

Ladies and gentlemen, when I was asked to talk about the development of the financial services industry over the next ten years, I immediately thought of Mark Twain, who famously pointed out that: The art of prophecy is very difficult, especially with respect to the future.

And the critically acclaimed Japanese author Haruki Murakami says in one of his books that evolution is like floods and avalanches and earthquakes. You never know what's happening until they hit, then it's too late.

If I listened to these gentlemen's warnings, I'd finish my speech here and now. But this would probably leave you feeling short-changed, ladies and gentlemen. So instead I'll follow the advice of Confucius, who took the view that: Men who do not care about the future will soon have trouble.

And even if evolution is like an earthquake, we can at least make sure that our home won't collapse when the very first tremor strikes. So it's certainly worth venturing a look into the future – at least into the future for the banks.

Let me say straight away: I won't be talking about the technical innovations awaiting us in the coming years. Nor will I try to come up with a one-size-fits-all business model for the bank of the future. Because there's one thing I'm absolutely certain of: the banking landscape in ten years time will be at least as diverse as it is today. What I would like to do is sketch out a few of the lines along which I think the banking industry is going to develop – the basic future direction of evolution, so to speak.

I believe there are three major trends which, though not specific to our industry, are going to have a particular impact on banking:

- increasing industrialisation,
- continuing globalisation and
- demographic change.

## **I.**

### **Industrialisation encourages focus**

Ladies and gentlemen, banking is based above all on discretion, trust and high-quality advice – concepts which at first glance would appear to have little to do with industrialisation. In reality, however, they are simply two sides of the same coin.

The banks expect industrialisation – that is to say the standardisation and automation of processes – to deliver not just greater cost-effectiveness, but also significantly higher quality. This is because the standardisation of existing processes and practices generates scope for innovation and does much to allow banks to focus on their core business. This, in turn, helps to improve quality.

But industrialisation has further implications. Just as a good shoemaker can obtain high-quality leather without having to raise cattle himself, banks, too, will start contracting out processes more than they do today. This will involve both the use of external specialists – that is to say outsourcing – and greater co-operation with competitors to exploit economies of scale.

Even if we have already seen some progress in this regard, particularly in IT and clearing and settlement, there is unquestionably still too much vertical integration in the banking industry.

### **Greater focus on corporate lending**

To date, we have seen industrialisation first and foremost in the retail area. Now, however, the focus is shifting increasingly to corporate banking. So it's hardly surprising to find that this is where banks currently identify the greatest potential for more efficient processing. According to a survey by Steria Mummert Consulting in collaboration with the F.A.Z Institute, almost two thirds of the banks interviewed see potential for further standardisation in processing corporate loans. In contrast, only around one third of the private banks interviewed saw potential in consumer lending.

### **Be aware of the risks**

Naturally, the potential risks associated with industrialisation should not be ignored. This applies, for example, to the security of data processed outside the banks. Proper monitoring is absolutely essential. It should also be borne in mind that re-insourcing is normally an extremely time-consuming and costly undertaking. Outsourced services must therefore be subject to rigorous control, not least with regulators' requirements in mind.

Nevertheless, the risks are outweighed by the benefits. And increasing competition, together with profitability levels that still lag behind those of our international counterparts, make it especially important for the German banks to continuously appraise their ongoing activities. Evolution also means diversity. The decision whether to make or buy is closely linked to the issue of core versus non-core competencies.

Banks will have to develop their own individual strategies for future success in the market. The standardisation of processes and outsourcing of non-core competencies will play an important role in helping them to find and refine an optimum structure.

## **II.**

### **Globalisation requires adjustments**

Ladies and gentlemen, industrialisation is closely linked to the second trend I'd like to mention – the influence of the international division of labour and an increasingly interconnected global marketplace. In short: globalisation.

The competition triggered by globalisation is forcing the financial industry to constantly make considerable adjustments. Today's information and communications technologies make it possible to offer services and do business all over the world. In the banking industry especially, geographical barriers are becoming less and less important.

But the banks cannot tackle all the necessary changes on their own. Let me be quite clear: it is up to policymakers to create the right environment to establish a competitive financial centre. Wrong decisions and procrastination can quickly result in innovative markets taking root elsewhere. Once this happens, it is extremely difficult to attract some – let alone all – of the lost business back to Germany. It is therefore to be warmly welcomed that the Federal Finance Minister Peer Steinbrück has set in motion the legislative process to introduce real estate investment trusts in Germany and wants to see REITs start operating at the beginning of next year.

