The Future of Global Financial Systems

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In the six months since becoming CEO of Citi, I've spent a lot of time traveling around the world visiting our many regional banking centers. I find it refreshing.

So I appreciate this opportunity to be in London. Of course, with operations in more than 100 countries and trading desks in 90 countries, I can look forward to much refreshment.

I have also learnt that with our focus on the challenges in our own backyard, it's easy to lose sight of something more fundamental that is going on in the world.

Trends that are reshaping the world are also reshaping the global financial services business. As always, the form and content of these changes will be influenced by technology and regulation. As we rethink regulatory and systemic risk issues we have an opportunity to incorporate these trends into our deliberation.

This is what I would like to talk to you about today.

Let me begin with a quick overview of the US before moving on to brighter news.

The long and the short of it is that the U.S. is going through a "rebalancing" on many fronts.

It started with softness in housing prices affecting the sub-prime market. But much of the rebalancing is directed towards shaping up and 'getting fit' for a more normalized environment.

We are in the process of rebalancing away from a very special, unusual time to a business environment where risk premiums, liquidity and savings are closer to normalized levels.

Financial institutions, whether they're banks, securities firms, or investment funds, are rebalancing their balance sheets by shedding assets, raising capital and increasing the duration of their funding. Individuals are re-

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Prezentujemy naszym czytelnikom przemówienie p. Vikrama Pandita, Prezesa Zarządu Citi Banku w Nowym Jorku, przedstawione podczas dorocznej Konferencji Bankowej Związku Banków Brytyjskich 10 VII 2008 r. w Londynie.

Wystąpienie p. Vikrama Pandita ukazuje niezmiernie interesujące spojrzenie na przyszłość globalnego systemu finansowego i jest ważnym komentarzem w debacie o nadzorze regulacyjnym nad systemem finansowym ze szczególnym uwzględnieniem trzech zasad: przejrzystości, równych standardów oraz równych warunków konkurowania na rynku.

balancing their consumption and personal leverage. On a national scale, the dollar is being rebalanced as well.

Housing inventory continues to rise. Buyers of this inventory will need financing from many of the same lenders that are rebalancing their balance sheets. All of us are watching intently how all of this comes together and how quickly the housing market clears.

The summer will be an important time to watch. That's when the housing market is most active. Home sales will indicate whether we are on a short or long rebalancing path.

In the meantime economic numbers continue to reflect the strain and the uncertainty.

But through all these challenges, the secular trends for the global economy and the banking industry are extremely strong. It is easier to observe them when you step away from New York.

Let's talk about some of these trends.

First, enormous amount of wealth creation is happening in the emerging markets.

In 2000, the GDP of the BRIC economies together accounted for less than 15 percent of the G6 GDP. In the next 20 years that's likely to be half and in the next 40 years it is likely that GDP of the BRIC economies together will be larger than the G6.

At the same time there is a significant shifting of wealth from west to east. More than $2 trillion in oil revenues have been transferred from oil consuming to oil-producing nations last year alone.[1]

A considerable amount of this wealth is collecting in Sovereign Wealth Funds which are projected to grow their assets from $3 trillion to $12 trillion by 2015. Today, Asia accounts for approximately two-thirds of the world's $5.75 trillion in reserve holdings, up from just one-third a decade ago.[2]

We're also seeing a new generation of emerging market multinationals. Companies like Tata in India, Embraer in Brazil, and Lenovo in China are taking world leadership positions in automobile manufacturing, aerospace engineering and computers. And they're rapidly expanding into added-value services such as Tata Consultancy, which is our lunch sponsor today.

This is also creating more emerging market billionaires than ever before.

This year, in fact, was the first year in which the percentage of the world's 100 richest billionaires from emerging markets is greater than the percentage from the United States… 37% from emerging markets and 32% from the U.S. according to *Forbes*.[3] That's up from 8% at the beginning of this decade.[4]

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[1] http://www.washingtonpost.com/wp-dyn/content/article/2007/11/09/AR2007110902573_pf.html.

