Trends in Financial Services*

by Sir David Walker**

Our industry of financial services is passing through a phase of evolution as radical as it has ever seen. Virtually everything is changing, in areas as diverse as ownership structures, technology, client expectations, product design, distribution, accounting and regulation.

At the retail end, the time is passing when name familiarity and integrity are sufficient to inspire client loyalty. Now, quality of service, charging arrangements and investment performance draw increasing attention, and firms from outside financial services that have built up reputations for dependability, quality and insistent attention to customer needs are finding that barriers to entry are not as high as they were formerly supposed to be. Affinity groups are proving to be extraordinarily powerful channels as well demonstrated by USAA in the United States; in the UK, we find Tesco, Sainsbury, Marks and Spencer and Virgin establishing serious bridgeheads in banking and insurance, and new non-bank entrants to the card business are acquiring significant market shares. In France, the parallel examples are of Carrefour, Casino and Galeries Lafayette; and, in Japan, Sony.

At the wholesale end, disintermediation continues to transfer the banks' corporate lending business to the capital markets, and life companies in Europe and elsewhere will similarly face increasing competition from these markets as S.401k-style retirement plans emerge as alternatives to defined benefit corporate pension schemes. And although reinsurance is currently in an excess capacity phase, the capital markets will increasingly provide rival, non-traditional instruments for hedging as and when premium rates turn up.

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In this unsettled situation, every bank and insurance company that is not able to indulge the luxury of mutual or some other form of protected status is finding its mettle under test. We have only to look at the scale of consolidation activity in financial services in the recent past, including even the last few days. This activity measured by market values has risen from an average annual rate of less than \$70 billion in the 10-year period from 1987 to 1996 to \$309 billion in 1997 and approaching \$400 billion of announced transactions in the first half of this year alone, involving banks, insurance, investment banks and asset management. Another indication of radical change in the industry's demography – though it is in one sense largely a statement in relation to Japan – is in the evolution of rankings by market capitalisation. In the first half of 1987, 15 of the 16 largest financial services businesses were Japanese, headed by Nomura Securities, with Generali as number 15 on the list. As of today, the list of 16 includes no names that were on the 1987 list and comprises 9 Americans and 7 Europeans.

I was a regulator when I last spoke to the Geneva Association, in 1991. I said then that, beyond insistence on adequate minimum standards for solvency and disclosure, and on sales practices in respect of retail clients, it was no part of the job of the regulator to stand in the way of commercial responses to competitive and innovative pressures. I suggested that these were likely, over time, to be greatly to the advantage of the industry's customers. Nothing has happened subsequently to change that view, which I would apply equally to banking as to insurance. But while customers are likely to be unequivocally the gainers, there will be winners and losers among firms themselves, with a much wider distribution of outcomes than in the past, depending on the tactics and strategies that they adopt.

In these brief remarks, I want to identify three groups of question. I do not presume to offer answers in a forum of this experience and distinction, except to say that the option of “waiting and seeing”, if it were ever a strategy, is less available now than it has ever been in past. The strategic answers will be different for different companies, but every CEO in this room needs to have a view on them that is applicable to his own business. The mnemonic to identify the three groups of question is ACT – accountability, competition and technology.

Accountability comes first because it embraces mission, objectives, attitudes to shareholders and other stakeholders. If this is not clarified at the outset, performance is unlikely to be optimal on any criterion except by chance. Clarity as to accountability is important not only between a CEO and his board and shareholders but, also, in setting the criteria for investment decisions and expectations for the contribution of key employees within the group.

The lines of argument in the accountability debate are fairly clear. At risk of oversimplification, the choice is between focus on some measure of size on the one hand and on value creation on the other, though this does not have to be a binary choice. Going for size may be predicated on a view of scale economies or the advantages of market dominance, but this might be expected to bring eventual returns for shareholders, even if acquired initially through price-cutting. Alternatively, it may involve diversification away from traditional business into higher margin activity, similarly expected to yield overall performance benefit after a phase of transition. In contrast, going for profitability or total

shareholder return sets a tighter focus and discipline. The yardstick for testing every proposed initiative will be whether it is likely to enhance shareholder value in what timeframe.

