SPEECH

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DATE: 10 November 2004
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LOCALITY: Dataföreningen, Stockholm

The securities market today and tomorrow

First, thank you for inviting me to speak at this conference about the Swedish securities market today and tomorrow. Securities markets are of course a significant part of a modern economy and fulfil several important functions, which include mediating information, supplying capital and acting as a channel for risk management. They also undergo an almost continuous process of change, which offers new challenges to operators in the financial sector as well as to public authorities. It is therefore particularly exciting – and important – to be able to discuss these developments here today.

Developments in the securities markets in recent years have been dramatic in many respects. For instance, we have experienced an intensive stock market upturn, followed by one of the largest crashes in modern times. IT shares went from being unbeatable profit-makers according to tabloid headlines to being worth only a fraction of what was promised. However, I am not here to discuss earnings, although the bubble phenomenon is an interesting subject in itself. Today I intend to concentrate mainly on structural change processes.

We have relatively recently witnessed some tendencies to increased *integration* in trading in financial instruments. This includes the closer linking of the stock markets in Stockholm, Helsinki, Tallinn and Riga through the establishment of OMX and – prior to this – the stock markets in Amsterdam, Brussels, Lisbon and Paris through EuroNext. An example of far-reaching integration in the clearing and settlement of securities transactions is Euroclear. The agreement on a merger of the Swedish and Finnish central securities depositories is another example of tendencies towards integration in the securities market.

Understanding developments in the securities markets and what these in turn mean for the future requires an understanding of the economic driving forces behind them. Today I shall discuss some long-term trends that I consider of particular importance. These include changes in the population structure, the demography; technological developments; internationalisation; changes in ownership structure and – as I mentioned at the beginning – changes in what we usually refer to as the financial infrastructure. This refers to the financial markets' railways and bridges; all of the systems that enable financial transactions to be made and the data regarding them to be transported as efficiently as possible, for instance, stock markets, clearing and settlement systems.

In addition to these economic driving forces, regulations play an important role for developments in the financial markets. Later on, the Director General of Finansinspektionen (the Swedish Financial Supervisory Authority), Ingrid Bonde, will give her views on the new EU regulations that are about to be introduced. I shall also touch upon this work and comment from the Riksbank's perspective.

A natural question in this context is why these driving forces and regulations are of interest to the Riksbank. The Riksbank has two statutory tasks, to maintain price stability and to promote a stable and efficient payment system. Both of these tasks give us reason to take an interest in the securities markets. To begin with, it is evident that the Riksbank's monetary policy requires an efficient fixed income market so that inflation will be affected by interest rate decisions. With regard to the payment system, the securities markets are becoming increasingly important to the banks, which in turn are central to the functioning of the payment system. In addition, large parts of the securities market infrastructure are directly linked to the payment system in different ways. The Riksbank therefore has every reason to monitor developments in the securities markets and to actively promote the development of regulations that contribute to stability as well as efficiency.

Demographic changes

One of the fundamental economic driving forces behind developments in the securities markets is demographic changes. The age distribution of the population sets the framework for savings. It is not too far-fetched to assume that people mostly borrow while they are young, save while middle-aged and then live off their savings when they are older. Savings vary over a life cycle. Studies show that household debt is mainly built up during the ages 20 to 40; while people aged 40 to 65 have positive net savings. At retirement age, net saving becomes negative once again. When the percentage of people in the respective age groups changes, it affects savings at a national level.

Seen from a longer perspective, the most spectacular demographic trend is that we are living longer. In 1950, 10 per cent of the population was aged 65 and over. Today the figure has risen to 17 per cent, and in 2035 it will be 23 per cent, according to Statistics Sweden's forecasts. Savings at a national level need to be adapted to be able to support this growing band of long-lived, active pensioners. The collective social insurance systems are currently undergoing development, which emphasises the need for additional private saving. There is uncertainty over what expectations and needs the welfare state should and can fulfil, but most people appear to agree that the role of the welfare state must decline as a declining workforce has to support a greater number outside of it. The original delegation of savings from the individual to society will revert to the individual in different ways. For instance, individual choices have been introduced within the framework of the pension system, giving the individual some responsibility for management of the savings. This applies to both occupational pensions and the state pension system. These changes stimulate savings and also channel some of the earlier collective savings into savings markets, particularly mutual funds and pension funds. The fact that we have had a large inflow of capital into the securities markets is therefore fairly unsurprising.