[2] Sir Win Bischoff, London Gateway 2008 remarks.

[3] http://www.forbes.com/lists/2008/10/billionaires08_The-Worlds-Billionaires_Rank.html.

[4] http://www.forbes.com/lists/home.jhtml?passListId=10&passYear=2000&passListType=Person.

[5] "Retail Banking: Facing the Future" *The Boston Consulting Group*.

Of course, wealth creation will happen in the developed markets as well although at a slower rate and the affluent segment is expected to grow twice as fast as the mass market.[5]

All of this suggests increasing demand for global investment opportunities and services such as asset management, portfolio advice and wealth management, particularly in the emerging markets.

The second trend is a d e m o g r a p h i c s h i f t in the developed and developing economies. The population of the world is expected to grow from about 6.7 billion now to more than 9 billion by 2050[6] with most of the growth coming from the developing world.

And while the working age population (ages 20–59) of the developing countries is expected to grow by 55% between now and 2050, it will decline by 8% in the developed countries over the same period.[7]

Middle class population is growing three to four times faster today than the long-term total average, with about 70 percent of that growth coming from Latin America, Central and Eastern Europe, and Asia.[8]

The World Bank predicts that by 2030, the number of people in what it calls the 'emerging middle class' will more than double with China, India, and Brazil leading the way but also in places like Indonesia, Ukraine, and Colombia.

Many of these people have never needed financial services before and banking is a new concept. The millions of "unbanked" may well decide their needs are best served by an entirely new approach. Millions will join our capital markets much along the lines of 401K plans in the US.

It is easy to see increasing demand for consumer banking, nontraditional payments services, mobile money, debit cards and microfinance. These trends are already being reflected in the market capitalization of emerging market banks. Some of these banks are now part of the Global top 20 in market capitalization.

The other side of this trend is the aging population in the developed economies. In the U.S. alone, the first of more than 82 million baby boomers have begun to enter their retirement years.

Between now and 2030, it is projected that the number of working-aged Americans[9] will increase by just 13 percent while the number of people aged 65 and older will increase by 93 percent.

Obviously, this means greater demand for retirement planning and payment services in the developed markets.

The third trend is the a c c e l e r a t i o n o f t r a d e a n d c a p i t a l f l o w s. In the last 15 years, the global economy has more than doubled and is

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[6] http://esa.un.org/unpp/.
[7] US Census.
[8] Morgan Stanley and McKinsey research.
[9] Those aged 20–64.
[10] http://www.fareedzakaria.com/articles/newsweek/051208.html.

now approaching $54 trillion. At the same time global trade has grown by 133 percent.[10]

And much of this is due to trade within the emerging markets themselves. According to the IMF, while global trade flows roughly tripled between 1990 and 2006, inter-regional trade involving emerging Asia rose by 5 times, and intra-regional trade within emerging Asia increased by 8½ times.[11] The Asian block and the Latin American block are likely to be enormous capital and trade partners amongst themselves.

One consequence of accelerating trade is that everything is becoming tradable. And, it's not just on eBay either. Over the counter markets are growing dramatically. Last year, notional amounts of all categories of OTC derivatives contracts rose by 15% to almost $600 trillion.[12] But also, non-traditional actors and companies are offering new products and services. Financial Services are becoming ubiquities and part of the business strategy of many businesses away from traditional financial institutions.

All of this means greater demand for infrastructure services, cash management and custody services, market making and advice. All of which can raise systemic issues as well.

Each of these trends is being amplified by the robust pace of technological innovation taking place throughout the world. That's the fourth trend.

Technology is transforming our ability to serve client needs as it extends the reach of financial services to the unbanked and underbanked around the world.

Innovation also allows us to change the way we deliver services by creating channels that make them more accessible to more people, by simplifying offerings, and potentially lowering costs.

According to one market researcher, global retail banking sales via the internet are expected to be 17 percent of total sales in 2010.[13] That's versus 2% in 2000. And mobile payment transactions are expected to grow at a remarkable 80% percent per year for the next 5 years.[14] That means new channels for banking services reaching new customers.

