CENTER FOR FINANCIAL STUDIES

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Transformation in the European Financial Industry: Opportunities and Risks

Lecture by the Governor of the Bank of Italy
Mario Draghi

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Introduction

In the past twenty years total gross financial assets have risen to ten times gross domestic product in the euro area and in the United States. New players have emerged. International financial integration has increased. The financial sector's share of total value added has risen from 5 to more than 7 per cent.

The main drivers of this growth have been innovation and deregulation. The industry has responded with a wave of consolidation, to exploit economies of scale and scope, and with new business models, to offer customers financial services ever better tailored to their needs.

This phase of rapid growth and innovation has brought new opportunities but also new risks. As a result, regulators and other policy makers face new challenges.

1. BANKS

Over the last decade the banking industry has been reshaped by two main trends: consolidation and a shift towards a new pattern of intermediation, the so-called originate-to-distribute model (OTD).

After getting started in the nineties in the US, financial consolidation swept the world. Since 1995 there have been about 20,000 deals, worth more than 3 trillion euro. So far most mergers have been domestic and within-industry. The share of cross-industry transactions has been relatively stable, between 20 and 25 percent of total value. Cross-border mergers, although limited, have been rising steadily. Over the past ten years there have been about 30 large mergers involving banks with at least 100 billion euro in assets. Consolidation has brought efficiency through economies of scale and scope but has also heightened the complexity of operations and of risk management, as well as raising competition issues.[1]

The shift from traditional banking, which mainly meant holding loans to maturity, to the OTD model has also resulted in a seismic change of the financial landscape. Asset-backed securities, almost negligible ten years ago, are now worth 9 trillion euro; in the US, where this process is most advanced, 50 per cent of the mortgage portfolio of banks has been securitized.

Financial innovation has increased the number of products available. Revenues in new business areas have surged. To capture them, the intensive use of information technology, and more generally the relentless exploitation of technological innovation, have become indispensable. This in turn implies high fixed costs that need to be spread over a large customer base. Whether this is achieved through an extensive retail distribution network that by itself represents an additional fixed cost or by catering to the needs of many large investors, for firms that act globally size has become a necessary condition for profitability.

Deregulation has promoted competition by removing legal and regulatory barriers to consolidation, both within and across countries, and across segments of the financial services sector.

Large financial conglomerates have emerged. They are global in nature and their activity increasingly relies on capital markets and fee-based income. Today the world's top ten banks each have assets in excess of 1 trillion dollars, whereas in 1995 the largest barely had 500 billion. Net interest income has declined from 60 per cent to around 40

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[1] ICMB, *International Financial Stability*, Geneva Papers on the World Economy, 9, 2007.

per cent of total income, while the share generated by a wide variety of services has increased. In 2006 the top ten banks sold 240 billion dollars worth of asset-backed securities.

In Europe the harmonization of accounting and supervisory practices is likely to stimulate cross-border deals. The domestic concentration that prevails in Europe – notwithstanding some highly visible cross-border deals – may have reached its limit. In most countries the market share of the largest banks is already high, and antitrust authorities are not likely to authorize further mergers.

Current developments in financial markets will probably lead to a divergence in banks' performance and, once the dust settles, stimulate cross-border consolidation. And the recent substantial variations in exchange rates might also be conducive to cross-border mergers and takeovers.

However the consolidation process is not irreversible, nor does it take but one shape. When size brings excessive complexity and poor risk management, eventually destroying value, market forces will act swiftly. That institution will be broken up, though this does not usually reduce the degree of concentration of individual lines of business, since the buyers themselves are likely to be large institutions.

The risk-return profile of the banks is changing. Financial stability depends increasingly on how large financial institutions deal with complexity and with capital markets, not just credit risk.

How might the structure of the financial services industry change in the wake of the recent crisis? Essentially, this is a crisis of the OTD business model. From a structural perspective the extraordinary success of this model in the last five years has had two main consequences: it allowed traditional banks (retail, corporate, mortgage lenders) to expand their activity to unprecedented dimensions, and it further blurred the distinction between commercial and investment banking. Commercial banks quickly became repackagers and securitizers of loans, other institutions' as well as their own. For investment banks, OTD relaxed a constraint on the expansion of their operations, so they could finally lend to clients on terms competitive with commercial banks. This blurring of roles weakened the incentives for mergers between commercial and investment banks. The blossoming of the OTD model also increased the value added of retail networks, thanks to their potential for origination, thus promoting consolidation across retail institutions.