However, one interesting question is what effect the change in population structure will have on savings and on the securities markets in a few years time, when those of us born in the 1940s retire. We are a fairly large group from the baby boom years. The life cycle hypothesis assumes that we will sell large parts of our assets, which will lead to negative net savings. However, some studies indicate that pensioners may not consume their capital to the extent assumed. And of course, some people actually have something left to pass on to their descendants.

One decisive factor for the future development of savings is how the pension system will function in practice and what responsibility the individual will have in the future for other parts of the traditional welfare system.

Technological developments

Another important driving force behind the securities markets is technological developments. These occur in several ways. Look, for example, at the current procedure for a securities transaction, from start to finish. The process from placing the order to buy or sell until the transaction is finally settled has become increasingly automated. I don't just mean the actual trading, which has become increasingly electronic, but also the processes following on from this, namely clearing and settlement. Straight through processing, usually referred to as STP, is becoming more common. This involves the entire chain from placing the order to clearing and settlement being implemented without manual intervention. The increased automation has led to transaction costs falling. However, it is still possible to rationalise further and there is considerable scope, in my opinion and the opinions of many others, for reducing transaction costs further, particularly in cross-border securities trading.

The technological developments also inspire hope of reducing the *time* between trade and settlement. A situation where settlement could be made as soon as possible after the deal would be very welcome. This is because it would limit the risks the various counterparties have against one another. Most financial instruments traded in Sweden today are settled three days after the trade. It should be possible to reduce this period now, so that settlement is made one day after the trade. This would increase efficiency and reduce the settlement risks. If I act as visionary a moment, I can see that in the not too distant future settlement could in principle be simultaneous with trade, so that no time lag arose at all.

There still remain some practical obstacles before this becomes a reality. However, I have every hope that these obstacles will be overcome in time.

Another, equally important aspect of the technological developments is that they have made it easier for new operators to enter the financial markets. This has led to stiffer competition, which has put further pressure on transaction costs. Technological developments affect competition in several ways. Improved information technology enables operators to offer customer more and cheaper services. The Internet has revolutionised both the spread of information and order systems. Physical distances have lost significance as a result of these developments, which promotes cross-border securities trading. However, cross-border transactions are still unnecessarily dear. As I said, there is reason to hope that transaction costs can be pushed down further as cross-border trading becomes smoother.

Increased internationalisation

Cross-border trade is part of an increasing internationalisation process in the financial markets. Over the past ten years, both non-resident ownership of Swedish securities and trading by non-resident investors in Swedish securities have increased. At the same time, Swedish investors have invested more of their capital abroad. The internationalisation of capital is a development welcomed by the Riksbank. It entails both improved risk spreads and the opportunity for higher earnings. In addition, it could lead to better competition and more efficient use of capital in the economy and thereby to greater welfare. This development also makes greater demands on the Swedish securities markets. If we diverge too much from international practice with regard to norms and regulations, particularly tax regulations, it will reduce the economic benefits we obtain from the internationalisation of the markets. However, it does not mean that we should stop thinking about designing regulations. I shall return to this later.

Altered ownership structure

Another trend that affects the securities markets is the increased institutional ownership. When an increasing share of financial savings in the economy is through mutual funds and large financial institutions, securities trading is also affected. Financial intermediaries are often more focussed on short-term earnings than private investors, and more likely to move capital in the event of anxiety or problems. There is therefore a risk, although this should not be exaggerated, that increased institutional ownership will reinforce herd behaviour and lead to larger fluctuations in prices in the financial markets.

