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Challenges for financial markets

In a speech at the Association for Financial Markets in Europe's annual dinner on Thursday, Bank of England Deputy Governor for Financial Stability Jon Cunliffe reflects on the factors that have influenced London's position as a global financial centre and considers some of the implications for European financial markets from the UK exiting the EU.

Jon observes that concentration in the financial sector has increased with financial globalisation and with the revolution in information technology; so that there are more financial centres now and the largest have become very large. He also observes that while historically, the clustering of financial activity has tended to follow trade and commerce, London has emerged as a global financial centre over the past 50 years even though the UK's importance in the global economy has declined.

"As we know, London did not enjoy uninterrupted status as a premier financial centre over the intervening period. As the British economy declined in global importance, as the empire shrunk and as sterling ceased to be a reserve currency, London's importance as a global financial centre also declined. It was only with return to financial globalisation, some 50 years ago, that this process was reversed – leading to the concentration we now see."

There could be a number of reasons for this, according to Jon. First, that London has become the financial centre for the whole of Europe, though its revival pre-dated the EU's market in financial services and its share of non-EU related business is markedly greater than EU business. Another is that modern financial markets are so large that the surplus generated by trade or manufacturing activity is less relevant now than before and that once financial flows start to move through a financial centre, the ensuing returns to scale and specialisation generate greater financial flows through the centre.

"A related point, one that I touched on earlier, is that physical location does not matter anymore, since technology allows investors to pick the most efficient location to manage the global allocation of capital. In this case, London is playing the role of asset manager, intermediating flows between different global regions. The investment decision and risk management skills are in London but the assets may be booked elsewhere." Jon said, noting that London could be intermediating flows between different global regions.

Another reason could be that financial markets demand different inputs than they did in the past. For example, the market for derivatives requires a high degree of legal expertise. “Given the dominance of UK law, this would tend to encourage activity in London.” Finally, the wave of deregulation in the 1980s and 1990s may have contributed to London’s position as a global financial centre.

Jon emphasises the importance that financial markets address ethical drift and restore public support. This also requires authorities and the financial sector to demonstrate that the risks posed by large, complex and highly interconnected financial markets can be effectively managed.

“As far as the Bank is concerned, there will be no going back to the future. The great financial crisis reminded us that the failure of the financial system, though rare, is possible. Contrary to the received wisdom pre-crisis, we learned that greater scale, complexity and sophistication of financial markets can make the system more not less vulnerable.”

This lesson has shifted regulators’ tolerance for risk. The regulatory reforms now being implemented will not in practice prove perfect in every specific. There will be places where reforms aimed at one part of the financial sector will cut across changes made elsewhere. “Where justified, we are prepared to adapt the reforms,” Jon says. “But while I can envisage that there might be specific and targeted change based on clear evidence, I do not envisage wholesale changes to the reforms.”

Finally, Jon turns to the challenges for Europe’s financial markets posed by the UK’s exit from the European Union. The arrangements governing the trade of financial services and the integration of financial markets between the UK and the EU will be one of many issues to be determined by governments during the negotiations. Nor do we know how the financial sector in the UK and elsewhere in Europe will respond to the outcome. “What I think is clearer is that this is not a zero sum game”.

Jon notes that it is possible that some wholesale financial market activities currently carried out in London and elsewhere in the UK are in future carried out elsewhere in Europe. However, the scale and scope of broader international activity here suggests that clustering effects such as labour market externalities, specialised inputs and knowledge transfer have become even more powerful in a world of financial globalisation.

“It is conceivable that given time these effects and the benefits they bring in terms of more efficient allocation of capital and risk could be replicated elsewhere in Europe. It is in my view more likely that if they are lost in London they would be lost to Europe – for the foreseeable future at the least. Fragmentation of wholesale financial markets activity in Europe, to the extent it occurs, is likely to have a general cost to European economies, including the UK. And to the extent that the transition to whatever new arrangements will apply is not orderly and smooth, the costs and risks will be greater.”

“Whatever the outcome, and the twists and turns on the way, the Bank will continue to focus on its role in protecting financial stability.”

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