At the same time the ubiquity of broadband, low cost memory and CPU gives us the analytical capability to customize any pattern of payoffs that is interesting to a client… a 'solution of one' for each and every client.

More than ever we have the ability accelerate the drive from incomplete to complete markets. Over the counter markets for contracts on all that is deliverable or on prices that are observable are relatively young.

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11 http://www.imf.org/external/pubs/ft/survey/so/2008/CAR02608A.htm.
12 http://www.bis.org/press/p080522.htm.
13 CapGemini.
14 "Mobile Banking is Ringing Again" Deutsche Bank research.

One outcome of the technology trend is that entities other than traditional financial service providers can be at the center of delivery transformation… entities such as telecom companies and retailers in cities and internet kiosks in small villages.

Another outcome is that technology allows you to separate out the origination, manufacturing, distribution, and risk taking in financial services.

For example, a retailer or telco can now decide which part of the end-to--end process to participate in.

But the ultimate outcome of all the trends is an incredible increase in complexity implied by a nearly infinite variety of products and delivery channels. Growth and complexity are not new to us. What is new is the potentially enormous scale of the activity.

And of course, our clients want simplicity. They want service, convenience, no-hassle execution and will pay for removing complexity from their lives.

We, at Citi, and other financial services companies are the intermediaries that will continue to take the complexity associated with new payment methods and novel new capabilities and make it simple.

That's the business we're in…we transform complexity into simplicity.

Financial architecture and financial institutions will continually evolve to manage this complexity.

As I said before, we can expect the separation of origination, manufacturing, distribution and risk taking. There will be some, like Citi, who will be involved in the end-to-end process in a universal banking model. There will be others that will be monolines.

There will be those that will internalize risk through pooling. And there will be those that are set up to absorb risk and liability in limited liability vehicles. Some will be part of a systemic risk umbrella and some will be set up to arbitrage the regulatory architecture.

All of this architecture in turn will create complexity around how all these models and institutions interrelate. Market structures, market incentives and regulation clearly provide a road map for well functioning and stable interactions. But, someone always has the incentive to arbitrage stability. And, as we have seen recently, complexity can suddenly spill out into the economy.

I began by saying that the changes to our industry and the associated financial architecture wrought by the global trends will be influenced by technology and regulation.

The technology trends are clear. The regulatory trends are less so. But if there is any consolation in the latest credit crisis it is that it has opened a vigorous global debate on regulatory reform. We therefore have a window of opportunity to get organized around guiding principles that can help financial institutions and financial markets handle the complexity of the future.

To this end, I would like to raise three principles that I believe should be part of any healthy debate.

And I believe the goal of this debate should be global coordination between central banks, regulators, and financial institutions to understand and manage systemic risk.

The first principle is transparency. Markets cannot clear without transparency. We all know that. We're seeing that happening yet again. Fixed income and credit markets are some of the most opaque markets. The rise of OTC contracts, commodities trading, and individualized solutions all raise concerns about transparency and that can lead to illiquidity.

Transparency is simple in concept but difficult in practice. It requires a continual quest to standardize products, putting them on exchanges, creating counterparty clearinghouses, settlement systems and creating market data of prices and volumes of the transactions flowing through them.

It also must involve public disclosure of pertinent risk and financial information by financial institutions that give the market a chance to make informed judgments.

And it means a robust information requirement to the overseeing regulatory agency (by all systemically significant institutions) so that the regulatory body has the ability to understand the risks… not only in each financial institution, but more importantly, so that regulators have a better understanding of the systemic risk in the market as a whole.

This doesn't mean deluging oversight agencies with data. That serves the opposite goal. We need transparency with a purpose. The purpose being to allow the market to function more efficiently.

The next principle is the concept of a level playing field. And I would point to two distinct issues within this level playing field-standards…and capital requirements.

