Ladies and Gentlemen,

It was a great pleasure for me to have ben invited as a keynote speaker at this year's FERMA forum. As we all learned during the crisis, risk management is crucial for successful financial instituions. Defiencies in controlling risk were at the heart of the crisis. As a result, many financial institutions have strenghened the role of risk managers witin their financial organisations, have revised teir risk methodolges and revisited the instruments they use for mitigting and controlling risk.

However, the crisi has not only required a rethinking o the structure, methods and practixes of risk management . More fundamentally, it has led to a wide ranging review of the outlook for the financial industry as managers and investors reassess it long term prospects.

I believe this fundmental reassessment hs also been reflected in the recent market movements. Over the past months, markets have been unusualy volatile and, generally on a downward trend. First and foremost, no doubt, this reflects the considerable uncertainity that hangs over the global economy. Sentiment indicators, like the Purchasing Managers' Index (PMI), suggest that the global economy is on the brink of a sharp slowdown. Growth forecasts have ben lowered. And of course, uncertainty about the management of soverign debt problems, especially in Europe, lies at the heart of th market turmoil. Investors are clearly unsure whether the necessary deleveraging will be achieved via austerity measures and deflation or via inflation. As long as this uncertainity persists, it is almost inevitable that investors will reallocate their funds beteen asset classes to

protect themselves against either **de**flation or **in**flation – as a result, we will see asset price volatility.

It comes as no surprise that under such difficult overall market conditions, the financial sector has been badly clobbered; the financial industry reacts very sensitively to political and macro-economic news. As a result of the recent share price falls, almost all listed European banks are currently trading at below book value, in some cases even considerably below their book values.

But it would be a mistake to assume that this only reflects the present difficulties in the macroeconomic environment. While macroeconomics and sovereign risk undoubtedly play a role, the low valuations of financial firms also reflect fundamental concerns about the prospects of the industry.

Prior to the financial crisis, the financial industry was considered a growth industry. It benefitted from liberalization and market opening. Earnings and profitability were on an upward trend. The share of the financial industry in total value-added increased in many countries. A number of governments launched programmes to develop and promote their countries' financial centers. Finance was regarded as one of the industries that would provide high-quality jobs as our economies moved from industrial production to services.

How the world has changed since then! Today investors regard financial institutions, especially banks, increasingly as a slow-growth industry subject to strict and unpredictable regulation as well as volatile earnings. At the same time, political efforts are generally aimed at reducing, or at least

limiting, the size of the financial sector rather than promoting its growth. All this suggests that the financial industry is not facing just another one of the occasional upheavals that have become so unpleasantly familiar to us, but that we are witnessing a tectonic shift in the outlook for the industry.

Let me first look at the main causes of this tectonic shift, some of the potential consequences, and then discuss the necessary responses.

[The challenges]

1) Growth prospects

First, I think, we have to recognize that the growth prospects for the financial industry in the Western world are limited.

In many, if not most of Western economies, debt levels rose significantly in the years prior to and in the wake of the crisis. Usually, the process began with an increase in household and financial sector debt, most often in the form of mortgage-related debt. Once the mortgage bubble burst and governments sought to fight the repercussions of the crisis, public deficits rose as tax revenues shrank, public expenditures mounted and private debt was assumed by the state. These increases in public debt levels occurred at a time when public finances were already under strain due to a lack of fiscal discipline.

As investors became more risk averse, the debt levels incurred were no longer sustainable and, we have now entered a period of

deleveraging. Unless debt reduction is engineered by means of inflation – a strategy that, at least in the euro area is rather unlikely – reducing debt will inevitably entail a long period of austerity as governments, households and firms raise their savings. It is therefore highly probable that growth rates will be below their long-term trends for some time.

Long-term growth rates in most Western economies are set to decline in any event due to demographic developments. In some European countries, the population is already shrinking; in others, the decline will start soon. Everything else remaining the same, lower population growth means lower GDP growth – and this, in turn, goes hand in hand with lower financial market growth.