It is too soon to tell how the crisis of the OTD model may change the structure of banking, but it is hard to imagine that the industry will abandon securitization. The OTD model, together with the explosion in the use of credit derivatives, has now become the real engine for the development of the secondary market in bank loans, which did exist before but on a far more limited scale.

Faulty, possibly fraudulent origination (especially in the US sub-prime market), weak incentive structures in the securitization chain, excessive complexity of the resulting products, serious shortcomings in the rating process and its perception by investors, and most importantly a general repricing of risk underlie the present crisis. As one can see, the OTD business model has shown cracks in some of its components, but I think it is too valuable to all parties to be abandoned. The primary responsibility for adapting the model in a manner that restores market confidence will fall to the private sector.

The role of the public sector is to supplement private sector efforts by adding discipline where this is needed to strengthen the resiliency to the OTD model. The areas being examined by the relevant supervisory and regulatory committees comprise greater oversight of the origination process, greater transparency of the financial products being sold, more balanced incentive structures between the securitizers and the final absorbers of risk, and revisiting the inherent conflict of interest of rating agencies and their rating assessment.

A final word on liquidity management. Recent experience has shown that the OTD model calls for careful, skilled management of the liquidity risk that is usually associated with large firms. In spite of the improvements that may be introduced in the future, the OTD model will always challenge smaller institutions that cannot benefit from scale economies in funding and liquidity management.

2. ASSET MANAGEMENT

Globally over the last decade the asset management industry has grown at almost 10 per cent a year, to more than 16 trillion euro invested in mutual funds at the end of 2006. In Europe the industry has reached total net assets of 8 trillion euro, or about 70 per cent of GDP.

The European industry is dominated by banks and insurance companies, whose market share amounts to nearly 90 per cent in most continental European countries, as opposed to less than two thirds in the US and UK, where independent providers play a larger role.

The pervasive role of banks and insurance companies affects the structure of the continental European asset management industry. First, mutual funds are largely distributed through captive networks (where banks and insurance companies distribute in-house products)[2] and domestic players dominate the market for institutional mandates (in the UK investment funds are mainly distributed by independent brokers, and international players manage nearly half the institutional mandates).

Second, the industry is fragmented and structured along national lines. The market share of the top five players in terms of assets under management is nearly 50 per cent on average in individual countries but only 10 per cent in the EU market as a whole.[3]

Two forces may soon reshape the European asset management industry. On the supply side, regulatory changes are opening up the field for competition. At the same time, demand is changing considerably in response to aging and pension reforms, which expose households to financial and longevity risk.

The MiFID directive, which came into force on the 1st of November, strengthens investor protection by introducing new rules on advice, disclosure, conflicts of interest, and fees paid and received by intermediaries. These provisions go in the direction of ensuring that consumers receive objective guidance that helps them make informed choices; coupled with improvements in consumers' financial education, they will heighten competition among asset managers. The regulatory framework is also affected by initiatives at Community level, to foster cross-border integration of the asset management industry. These initiatives culminated last year with the adoption of the

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[2] Retail inflows to third party products range between 10 and 25 per cent of total inflows. Cfr. The Boston Consulting Group, *Playing the long game, Global Asset Management 2006,*

[3] Cfr. Observatoire de l'Epargne Europeenne - Zentrum fur Europaische Wirtschaftsforschung, *Current Trends in the European Asset Management Industry, Lot 1,* 2006.

"White paper on investment funds",[4] which envisages measures ranging from facilitating fund mergers and asset pooling across Europe to permitting asset managers to set up funds in any European market.

Changes in demand are also likely to influence market dynamics. As public pension systems become less generous and private pension plans shift from Defined Benefit to Defined Contribution, aging households are increasingly subject to investment risk and longevity risk. They might prefer to hedge these risks, giving the asset management industry an opportunity to provide this service. This is particularly true for longevity risk, since at the moment the annuity market is very small, possibly because as yet nobody has devised a truly convincing way of hedging or diversifying this particular form of risk, which has systemic characteristics.

