

# A Banker's Perspective on the Future of the Financial System

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## 1. Introduction

The changes affecting the banking industry are well known and widely discussed. The key questions are how quickly these changes evolve, the form in which they will take root, how existing institutions adapt to them and the ultimate impact they have on the efficiency, stability and safety of financial markets. Citibank itself has been at the forefront of many of these changes and they are totally altering the way we do business, just as they are restructuring the industry in which we do business.

Banks have dominated the provision of financial services for several centuries providing five basic services: financing (debt and sometimes equity capital); safekeeping and investment services; payments and settlement mechanisms/systems; risk-management techniques; and financial information and advisory services. This domination has been due to various factors but certainly a protected franchise derived from the state as licensor and regulator, together with the relative simplicity of the services provided, demanded and required by the end-users, have been pre-eminent.

The late modern industrial period for banking began in the 1930s and lasted some 50 years into the early 1980s. During this period, banking was relatively stable, though alternative models were adopted in the functional separation of the United States and the universal banking of Europe. The forces of change were already at work in the early 1970s to undermine this equilibrium. And certainly since the 1980s the industry has been subject to enormous pressures to change driven primarily by technology, deregulation and globalisation. The five basic services still exist but banks are no longer the sole providers and customers are increasingly sophisticated in the type of products they require, what they are willing to pay for them and how they want the services delivered.

As practitioners we deal with the issue of adapting to changing times and it is no less urgent and threatening to the large institutions like ourselves than it is to the smaller players. The marble plaque commemorating the New York Clearing House building contains the names of some 134 banks of which only seven or eight are left as members. This serves as a vivid reminder of what happens over time and the imperative of adapting to change if one is to survive.

We all operate in the same environment, we see the same trends but what should we do – as bankers, as non-bank financial service providers and as guardians of the public interest? Making the task even more challenging are the often unanticipated consequences of identified trends. Where you end up is not always where you seem to be headed. It is also not clear how quickly the trends will evolve. History would indicate a strong tendency to overestimate the pace of change in the financial services industry. There is considerable viscosity built in through special interest groups, regulatory barriers and consumer conservatism related to their financial affairs.

I believe that the slower pace of change is advantageous in that it gives us more time to carefully consider options and strategies, by both practitioners and regulators, without the need to rush into new business strategies, altered structures and new systems. A clear understanding of this point will help ameliorate some of the difficulties often created by overreaction and undue haste.

In my brief comments, I want to make several observations about the underlying trends in the financial services industry that I think are pertinent to the Australian banking scene. These include: the unavailability of the fundamental changes underway; the dual impact of globalisation; changing cost and performance dynamics; risk management; and the major changes ahead in consumer banking. In doing so, I am more than mindful that the regulatory environment is a critical element in how the Australian financial system develops, and in particular the role of banks in that system. However, I intend to make only passing reference to this important dimension adequately covered elsewhere.

## **2. Unavailability of Fundamental Changes**

My first observation is that the Australian financial sector is subject to all the same trends we see in the United States and Europe. These trends will continue and intensify, not diminish, and they will have an increasing impact upon the Australian market. The result, I believe, is that in the not too distant future in the OECD countries, the banking industry as we know it today will no longer exist. Institutions called banks will remain for either the simple and relevant reason of customer awareness or for more complex and important regulatory reasons. But the provision of the five basic financial services will be from a very different industry structure with a different profile of providers. The point is that markets are more efficient than institutions and the process of banks being disintermediated by capital markets and more efficient, competitive non-bank providers of financial services will not abate.

The institutions – or ‘holding companies’ – that evolve from the likely series of new entrants, amalgamations, takeovers (hostile and friendly), and organic growth over the next few years, will be operating along a spectrum of service positions. Some providers will be operating in a manner which is characterised by traditional bank balance sheet intermediation but to a more restricted customer base. Other providers will be underwriting capital market fundraising activities, managing investment funds, selling investment instruments, issuing credit cards, offering insurance, and so on. More and more we will see specialty providers. Universal banks will remain but in a very re-engineered structure with more disaggregated and focused service delivery. Overcapacity and inefficiency is everywhere which means continued consolidation at the same time we experience diversification of providers. Regulation will dictate the framework for the extent, speed and exact form of how these changes and institutions evolve.

