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Financial Market Innovation

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First, I would like to thank you very much for inviting me here today and in particular to John (Thornhill) for moderating this panel. Innovation is changing all our lives – and this is nowhere more true than in my sector, banking and financial services.

Innovation has been a major characteristic of the financial sector for two or three decades. It is the pace of innovation and change which has increased so radically in the last few years.

In 1986 Merton Miller, one of the fathers of the financial economy, stated that the decade from the 1970s until the mid 1980s had been extraordinary from the point of view of financial change. He lived in a time when new products - such as new forms of derivatives - were coming on to the market. And of course the economy was then preparing for the “big bang” of financial deregulation.

He asked himself if such a period might again be possible in the future. To the question: “Financial innovation – is the great wave subsiding?” his answer was “yes”. In reality, of course, the pace of financial change has quickened not slackened. We can now look back with the benefit of hindsight and say Miller’s answer to the question ought to have been a firm “no”. But then as the great movie maker Billy Wilder said “hindsight is always 20-20.”

Over the last decade many innovations in the financial world are worth mentioning.

First, there has been an explosion in products:

- Securitization
- Structured financial products
- New types of products aimed at groups who are outside the banking system and others designed for an ageing population

Secondly, new processes have been developed such as:

- More efficient clearing and payments’ systems
- New techniques for risk management
- Internet banking – for example there is now a web site which allows borrowers and lenders to come together in a financial community.
- Mobile banking in countries such as South Africa. Here customers can now use their cell phones to make person-to-person payments and transfer money. They can also purchase pre-paid electricity and buy airtime for a pre paid mobile phone subscription.

Finally, many new agents have now entered the financial market.

The growing competition in the market and – above all – technological development and financial deregulation has led to an increasing pace in innovation.

This process of financial innovation is a response to some of the changes which we have seen throughout the economy. It is estimated that up to three billion more people have begun to participate in the global economy over the last few decades.

The implications of this for the providers of financial services are profound. Many of these new participants in the global economy have not yet engaged with the banking system. For many of them conventional banking processes will not work. They need new services to meet their needs. One example might be the current development of micro-credit in different emerging markets. Other people are now working as migrants. They are increasingly using banking and non-banking institutions to send remittances home to their families and communities in their countries of origin.

In a growing number of countries the economic agents find themselves in a situation where interest rates are at a historic low. The search for yield has stimulated the development of some new financial products. It has also led new agents to enter the market such as Hedge Funds and Private Equity Capital.

In general then, financial innovation is a response forced by the need to meet the new requirements of clients, improving returns or reducing costs.

In formulating this response the financial world has had to become more efficient and also more sophisticated. Financial innovation has had significant advantages. But, as always, fast moving change also leads to important new challenges:

- First, recent innovation is leading to greater diversification of risk between the agents in the market. It is clear that innovation supposes a change in the risk profile of the banking sector. To a great extent this implies a transfer of credit risk from the financial system, the traditional manager of this risk, to other agents. So, for example, through asset securitisation financial institutions transfer the credit risk which was previously on their balance sheets.
- Secondly, innovation makes the financial system more efficient. The relationship between the financial system and economic growth is clear. With a more efficient financial system there is a greater possibility of more economic growth. In particular there will be greater access for corporate finance and this should make a greater contribution to investment and growth. Financial innovation should also help smooth out consumption over time and this could help reduce the volatility of economies.
- Finally, an increase in the number of heterogeneous agents participating in the financial system should increase market liquidity. This is particularly the case for those instruments which were less liquid in the past, so that risk premiums decrease. Liquidity and reliance on the existence of a counterparty are key for the appropriate functioning of markets.

Despite the notable advantages which financial innovation supposes it is also associated with some risk factors. These risks could affect the stability of the financial system.

Especially worrying is the combination of excessive use of some of these innovations in a context of a macro-economic downturn – whatever may be the cause of the downturn. Many of these new products have not been properly tested in crisis scenarios. It is therefore difficult to anticipate how they will behave under pressure. There are factors which increase the possibility of a systematic risk scenario in the face of such a downturn.

In the first place the speed, complexity and growing links between markets could be a point of vulnerability. Global financial integration is growing. Financial shocks could affect several geographical areas or intermediaries, entailing a higher contagion risk.

In the second place recent history has seen a relatively benign period in the world economy. This could be leading to an underestimate of risk in which many intermediaries are inclined to undertake operations that are feeding an unsustainable boom.

The situation is especially worrying with respect to new agents that are now participating in the market. Non-bank financial intermediaries are less experienced in risk monitoring.

Against the background of increasing risk taking, we are bound to see adjustment processes in the future in certain sectors and countries. Whether they will be mild and local or severe and global is the issue at stake. Recent experience, such as the experience of the US subprime market, suggests the former is true. But such inductive reasoning can be dangerous and it would be foolish to assume that there will always be a benign outcome in the future.

We must do our utmost to avoid the latter scenario of a severe global shock and in this context several measures are worth discussing:

- Although the risk management of banking techniques has improved a great deal the proliferation of new intermediaries and instruments pose new challenges.
- The activities of hedge funds and other similar institutions should be guided by the appropriate codes of conduct. In this area enhanced transparency is a must.
- It is essential to develop further broad agreements – for example, in terms of information sharing amongst supervisors. It seems to me that previous arrangements have become old-fashioned and that we need to apply some new thinking.

Finally, I would like to conclude by explaining a little about how a bank like BBVA is trying to face up to the challenges of innovation.

In our view, innovation should be understood in the broadest possible sense. In the 21st century one of the keys to differentiation is innovation.

For that reason BBVA created a department of Research, Development and Implementation in 2004. Two years later the bank effectively decentralised innovation and asked each department to take responsibility for its own innovation strategy. The initiatives which have arisen from this are co-ordinated at a senior level through an Innovation Committee.

Any innovation strategy should develop along four axes – organisation, operations, business and business models.

In the case of organisations and operations, new processes can reduce costs substantially, and bring flexibility and a closer relationship with clients.

In the case of business, new products and services are sought out which attempt to meet clients' needs. The "business coastline" may also be explored. That is to say new products and services which are a natural extension of those which already exist can be developed.

A case in point is the development of investment funds. There have been considerable increases in the range of offered funds over recent years. For example, it is now possible for clients of BBVA to invest in hedge funds and in capital risk funds. A fund has recently been launched that lends money to firms which extend micro credit in developing areas.

It is also important to emphasise the need to innovate in the business model. Increasingly, non-financial solutions are sought to meet the needs of the clients. Through this development financial institutions are on course to become service companies.

Through innovation financial institutions will be able to take advantage of opportunities in a very competitive world. Innovation will allow us to get closer to our clients in an increasingly global market.

Thank you.