Changing boundaries in financial services

*The **Governor** describes[1] the currents of change that are eroding, and in some areas sweeping away, traditional barriers between different types of financial services. Competition for personal savings, and in housing finance, has already made an impact. More recently, substantial change is in train in the securities area, and in particular in the Stock Exchange.*

Such developments, in particular marking the response of the financial services industry to technological change and competition, have implications for the supervisory authorities. While it is important that markets should be able to adapt in a manner that is consistent with maintaining and strengthening the position of London as a leading international financial centre, these changes pose new problems for regulation and supervision as some conventional means of providing client protection and coping with potential conflicts of interest become less appropriate and other means have to be established. Foreign involvement in UK financial markets continues to be welcome though this will need to be properly accommodated in the changing structure and there is need for a strengthening in the capital base of the British securities industry if it is to be able to compete on a fully international basis.

I have chosen as my theme change in institutional boundaries in the financial services industry because the professionalism and originality that have distinguished this series of seminars flourishes best, and has most relevance, in a liberal economic and financial environment and because, in accommodating the change that is now in train, that environment is itself becoming more liberal at present. No one who was a close observer or participant in these matters can fail to have been struck by the stimulus that was given to fresh strategic thinking by the abandonment of exchange control in 1979. The change now in train in the financial area is less substantial only in the sense that it is less specific than the abandonment of exchange control; and I believe that its consequences are likely to be more far-reaching because it not only opens up new investment opportunities—and for business at home as well as abroad—but also because it is likely to call for and to precipitate substantial change in our institutional structure.

The international context

Changing boundaries in financial services is admittedly a rather pedestrian description for a development which is in reality of great importance for the future of the financial services sector in this country. The excitement comes not in the development itself but through the energies that it releases, and in what it portends. Let me begin by defining the terms. Changing boundaries in the sense in which I am using the term means the removal or modification of barriers between different types of financial services. It is, in other words, a departure from the practice of confining by statutory or other means particular financial services to particular classes of institution.

It is, as we shall see later, a process which has already begun here and may have a considerable way to run, but it is not a development peculiar to this country; nor is it a product of any particular institutional environment. Similar changes are in train in the United States where, in comparison with the United Kingdom, much greater reliance is placed on formal regulation of financial institutions and less on the conventional or traditional boundaries that have been observed here. In that sense, our two countries, although starting from different points, are sharing a common experience.

In some respects, change in the United States has already gone further, and is, so to speak, requiring and leading change here. Two major trends have emerged in the United States in recent years. First, we have seen the formation of large financial conglomerates, bringing together activities which had previously been considered at least ill-assorted, if not incompatible. Thus we have seen the Prudential Corporation, the largest American insurance company, and Sears Roebuck, a major retailing group, each acquire a leading securities and commodities trading house. Somewhat less surprisingly, American Express has also made a similar acquisition, and Phibro, a major commodities trading group, has acquired one of the best known securities trading houses. The formation of these groupings, which are powerful in terms both of the human and financial resources at their disposal and of their access to clients, has been accompanied by growing pressure on the statutory barriers between various types of financial services in the United States. This is reflected partly in circumvention of the limitations that are currently in place and partly in calls for their modification or abandonment. Thus the geographical limitations on banking in the United

(1) In a speech to a joint meeting of the Glasgow Discussion Group on Finance and Investment and the Edinburgh-Stirling Finance and Investment Seminar, given in the University of Edinburgh on 6 March 1984.

States imposed by the McFadden Act have been largely eroded in a variety of ways.

At the same time, securities houses have begun to offer something very like countrywide bank account facilities through the so-called money market mutual funds. Indeed, the division between banking and securities trading enshrined in the Glass-Steagall Act is being increasingly tested from both sides. One much debated move has been the acquisition by Bank of America of the largest discount brokerage house in the United States—a matter now before the Supreme Court. The US Administration itself is concerned to eliminate some of the inequities and restraints on competition inherent in the present legislative framework. To that end, it has developed proposals which, while preventing new acquisitions of banks by non-depositary institutions, would authorise banks and savings institutions to expand through holding companies the financial services which they can offer to the public by the addition of insurance, certain types of securities trading, and operations in real estate.

This tide of change in the United States clearly cannot be ignored by the financial sector in this country. If there are persuasive commercial reasons for the removal or readjustment of barriers between different activities in the United States, might not those reasons apply with equal force in this country? More particularly, what are the implications of developments in the United States for the relative competitiveness of our own financial services industry? Will we as a consequence find it more difficult to maintain or increase market share either in the United States or in third markets, or indeed in our own domestic markets?

Posing these questions does not of course imply a view that we have to imitate American experience. I confess that it is not clear to me that financial conglomerates do not create as many organisational and regulatory problems as the new business opportunities and linkages that they supposedly generate. But while we must ask and consider in a mature way, mindful of the many strengths of our own arrangements, what lessons are to be learned from American experience, we cannot proceed as though it has not happened, and some reaction is called for unless we believe in a Panglossian way that our present arrangements can withstand any challenge without the need for adaptation. Few of us would subscribe to such a view and, while it is important that what is done here goes as far as possible with the grain of traditional structures, many of which have served us well, I believe that early and substantial change is now unavoidable if we are not to lose out in the world market place.

