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Financial World Transformation

Introduction

It is my pleasure to develop some thoughts on a topic that has been called a little grand: 'Financial World Transformation'. I would rather describe it more modestly as: 'What is really going on around us and is there some hope that we can cope with it in the future?' ECN's (Electronic Communication Networks), E-Commerce combined with UMTS (Universal Mobile Telecommunications System) as the next data revolution - just to name a few - present not only in words a formidable challenge inconceivable only a few years ago.

My observations have a European background and are based on experiences in a rather small, progressively profitable but self-standing entity of a large concern. This was and is based on three words beginning with a 'c': culture, class and cohesiveness - something that some firms have nearly forgotten to the point of becoming hard to identify.

I. The new environment - driving factors

1. From regionalization (like Euroland) to globalization

The recent efforts to merge the main European stock exchanges mark just an interim step in the drive to have one world exchange as the 'end state'. This is a firm prediction by many eminent personalities that are wise and worldly but they may overlook the implications for the profitability of their business.

That any related business segment faces the same future, is a foregone conclusion. Given the considerable legal, practical and human resistance obstacles, it may take some time. But it seems an inevitable development for all goods that are tradable in exactly the same form a million times over. Not only securities but many other similar businesses will be part of the globalization. In this process globalization is inevitable, unstoppable and irreversible. Global data streams, world-wide web and electronic exchanges are driving a rapid transition from national to global economies. For Europe, a historically fragmented continent of individual nations, this means jumping two steps in a very short order. Therefore, the resistance level is not to be underestimated.

2. Demographic momentum and changes in the pattern of retirement saving

The growing age expectation of billions of people will force different patterns of behavior to accommodate the increasing population in a static territorial space. The biggest single factor emanating from this momentum is the need for higher returns in retirement savings.

Although prevalent in the Anglo-Saxon world and a few other countries, many large populations still have to change from state pensions to higher-yielding securities investment. This will obviously change the pattern of their capital markets.

This development is not without inherent dangers as a sharp and/or lasting decline in share prices would undermine the confidence in this new found retirement system. This particularly applies to countries that have just made or are about to make this change.

3. Institutionalization gives smaller investors greater power

The sheer magnitude of the number of securities on offer today has produced a lasting shift to professional intermediaries: Millions of people that were individual investors are now investing collectively through investment funds or similar institutions. Through such institutions they now exercise a great deal of indirect power which they could never even dream of achieving themselves.

From the perspective of corporate control, this change resulting from the need for higher returns is quite significant. No longer can even European Continental companies be immune to sensible requests to increase shareholder value and institute proper Corporate Governance. By giving their mandate to professional institutions as intermediary, the general public has vastly increased its power to ask for a proper balance between the interests of companies and shareholders. This equally applies to the governance of the securities markets where significant improvements have been achieved in takeover regulations and market practices. A lot more is on the way in terms of institutionalization as the institutions themselves have millions of customers asking for better performance.

4. Convergence of financial market players

Despite a few false starts lately, we will see a growing convergence of financial market participants. Looking into the crystal ball, I would rather put my money on cross industry mergers. One example is that it makes more sense for an insurance company to use an existing retail bank network if the insurer wants to drive its consumer services through stationary retail outlets. This was an important element driving the much discussed 'Allianz/Deutsche/Dresdner' deal. Given the deep cultural roots of European banks it is a lot easier to 'cross fertilize' than to insist on blending the best in a 'merger of equals'. In such a convergence, the identities can be much better upheld than in a forced combination of two operators in the same business line where one has to be the looser in image and reality.

5. Internet and other technological developments

Lower transaction costs, higher turnover, increased transparency, global networking and increased connectivity will force further changes in the financial markets. In a macroeconomic sense it will dramatically reduce the cost scenario for many industries (including the financial). This significant cost saving will, however, not be achieved on a gross basis. It can only be counted on a net basis after deducting the cost for important items like social payments for the inevitable redundancies.

