the evolution of the greater part of Irish long-term savings. Over the 14 years that they have been conducted, they chronicle the growth, the composition between the principal modes of investment (segregated, unitised, insured) and, crucially, how the assets have been invested around the world's capital markets. This latter part of the survey is perhaps the most interesting aspect, as the asset allocation of pension funds is the key determinant of their performance.

The asset allocation of Irish pension funds also has an important macroeconomic dimension as such funds now represent almost two-thirds of the long-term, mobile capital in Ireland. The size of the accumulated funds has not avoided the attention of policy makers. Throughout most of the 1980s exchange controls limited the extent of new overseas investments and, though subsequently dismantled, various forms of moral persuasion were then used to encourage pension funds to invest more in Ireland. Such attempts proved ineffectual: two-thirds of Irish pension assets were invested in overseas securities at the end of 2000, up from one quarter a decade earlier.

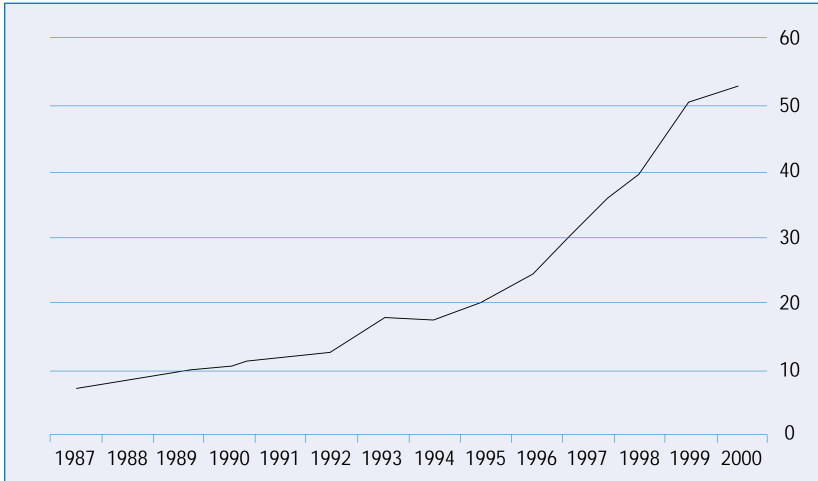
ASSET SIZE AND GROWTH

The IAPF Survey at the end of 2000 puts the size of Irish pension assets at €52.6 billion – see Figure 1. This amount exceeds the expenditure by individuals on goods and services in Ireland in 2000 (€50.7 billion), is almost double the size of the national debt (€29.5 billion at the end of 2000) and represented 60% of Irish GNP in the same year. In terms of Irish financial markets, Irish pension funds are over twice the size of the Irish gilt market (€20.8 billion) and two-thirds the size of the Irish equity market (as measured by the capitalisation of the Irish Stock Exchange Equity Index of €79.9 billion).

Prior to the annual IAPF survey, ad hoc investigations were undertaken of the size and structure of Irish pension assets – such as that by Keogh & Whelan (1985), Bristow & Ryan (1985) or those previously undertaken by the IAPF itself. A useful summary of such work is provided by the OECD (1994). For instance, in 1983 the size of Irish pension assets amounted to about €2.9 billion – that is the average of the estimate of €3.0 billion by Bristow & Ryan (1985) and €2.8 billion by Keogh & Whelan (1985) – which was just 17% of GNP at that time.

[3] There tends to be a delay in reporting and compiling such figures with, at the time of writing (end May 2002), the survey for 2001 as yet unavailable. International comparisons tend to be even less timely.

FIGURE 1: GROWTH IN IRISH PENSION ASSETS, 1987-2000 (€ BILLIONS)



Source: IAPF Annual Surveys, 1988-2000.

Irish pension funds have grown very rapidly, dwarfing the growth of the Irish economy over the last few decades. From 1975 to 1989 pension fund assets grew at an average rate of 32% per year or about 20% per year in real terms.[4] From 1989 to 2000, the nominal growth rate has halved to about 17% per year (see Table 1 later), or about 14% in real terms. The average real growth rate of pension assets has therefore been 17% per year over a quarter of a century. Irish pension assets have grown from being a relatively insignificant savings medium in 1975 to now being the dominant form of long-term savings in Ireland.

SOURCES OF GROWTH

The growth of pension assets can be attributed to a number of underlying factors. First, it can be decomposed into either that arising from net new money flows into pension schemes or into that arising from the performance of the underlying investments. The new money flow into pension schemes can further be attributed to contributions on behalf of existing members or that due to an overall growth in membership of schemes.