Investors are also starting to shift away from the traditional single-manager, long-only funds. As this trend gathers momentum, the industry may be polarized between commoditized passive products offering exposure to markets at very low cost (such as ETFs), on the one hand, and truly active high-price specialist managers (such as hedge funds) on the other.[5] This would stimulate innovation and intensify the downward pressure on the cost of traditional products.

These two forces - cross-border competition and demand for new products - increase the fixed costs of research and marketing and require efficient "product factories" and distribution networks, thus leading to consolidation. In the medium term competitive pressures and the benefits of selling third-party products – not least in terms of lower

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[4] Cfr. European Commission, *White paper on enhancing the single market framework for investment funds,* COM(2006) 686 final.

[5] Cfr. McKinsey&Company, *The Asset Management Industry in 2010*, p. 7, 18 e 26, 2006; McKinsey&Company, *2015: The radical redesign of the asset management chessboard*, p. 10-11, 2007, UBS cit., p. 41, 2002; The Boston Consulting Group cit. , p. 11-14, 2006.

reputation risk due to the elimination of conflicts of interest – will likely induce vendors to adopt "open architecture" models of distribution and focus on investment solutions for investors rather than the direct manufacture of products.

Changes may already be under way, if slowly.[6] Vertical integration is decreasing, as banking and insurance groups are weighing the pros and cons of producing investment products as opposed to distributing third-party products. Some leading US banking groups have recently sold their asset management divisions to independent investment managers,[7] in order to concentrate on core activities and avoid the conflicts of interest inherent in the marketing of in-house products. These changes could set the stage for the emergence also in Europe of a few specialized asset managers operating on a truly continental and possibly global scale.

Much has been done to foster competition and protect investors, but some unresolved issues still need the attention of policy makers. As noted above, MiFID and other regulatory initiatives go in the right direction of integrating domestic asset management markets. But in order to guarantee a truly level playing field, it is crucial to guarantee consistent interpretation and enforcement of the regulations throughout Europe, as well as effective cross-border supervision, which requires convergence of national supervisory practices and coordination among the competent authorities.

The boundaries among the different financial products are being blurred. It is therefore crucial, for customer protection, to ensure a consistent approach for all products.

[6] Cfr. UBS cit., p. 43, 2002; The Boston Consulting Group cit., p. 15, 2006; The Economist, *A survey of asset management*, 2003; ZEW cit., p. 38-45, 2003; OEE cit., p. 7-9 2006.

[7] The most significant deals over the last two years are the following: in 2006 Merril Lynch sold its asset management division to BlackRock for a minority stake in the latter; in 2005, Citigroup swapped its asset management division for the retail brokerage business of Legg Mason. Cfr. The Economist, *BlackRock and a hard place*, February 18th 2006; The Boston Consulting Group cit., p. 18, 2006

Nowadays, investment products such as investment funds, unit-linked life insurance, and structured notes, though they have similar risk-return profiles, may follow different marketing and sales disclosure regimes. This may give rise to regulatory arbitrage, harming investors. The problem is being investigated at the EU level and in international cooperation forums. Some national legislators are also tackling the issue; for example, in Italy a recent law provides that the same rules of conduct apply to all financial products, regardless of their nature.

Another important issue relates to the spread of complex and lightly regulated investment vehicles, such as hedge funds. More and more of their resources come from insurance companies and pension funds, so regulators and supervisors ought to tighten the fiduciary obligations of institutional investors investing in hedge funds on behalf of their retail clients, in order to avoid excessive risk-taking with what amounts to households' retirement savings.

An additional area of policy intervention is financial literacy. According to surveys, households' financial literacy is poor even in countries with a long tradition of stock market participation, such as the US and the UK. Financial literacy is necessary to plan wisely for retirement and to invest efficiently; financial education programmes should aim to raise awareness of the benefits and risks associated with participating in financial markets.

