Financial services in 2008: Who will be around?

The paper presented to the Shaping Tomorrow conference
At Lloyds of London by Frank Shaw, Foresight Director
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I'm going to take a retrospective scan of the forces of change impacting on financial services over the nineties; I will identify the current hot topics and pressure points and discuss the implications for the coming four years. You will either be in a different business by 2008 or out of business.

A large number of economic and social forces shaped the economic landscape of the nineties and produced one of the most amazing decades - in terms of economic stability, prosperity and increasing standards of living.

In hindsight, it is obvious that the feeling of a new era, limitless opportunities, and the abolition of standard economic laws, was built on shaky foundations, and that many 'bad' economic decisions were taken, especially in the latter part of the decade.

Yet, many of the systemic drivers that contributed to this so-called exuberance are still with us, though one tends to look at these with a greater degree of prudence, if not pessimism.

Only future economic historians will be able to judge whether the pendulum has currently swung back too far. But, it is important to put these systemic drivers into a proper perspective, as one looks forward into the future to draw a picture of how financial services might look down the road and who the future players might be.

The ICT revolution.

Looking back

Obviously, the most important catalyst of change in financial services was the information and communication technologies revolution. This had a profound effect on the organisation of financial institutions, their product delivery and the competitiveness of various types of financial services players. Moreover, it gave rise to a large stock market bubble in the nineties, which is still being unwound at the present time, and whose full economic effects may not have been fully felt yet.

ICT gave birth to new players in the financial field that challenged existing practices and traditional players. Electronic equity trading systems aggressively pursued the business of established stock exchanges, forcing them to adapt and adopt new products, and deliver new services to survive. Internet banking made inroads in the traditional retail banking sector. Indeed, significant cost advantages favoured a large shift to electronic banking and financial intermediation.

Technological advances since 1998 will have further reduced the costs of Internet-based transactions, while there is little scope to further reduce the cost of a branch-based transaction.
Vastly superior, faster and lower cost financial data processing abolished the concept of time and delays in financial transactions. It allowed financial institutions to adopt ever more sophisticated investment and lending strategies and, increasingly, to develop and deliver tailor-made products and services.

The resulting competition among various financial institutions led to considerable pressures to control costs and increase efficiency, although these pressures temporarily eased in the late nineties. This is one of the factors that drove many financial institutions to merge in the nineties in the search of economies of scale and greater efficiency.

At the macro-economic level, the ICT revolution boosted productivity growth and standards of living, although the precise quantitative contribution is still a subject of many debates.

But, the ICT revolution also had a number of pernicious effects. Among many other factors, it increased investors' risk appetite and enticed them to invest their funds in new and different instruments. This, in itself, is a positive development, as a greater risk-taking economy should eventually experience more robust growth.

However, a condition for this to be true, is that risk is properly assessed and rewarded. Unfortunately, the ICT driven stock market boom led many investors and financial institutions alike to either vastly under-estimate or completely ignore the risks they were taking.

Rapidly rising stock markets hid this fact for a while but, as the bubble burst, many faced substantial losses. In addition, it is estimated that financial institutions are left with portfolios of doubtful quality – for example, the trillion dollars in loans to the telecommunications sector.

Together with the wealth loss arising from the sharp fall in equity prices, this over-investment in physical capital is a major source of the current volatile economic situation. At issue is how long the capital overhang will last.

Looking forward

The ICT revolution is here to stay. New ICT-related inventions and applications will undoubtedly be brought to market. In the case of financial intermediaries, the competitive pressures from electronic service delivery platforms will undoubtedly intensify, especially if the economic downturn is prolonged and pressures to cut costs intensify. This may also give a further impetus to continued re-structuring and consolidation within the financial sector.

On the other hand, it may also give rise to new attractive investment opportunities that may appeal even to those who are currently disenchanted with the performance of stock markets. It may also contribute to improving the functioning of markets - more information, greater transparency - While this would be of obvious benefit to society at large, it may put pressures on those financial market players that benefited from a lack of full transparency.

Globalisation

Looking back

The volume of information, financial and non-financial, that the ICT revolution made available, supported the trend towards increased globalisation. But globalisation is a much deeper and more complex phenomenon. It reflects the interaction of a number of factors such as:

- The national and international economic policies put in place in the late eighties and early nineties;
- The rapid growth of transnational businesses;
- And the major technological advances in both communications and transportation.