In parallel, we are seeing a secular shift of economic power from the Western economies towards emerging markets. The financial and economic crisis that started in 2007 has further accelerated this process. The pace of the growth of emerging markets relative to traditional industrial countries has increased because their financial systems were less affected by the crisis and because the downturn in their economies was less deep and more quickly reversed than in the West. The share of emerging markets in global GDP, measured at purchasing power parities, will probably rise above 50% for the first time this year. Europe's share of global GDP will be around 20%.

Of course, this will have repercussions on financial markets and banks

in particular. The U.S. and the EU are the largest and second largest financial markets in the world respectively, but the financial markets' growth rates in the emerging markets are three to four times as high. Such growth prospects, combined with a lower outlook for growth in their own home markets would suggest that financial services companies in the U.S. and in the EU expand in and to other regions of the world. Indeed, many of Europe's leading banks, including Deutsche Bank, have already done so successfully. Today, the top 20 European banks already generate 30% of their revenues outside of Europe. They benefit from the attraction of their brand names, high-quality products and expertise, not least in risk management.

However, Europe's banks will face increasingly strong competition in expanding into growth markets: On the one hand, many large U.S. banks are currently making a push into emerging markets as growth rates in their home market are limited by the deleveraging process there. On the other hand, emerging market-based competitors are going from strength to strength: As recently as 2004, **none** of them were on the list of the top 25 banks worldwide by market capitalization – today **seven** rank among that group, accounting for approximately 35% of the combined total market capitalization of that group.

2) Regulation

The second cause for the tectonic shift we witness in the financial industry is the regulation. After more than two decades of **de**regulation, liberalization and market integration, we are now seeing a move towards

re-regulation and **dis**integration. In the future, financial regulation will be more prescriptive and less principle based. Rather than just setting the framework within which market forces can play out freely, regulation will aim at prescribing market results. And regulation will certainly try to segregate – or in other words, ring-fence – national markets, even though this may actually prove to be counterproductive by increasing risk concentrations and trapping liquidity.

Please do not misunderstand me: Changes to the regulatory framework are clearly necessary to address the financial markets' deficiencies revealed by the financial crisis and to make global financial markets more resilient to shocks. Banks have supported these efforts, and continue to do so, also by pursuing their own reform initiatives and efforts in parallel – like deleveraging, bolstering capital and improving risk management.

However, it is undeniable that all of these changes are coming into force very quickly, leaving little time for banks to adjust to the new world. The risk is that the cumulative effect of all of these reforms will be massively negative.

3) The reputation of the industry

Let me close my list of reasons for a fundamental shift in the financial industry with an observation on the reputation of our industry, which has undeniably taken a severe blow during the crisis. Trust has been lost. This loss is obviously a severe matter, as confidence is the prerequisite for our business. The loss of trust comes in two forms:
One is more general, reflecting the fact that the crisis and ensuing scandals

have undermined trust in the integrity of its representatives as well as in their ability to perform the key element of banks' business, namely to control risk.
The other form is a more specific loss of trust in banks' business models, specifically whether they add any real value to society and serve any useful purpose that benefits the real economy. While such questions have traditionally been confined to the fringes of the political spectrum, today it is the political and social mainstream that questions the social value of financial services. And so, indeed, do many of our clients.

All this has a direct bearing on two factors mentioned earlier, i.e., growth and regulation: If trust between financial institutions and their clients is not re-established, this will reduce business opportunities. Similarly, the worse the public mood towards the financial industry, the greater the temptation for rule-makers to impose even harsher regulation on the industry.

That alone provides for a strong interest in restoring trust in our industry – not by image campaigns, but by engaging in a meaningful discourse with our critics and serious introspection on whether any of our products, processes and strategies are in need of revision. I believe it is of paramount importance for us to think about our business activities in a more holistic manner going forward: Interestingly enough, this mirrors an insight that supervisors gained during the crisis: It isn't enough to look at the health of individual institutions; there is a need to look at systemic risks, too – in the specialist jargon: micro-prudential supervision must be complemented with macro-prudential supervision. In like manner, financial institutions must learn to think about the systemic – and that includes social – implications of their business decisions.