Increased institutional ownership also means that the passive owners will have relatively substantial influence over the companies. In most cases, the mutual fund companies do not participate in the management of the various companies. This in turn means that corporate governance issues gain in significance. What ability and interest do the mutual fund companies have in influencing management to participate in the board work of the limited companies? In recent years, mutual fund companies and other institutional owners have shown slightly greater interest in the work on management of these companies.

However, an interesting question of principle here is what mandate they have for this. The primary goal for a unit trust investor ought to be to achieve the highest possible yield at a given risk level. It is not necessarily in the interests of the mutual fund investor for the mutual fund company to conduct corporate governance. However, from the point of view of the economy as a whole it is important that there are owners who can actively govern the companies. I find it difficult to believe that the mutual fund companies' growing interest in influencing boards of directors through the selection of board members or using other means would solve the fundamental problem of weak institutional ownership. We cannot therefore ignore the conflict of interests in indirect ownership.

Changes in the financial infrastructure

There are other important ownership issues in the securities market. Here, I am thinking in particular of corporate governance with regard to marketplaces, clearing houses and other systems used for trading financial instruments and which are part of the financial infrastructure. Many companies active in the financial infrastructure have traditionally functioned as cooperatives or been owned by their largest users. In some cases, these companies have been transformed into profit-making limited companies, where other parties than the users have gone in as important owners. Stockholmsbörsen is of course the most striking example of this. This development is not specific to Sweden. The same tendencies exist in the international securities markets.

Otherwise, each country has traditionally had a separate organisation for each vertical stage of the transaction chain: a *stock market*, a *clearing house* and a *central securities depository* for the financial instruments. There has thus been a significant degree of centralisation at national level. The reason for this is of course that there are substantial economies of scale in these operations. The fixed costs for operating the systems are high, while the floating costs are low. Moreover, there are considerable network effects. If a marketplace has a high level of liquidity in an asset, many people will probably trade there, as they will be able to trade at the best, that is to say, the most correct prices. If a marketplace has liquid trading in *one* asset, it will often attract trade in other assets, as other companies want their instruments to be traded on a marketplace with many participants. In other words, there are natural tendencies towards concentration in financial instruments trading. The same applies to settlement and registration of ownership.

However, technological developments have enabled increasing integration of the various parts of the transaction chain. This has also created incentives to establish automated systems all along the line, from order placement to settlement. The result is a vertical integration, where different stages of the value chain are integrated. Integration requires cooperation between, or even a merger of, the various parts of the infrastructure.

Even if this, as I have mentioned earlier, leads to lower transaction costs, it is not certain that these cost reductions will benefit the end customers. When all of the stages of the chain are implemented automatically and ownership of the various parts may even lie with the same organisation, everyone will be dependent on a single supplier. This creates a risk that pricing will follow monopoly principles, which rarely benefits the economy.

Parallel with the move towards vertical integration, the internationalisation of the capital markets and harmonisation of laws and rules within the EU has led to increased pressure to consolidate operations across national borders. In many cases there have previously been legal barriers to international consolidation. Now that the barriers are gradually being removed, competitive pressure on the existing national infrastructure companies is increasing. At the same time, there are stronger incentives for cooperation and even mergers between stock markets in different countries and also between clearing and settlement organisations. In other words, there are also tendencies towards horizontal integration. The question of what is most beneficial for the functioning of the economy as a whole - vertical integration or horizontal integration - is not an easy one. In both cases there are benefits from economies of scale. There are also concentration tendencies, which can in turn lead to deficiencies in competition in the markets for trading and clearing securities. I believe that it is extremely important that we authorities – and I mean here financial supervisory authorities, competition authorities, ministries of finance and central banks – closely monitor developments in this field.

The public authorities' supervision and oversight of the financial infrastructure is also affected by how the infrastructure companies are owned.

When these are run as profit-making limited companies with external owners, there is an evident risk of monopolistic pricing. Here the Swedish Competition Authority has a difficult but important task. There are also reasons for closer study of the potential threats to the stability of the financial system arising from such developments. Finansinspektionen and the Riksbank play important roles here.