The implications of globalisation for the financial sector are quite clear. The trend implies that national financial markets have increasingly become integrated with each other and shocks in any of these markets are rapidly transmitted to others.

Looking forward

What are the implications of globalisation for the future landscape? Two factors are worth noting. These are, first, the strong competitive pressures arising from international competition in and across various segments of the financial industry and, second, the increased exposure to both systemic risk and internationally transmitted financial shocks.

The European single market in financial services and the euro

Looking back

The drive towards a single European market in financial services that began in the early nineties gathered considerable momentum in the second part of the last decade with the adoption of the Financial Services Action Plan whose target date for the completion of a fully integrated financial market is 2005.

This push towards a fully integrated European financial market was one of the factors contributing to the recent restructuring and rationalisation process in the European financial industry.

Financial institutions had to prepare themselves for the unavoidable increase in competition within the European Union. The introduction of the euro in January 2002 and the associated elimination of 'exchange risk' in cross-border activities have provided a further push to the consolidation process.

Looking forward

What lies ahead? According to many observers, the financial sector has not yet felt the full impact of EMU, and the drive towards a single market in financial services. The adjustment process is far from completed and much rationalisation, restructuring, and merger and acquisitions are to be expected over the coming years.

Monetary and fiscal policies in Europe

Looking back

The second half of the last decade will be remembered as one during which policymakers pursued low inflation and low budget deficit policies. This has had a number of major implications for financial markets.

Under the higher inflation era of the late eighties, investors had become accustomed to high nominal rates of return on their investments. The advent of a low inflation era across the European Union sharply reduced the inflation premium built into many investment returns. This led numerous investors to seek new investment avenues in the search for higher nominal rates of return.

Looking forward

The issue is whether these policy factors will continue to be significant drivers of change in financial services in the decade ahead. Monetary authorities and governments appear to remain highly committed to pursuing low inflation policies and there is no reason to believe that this may change in the future.

Privatisation

Looking back

Privatisation of public enterprises played a major role in shaping financial services in industrialised economies in the nineties, especially in Europe. It generated considerable business for financial institutions and contributed to reduced budget deficits.

But, more importantly, it enticed many consumers to invest in equities, many for the first time in their lives. Indeed, in some countries, such as the UK, one of the explicit purposes of privatisation was the spreading of an equity ownership culture among the population at large.

What started as a relatively small trend in the late eighties rapidly gained momentum through the early nineties. However, privatisation sales and proceeds have fallen sharply since 1999 and the field of privatisation candidates has shrunk considerably.

Looking forward

I do not expect a large upswing in privatisation sales in the European Union over the coming years, with the exception of a few countries such as France that have been slower in bringing their public utilities to the market. However, in the light of the general population's disappointment with the performance of the equity bought in previous privatisations, it is unlikely that these future privatisations will be geared towards retail investors

Increased willingness of consumers to take risks

Looking back

The development of an equity ownership culture in Europe was encouraged by a number of factors:

- stable macro-economic conditions,
- low inflation and low nominal rates of return on traditional savings instruments,
- privatisation and the push towards 'popular' capitalism,
- financial product innovations
- and last, but perhaps most importantly, the recent stock market bubble and the high returns that could be earned with no or few perceived risks.

According to a recent study, by the end of the nineties, 17.3% of households in France, Germany, Italy, the Netherlands and the United Kingdom were holding stock directly. Including indirect stock ownership through unit trusts, the overall stock market participation stood at almost 50% in the United Kingdom.

This exceptionally large shift towards equity investment came at the expense of both traditional bank deposits and bond holdings. In fact, in 1997 and 1998, households in the eurozone reduced their holdings of bonds and similar market-debt securities to finance their acquisitions of shares.

However, by 2001, the pendulum had swung back sharply, and consumers again favoured traditional banks and market-debt instruments. This trend towards greater security will most likely have continued into 2004.

The final interesting point to note is that, since 1995, consumers have devoted a growing share of their investments to insurance products. To the extent that insurance companies themselves are exposed to movements in the stock market, consumers have found that their portfolio of investments are far more sensitive to movements in equity prices than they had anticipated.

This is certainly the case in the United Kingdom where life insurance companies invested a significantly larger proportion of their assets in equity than their European counterparts.