[Strategic consequences]

Taken together, the changes ahead will have a clear effect: Top-line growth for European banks will be difficult to generate, while at the same time the costs of doing business will rise and banks will need to hold more capital to back this business. The combined effect of all regulatory initiatives will be lower profitability. In fact, banks have already scaled back their RoE targets to a range of 16-19% pre-tax, until they have adjusted to the higher capital requirements, which then should make higher RoEs again possible for individual institutions.
Little wonder, then, that investors are disenchanted with bank shares and, against this background, it is hardly surprising that many banks, as mentioned earlier, are currently trading at or below their book values.

So what are the strategic conclusions banks should draw from this? I believe they can be boiled down to the following:

- First, a solid capital base and, no less important, rigorous capital management are crucial. Discipline with regard to internal capital allocation and pricing is as important as satisfying investors' expectations regarding capital ratios.
- Second, in a world of uncertainty, risk discipline is the linchpin of commercial success. This includes discipline in acquisitions.
- Third, greater uncertainty also has consequences for the business mix: When income streams become more unpredictable, a broad

product mix and a good balance between stable and dynamic business lines become more important.

- Fourth, diversification and stability also matter when it comes to the sources of re-financing. In light of the lessons from the crisis and in anticipation of the new liquidity regulations, banks have reduced their exposure to wholesale financial markets. Deposits and covered debt have taken on greater importance. It should be noted that this will affect funding costs and the composition of a bank's asset base in the case of covered debt, as only high quality assets qualify as collateral for covered debt.
- Fifth: Whoever wants to remain an industry leader has to establish a presence in growth markets – and this means a strong presence in emerging markets.
- Sixth: When top-line growth is difficult to achieve, it becomes even more important to keep the cost base down.
- Finally, in a market with lower top-line growth and lower profits, consolidation plays a more significant role. Stricter regulation also creates entry barriers as well as fixed costs that are working in favour of large banks. Incidentally, being denoted a "systemically important financial institution", or SIFI, may actually confer a competitive advantage, as depositors will be attracted to these closely supervised and well-capitalized banks, while the threat of having to pay a SIFI surcharge will discourage medium-sized banks from growing further.

[Supporting action]

It is clear: To address the tectonic shift in our industry is first and foremost the duty of the management of financial institutions, but the public sector can help to ease the adjustment process, to ensure that the financial sector can maintain its role as a supporter of economic growth.

Essentially, I see three areas where Western governments could make a difference and significantly soften the impact of the tectonic shift on our industry:

- First, by getting on top of the sovereign debt problem;
- second, by doing no undue harm via financial regulation; and
- third, by supporting growth in general and opening growth prospects for the financial sector in particular.

1) Getting on top of the sovereign debt problem

Many still think of the debt crisis as a short-term phenomenon, linked to the financial crisis. However, as I indicated earlier, it is more accurate to see it at least as a medium-term problem. Many have lived beyond their means for years, if not decades. The ageing of societies – with the ensuing consequences in terms of higher public spending on pensions and health care – will only compound the debt problem. Many politicians still shy away from consolidation, not least because an ageing electorate is less inclined to support cuts in social welfare expenditure. But failure to address fiscal problems will not only make life more difficult for the financial industry in

Europe and the US, it will also curtail the ability of societies to deal with the other challenges that we face like ageing, education and environmental protection to name just a few.

To give you an idea of the scale of the problem: Public debt in mature markets is expected to soar from around 100% back in 2010 to 126% of GDP in 2020, even under the assumption of a gradual tightening of fiscal policies. In contrast, emerging markets' public debt-to-GDP ratio will fall from around 46% in 2010 to 35% in 2020.

2) Doing no harm in financial regulation

To prevent things from getting worse governments should not cause additional harm when putting the new framework of financial regulation into place. I do not doubt regulators' good intentions. But from what we have seen in the course of the design and implementation of the new rules already under discussion, sound initial ideas for regulation often morph into bad practice.

Specifically, I perceive three issues of concern in this context.

- First, there is a serious danger that rule-makers are underestimating the cumulative impact of all the regulatory changes on the economy. Tougher capital requirements and the other changes will impair the ability of the financial sector – banks and insurance companies alike – to provide credit to the economy. This in turn will reduce growth opportunities for banks. I am disconcerted by the fact that no impact assessment has been made so far on the macroeconomic

consequences of all the regulatory changes. Against the background of the current economic uncertainty and generally impaired growth prospects, this is mind-boggling.