The dynamic underpinning to this evolution has both demand and supply characteristics. The demand side will be the dominant one. It will be the services that the end-users want, the products they like, the style of delivery which is most convenient to them and whether the relationship is transaction-specific or long-term, which will primarily dictate how the provider responds; not, by and large, the provider determining what the customer needs. Individual providers have the big task of anticipating these needs and responding before others do. And in that intensely competitive arena, while customers will invariably win

out, the challenge for providers will be to win market share, maintain profitability and minimise risk. The challenge for the regulators will be to ensure that industry standards and the soundness of the financial system are maintained without impeding innovation or imposing high costs.

In the Australian context, the above considerations imply that there will be an evolution towards further consolidation, fewer domestic providers, more specialisation and a greater share for non-bank and international providers. Obviously the recommendations of the Wallis committee and the government's position will either facilitate or inhibit these trends.

### **3. Globalisation**

My second observation relates to the impact of globalisation on Australia. A relevant question, is how can a strictly local 'player' remain competitive?

As more sophisticated corporate and individual customers require increasingly competitive products, many traditional domestic providers find it difficult to match global institutions. Similarly as more customers engage in business or investments overseas, local providers encounter barriers to meeting best of class services on their own. For most it is a matter of critical mass, resources or the inclination to undertake the difficult task of establishing an international network, be it via branches, representative offices or acquisitions, and that is fair enough. Recent history clearly underlines how difficult such a process can be, particularly if it is undertaken more by way of 'keeping up for the sake of keeping up'. The demand for global services and for best of class products will not diminish, however; it will only grow. While I am sceptical about the ability of local banks to compete broadly for the business of sophisticated and/or internationally orientated customers, I believe some can do so selectively in areas where they have special competencies. Beyond that they can also form alliances and outsource, and in fact will do so. I have a suspicion that the going will be tough for the smaller local banks in this area. Capacity to deliver global products and to satisfy global needs will be the hallmarks of successful major financial service providers in the future, be they of domestic origin like the 'Big Four', or of foreign origin like Citicorp. Large regional or global financial institutions will increase market share at the expense of smaller, local players. But there will also be consolidation among regional and global players with fewer players at this level as well. This trend argues for the emergence of possibly one or two Australian-based banks that can compete effectively regionally if not globally.

In part this issue will be determined by the regulators. Will they let large multinational organisations, or for that matter large domestic organisations, absorb smaller banks? Or will they preserve an independent role for them? In the former case, I see similarities between what has occurred in the computer services industry and accounting professions, with the development of big organisations which have the capacity to easily stretch over national boundaries and provide services more competitively and comprehensively. Smaller bank players, to the degree that they survive, will have largely niche roles. Under either alternative, a major issue for the larger traditional domestic banks is the extent to which they want to become really international, or whether they want to focus their abilities on building up a strong regional business in Asia and the Pacific. And in pursuing their desired strategy, they will need to determine how they go about it: whether they

decide to rely more on their own resources, or whether they see merit in expanding through affiliations with other local, regional or international banks.

#### **4. Another Aspect of Globalisation**

My third observation is that globalisation presents an opportunity for Australia, for I believe the country has the capacity to develop as a major regional financial services centre. Clearly Australia is already a reasonably large financial centre in this part of the world but it has tended to take a back seat to Tokyo, Hong Kong and Singapore. There are various reasons for this, some economic or financial and some to do with inertia. Notwithstanding this, the trend to disaggregate and create centralised processing and service centres, as well as the trend toward 24-hour trading not just in financial markets but in corporate banking, investment management and transaction banking, requires access to sophisticated financial service centres around the globe. With its well-educated workforce, its supportive political, economic and legal systems, its favourable time zone and, increasingly, its competitive cost base, Australia has a very good opportunity to establish itself as a favoured domicile for regional operations centres. The more that this occurs, it will strengthen the local financial sector, which in turn will attract more regional operations. Certainly the trend is for further consolidation in designated centres and Australia should be able to be one of those centres. What is lacking is a widely held vision that such a role is possible for Australia and the commitment to leverage its natural advantages and create a more hospitable environment through continued tax reform, liberalisation of immigration policies, more competitive transport and telecommunication facilities and continued improvement of financial trading markets.