### **Policymakers must establish framework conditions**

Policymakers seem to have recognised the importance of the financial markets. Germany's

governing parties have for the first time devoted a specific section to the financial markets in their coalition agreement and have made strengthening Germany's position as a financial centre one of their key objectives. This is only logical, since a flourishing financial market can make an important contribution to reigniting strong economic growth in Germany.

The creation three years ago of Initiative Finanzstandort Deutschland, or IFD for short, saw the launch of a highly ambitious project aimed at strengthening Germany as a financial centre. Market practitioners and specialists from banks, insurance companies, Deutsche Börse, the Federal Ministry of Finance, Deutsche Bundesbank and last but not least industry associations – including, naturally, the Association of German Banks – work across competitive boundaries on pragmatic solutions.

The idea behind the IFD is to strengthen Germany's financial industry by promoting product innovation. Its goals are to stimulate growth in the financial services industry and in the economy as a whole. It deals with matters as diverse as improving financial literacy, financing SMEs, eliminating bureaucratic hurdles and developing property markets. And that is just to name but a few.

### **European financial market integration is progressing at differing speeds**

Another important sphere of activity is European financial market integration. Europe's single market will be the biggest integrated financial market after the US.

But integration is proceeding at different speeds in different sectors of the market. In the market for corporate loans, the proportion of cross-border transactions has already risen sharply since the introduction of European economic and monetary union. Lending by German banks to companies in other member states, for example, more than doubled between 1999 and 2005. Conversely, German companies are making increasing use of the services of banks in other EU countries.

The retail sector, on the other hand, is lagging behind. This is all the more unfortunate since the "European on the street" would benefit directly from greater integration. There are many reasons for the slow progress: differences in language, in payment habits and, above all, continuing differences in national consumer protection rules.

These make it virtually impossible for a bank to offer a product such as a consumer loan in another member state without making substantial changes to ensure that it complies with local rules and regulations. This is hardly conducive to integration. As things stand, consumers are unable to exploit the potential of the European market. I am confident, however, that we will see progress here in the next few years and believe the European Commission is quite right to put this issue at the top of its agenda.

### **Consolidation often merely domestic**

The integration of Europe's financial markets ought also to encourage the consolidation of its banking market. Up to now, however, the number of mergers and acquisitions between banks in different countries has been limited. This has prompted the Commission to try to identify possible obstacles to cross-border consolidation.

At first glance it hardly seems surprising that most banking mergers still take place at national level. It is, after all, quicker and easier to achieve synergies in a domestic context. In consequence, the last few years have seen a considerable amount of successful consolidation within individual member states.

The exception is Germany. Despite the progress made by the German banks, the market undoubtedly remains too fragmented compared to its international counterparts. The five biggest banks in Germany have a combined market share of only 22% – the lowest in Europe. In countries such as Belgium, Finland or the Netherlands, the five biggest financial institutions share over 80% of their domestic market.

This situation is due first and foremost to Germany's rigid banking system with its three distinct groups, or "pillars". More than 40% of the German banking market is still in the public sector. True, it is possible for public-sector banks to acquire private ones – and indeed they do so. But for political and legal reasons, this cannot happen the other way around.

This barrier is a major reason why the German banks, despite their notable success in restructuring, are still languishing at the bottom of the European league table for profitability. Numerous institutions – such as the International Monetary Fund, the European Central Bank and the OECD – have been saying for years that the best strategy for the German banking market would be market-driven modernisation with a dismantling of the current compartmentalisation.

### **A single supervisory regime for the single market**

Ladies and gentlemen, leaving aside this special feature of the German banking system, the reasons for the comparative lack of cross-border consolidation in Europe so far are many and various.

Direct obstacles are outnumbered by indirect ones. Indirect obstacles exist when different legal systems, while not actually ruling out mergers or acquisitions, make them commercially unviable. An insufficient level of harmonisation in European banking supervision, for example, reduces the economic benefits of cross-border consolidation quite considerably. Banks wishing to offer products in various member states have to satisfy differing requirements imposed by different national regulators. In today's EU of 25, there are a total of 49 supervisory authorities. A single financial market needs a single supervisory regime, in my view.