Looking forward

In the absence of a substantial rebound in equity prices and rapid resolution of the corporate governance problems that have come to light since the bankruptcy of Enron, it is unlikely that consumers will return in droves to equity markets over the foreseeable future.

Many will need to rebuild their assets and, in general, they are more likely to favour security over risk-taking, and prefer the types of savings instruments offered traditionally by banks and other financial institutions.

Growing importance of non-bank financial intermediaries

Looking back

The development of an equity-owning culture in the nineties stimulated the growth of non-bank financial intermediaries, as consumers often preferred to invest indirectly in stock markets via intermediaries such as unit trusts or life insurance companies. This trend was further supported in a number of countries where consumers were given greater responsibility for their own pensions.

Looking forward

It is unclear how the importance of institutional investors will evolve over time. On the one hand, no recovery or only a limited rebound in stock markets will dampen investors' enthusiasm for investing in equity-related instruments.
On the other hand, the looming pensions crisis and the need to shift increasingly towards private pensions may boost these institutional investors further.

For example, some observers estimate that Europe's corporate pension industry will grow by 13,500 billion euros to 17,000 billion by 2020 as governments force individuals and companies to pay into private pensions schemes.

Banks and insurers are expected to be the main beneficiaries of such a development.

Restructuring and consolidation in the financial sector

Looking back

Many factors have exerted considerable competitive pressures on the traditional financial sector players. Each has faced new players in the field and increased competition from other segments of the financial industry.

The borders between various types of financial sector activity often became blurred, and some observers expressed concerns about the risk of significant disintermediation. Such a development would obviously have serious implications for the implementation of monetary policy, and more importantly, for the banks themselves.

Academic studies do not appear to find strong evidence of disintermediation in the first half of the nineties. However, it is suggested that intermediation chains are getting longer with non-bank financial intermediaries becoming more active in mobilising capital from non-financial sectors.

In combination with the trend towards the securitisation of bank liabilities, this change increases the funding costs of banks and may have put banks under pressure.

Whether financial disintermediation was important or not in the nineties, it is clear that financial institutions engaged in a major wave of consolidation and restructuring. Each segment of the financial services market was aiming to gain a competitive edge over the others and, within each segment, competitors jostled to gain the upper hand. Generally, this involved mergers, acquisitions and the establishment of strategic alliances.

In the life insurance industry, many mergers took place with institutions looking to cross-border acquisitions and mergers in order to consolidate their market place. The banking sector experienced a similar unprecedented wave of merger and acquisition activity.

The comprehensive review of the consolidation trends in the financial sector established by the Group of Ten shows that merger activities accelerated in the nineties, especially in the last three years of the decade, as banks sought opportunities to exploit economies of scale.

The single bank-insurance institution was much in favour in continental Europe during this period as it was supposed to generate large business synergies. Consequently, a significant number of large and occasionally complex financial institutions have been created.

So far, most mergers occurred within national borders, either in similar segments or across different segments. As a result of this restructuring and consolidation, the number of banks in each country has generally fallen and concentration has tended to increase. However, the structure of the banking industry still varies significantly across the European Union.

Looking forward

Some of the fundamental forces that encouraged consolidation and restructuring in the financial sectors will continue to be felt. In particular, the ICT revolution and the completion of the single market will continue to push financial institutions to increase efficiency and become more competitive. The precise shape of further consolidation is, however, unclear.

In the banking sector, the bank assurance model does not appear to have delivered the expected efficiency gains and those who pursued this route are re-evaluating their approach. More generally, questions are being raised about whether any efficiency gains have been achieved from the recent spate of mergers and acquisitions.

The bottom line is that the financial sector's merger and acquisitions phase is far from completed in the European Union and that many further changes are likely to occur.

Regulation

The implications for firms in the retail financial services sector are huge. Such firms are already struggling to keep up with existing regulations, and the forthcoming changes could stretch the resources of some firms to breaking point. For many companies, the burden of compliance is a serious threat to profitability.

However, firms have no choice but to comply. Over the past three years, the FSA has shown that it is ready to impose heavy penalties on firms that fail to comply. What's more, it is active in "naming and shaming" these firms, publishing details on its website and sending out press releases to relevant publications. The resulting publicity can seriously damage a firm's reputation and drive away clients. In some cases, companies have been banned from doing investment business for failing to comply.