#### **5. Cost and Performance Dynamics**

My fourth observation is that in the intensely competitive world of modern banking, the imperative to reduce costs and increase productivity will be unrelenting, as will the pressure for improved operating performance. Banks have tended to be high-cost organisations with low and inconsistent returns on equity. That luxury is no longer available. As is the case with other 'traditional' industries such as retailing and manufacturing, the pressure on margins from competition is growing. With a limited capacity to raise prices, a reduction in unit costs is the only solution. The 'easy' way of doing this is to reduce overheads and this process is continuing. The harder way is to boost productivity. That is where technology and the pursuit of high-volume, low-cost products in different markets will come to the fore.

It is only recently that years of investment in technology and gradual liberalisation has resulted in major productivity improvements. The trend is accelerating. Whole new delivery systems are emerging based on ATMs, telephone banking, PC-based banking, and now the Internet. We are also seeing rapid developments in electronic data interchange, image processing, laptop sales support systems, computer trading, computer-driven risk management and a whole array of new automated product-processing systems.

Globalisation is permitting consolidation as previously discussed and the resources to create world-class facilities and leverage global supplier relationships. The cost and

performance pressures will also result in increased outsourcing and new forms of alliances between banks and non-banks, particularly technology providers.

## **6. Risk Management**

My fifth observation relates to the implications for risk management. Because of the intensity of competition, risk-management standards will be under pressure, and continued vigilance is therefore required to ensure that the excesses of the recent past are not repeated. Moreover, as we move further towards a global economy, we are in many respects still relying on risk-management systems geared to a less integrated world. And with increased global linkages comes greater vulnerability to events from which we may have previously assumed we were immune.

The old problems of bad debts and non-performing loans for banks are unlikely ever to go away. The economic cycle and human nature – both from the perspective of greed and the capacity for errors of judgment – will ensure that. But in addition, risk issues are changing because of globalisation, the changing nature of products, the complexity of payments and settlement issues and the impact of new entrants. If banks and other financial institutions, in pursuit of market share – or perhaps survival – are led into ever more marginal transactions or activities for which their monitoring systems are really not designed, problems will emerge again. This has obvious implications for systemic risk and economic management.

An onus to avoid such outcomes is obviously on the regulators, but the more important onus is on each organisation in the industry itself. It will be important for us to monitor and assess emerging risks and potential problems over the medium term. While working out exactly when and how the next financial problem is likely to occur is impossible, this should not prevent financial organisations from being at the forefront of judging where, how and why potential risks will build. In doing so, the relaxation of risk-management guidelines in the face of competitive pressure and the inadequate appreciation by senior management of exactly what risk the organisation is exposed to (and this a real concern given the knowledge gap between many new derivative and capital market instruments and senior management career experience) are just two of the issues to which organisations need to be sensitive.

Another area of concern grows out of the rapid increase in risk exposure by many of the emerging non-bank players in the financial system. Their lack of experience in many cases with credit problems could lead to a repetition of the mistakes of the generation of bankers who experienced the pain of the bad loan problems of the early 1990s.

Despite the liquification of our balance sheets and the big changes in products and innovation, we are not necessarily taking on any less risk. Risk assumption is only taking a different form. This need be of no concern as long as we are confident that the new and highly automated risk-management systems in place are accurately measuring the extent of our exposures. It will prove to be a nasty shock if we discover that, in the event of a major financial problem, our theoretical risk models have given us a loss profile which is substantially different to what is actually incurred in the real market. One need look no further than the 1987 stock market crash and the more recent problems with some major derivative deals in the wake of the 1994 bond market sell-off in order to gain an appreciation of this point.

Overlaying all of the above is the technological revolution in risk information processing. Many of our new financial products are possible only because of the capabilities of computers to process and analyse high volumes of data and market variables quickly and accurately. This is not inherently bad; quite the contrary, many of these products are greatly improving our ability to manage exposures generally. But it is new and different, involving large volumes and with limited experience. I do not wish to sound alarmist, but this is an area that needs continuous review.