The gradual Europeanisation of financial supervision should lead in the long term to a single institution responsible for supervising banks that operate across the EU. National regulators, on the other hand, would continue to be responsible for banks operating exclusively at national level. The European System of Central Banks could serve as a model for such a regime. An arrangement like this would considerably accelerate the integration of the Europe's financial market. It would be an important step to better regulation.

### **US banks lead the way in profitability**

But if we are casting our eyes to the future, we mustn't focus on Europe alone. The world's 5 biggest banks by market capitalisation currently include only one European bank, but three US financial institutions and one Japanese bank. The situation is the same if we compare tier 1 capital: three US banks versus one European and one Japanese bank.

Despite the success of recent years, Europe lags behind in profitability, too. Last year's average return on equity at US banks was around 29% before tax. In the EU, the figure was 21%. And though German banks managed to almost double their ROE compared to the previous year, at 13% they still trailed far behind their competitors.

The big banks of our day are US financial institutions. But their domestic market now offers them little opportunity for growth in the retail or corporate sectors. So it is only a question of time before they seek to expand their activities in the European market.

### **US success in investment banking**

Let us cast our mind back: we saw a similar development in investment banking. American banks now play a leading role in investment banking in Europe. US banks' market share in issues of euro-denominated bonds in the euro area, for example, soared from 2% in 1995 to 32% in 2001.

It's a similar story when it comes to European share issues. The market share of American investment banks rose from around 10% in 1995 to 37% in 2001. So we in Europe have no time to lose; we need to act now.

### **Growth potential in the BRIC states**

But the banks can and must succeed in future in participating in growth markets not only in Europe and the US, but also worldwide. The countries on everyone's lips at the moment are the BRIC nations –Brazil, Russia, India and China – with their above-average economic growth. And a number of other threshold countries are also highly promising markets.

Consumer loans, current accounts and private pension products are still extremely thin on the ground in these markets. Experts have identified a growth potential in the lendings business of 20 to 30% in the medium term. Even today Latin America's banks, for example, are among the most profitable in the world with an enviable return on equity of 33% before tax. Conversely, it is in the interests of the threshold countries themselves to open up their banking markets to foreign banks since this will deliver higher-quality and more diverse financial products.

### **Make market access easier worldwide**

Nevertheless, ladies and gentlemen, even if the threshold and developing countries currently offer excellent prospects, foreign banks trying to become established there still face considerable disadvantages. Access to the "gardens of growth" is highly restricted at present. Banks are limited to certain forms of establishment, for instance, and there are often constraints on the activities they are allowed to engage in.

Recent years have seen some progress in eliminating these obstacles – whether by liberalisation measures negotiated under the auspices of the World Trade Organization, the WTO, by means of bilateral free-trade agreements or even by some nations opening up their markets unilaterally. Nevertheless, a swift revival of the Doha round is needed more than ever. It would be illusory to believe that bilateral negotiations can offer a viable substitute. There is simply too much to do, especially where the threshold and developing countries are concerned.

### **Regulatory spillovers impede integration**

As well as impediments to market access, differing or even contradictory rules and regulations – so-called regulatory spillovers – also hamper the integration of the world's financial markets. This applies to the transatlantic financial markets, too. Recognition of home-country regulation often requires prior convergence of the national rules involved. Such convergence would not only facilitate market access, but could also reduce funding costs. The result would be significant growth impetus for both economies concerned.

It is therefore gratifying that the European Commission has expanded the regulatory dialogues it has conducted with the US since 2003 to include other countries – Japan and China. The EU-US financial markets dialogue has already helped to prevent or at least mitigate the risk of rules spilling over onto the opposite side of the Atlantic. Such successes should encourage the Commission to continue on its path. All parties to the dialogues are called on to remain at the negotiating table.

Ladies and gentlemen, these examples show that the challenges of globalisation demand a joint approach by the business community and politicians. It is above all regulatory and legal obstacles which need to be eliminated. Even Marco Polo – the founding father of globalisation – could count on political support. It is reported that Kublai Kahn, the ruler of the ancient Mongolian empire, gave him two golden tablets when he set off for home. These tablets were a kind of pass instructing the officials of the Mongolian empire to afford the traveller every assistance. Without them, Marco Polo's return journey would not only have been much more arduous, it would, above all, have taken a lot longer.