Looking back

In the late 90s, the government announced major reforms to the regulation of the financial services market. The reforms brought together nine regulators into a single body, the Financial Services Authority, which formally acquired its full range of powers in late 2001.

Looking forward

Strict though the existing regulatory situation is, it is about to become a great deal stricter, driven by the government's desire to restore public confidence in financial products and markets. The authority of the FSA has already been extended to cover mortgage products (from October 31 2004), and general insurance products (from 14 January 2005). Other changes coming up shortly include:

- Integrated Regulatory Reporting. From 1 April 2005, firms will have to start preparing their returns to the FSA electronically, which will be mandatory for all regulated firms by 2007

- Reforming Polarization. This will change the rules that define the products that a financial adviser can sell, as well as putting in place new arrangements for the disclosure of commission to the consumer

- Operational Risk: systems and controls. This sets new standards for the identification and control of operational risks.

In addition to these changes there is a raft of new regulation and legislation emerging globally, much of which will affect UK financial services firms.

This includes:

- The US Sarbanes-Oxley Act, passed in July 2002 in response to financial scandals such as Enron. This tightens up rules on auditing and corporate governance. US companies, and European ones dealing with the US, have been struggling to comply with this. It has been estimated that over $2.5 billion will be spent in the US alone on new systems to support Sarbanes-Oxley compliance. A European equivalent is in the pipeline.

• The Basel II accord. Financial services firms will have to comply with this by the end of 2006.

• The Combined Code on Corporate Governance, to which all companies listed on the London Stock Exchange must comply. This incorporates the Turnbull Guidance on Internal Controls that specifies that internal controls should be embedded within business processes and that these should remain relevant in the continually evolving business environment.

These are just some of the regulatory and legislative changes that will affect UK financial services firms in the near future, increasing the amount and type of information firms will have to make available to regulatory bodies, and making the need for effective record-keeping greater than ever.

Conclusions of the retrospective

The main conclusion that one can draw is 'more of the same'. All of the main factors that contributed to shape financial services in the nineties are expected to continue to do so over the present decade, with the exception of the privatisation driver.

Over the coming years, however, a set of additional factors reflecting new, contemporary pressure points and concerns will also become significant drivers of change in financial markets.

Today's new pressure points

In the spring of 2002 there was great optimism that the recovery from the 2001 slowdown had taken solid root. However, nowadays the outlook is much less clear. Vastly divergent views are being expressed about where the world economy is likely to head over the coming years and all economic agents face an exceptionally high degree of uncertainty.

The current developments may well prove to be just a temporary pause on the path back to sustained growth. But, in light of the increased uncertainty, it is more than likely that investors will adopt a highly cautious approach in the near future.

Perhaps the most important new factor is the general lack of trust in financial services companies.

Numerous exercises are under way with a view to improving the governance of financial institutions. Consumers will be more able to assess the true financial performance of a company. At the same time they should be more confident that they will receive truthful and unbiased advice from financial intermediaries.

An issue that has attracted considerable scholarly attention is whether corporate governance systems have converged, either as a result of deliberate policy or financial market pressures. Recent studies give somewhat conflicting conclusions.

It is essential to note that, despite the many reforms underway, considerable differences in corporate governance are likely in the coming years. However, financial integration in Europe may have significant implications for the preferred model of corporate governance.

Finally, the increased attention given to corporate social responsibility (CSR) may also have significant implications for financial services. If businesses are required to account for the impact of their actions to various stakeholders, and to consider the implications for the sustainability of the business, this will create a longer-term view.

Such a development should divert financial analysts' and investors' attention away from short-term financial results and force them to adopt a longer-term perspective in their assessments of the performance of a company.

This more patient approach to investing would allow companies to take a longer view in their strategic planning, which would contribute to improved business performance over the longer run, as many expect.

On the other hand, a badly-handled implementation of CSR may divert management's attention from more critical short term issues and result in a less satisfactory performance than would have otherwise been the case. In terms of financial markets, the main implication is that socially responsible investment will become increasingly important.

Future pressure points

Pension reform

The relates to the long expected, and often postponed, pension reform in most EU Member States. The combination of an ageing population and relatively slow productivity growth will result in such a burden on public finances that it will be very difficult to maintain sound budgetary policies.