## **7. Consumer Banking**

My sixth and final observation is that often most of the attention in discussing the changes in the banking industry relates to wholesale banking. There are many reasons for this, ranging from the initial disintermediation of corporate borrowing that began the current restructuring of the banking industry, to the fact that most major bank CEOs and senior officers are corporate or investment bankers. But retail banking is in many ways undergoing even more fundamental and revolutionary changes than wholesale banking, with far-reaching effects.

While the change is just beginning in Australia, as alternative providers of mortgages have entered the market and retail funds managers have grown, overseas it is a major area of change. Consumers in the United States no longer keep the majority of their funds in the banking system. Fidelity's mutual funds have grown to over US\$400 billion in 1996 making its 'deposit base' larger by far than any US bank.

Growing consumer wealth is driving demand for new products. The consumer is interested in convenience, good service, low costs and competitive rates. Technology and deregulation are providing flexibility to consumers and lower costs. Suppliers have multiplied rapidly and high service/product quality and 'fair value' are required for brand loyalty.

In Australia, like the United States, we see growing consumer wealth underpinned by an ageing population, and the concomitant rise in savings and disposable funds in search of attractive investment outlets and the growing sophistication of customers interacting with mushrooming technology.

From the supply side there are more service providers than just banks, for example, brokers, insurance companies, and funds or mutual fund managers, which can provide retail services across a range of products either packaged or unbundled.

From only a few years ago, when bank passbooks were slipped down a chute for signature verification, when account balances were depicted in neat handwriting and bank managers decided whether to grant loans on the basis of the length of time applicants had been clients, not only of the bank, but of particular branches, we have come a long way. The retail world is now one of ATMs, CATs, EFTPOS, credit, debit and charge cards issued by banks or non-banks, home banking and now the Internet. With rapidly improving network security, transaction execution is just around the corner. In fact, it has already begun. Many banks offer on-line banking through Intuit's Quicken Software; Microsoft Money offers a similar service. And this is just the beginning: in the end a banking function can be a few lines of application code on a network. And thus we are on the way to electronic money – freely exchanged over communication networks

and other electronic media – the foundation for which is already being laid as we move to automated payroll credits, debit cards, scriptless securities, and the like. Customers can choose from a smorgasbord of investment and loan products. While it might seem that a lot has already been undertaken, I consider that the changes have only just got under way.

I expect to see a further proliferation of retail services, especially in the investment and deposit areas but also extending to financing activities and the payments system. As the ‘high-end’ corporates become more separated from traditional banking services, switching to the capital markets and independent service providers, banks are going to increasingly concentrate on the ‘middle market’ and consumers in their quest for business. Small businesses and consumers are therefore going to have before them an even more extensive, possibly bewildering, array of options.

For some, this may seem a rather strange conclusion given the ever-increasing number of bank branch closures and the introduction of fees, both of which are often equated with reductions in consumer service. But the reduction in cross-subsidies will permit a clear quantification of the economics of viable service provision and hence the capacity to deliver better, more targeted products. The closure of branches, while the end of an era, marks the acceptance that customers can be serviced by an increased proportion of behind-the-scenes bankers using new technology in a variety of ways, such as over a telephone, a computer line or a ‘kiosk’ in a store.

The critical issue will be how customers react to these and other changes. The bottom line, I believe, is that the reaction will not be adverse and that customers will increasingly appreciate the improved services available to them. From the providers’ perspective, they need to keep firmly in view the fact that only through technology and the drive to be innovative can they attract and retain consumer customers. As previously stated, the consumer is loyal to individual organisations for four basic reasons: convenience; low costs; service levels; and competitive rates. More sophisticated consumers will appreciate factors such as global reach. But the capacity to deliver on the above factors will determine the success or failure of organisations involved in the retail sector.

## **8. Conclusions**

In summary, banking definitely has a future and it will be an exciting one. But it is unclear exactly what role traditional banks will play, assailed as they are from all sides by an array of competition: ever-larger banks, specialised banks, global banks and, not least, a variety of non-bank competitors. I believe that there is a role for many existing banks but not without change and we should be under no illusion that this will come easily.

Similarly, it will be difficult for the regulators as well to effectively promote economic efficiency, prudential soundness and the public interest in such a vastly different environment. We can all take comfort from the earlier observation that while the change process is irreversible it moves slowly, with time for both practitioners and regulators to digest, analyse and respond wisely. I have no doubt that this will be the case in Australia.