The choice here links to the key issue of shareholder expectations, partly a matter of inheritance and tradition but also increasingly influenced in the fast-unifying global equity market by the statement of objectives given by the company to analysts, and its performance against the broad target that it sets. In one sense, the greater the weight of tradition and the less the exposure of a company to Anglo-Saxon style performance pressure, the greater the flexibility of the board and CEO to decide what sort of objectives, accountability and corporate governance a company should have. However, the value of this flexibility may become more apparent than real over time because the cost of equity, a key competitive factor in capital-intensive business, is likely to be lower where performance is clearly geared to total shareholder value.

Before I leave the subject of accountability, I want to mention one other aspect, the priority of effective risk control. There is almost a banality in uttering these words to such a group of insurance company chief executives. But the development of derivative instruments to accumulate or diversify risks creates a quantum of new opportunities and exposure. Given that major financial service companies are quintessentially concerned with the intermediation of risks, most will be involved in this new market activity in both the hedging of particular risks and in the absorption of new ones, for example by writing options. But the fact that markets in many of the new instruments are often relatively liquid – and are set to become significantly more so, for example in the case of credit derivatives – does not provide assurance that counterparties will survive or that the market will not dry up in some future long-tail situation.

My concern is not to dwell on the right approach to particular risks, but to emphasise that the huge advantage for the management of your businesses that the derivatives markets have brought can only be safely harvested on the basis of the most rigorous risk identification, measurement and control systems. How each of you do this will vary from company to company, but there can in my view be no argument that this is an accountability ultimately to be discharged to the board by the chief executive. If emphasis is needed, I should add that, in every case of which I am aware of failure of a bank or insurance company over the past couple of decades, the after-the-event review of what went wrong revealed a palpable but avoidable failure on the part of senior management to price or control risk adequately.

With a clarity about objectives and accountability for them established, the focus is then on *competition*. The reasons for intensified competition and narrower margins in many product lines prominently include deregulation, disintermediation into the capital market for both bank and insurance company business, eroding customer loyalty to established relationships and providers and the move to EMU in Europe. As we have seen, competition is now coming not only from established industry participants but from outsiders and from capital market products in a variety of forms. Although the reasons for intensified competition differ from company to company and country to country, they are present in varying degrees for all financial service businesses and even for those that continue to enjoy state protection and subsidy – I should add, potentially at the expense of their customers or taxpayers, or both.

These competitive pressures will bear on different firms in different ways, partly because of the different pace of deregulation around the world. This is one reason why appropriate strategic responses are likely to be very different. But the main point, on which there will be little difference of view, is that these pressures are probably irreversible and are set to intensify, even for the CEO of a bank or insurance company with a healthy market share, good profitability and a strong balance sheet.

Apart from the continuing drive in most companies to sharpen internal efficiencies, the broad options to respond to such challenge broadly comprise larger volumes and diversification into new business lines. Two observations in relation to the scale option are these. First, despite the attraction of achieving a stronger share or indeed dominance nationally, regionally or globally, what assumptions are being made about the vulnerability to competition from new entrants in key elements of the business chain? An element in the response will plainly be the strength of the marketing effort, and in particular, the confidence and loyalty inspired by branding in the particular markets being served. Nonetheless, a key sensitivity, where the target is a stronger market position in existing product lines, is whether volume leadership provides greater insulation against, for example, new entrant competition or merely broadens the front of vulnerability.

Second, although scale efficiencies are clear in some areas, for example in the development and use of information technology, customer profitability in banking and insurance is so widely skewed that the pursuit of volume can involve booking new customers whose business will represent an ongoing net loss exceeding any benefit from economies of scale. The point is obvious, but the mistake of going for scale in an indiscriminating way has been made frequently in this business; and, after all, the least tolerable mistakes are those that have been made before.

In relation to diversification as a response to intensified competition and to the squeeze on margins in traditional business lines, two key questions at present, for both banks and insurance companies are: are premia so high as to exclude acquisition possibilities and, whether or not the diversification is organic or through acquisition, is there a competence to manage it effectively. In a sense, my own comments here are bittersweet. Premia are sometimes extraordinarily high – the highest in financial service consolidation in the last 4 years was probably the 26 times earnings paid by ML for MAM, though in other situations the price was less expensive on an earnings basis but expensive on a price/book basis. But whatever we may think of such prices, my observation in financial services, and also more widely, is that strategic transactions that subsequently run into difficulties do not for the most part fail because the price was too high but because there was either a miscalculation as to underlying strategic fit – not itself directly a function of price – or because of defective implementation.