Starting with standards… if we all agree, at least to some substantial extent, that the separating of risk origination, manufacturing, distribution, and ownership is inevitable, then some standards should also be inevitable. Should there be underwriting rules, reporting requirements or capital requirements? Rating agencies, independent monitoring entities, risk bureaus are all important if accredited correctly.

There is a whole debate on accounting standards. Global coherence and consistency can only help. In recent dysfunctional markets, we have seen accounting differ by the form of the institution and the regulatory jurisdiction.

We have also seen that accounting based on mark-to-model has been severely tested with unobservable inputs that try to estimate the market. These are not just accounting issues. They feed into real issues as they impact capital, collateral triggers and other behavior as one misinformed trade sets off a chain reaction of similar trades. So, the question is: are there alternative accounting approaches in dysfunctional markets?

These are all controversial issues that need to be debated if we are to deal with complexity.

The next part of a level playing field is consistent capital requirements for all substantial-sized financial institutions.

We can debate what constitutes "substantial-sized." I would say that substantial size refers to institutions that have systemic significance. And, beyond size, maybe another interesting question might be about what constitutes a "financial institution" in an age where financial services and parallel banking activities are becoming ubiquitous and to some extent interchangeable.

When judging which institutions should be allowed access to the playing field, we should concentrate on their function rather than their form. After all, Chelsea and Manchester United may wear different strips but they're playing the same game.

The same is true of financial institutions. "Functional consistency" is the key. Capital consistency should follow functional consistency.

The last principle surrounds the need for systemic oversight for substantially sized institutions.

Do they warehouse risk? Do they borrow short and lend or invest long? Do they leverage their investments? Most importantly, would their failure impact the financial system in a similarly adverse way?

In the States, we recently saw the unprecedented opening of the Federal Reserve discount window to non-bank dealers. But by definition, unprecedented events set a precedent. And regardless of whether that window is officially opened or closed, the market now assumes that it will be opened if necessary on an ad hoc basis.

This is a hot topic of debate in the U.S. as you can imagine.

Every institution has the right to lose all their money if they want to. But no one should have the right to impose externalities on the rest of the financial system. Once a company gets large enough to impact the financial system, shouldn't it operate under the same systemic risk umbrella in terms of capital, liquidity, and transparency?

Capital and liquidity speak for themselves. Systemically significant institutions need to be as transparent to regulators as regulated institutions are-because without that, agencies that are charged with safeguarding the world's financial systems simply won't have enough information to mitigate systemic risk.

An uneven application of the rules in an environment where capital and talent are mobile and where traditional classifications are being redefined could only make the threat of systemic risk worse.

In other words, applying rules partially is *not necessarily* the second best option to applying them consistently.

So, in conclusion, to realize all the possibilities of the global trends reshaping our world, we welcome a robust regulatory architecture… one that sets standards broad and clear enough to apply to all participants… and yet is flexible enough to be adaptable to unforeseeable changes in a dynamic market.

With the right architecture in place, all these trends—greater velocity of change, greater complexity, greater choice for customers—become drivers of our business not threats to it.

In the end, they will only enhance the importance of intermediaries for expert advice and bespoke services.

Before I end, let me say a word about Citi.

We're restructuring ourselves to take advantage of these possibilities. Our core businesses are squarely positioned against secular growth trends in trade, capital, payments, and wealth creation.

About half of our operations are ex-U.S. and about 35 percent are in the emerging markets. And our five businesses are well-positioned to capitalize on these trends.

We have the largest credit card business in the world and the largest outside of the US.

We have approximately 8,500 consumer finance and bank branches worldwide with more assets outside the U.S.

We have a wealth management business with $2 trillion of client assets that is already #1 in Asia and #2 in both North and Latin America.

As I said up front, we have securities trading floors in close to 90 countries and we can execute in 140 countries with a unique transaction services capability for global clients.

And we're bringing all these businesses closer together in a global universal bank model. That's the dominant model in financial services around the world and the most stable architecture to handle end-to-end processes.

If we take the future trends into account… if we look ahead as we debate the design of our global financial systems, I think we have an excellent opportunity to build an exciting new world for our clients and for ourselves.