Me, I'm a realist. I'm not expecting any golden tablets from our politicians. But I do expect a readiness to respond actively to a changing competitive environment. Otherwise there is a danger of losing relevance. And a strong domestic basis is a key prerequisite for remaining competitive in a globalised world.

### **III.**

#### **Demographic challenges**

This brings me to the third factor I believe will play an influential role in the coming years: the demographic development of our society. This is probably one of the most radical changes we face in the 21st century – an unprecedented increase in the global population coupled, at the same time, with a rapid rise in the proportion of older people.

World population growth is extremely uneven. It is growing above all in the developing countries of Africa, South America and Asia. This means that the demographic weight of the industrialised nations will fall.

At the same time, the proportion of over 60s has risen to around 10%. It is anticipated that the next 50 years will see this figure increase further to over 20%. The proportion of older people will grow at above-average speeds not only in the industrialised world but, above all, in developing countries. Yet as things stand, robust – meaning funded – pension systems are either thin on the ground in these countries or virtually non-existent.

#### **The effects on the financial markets**

The effects of this ageing process will change our world in many ways. Some of these changes are obvious: the workforce in industrialised countries will shrink, for example. Measures such as raising the retirement age, encouraging more women to enter the workforce or employing more older workers can mitigate this development. But, in themselves, they will not be able to compensate for it.

What do these demographic changes mean for the banks? What steps will they need to take to adapt to them? I'd like to leave aside the strategic challenges for the banks' personnel policy. In any event, these will probably become acute only after 2015. Here, instead, are just a few key points:

1. To respond to the lack of qualified workers, we will have to invest more in in-house training.
2. Companies will have to become more attractive to compete successfully for qualified junior staff.
3. The search for qualified personnel will not confine itself to the domestic labour market.

So much for the briefest of brief overviews. As you can see, this issue really deserves a speech of its own!

### **Targeting senior citizens**

Ladies and gentlemen, demographic change is both a challenge and an opportunity for the banks. The challenge consists in being ready to respond to changing customer behaviour. We need to adapt our services and products to the needs of an ageing society. Look at Japan, for instance: the mean age there is 41 – the highest in the world. The economy is adapting to this trend and developing new products accordingly: even today one in five consumer goods are “old-age proof” products. And this market is continuing to expand.

The implications for the banks will be somewhat less spectacular since a bond remains a bond. We can't make its design more senior-citizen friendly or change the colour because it's something virtual, intangible.

Nevertheless, the market requires adjustments. Banks must ask themselves which distribution channels are most suited to this generation. And even if the senior citizens of the future are likely to be well familiar with internet banking, they won't necessarily want to do without personal advice. Given the size of the accumulated assets held by this section of the population, this will be a particularly important task for the banks.

At the same time, it can be assumed that tomorrow's pensioners will be considerably more demanding because they will have had to deal with financial matters from a comparatively early age. This means that, in future, senior citizens will want more from their bank than a traditional savings account or a simply structured bond portfolio.

The quality of advice will become more important in another area, too. The range of pension products is already highly complex. It will be up to the banks to assist their customers in making informed selections.

There are also opportunities to be seized in new markets: central and eastern European states and numerous threshold countries have a largely underdeveloped system of funded provisioning for old age. And these countries' problems with an ageing population will become acute only at a later stage.

Many countries, particularly our neighbours to the east, are in the process of switching their pension systems to funded schemes. Banks with a track-record of expertise, not least in the area of occupational pension schemes, can play an important role here. Demographic developments should therefore be considered not only in terms of risk.

At the same time, there is no cause for complacency. It will be crucially important to take timely steps – meaning immediately – and to remain, or become, flexible. For banks that position themselves in good time, upcoming demographic developments offer a number of

promising opportunities to do business.

### **Conclusion**

As you can see, ladies and gentlemen, you don't need to be a clairvoyant to look into the future. Though it's impossible to make exact predictions, it is certainly feasible to identify a few major trends. I haven't been able to say all that needs to be said, but it's tricky to sum up ten years in thirty minutes or so. And, naturally, I'm a businessman, so I don't want to give everything away. As the Greek shipping tycoon Aristotle Onassis put it: The secret in business is to know something that nobody else knows.

Thank you for your attention!