IAPF surveys in the years 1988 to 1996 detail net new money flows into schemes from the surplus of contribution income over benefit outflow. This decomposition is not available for later years. Between 1989 and 1996 there was, of course, an upward trend in the net new money flows from €378 million in 1989 to €1,137 million in 1996. When

[4] OECD (1994) p. 44.

the flow is related to the size of the assets at the start of the year, a more stable picture emerges. New money flow averaged 4.4% of the value of assets at the start of each year, a figure that varied between a low of 3.5% and a high of 5.6%. It is reasonable then to suggest that one-quarter of the growth of pension assets over the last decade or so is due to net new money – that is, 4.4% of the total growth of 17% per year – and that the remainder of the growth is due to performance of the underlying investments.

This attribution can be checked by comparing the implied performance figure with the actual performance of Irish pension funds. The Combined Performance Measurement Service (CPMS) has tracked the performance of a large universe of pension funds over almost two decades. At the end of 2000, the CPMS reported on the performance of 210 of the largest schemes in Ireland with a total value of €28.7 billion, roughly half of Irish pension assets.[5] From 1989 to 2000 the median performance of pension funds in the survey was 13% per year, thus supporting the earlier apportionment.

Therefore, just 4%-5% per year of the growth of pension fund assets can be attributed to net contribution inflows. This relatively modest figure suggests that the growth in scheme assets has not been accompanied by a significant growth in scheme membership and this is borne out by the annual surveys of pension scheme membership undertaken by The Pensions Board.[6]

INTERNATIONAL COMPARISON

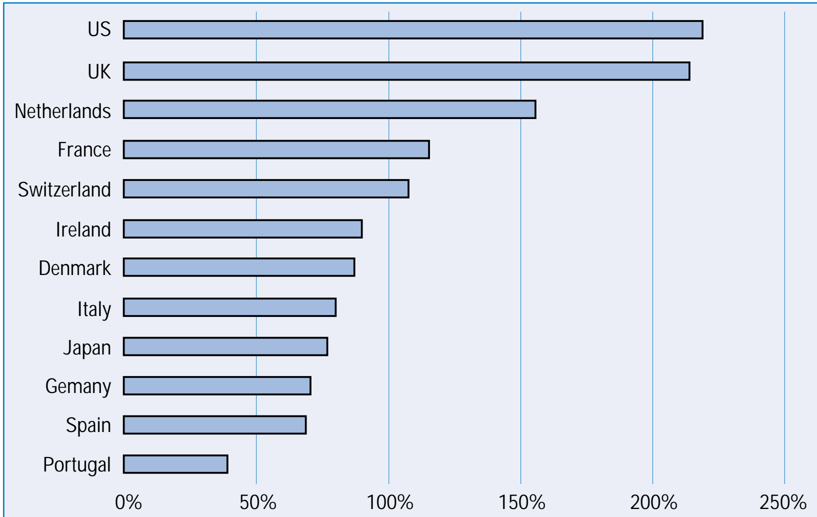
A comprehensive study by the World Bank of international patterns in pension provision ranks Irish occupational pension assets as a percentage of GDP as seventh largest out of the 43 countries studied.[7] This is all the more remarkable given that Ireland's population is not as aged as that of most other developed economies. In a recent qualitative review of European pension systems, focusing on their adequacy and stability, Ireland scores top of the 13 European countries studied.[8] Of the many indicators used to rate countries, Ireland scored particularly well on the high level of prefunding of future commitments and also on the adequacy of pension provision, as Irish pensioners had the highest relative living standard – measured by the ratio of income of those over age 65 to that of the whole population.

The initiative to prefund public service and State pension liabilities, the National Pensions Reserve Fund, will further flatter Ireland in international comparisons in years to come. Indeed, the initial amount of over €6 billion used to seed the Fund already amortises the equivalent of about one-quarter of the accrued liabilities in respect of public service pensions (estimated at about €24 billion in 1997)[9] and the annual commitment of 1% of GNP (about €900 million) will make further significant inroads in the years to come. The National Pensions Reserve Fund is already one-eighth the total size of assets of private pension schemes and its contribution income bears comparison with the net new cashflow into private schemes when last surveyed in 1996.

[5] CPMS (2001), Fund Manager Report to end 2000.
[6] Annual Reports of The Pensions Board, 1991-2000.
[7] Palacios & Pallares-Miralles (2000).
[8] Merrill Lynch (2001).
[9] McAleese et al. (2000), p.164.