So, a large number of experts have advocated a shift from publicly funded, generally pay-as-you-go, pension systems to privately funded pensions based on past contributions to the pension fund.
Given the long lead-time required to build viable private pension systems, most experts have advocated shifting as rapidly as possible to the private pension system.

This will obviously have a major impact on the structure of the financial services industry as significant amounts of new savings would need to be channelled through pension funds and invested in various instruments. Paradoxically, it may benefit both non-bank financial intermediaries - pension funds, life insurance companies, - and stock markets, as the savings channelled to these non-bank financial intermediaries will need to be invested in capital market securities yielding significant returns.

Basel II

The new regulatory framework that is currently under discussion for intended implementation in 2005 will result in a closer alignment of the risk taken by banks and some other financial intermediaries, and the capital these institutions will be required to hold as a protection against potential losses.

While, in principle, Basel II should not increase the capital requirements for the sector as a whole, it will probably have a varying effect across the banking industry, with larger banking benefiting from reduced capital requirements relative to the current regime, and smaller banks requiring potentially more capital.

It may also affect the price and availability of banking funds to various sectors of the economy, as lending to some sectors may require a higher capital charge than at the present time.

Looking ahead, the list of issues that the future of financial services raises is almost limitless, reflecting the complexity of the situation. We are reasonably confident about the following assumptions.

- **the impact of the ICT revolution will continue to be felt in all scenarios**. Competition from electronically-based providers of financial services will continue to be relentless, forcing traditional providers of financial services to continue to reduce operating costs and improve the efficiency of their organisation. A number of observers are of the view that the ICT developments seen so far are only the tip of the iceberg and that the potential of internet-based systems remains yet to be exploited.

  In practical terms, this implies considerable service and product innovation for the customers of financial services and further drives towards consolidation.

- **Monetary policy will remain resolutely anti-inflationary.**

  While this factor should be roughly neutral in a period of low inflation, it could favour those financial services providers that provide interest-sensitive products to savers.

- **The European Union will complete the implementation of the Financial Services Action Plan** on time or only with a minor delay. The major impact of the creation of a single market for financial services will be sharply increased cross-border competition, putting further pressures on all providers of financial services to control costs and increase their efficiencies.

  Like the ICT driver, this will underpin a continued process of consolidation, mergers and acquisitions, with perhaps a greater emphasis than in the past on cross-border transactions, leading perhaps to the emergence of truly pan-European organisations.

  There is no reason to believe that it will favour one type of financial services provider over the other. However, to the extent that substantial economies of scale exist in the provision of various types of financial services, it may favour the emergence of larger entities in each segment of the financial services industry.

- **The current degree of global trade and financial integration will increase.**

  The various trade disputes between the major trading partners are assumed to be eventually resolved and no measures will be taken that would undermine the current system.

- **There will not be a significant financial crisis that has a lasting impact on the economic outlook.**

  Any serious financial crisis will be quickly addressed and resolved by international financial institutions such as the IMF and the World Bank, governments, central banks and regulators.

  It is possible that a new emerging-market crisis may erupt, perhaps in Latin America, or that the persistently large US current account deficits may result in a serious exchange rate crisis. But it is assumed that policymakers will be prompt to act and take all the necessary measures to contain the crisis and limit its effects.

  Any such serious crisis will lead to a flight to safety, favouring those investment instruments perceived as the safest at the time of the crisis.

- **The drive towards better governance of corporations and financial institutions will be pursued with increasing intensity**

  This may favour capital markets at the expense of banks in continental Europe since the benefits of bank-finance as a mechanism of corporate governance no longer arise.

- **Corporate social responsibility will become part of mainstream economic governance.**

- **Basel II will be implemented**

- **Restructuring and consolidation within the financial sector will continue**, irrespective of the economic and financial outlook. However, this process will be much more intense in scenarios where economic growth is slow, as pressures to control costs will be far greater in such a case.

The main drivers that matter critically are:

- the general outlook for the economy
- the performance of stock markets
- regulation
- and consumer trust

In the face of the forces now driving the industry to change, it will be a question of the survival of the fittest. The capacity of an organisation to understand and respond to the drivers that will shape the future will determine the survival of the enterprise. We have written three scenarios:

- **how are the mighty fallen**
- **the phoenixes rise from the ashes**
- **new brooms make a clean sweep**

A thought to leave you with. Things could always be worse. You could be ugly and work in the Post Office at Christmas.

You've been a very attentive audience. Thank you.

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