On the question of strategic fit, I would distinguish between the strategic concern to boost the annuity component of revenues, which may justify a high premium, and a concern to acquire product manufacturing capability where, in my view, a much lower premium is justified because, looking ahead, the scarcest commodity is likely to be an effective distribution capability. But the question on implementation highlights a recurring question in the current wave of consolidation in the industry: is what is being built or acquired capable of effective management?

Part of the answer depends on the criterion or objective. I believe that the greater the focus on total shareholder return, the harder the task will be. Similarly, the greater the diversity of the businesses being brought together, the greater the size of the task. Of course, this task is easier where the proposition is bancassurance, which offers a means of achieving larger balance sheet mass in a relatively painless way in management terms; but the jury is still out on the extent of synergies that can be reaped.

This leads to the third and last element in my mnemonic, *technology*. One immediate issue is the state of preparation of financial service businesses for the year 2000 transition. On the basis of the best but limited appraisal that an individual company can make, my sense is that the answer is like the curate's egg – good in parts. But while the focus for all financial service companies hitherto has been on how to ensure that their own systems are capable of making the transition, it is timely now to be reviewing the specific business and wider implications of a situation in which some counterparties will not be dependably ready. I suspect that these issues have, until now, been given inadequate focus.

Yet if we cannot feel confident in the capability of some of our normal counterparties to effect this transition and meet their early 2000 contractual obligations in a timely manner, this will surely cast a shadow on our readiness to do business with them from, say the second half of next year onwards. The fact that there is no authoritative survey of 'states of readiness' does not deprive us of responsibility for taking a prudent view of risk in individual cases. And if all, say, major financial service businesses proceed on a cautious basis, the implications for financial markets in terms of reduced transaction volumes and liquidity will be very significant. I do not mention all this in a alarmist sense, but these are factors to be factored into the risk management strategies of firms that are confident that they themselves will be prepared for the transition.

The difficulty is that IT as a tool for the development of our businesses has been, so to speak, hijacked for a time by the need for focus on the boring but essential Y2K project and, in the European context, for the still earlier EMU project. But it is clear that, looking beyond these immediate major distractions, IT is both a peculiar threat and an opportunity for financial service business. I want to make three value propositions.

First, scale creates the potential for greatly increased operating efficiency, with the marginal costs of computing and telecommunication falling close to zero, once a certain scale of operation is reached. Second, technology has become a much more powerful instrument for product development in banking and insurance, both life and property and casualty. A chronic problem is the short and shortening life cycle of new products. But for the well-positioned, technology offers the opportunity for product innovation virtually overnight with distribution through the web. The contrast could not be starker between product development as a discontinuous, long timescale process and the potential for virtually continuous adaptation and refreshment of the product offering. Third, technology has opened the door to significantly greater customer intimacy, a new but critically important piece of industry jargon which relates to the capacity to collate and integrate information on multiple aspects of the financial behaviour of individual customers, so that new products can be customised to meet their needs.

These themes are all familiar and I believe that, despite the technical complexities, the key problems are not in deciding how to use new technology but in overcoming organisational inertia and in jettisoning legacy systems swiftly enough. There is of course continuing uncertainty about how soon retail customers will be ready to switch from old allegiance to new product offerings from new providers and to embrace new channels of distribution. But the direction of change is clear, with technology rapidly becoming the key customisation tool, and advantage over time will equally clearly be with banks and insurers, and newcomers, that anticipate such change.

I said at the outset that I would not presume to offer answers. But there is one theme to which I want to revert, because I believe it to be crucial. It relates to clarity of objectives and communication. When objectives are unclear or inadequately communicated, the uncertainty for shareholders, for the decision-taking process within the company, for employees and for customers is likely to be a negative for both market valuation and operating performance. A product or geographic diversification may be a wise strategy and within a company's management capability, but unless carefully presented it can all too readily stimulate investor scepticism. In contrast, a company that communicates clear objectives externally and internally, with effective branding so that its customer knows what it stands for, will be able to reduce or avoid such transmission loss. This same message would of course be relevant for senior CEOs from other global industry groups, but there is in my view no business that offers more challenge and opportunity than now faces the CEO of a major financial services firm.