It has been argued by Hughes (2000) that the above comparisons of pension assets between economies tell only part of the story. In many countries, Ireland included, saving via pensions tends to dominate other savings media due to taxation incentives and freedom from excessive regulation. Hughes points out that there is surprisingly little direct evidence that taxation incentives lead to an overall increase in the savings rate; such incentives might simply lead to a rearranging of the existing level of savings into a different pattern within an economy. Viewed in this light, comparing pension savings only between one economy and another is a little spurious: one really should compare total savings. Figure 2 attempts to do this, with total Irish financial savings managed by Irish institutions (as a percentage of the size of the economy) compared with other economies at the end of 1998.

FIGURE 2: TOTAL INSTITUTIONAL SAVINGS, AS % OF GDP (FOR IRELAND AS % OF GNP), END-1998



Sources: For Ireland, IAIM Annual Survey for End 1998 of assets managed for Irish residents by Irish long-term investing institutions divided by Irish GNP otherwise *Institutional Investors Statistical Yearbook, 2000 Edition* OECD, p. 26.

In this snapshot the quantum of pension and other long-term savings in Ireland appears less remarkable. It ranks Ireland in the middle of the pack of wealthy nations. However, some important positives to having the structure of savings largely in pensions are ignored in the above broad argument. First, pensions when paid are taxed as earned income, which is currently taxed at a higher rate than capital gains. This entails that the State has a greater financial interest in these savings than in other forms. Secondly, pension money is all declared and easily tracked within the current taxation and financial system, limiting the potential for taxation fraud – an important practical consideration as money can be otherwise footloose. Thirdly, the draw-down of pension assets tends to be smooth, aiding macro-stability, and timely, as it replaces taxed earnings that would otherwise cease. Finally, where savings exist primarily in the form of pension savings,

this may indicate a greater spread of savings within an economy as the limit for any one individual is ultimately a multiple of salary.[10]

In summary, Irish pension assets appear relatively large in an international context and this comparison will become more favourable in the future when assets of the National Pensions Reserve Fund are included. More generally, the overall level of long-term savings places Ireland comfortably in the middle of the league table of wealthy nations. It can be concluded that Ireland has a reasonably provident society, especially so in pension provision.

COMPOSITION OF PENSION ASSETS

Pension assets can be subdivided either by how they are invested or in what they are invested. Table 1 sets out the total of pension assets over the last 14 years and decomposes the total by the investment vehicle used.

TABLE 1: IRISH PENSION FUND ASSETS WITH PROPORTION IN SEGREGATED, UNITISED OR INSURED ARRANGEMENTS, 1987-2000

Year	Total Assets (€ m)	Segregated (%)	Unit Linked (%)	Insured (%)
2000	52,546	57.1%	30.8%	12.2%
1999	50,293	54.7%	32.2%	13.1%
1998	39,116	56.9%	31.3%	11.8%
1997	32,719	60.6%	31.1%	8.3%
1996	24,394	58.7%	31.5%	9.9%
1995	20,265	59.4%	29.8%	10.8%
1994	17,349	55.9%	30.9%	13.2%
1993	17,700	58.0%	29.0%	13.0%
1992	12,366	58.0%	29.9%	12.1%
1991	11,815	58.1%	29.9%	12.0%
1990	10,281	59.1%	29.2%	11.7%
1989	9,575	59.7%	27.5%	12.8%
1988	8,115	62.2%	24.4%	13.5%
1987	7,019	n/a	n/a	n/a

Source: IAPF Annual Investment Surveys.

[10] Typically, the majority of financial assets in an economy are held by a small minority. For instance, in the US the market for household financial savings can be divided neatly into 2.8 million millionaires controlling US$10 trillion in assets and the 100.7 million others who between them control the remaining US$9.6 trillion in financial assets (source: Bernstein Research (2000)).

The proportions invested by the three different methods tend to have been reasonably stable over time with about 58% segregated, 30% unitised and 12% insured.

A more interesting approach is to subdivide pension assets into the proportion invested in each asset class, as this is the key determinant in the overall performance. Table 2 decomposes pension assets into the major asset classes for various years since 1983.