Finally, there is the issue of longevity risk. In principle a market solution would consist in the availability of financial instruments linked to a longevity index. However, the only experience with a bond of this type has not been successful.[8] Lack of demand for such products may be explained by the absence of incentives for pension funds to internalize the cost of unexpected increases in longevity. The main problem with longevity risk is its systemic dimension, as it affects the entire population. Governments could issue longevity-indexed bonds in order to create the critical mass needed to start a market, but they themselves are exposed to longevity risk through the public pension system and social security. An alternative form of public intervention would be the provision of incentives for inter-generational risk-sharing, as by allowing payments by pension funds that are contingent on cohort longevity.[9]

3. MARKET INFRASTRUCTURE

The infrastructure of financial markets – which includes trading exchanges, payment systems and post-trading systems – is crucial to the competitiveness and stability of the financial system; for example, the cost of listing is a key determinant of firms' propensity to go public;[10] trading costs vary by an order of magnitude from the least to the most efficient market; in a globalized world, firms and investors shop around for the most efficient combination of costs and services.

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[8] The only longevity bond issued by a private institution was engineered by BNP Paribas and issued by the European Investment Bank for the UK pension market. Payments were linked to survivor indices based on mortality rates of males aged 65 in 2003 in England and Wales (see OECD Financial Market Trends, p. 159).

9 A possible solution would be to shift from final-pay with recovery premia schemes to schemes that are based on career averages with conditional pension rights; this would make younger workers share wage risk with older ones and moderate the increases in contributions that would be needed should the fund experience a shortfall in assets. In essence, older participants would have senior claims on the fund's assets, while younger ones would have equity-type claims (see ICMB, *Dealing with the New Giants*, Geneva Papers on the World Economy 8, 2006)

[10] See Pagano, Panetta and Zingales, Why Do Companies Go Public? An Empirical Analysis, Journal of Finance (1998), no. LIII-1.

3.1 Stock Markets

Over the last ten years stock market turnover has increased from 42 to 137 billion dollars a day in the US and from 20 to 85 billion dollars in Europe. More than 14,000 firms have been listed across the US and the European Union and, after the slump following the burst of the dot.com bubble, the market for IPOs has regained strength; in the past few years private equity deals have grown exponentially.

Innovation and deregulation have sharpened competition among trading venues, inducing national electronic platforms operating as near-monopolies to question their strategic positioning and governance. After demutualization, exchanges have become competitive profit-oriented organizations. Today the main trends in the industry are consolidation and competition with intermediaries, which are increasingly able to internalize their customers' trades.

In Europe, consolidation started among local exchanges and between cash and derivatives markets, then expanded at a regional level with the creation of Euronext. This year was marked by a merger between exchanges using different currencies (Euronext and the NYSE), bringing consolidation to a higher level, involving five countries, two continents and twelve different cash and derivatives exchanges. Other significant mergers were those between Borsa Italiana and the London Stock Exchange and between Nasdaq and OMX.

Consolidation allows financial exchanges to benefit from the network externalities that are necessary to reach a critical mass of issuers and investors and to attract international trading. Larger exchanges benefit from increased liquidity, which results in reduced volatility, narrower bid-ask spreads and lower trading costs.[11]

Before worrying that we might end up with a single, but inefficient, global market place, lacking incentives to innovate and improve the quality of services provided, let us recall that the effects of consolidation may be offset by the emergence of new competitors. Although many alternative trading systems (ATS)[12] have been taken over by exchanges, others are already in the pipeline, such as the so-called project Turquoise, a new equity trading platform supported by leading investment banks. IT providers too are considering the possibility of competing with the exchanges, through exploitation of their expertise in managing strategic technologies.

Consolidation and competition, together with the continuing role of local specificities (information is still produced and gathered locally, especially for small firms, and legal and tax frameworks are still designed at national level) will presumably result in the coexistence of different platforms, each with a competitive advantage in some segment of the market (e.g. start up/blue chips, geographic markets, brokers/dealers markets,[13] etc).

Consolidation and the increasing integration of exchanges present policy makers with new challenges. The first is that the benefits of integration can be reaped in full only to the extent that there is full integration. For example, at the moment there is no common

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[11] See Pagano and Padilla, *Efficiency Gains from the Integration of Exchanges: Lessons from the Euronext Natural Experiment*, A Report for Euronext, LECG, (2005.

[12] ATS are operators originated by large intermediaries that, through proprietary networks or exploiting internet connectivity, create direct trading links among their clients (financial intermediaries, institutional investors, hedge funds, individual investors) that until then had traded indirectly on stock exchanges through brokers. See Domowitz I., Lee R., 1996, "The legal basis for stock exchange: the classification and regulation of automated trading systems", Mimeo.