So, efficiency has its price; not only in a monetary sense, but the human factor of large scale dismissals has not yet been properly evaluated and needs an intelligent solution quickly.

II. How to cope with the new environment - key determinants of success

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1. **Determine the real client needs**
2. **Accept inevitability of change and drive innovation**
3. **The danger of overloaded designs: Define precise business profile and model**
4. **Consultant and other dangers**

1. Determine the real client needs

This is obviously easier said than done as so many profound changes force constant adjustment of well conceived general plans. Reacting to each and every change will not do the trick but having the whole team in a constant process of search for the better solution could be the best advice of a distant observer. The best approach is still to ask the customers what they want as they are the ones who pay for your services, clients might be willing to share in the development of particular pieces and carry a certain amount of the development costs.

2. Accept inevitability of change and drive innovation

To really accept the inevitability of change is one of the better ways to cope successfully with the new environment. While it is quite wrong to change for change's sake, changes that are coming anyway should be pushed aggressively through the organization. Proper reward of compliance with the need for change seems to be the better approach than encouraging resistance. The same reward pattern should be implemented for the drive of innovation. Even in your technical environment, clearly defined incentive structures work wonders for achieving the right results and competitive spirit. I would certainly encourage you to increase the performance relates pay component - otherwise your best people will realize their better ideas with your competitor!

3. The danger of overloaded designs: Define precise business profiles and models

This does not need a great deal of discussion in a technical environment. It is, however, astonishing how many serious players cannot define a precise business model. They easily succumb to the temptation of doing it all in one new system instead of concentrating on the real necessities for the foreseeable future.

4. Consultants and other dangers

This comment will make some consultants quite unhappy: You should beware of their tendency to dominate your development. Only **you** have to lead your firm or division and you should therefore also control the way consultants are used in your business. They can be most helpful for clearly defined tasks. But they need to be set up as partners of change and development, rather than invaders who disappear to the next customer after getting your people all worked-up for a long period.

Another danger that is often appearing is the temptation to sell your own system to other firms. Apart from the obvious problem to give your best ideas away, this tends to occupy your own experts that are never under-employed with a different business. Any extra revenue has to be counted against the diversions resulting from such external business. Do your own thing the best way you can as there will be no shortage of opportunities to tackle additional demands in-house, not only given the tremendous speed of new developments.

III. Consequences for financial markets

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1. E-Commerce - domination - also for high valu-added products and services?
2. Increased requirements for minimum size
3. Regulatory and institutional demands of the new world business order
   - Supervisory matters
   - The drive for competition through ECN's - just an interim step?

1. E-Commerce-domination - also for high value-added products and services?

It is easy to be suitably impressed by the tremendous opportunities of E-Commerce. Internet brokerage and wireless online trading are just a few examples that will produce further adjustments on a global scale. The full domination of the business picture is, however, some years away although the papers seem to suggest differently. In the German retail fund business perhaps 10% - 15% of the total business volume will be handled through the Internet. Why only so little? The reason and the dividing line lies in the extent of added value and service input. So you have to decide to allocate your resources in the fields where you have a future with your customers.

2. Increased requirements for minimum size

Whatever is an easy business from a technical point of view, the minimum size is bound to grow substantially. Operators with no particular niche or proprietary qualities face the verdict: "Up or Out".
The same pattern will hold true from a products and services point of view. Global products need global operators and anyone below will not make the cut. However, as always there will be opportunities for specialist operators for services that have a regional or even local focus. They have to be nimble and even quicker than their world-wide competitors. Is this still possible today and in the foreseeable future? The answer is: 'Yes' for some and 'no' for many others. The best 'yes'-example is the top position that a Swiss private bank enjoys in a recent consultant's survey of global custodians.

The more the factors of intelligence and quality of service come into play, the higher the chances for profitable survival of smaller operators. The human factor remains the most decisive element. Operators that have an entrepreneurial family approach are not only preferred by the young and hopefuls.