TABLE 2: PERCENTAGE DISTRIBUTION OF IRISH PENSION ASSETS, VARIOUS YEARS, 1983-2000

	2000 (%)	1997 (%)	1995 (%)	1993 (%)	1990 (%)	1987 (%)	1983 (%)
Fixed Interest & Index-linked	22.2	27.1	30.7	34.8	38.4	46.1	33.7
Irish Equities	18.9	26.7	23.4	22.6	25.3	24.1	14.6
International Equities	45.4	31.9	35.0	33.9	20.4	14.8	22.4
Property & Forestry	6.6	6.0	7.0	5.4	10.0	7.0	18.8
Cash & Other	6.8	8.3	3.9	3.3	5.9	8.0	10.4
Total Irish	35.2	60.4	61.1	61.9	74.6	81.3	73.4
Total Non-Irish	64.8	39.6	38.9	38.1	25.4	18.7	26.6

Sources: 1990-2000, IAPF Surveys; 1987 calculated from the IAPF Survey and Table 30 in OECD (1994); 1983 calculated from figures of Bristow & Ryan (1985) in Table 29 of OECD (1994).

Two pronounced trends are evident. First, the proportion invested in Irish assets has fallen dramatically over the period, most of the fall occurring in the last three years. From almost three-quarters invested in Ireland back in 1983, or even as late as 1990, the proportion has fallen to about only one-third in Irish assets. The second trend is for the exposure to international equities to increase at the expense primarily of fixed interest and Irish equities. In the 1980s there was a marked decrease in the exposure of Irish pension funds to the domestic property market. A comparison with the CPMS survey over the 1990s confirms these trends, although there is a minor dispute over the precise timing.

Taking 1990 as the basis of comparison, the movements in the asset distribution of Irish pension schemes are summarised in Table 3.

The swing has primarily been away from the fixed interest sector towards international equities. The fall in the proportion allocated to the Irish equity market is rather modest at about 6% of total pension assets. The move away from Irish assets is more pronounced than the move to international equities, a difference that is almost all accounted for by the substitution of other euro bonds for Irish sovereign bonds following the introduction of the euro. This latter change, swapping two almost identical assets, is not economically significant to either pension funds or to the Irish economy.

TABLE 3: CHANGE IN DISTRIBUTION OF IRISH PENSION ASSETS IN LAST DECADE (ALL PENSION ASSETS)

	2000 (%)	1990 (%)	Change (%)
Fixed Interest & Index-linked	22.2	38.4	-16.2
Irish Equities	18.9	25.3	-6.4
International Equities	45.4	20.4	+25.0
Property & Forestry	6.6	10.0	-3.4
Cash & Other	6.8	5.9	+0.9
Total Irish	35.2	74.6	-39.4
Total Non-Irish	64.8	25.4	+39.4

Source: IAFP Surveys for 1990 and 2000

EXPLAINING THE TREND IN ASSET ALLOCATION

The impressive growth of pension assets was outlined earlier. Given such a high growth rate, were Irish pension assets forced abroad by a growing shortage of investment opportunities in Ireland? Table 4 attempts to answer the question.

TABLE 4: SIZE OF IRISH PENSION ASSETS COMPARED TO IRISH CAPITAL MARKETS, 1990-2000

Year	(1) Irish Pension Funds (€ m)	(2) Irish Gilt Market (€ m)	(3) Irish Equity Market (€ m)	(4) (1)/(2)	(5) (1)/(3)	(6) (1)/[(2)+(3)]
2000	52,546	20,754	79,868	2.53	0.66	0.52
1997	32,719	25,946	46,688	1.26	0.70	0.45
1995	21,535	21,467	20,213*	1.00	1.07	0.52
1992	12,366	16,233	8,346*	0.76	1.48	0.50
1990	10,281	15,607	7,445*	0.66	1.38	0.45

Sources: For Irish pension funds, IAPF, otherwise *Irish Stock Exchange Annual Statistical Review 2000* or various *Quarterly Bulletins of The Central Bank of Ireland.*
Asterix (*) denotes the capitalisation of the official list (of which the ISEQ Index is a subset). Otherwise, it is the capitalisation of stocks within the ISEQ Index.

Table 4 shows that Irish pension funds grew considerably faster than the size of the Irish gilt market, growing from two-thirds its size at the start of the decade to more than two and a half times the market size by the year 2000. Clearly, the proportion of Irish pension funds in the domestic gilt market had to fall. However, columns (5) and (6) highlight that the Irish equity market had expanded faster than the gilt market had contracted and could have absorbed the increase in pension funds. Thus, the

explanation that Irish pension funds had outgrown their domestic capital market, forcing them to diversify internationally, is not supported by the evidence. Irish pension funds may have grown increasingly concerned with the stock specific risk inherent in the relatively small and narrow range of the Irish equity market and this rather than size considerations could have led to the overseas diversification.