[13] See also Steil B., 1996, The European Equity market, The Royal Institute of International Affairs.

trading platform between Euronext and NYSE (although there may be in 2008), and since legal and regulatory requirements have not yet been harmonized, firms have to list separately on each exchange.

This leads naturally to the second issue: what regulatory framework is best suited to a rapidly integrating marketplace? Transnational exchanges mean that firms might be subject to the legal framework of their country of residence but regulated as listed companies by a different set of standards. This leaves some scope for confusion and regulatory arbitrage, which would result in higher trading costs and a higher cost of capital. More closely integrated markets require regulatory convergence, which will entail ever greater cooperation among authorities, in order to avoid among other things a deleterious "race to the bottom" in regulation.

The MiFID directive goes in the right direction of creating a more integrated and efficient European capital market by removing barriers to competition. Improvements are nonetheless possible. The Directive states that the trading venues must be made transparent, but doesn't explain how: the gathering and disclosure of the relevant information is devolved to market solutions. But if local specificities continue to dictate tailor-made approaches, they will not necessarily converge on common standards.

Finally, once we have achieved harmonization within the continent, we may soon realize that MiFID is great for Europe but that we are probably already a step behind, as harmonization should really be transatlantic (if not already global), as the most recent deals have made clear.

3.2 Post-Trading

Post-trading infrastructure - the complex network of securities settlement systems, central counterparties and specialized intermediaries such as custodian banks – plays a key role in financial markets, since it affects the liquidity and integrity of trading, portfolio diversification and risk sharing.

Although it is widely accepted that post-trading services are characterized by major economies of scale and scope and powerful network effects, in Europe the industry remains highly fragmented, based on local systems originally designed to serve the needs of domestic markets. There are significant differentials between settlement costs of domestic and cross-border transactions. It has been estimated that an overall trading cost decrease of 18 per cent, achieved by boosting post-trading efficiency could increase euro-area GDP by 0.6 per cent.[14]

The optimal industry structure in Europe would most likely consist in a small number of providers in competition with each other. The regulatory framework should aim only at preserving the contestability of the business. However, if for some reason – market power of service providers, say, or conflicts of interest among users and owners of the systems - the private sector has insufficient incentives to create the conditions for a more integrated post-trading infrastructure, the public sector should take the lead, encourage integration and design incentives for innovation.

In recent years much has been done by the private sector and public authorities to dismantle existing technical and procedural national barriers, along the lines suggested by the second Giovannini Report. Much remains to be done, however. As for the private

[14] Niels Schulze and Dirk Baur, "Economic Impact Study on Clearing and Settlement". European Commission, May 2006.

sector, while the price transparency and the access and interoperability commitments have gone into effect in recent months, the deadline for service unbundling and accounting separation is January 2008. For public authorities the removal of the fiscal and legal barriers remains a key priority for the near future.

In this perspective, the Eurosystem is evaluating opportunities to provide settlement services via the so called TARGET2-Securities system. The single platform for the settlement of domestic and cross-border securities transactions in central bank money would, thanks to the existing TARGET2 infrastructure, increase the security and the efficiency of settlement and speed up market integration. The new system would bring efficiency gains and more intense competition between central depositories in core functions such as custody and asset servicing.

3.3 Payment Systems

The average daily value of payments processed by large-value payment systems in Europe equals almost 40 per cent of GDP. The number of payments for non-cash retail transactions continues to grow rapidly (6–7 per cent in the last five years), slightly more than in the United States.

Card payments are experiencing the most rapid growth in EU retail markets. In the last four years the number of debit and credit cards increased by almost a fourth, to more than 700 million, and their use is increasing even faster (from 10 per cent in the nineties to over 30 per cent nowadays). This reflects structural changes in the market for card transaction processing, where the market share of non-banks - from telecommunication companies to large retailers - is increasing.

The role of non-banks in European retail payments is expected to grow further and might become even stronger than in the US, where they dominate several payment activities. This trend is fostered by ongoing consolidation within the payment industry and by the integration of retail markets, of which the Single Euro Payment Area (SEPA) project is an example. The companies leading the sector in Europe are owned by international IT firms that tackle mass information and exploit network externalities.