3. Regulatory and institutional demands of the new world business order

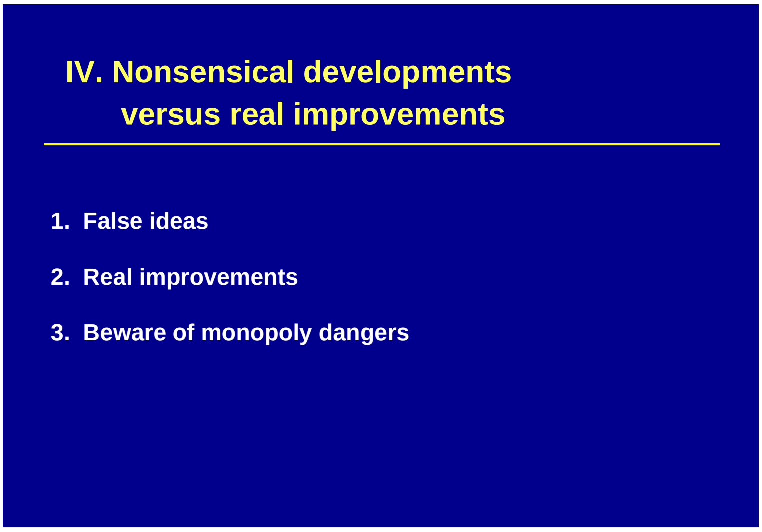
The real tough issues that are beyond the reach of the commercial operators are the regulatory demands of the new business order. This particularly applies to supervisory affairs that are mostly governed by civil authorities that tend to move in a more considerate way.

This must not necessarily be bad: A balance of power between for profit-operators and protection-minded public bodies is useful, particularly for the investors. Undoubtedly the speed of the supervisory authorities is never quick enough for the commercial world and this will never change, if only because of the vastly different compensation structures.

How justified are the demands of large institutions for a faster consolidation in the industry? Their push can become rather strong as evidenced by the undeniably intense efforts to encourage competition through ECNs. This also shows how important it is to keep a competitive environment instead of forcing everything into a one source global affair. The ramifications for the stock exchanges have been born out very quickly: If you take the critics in the UK and Germany on their merger plans for face value, then too much haste has been applied as a result of the commercial pressure. The irony of this development seems to be that neither the UK nor Germany will be the winner. With the takeover of the investment banking operations of Schroders by another American mega firm, no sizeable UK player remains. In all international firms operating in London, the influence of US practices is quite pronounced (as the papers always describe the example of the Deutsche Bank London operations).

This Americanization has many good aspects but Europeans or Asians are well advised to keep good control of their destiny and identity.

IV. Nonsensical developments versus real improvements



Not many front-office people will forgive me for my short list of false ideas:

- This starts with a profound aversion to **day-trading** as a separate business for individual operators. Whilst I have no problem with a short-term trade, this should be part of a well-balanced investment approach and not the only reason for opening a business. I cannot see any real value in this business as the simple result is to fortify trends against a high risk background scenario. Suitable measures like higher reserve requirements and risk provisions should be installed in order to make the life of day-traders a difficult one.

- My second point of dissent is of lesser importance but serves to illustrate unnecessary developments. This is the obligation to make **continuous two-way markets for even a single share**. If you compare the cost of processing a ticket or keeping a watch on limit orders against the sensible way of bunching orders up to a certain minimum size, then you have a perfect example of an overkill in terms of accommodating individual customers.

  Both day-trading and one share market making also have the unwanted feature of giving private investors the idea that equity investment is nothing short of a casino where you can win or loose in a split second. This serves no valid economic purpose and should therefore be discouraged to the extent possible.

- **Stock exchanges should not go public**. These institutions quite simply have too many non-commercial tasks that are not compatible with a full market approach. Among them are setting and governing the rules for admission of securities, supervising orderly trading, setting standards for settlement and other technical functions. In some countries some of these tasks are now the primary responsibility of other bodies; nevertheless stock exchanges must be fully involved in these processes. In general, I see their primary purpose in serving as a business facilitation organization rather than an only for-profit stock market company.