- Second, there is a risk that tougher rules in the regulated part of the financial sector will set incentives to shift risks to the non-regulated part of the system. And even if no one actively transfers risks from one to the other sector, there is a risk that the unregulated part of the system may simply grow faster. The Financial Stability Board has indicated that it will try to shed more light on the unregulated part of the financial system. Although this would be a welcome step, it is unlikely to prevent business from migrating there. From the perspective of financial stability this is undesirable.
- Thirdly, there is a growing risk of inconsistent implementation of the new rules across the globe. While the G20 have made solemn declarations on harmonized rule-making and consistent implementation of the G20 regulatory agenda, there have repeatedly been deviations in regulatory detail and national initiatives outside of the G20 consensus between this and the other side of the Atlantic. More fundamentally, emerging market countries argue – not without reason – that the crisis did not originate in and did not particularly affect their banking systems. Hence, they see no reason for tighter regulation and will be reluctant to implement G20 agreements on financial regulation that may stifle growth.

These emerging inconsistencies are of great concern for two reasons: On the one hand, they increase the risk of market fragmentation, on the other hand, they will have a potentially negative

impact on the competitive position of European banks versus their peers abroad. European rule-makers should remember that even if emerging market banks were to be subject to the same rules, they would still find it easier to satisfy the new rules as their profitability, and hence their ability to raise capital organically, is higher. If the rules are tilted in their favour on top of this, European financial institutions will fall behind even faster.

3) Foster growth

Fostering growth is the third area policymakers in the West should clearly focus on. At the end of the day, we will only be able to master the debt problem if we grow out of it; growth is necessary to maintain the social fabric of our societies, to fight deprivation and unemployment, especially that of young people; in addition: Europe needs to grow if it wants to maintain its role and status in global affairs. And its growth perspectives are not rosy anyway because of its ageing population.

A structurally higher growth rate will not result from monetary and fiscal stimuli alone; it requires structural reforms. As international organizations such as the OECD keep reminding us, and rightly so, there is a lot of potential for raising the underlying trend growth rate of our economies. The list of policy measures is well-known: Investments in knowledge and technology, investments in infrastructure, higher labour force participation

of women and the elderly, deregulation and greater openness to trade and investment.

Those policy measure present new opportunities for financial institutions: Infrastructure investments obviously hold potential, e.g., in the form of public-private partnerships. In addition, by way of example, let me mention two other areas:

- One is the ecological transformation of our economies. "Green growth" has become the catchword for a number of initiatives aimed at making economic growth cleaner and more sustainable and reducing the dependency of our economies on fossil fuels and energy imports. This process not only calls for innovation and investment, but also presents a challenge for the financial industry. Through the economic stimulus packages launched after the financial crisis, governments around the world provided close to half a trillion U.S. dollars to foster green growth. This was a very useful impulse, but the process clearly needs to be long-term with a corresponding financing strategy. Direct bank financing, innovative capital market structures and, again, public-private partnerships will all play key roles here.
- Another area with potential is European financial market integration. In spite of several EU-level action plans and hard work on the part of both legislators and industry, the integration of European financial markets is still far from complete. Specifically, in the areas of asset management and retail financial services, pan-European platforms, products and processes are still a long way off. Policymakers should be aware that Europe's pension crisis would be easier to solve if asset management markets were made more efficient. In like

manner, the legitimate interests of European consumers will be better protected by greater competition across borders.

[Conclusion]

Ladies and Gentlemen,

This concludes my tour d'horizon on the outlook for the financial industry. As I mentioned at the outset, I truly believe that we are witnessing a period of transformational change, with the entire structure of the industry being redesigned. And all of this is taking place while we are also trying to control risks in our daily business in a highly uncertain environment.

We should therefore be aware that the re-design of the financial industry is a delicate matter, not only for us, but for society as a whole, given the pivotal role financial institutions perform in our economies. In light of the poor reputation we have at present, I believe we would be well-advised to engage in a constructive dialogue with our clients and stakeholders while charting our future. I would therefore like to thank you for the opportunity to do so today and wish you a successful conference with many new ideas for the future of your own institutions!