Moreover, competitive pressure induces banks to reduce costs by outsourcing a growing number of non-core functions to specialized service providers. Major international financial conglomerates are assigning both payment and securities transactions to the holding company or to a specialized firm within the group.

The introduction of the euro has been a strong driver of integration and innovation. Full integration of the monetary markets within the euro area was achieved rapidly, whereas integration and consolidation of payment systems' infrastructures has progressed at a slower pace. A single payment system for the whole area would generate significant economies of scale and network externalities, but today European financial markets are still fragmented and based on national systems.

As for the integration of payment services to final customers, the Payment Services Directive (PSD) establishes a new category of players – "payment institutions" – that can offer a wide range of commercial and financial products and services in all EU countries. This Directive will enhance competition and innovation. Customers will benefit from payment services based on technologies like the mobile phone, contactless devices and digital platforms. The public sector, especially the Eurosystem, has stimulated progress in payment systems; the TARGET2 system, successfully launched just days ago, will enhance security and business continuity in large-value payments.

However, the new on-line technologies are vulnerable to identity theft, fraud and irregular activities (e.g. money laundering, financing of terrorism). Adequate investment is needed to ensure that efficiency does not come at the expense of security.

4. EFFECTS ON MONETARY POLICY

The development of the financial services industry has been extraordinary both in its own size and compared with that of most other industries. It has also been truly global: domestic monetary and financial conditions are increasingly affected by international developments. On average it has produced larger financial firms and innovations in the business models and in the products that have changed the financial landscape. These developments have had profound consequences on the operation of monetary policy and on its channels of transmission. The relaxation of funding constraints was common both to regulated and unregulated institutions, though more significant for the latter. This accelerated credit growth in good times and shrank it rapidly in bad. The effect of monetary policy on bank credit supply and transmission through the "bank lending channel" have become less powerful than in a fairly recent past, although possibly more dependent on cyclical factors. However, recent events remind us that banks' balance sheets, and especially the capital that support them, remain as key to stable credit markets as before.

Central bank communication has become more important. In more complete and more efficient markets, actual and expected changes in official interest rates more readily affect financial asset prices. This gives monetary authorities an additional instrument for affecting the economy, through their influence on market expectations. At the same time, misunderstandings may be disruptive; unexpected policy actions that diverge from expectations, which are built into asset prices as well as into positions taken on the market, may induce a simultaneous revision in positions and have disorderly effects on liquidity and asset prices.

As a consequence central banks strive to avoid surprises and be predictable in order to reduce uncertainty and volatility in financial markets; but their actions must be dictated by the economic outlook, not the views of market participants. Leadership must continue to be in the hands of the monetary authorities.

Thanks to the wealth of information that can now be extracted from financial markets, central banks can precisely estimate market expectations about crucial variables such as inflation, growth and policy decisions, as well as the uncertainty surrounding them. This helps produce better policy decisions. However, the diffusion of new financial instruments is also likely to affect the interpretation of some of the indicators that central banks rmonitor, especially the behavior of money and credit. Research at the Bank of Italy has shown that monetary and credit aggregates still convey important information for the conduct of monetary policy, but in order to assess this information properly we must consider a larger set of data.

Recent developments have made monetary policy more complex in yet another dimension. The spreading of securitization has enlarged the magnitude of banks' off-balance-sheet items, and contributed to the birth of new non-bank intermediaries, some of which have become systemically relevant.

Events since the summer have shown that this system is inherently prone to liquidity crisis. These crises are large and sudden, and affect both types of intermediary. Central banks face a twofold challenge: to achieve their institutional objectives – price stability, in the case of the ECB – and to maintain financial stability while ensuring that the liquidity they inject reaches the points of the financial system where it is most needed. This last objective has proven more difficult than expected.

Until the recent crisis, for central banks lending at penalty rates to illiquid but solvent institutions and the lists of acceptable collateral and counterparties were fairly uncontroversial. Now they are the object of a ranging reflection within the relevant committees, and the Financial Stability Forum will report on it in the course of 2008.

The financial turmoil of recent months has tested all our institutional arrangements, but central banks generally and the ECB in particular have maintained a monetary policy stance consistent with their target while doing everything in their power to preserve world financial stability. They have shown how important it is to keep a firm anchor for price expectations, especially in times of great market turbulence.