If the infrastructure is instead mainly owned and run by the users, the problems may not primarily concern pricing, but rather how the conditions for changing established structures are affected. Here I am thinking of the incentives for new developments and the possibilities for new participants to become established in the market. This is extremely important to avoid rigid structures in the financial markets.

The conclusion is that it must be possible to adapt the rules and supervision governing the companies working in the financial infrastructure to the organisational form chosen by the companies. In a changing world, our task is to ensure we employ the best methods for carrying out our supervision and oversight work. The picture is further complicated by the fact that the authorities in different countries become involved when consolidation work crosses national boundaries.

EU regulations

Another important driving force for change is the new regulations being produced within the EU, arising from the Financial Services Action Plan of 1999. One of the purposes of these plans was to harmonise regulations for securities trading between the different European countries. The EU has decided to introduce what is known as the Lamfalussy Process to achieve the target of implementing all parts of the plan prior to 2005. This entails the EU Parliament and Council providing framework directives on issues of principle, while the Commission chisels out the details in follow-up directives and regulations. After this, a group of representatives of the countries' different supervisory authorities will adapt the interpretations of these directives. This plan can be regarded as a building stone of the Lisbon Strategy – the ambitious target set at the summit meeting in Lisbon in March 2000 – which aims to make the European economies “the world’s most competitive and dynamic knowledge-driven economy by 2010”. An admirable ambition, although it could possibly have been worded more modestly.

Harmonising regulations and strengthening competitive advantage in the European economies is a commendable aim. Increased harmonisation simplifies price comparisons and thereby strengthens competition between producers of financial services. If these producers also become competitive internationally, there will be benefits for both domestic consumers and shareholders in these countries.

I nevertheless wish to say a few words of warning. While harmonisation that is achieved through regulations can promote competitiveness in the short term, it can also cause concern in the slightly longer term. When all participants have to follow the joint regulations, it makes competition in the dynamic sense more difficult. This is not the idea behind the Lamfalussy Process. We often forget that regulations may also need to be subject to competition in order to become efficient. As the directives produced by the EU are often compromises between views expressed by different countries, it is not certain that the final result will be the most efficient solution for the securities markets. If the EU wants to promote competitive economies, it must also ensure that this does not result in a competitive advantage based on more or less explicit subsidies. The best way to build up competitiveness is by creating environments for competition. It is only then that the economies will become efficient. Competitiveness in itself is not the goal; efficiency is.

Some issues for the future

In this speech I have pointed out some long-term developments that affect the future of the securities markets. Unfortunately, they give rise to more questions than answers. I would like to conclude with a few questions you can ponder.

In recent years, inflation in many countries has fallen, and inflation expectations have stabilised at a level that reflects the monetary policy targets. This can reasonably be said to have reduced the uncertainty in the financial markets caused by fluctuating prices. Interest rates have also fallen and this, combined with reduced uncertainty over price trends, has increased households' incentives for borrowing. It has affected house prices, but may also affect other asset prices. At the same time, it strengthens institutional investors' search for yield. Does this mean that the risks in the financial system will increase and make it easier for exaggerated speculation, such as the IT bubble in the stock market, to develop?

Earlier, I drew the conclusion that demographic changes will increase the need for long-term saving. This need is reinforced by the transition from allocation-based pension systems to systems that are based to a greater extent on premium reserves. In addition, the indications are that individuals will need to take greater responsibility for their own pensions. All in all, this should lead to a larger percentage of savings being channelled through the securities markets. How will the markets be able to meet this need? Are new products required, for instance, bonds with a much longer time to maturity, to manage the assets side of the life insurance companies?

One of my earlier points was that we probably have not seen the end of the international consolidation of the financial infrastructure. On the contrary, there are indications that we will see more cooperation and more mergers between different stock markets and between different clearing and settlement organisations. A few years ago there were 27 stock markets in Europe. Now there are 20. Will this consolidation process continue? My guess is that in five years' time there will be 10 or less.

When we know the answers to these questions, we will also know more about the shape of future securities markets.

Thank you.