The evolution of the average asset distribution can best be viewed more as two step changes than as a continuous trend. Indeed, the two step changes can be identified with significant changes in the investment environment in Ireland: namely, the abolition of exchange controls on overseas investments on 1st January 1989 and the introduction of the euro on 1st January 1999. Between December 1978 and December 1988 Irish pension funds were restricted to investing no more than 12.5% of their net cashflow in quoted overseas securities. When this restriction was lifted, a significant realignment in pension portfolios towards overseas equities took place at the expense of Irish fixed interest holdings. The other significant shift was in and around the time that Ireland became a founding participant of the euro. The direction if not the magnitude of this portfolio shift, away from Irish equities into other equities, was reasonably well anticipated at the time and it is envisaged that this will continue over the coming years.[11]

INTERNATIONAL COMPARISON OF PENSION FUND DISTRIBUTIONS

Ireland is one of a small number of economies where pension funds are almost entirely free to choose their investments. The trustees of pension funds in Ireland must simply be 'prudent' persons when it comes to selecting investments and State regulation has allowed them near total freedom of choice, save for a restriction on the level of self-investment – that is, investing in the sponsoring employer – so that the pension promise is not too tightly tied to the fortunes of the sponsoring employer. The 'prudent man principle' of investing and freedom from State regulation other than on self-investment is also a feature of the pensions industry in the Netherlands, UK, Australia, the US, and Canada. Accordingly, in comparing the asset distribution of pension assets around the world, it is appropriate to compare the asset distribution of Irish schemes only with those other jurisdictions where the 'prudent man principle' applies untrammelled. Table 5 does just this.

Table 5 shows that there is nothing unusual in the asset distribution of Irish pension assets when it comes to the major asset categories. The significant difference is the proportion invested in international assets, which even exceeds that of the Netherlands. Since Ireland is a smaller and more open economy, perhaps it is no surprise that Irish long-term savings are more integrated into the world's capital markets.

The trend over the last decade and longer is for pension funds around the world to build up exposure to equities and to foreign assets.[12] Accordingly, the evolution of the asset distribution of Irish funds reflects international trends.

[11] See, for instance, Whelan (1998).
[12] See Whelan (2001), pp. 34-35.

TABLE 5: AVERAGE ASSET ALLOCATION (%) OF PENSION FUNDS WHERE INVESTMENT GUIDED BY 'PRUDENT MAN PRINCIPLE', 1999

Asset Type	Ireland (%)	Netherlands (%)	UK (%)	US (%)	Australia (%)	Average (excl. Irl.)
Bonds	25	41	17	28	25	28
Equities	65	50	75	65	55	61
Property	5	6	4	3	5	5
Cash & Other	5	3	4	4	15	6
% of which foreign	60	57	28	11	19	29

Sources: For Ireland, IAPF Survey (1999); otherwise Phillips & Drew (2000).

CONCLUSIONS

Irish pension funds have grown at a real rate of 17% per year over the last quarter century and this heady pace of growth has seen little slowdown over the last decade. Most of the growth in assets has been due to the underlying performance of the investments made, leading to an equally impressive growth in average assets per member.

The size of Irish pension funds is now significant in a national context, amounting to 60% of GNP. This compares well with other economies and, even when pension assets are combined with other long-term savings, Ireland still ranks amongst the most providently provided for nations. The new initiative, the National Pensions Reserve Fund – whereby previously unfunded State pension liabilities are now partly funded – ensures that this comparison will remain favourable in the coming years.

There has been a significant shift in the distribution of Irish pension assets around the world's capital markets. Exchange controls limiting the amount of money to be invested overseas were abolished on 1st January 1989 and this allowed Irish pension funds to invest up to their risk tolerance in overseas equities, thereby leading to a portfolio shift of 10% of total assets in the late 1980s from fixed interest to international equities. Another key shift of the order of 10% of total assets accompanied the adoption of the euro at the end of the 1990s, this time the disinvestments appearing to be permanently from Irish equities and directed primarily to other euro-denominated equities. Finally, in between these two major events, there was a drift away from the underperforming fixed interest sector towards equities (of about 5% of total assets), which reflects a general trend in pension assets worldwide. The upshot is that, over the last 12 years, Irish pension funds have effected a movement of one-quarter their assets from Irish assets – mostly fixed interest but partially domestic equities – to international equities.

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