  The main idea behind a going public: to produce money for the acquisition of other stock exchanges, has been put into perspective through the iX merger proposal. Given the still remarkable profitability of the stock exchanges, there is sufficient funding for an expansion. This can easily be increased by loans from the banking world and/or their principal user-shareholders. These shareholders can also exercise their rights of governance and pursue appropriate cost-driving measures much better than the general public. Furthermore, the necessity to meet stringent publicity and other investor requirements of a quoted company may be quite a deterrent for a quotation.

Last not least there is no particular need for one more new company on the stock exchange as the financial sector is already well represented through operators with a clear commercial profile.

Have we seen NASDAQ or the NYSE go public? Australia and Sweden have - but their shares are nothing that you hear a lot about!

2. What are then the real improvements coming from the transformation of the financial world?

The biggest winner is the investor whether institutional or private. They all are the main beneficiaries of globalization and its ensuing developments. Their **transaction costs** that are already down substantially from levels of a few years ago will continue to become even lower. This provokes the question of who drives these processes? Who wants to make less money although the end customer is already reasonably happy? For the distant observer this could easily pose the question of self-destruction if cost cutting was the major propellant for change. A reduction in the quality of execution and service could well be the unwanted flipside of an overdone cost reduction exercise.

Then we have **liquidity** and **speed** that are very welcome improvements. Again, my observation is that most investors are already quite happy with the service they get on these two points. Maybe we are even better off if we move uniformly to a T+1 settlement but I would not advocate to push for same-day settlement. How can you then reverse mistakes that take at least a day or night to discover let alone to rectify?

Another obvious advantage for investors, but this time also for the operators, is the reduction of risk achieved through **netting arrangements on a word-wide basis**. Whether this means that only one clearing and services firm has to survive should be carefully evaluated. Is it not possible to link the systems in such a way that netting is a real feature but some competition remains?

3. Beware of monopoly dangers

Investors therefore have every incentive to see that the competitive pressures are intact but that they do not result in cut throat competition or elimination of all market participants but one. The dangers of a monopoly are too well known not only in the financial world. Whilst healthy competition produces improvements on a continuous basis, this can well be stifled by a monopoly. Then the incentive to move forward is reasonably small, also due to intense price cutting before the establishment of the monopoly. So investors should insist on a minimum of choice or an important governance role. I tend to prefer competition as guarantor of the necessary minimum of competition and new market developments.

V. Soft factors and their impact on lasting success in the fight for survival

It would have been too easy for me to conclude with the comments just made. Having worked in the securities business for close to 30 years I have some observations that are really convictions. These concern the soft factors that are often forgotten in the technical world.

1. Insist on good Corporate Governance - also at your own firm

This concerns good Corporate Governance in the widest possible sense. I am very pleased to see that the new ISSA Recommendation No. 4 has a reference to Corporate Governance. This recommendation says that securities services firms should insist on good Corporate Governance. But as the saying goes: 'Charity begins at home', it is equally important that good Corporate Governance is also fully exercised at your own firm.

It is not enough that some large institutional investors demand the application of meaningful Corporate Governance from big companies; it needs to be lived everywhere including your own place. More and more of your own people expect you to show them your own division of labor and power as well as how to deal with conflicts of interest.

2. Keep or develop your identity

The second soft factor has to deal with the triple 'C' words mentioned at the outset of my speech: **Culture, class and cohesiveness.** This will produce or maintain your own identity. Without an identity your business will easily become marginal, as market participants will not give you preference for anything in your product armory. So be yourself rather than everything to everybody. Your customers will quickly recognize your contribution and even surprise you with more business and that at reasonable prices.

3. Courage and entrepreneurial attitude

Finally: Have **courage** and be an entrepreneur. There is nothing that a skilled operator with entrepreneurial spirit cannot achieve even in today's competitive environment and globalized background. As mentioned before, the motto must be: Either forward or out. I am sure that all of you will stand up to the challenge and serve us investors well.