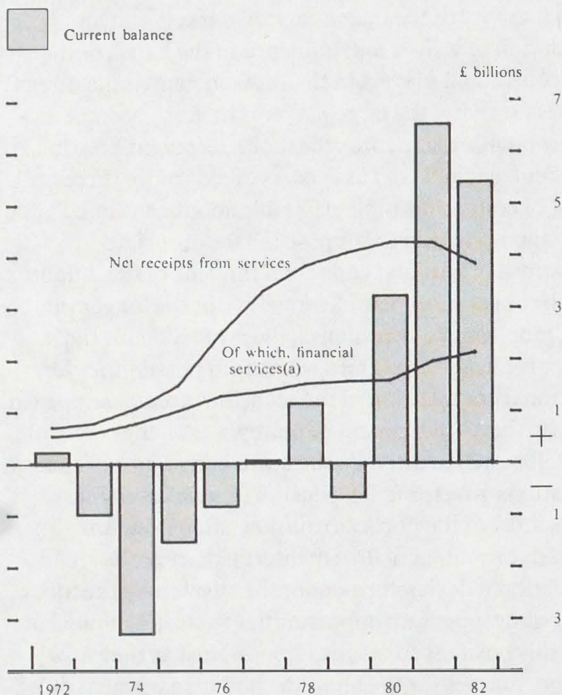
Time is relatively short, for several reasons. First, innovation and development in our securities industry were severely hampered during the period of the restrictive practices case against the Stock Exchange; this coincided with a phase of exceptional change in the shape of the international securities industry, to which the British response—though now well under way—started relatively late. Second, advances in communications technology have brought both a substantial increase in the interdependence and conductivity of the major capital markets and an accumulation of weight and influence in the hands of the major professional players in them. As in many other areas of business activity, the large player is liable to become a more formidable competitor the more deeply his position becomes entrenched, and as success breeds more success. There is, of course, nothing inevitable about continued success, and no reason to suppose that appropriate combinations of wits and capital on this side of the Atlantic will not be able to compete effectively. But the longer the delay in mobilising our response, the more difficult the challenge is likely to be. Third, enhanced possibilities for international competition in the securities area were opened up both by the abandonment of our own exchange control and, much more recently, by the more liberal interpretation of regulations governing US pension fund investment. Whereas most of the portfolio outflow after 1979 was transacted through non-British intermediaries, the creation of international dealerships under the auspices of the Stock Exchange now opens up opportunities to start winning back some of this business for British houses, just as they now have opportunities for the handling and management of US pension fund investments outside the United States. Large opportunities such as these are more clearly there than a couple of years ago, but they will not wait for long to be taken.

Time does not permit detailed examination of the technological and competitive pressures to which the financial service area has become subject both domestically and internationally in the last few years. But given the very substantial sums that have been invested in financial services in this period, the inference is irresistible that the prospective rate of return in much of this sector is seen as at least as high or higher than that elsewhere. This being so, and given the decline in our manufacturing capability, the fact that our oil and gas reserves will not last indefinitely, and thus the need to develop new areas of wealth generation, we cannot as a nation afford to neglect financial services. It is true that investment in financial service activity tends to create less jobs than, say, a comparable investment in manufacturing; but our primary concern must be to ensure that new areas of wealth-generating activity develop to take the place of those that are actually or prospectively in decline.

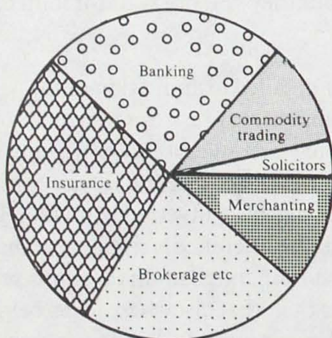
Performance in the 'invisibles' area generally has been good. Large net surpluses in external transactions have been generated, much of which is attributable to financial services, with banking and insurance making the major contribution. But we cannot rest on our laurels, and there is a keen national interest alongside the private interest for companies, partnerships and others who are at present being obliged to face, and go through, a rapid period of transition in the short term. Fortunately, the national interest and the private interest substantially converge here, since there is a common interest in seeing British businesses both more competitive and increasing their market share. The only potential divergence of which I am aware turns on

Financial services

Contribution to balance of payments



Composition in 1982



(a) Credits only. Similar earnings in the United Kingdom by overseas financial institutions are negligible. Some components are estimated from historical information and are subject to considerable uncertainty.

the argument that some protection is needed for British securities firms during the period in which they are gearing up to meet foreign competition. If such protection means that a contrived advantage is given to British firms through restricting the ability of others to participate actively in our markets, I would be very sceptical about the case to be made for it, either on wider national interest grounds or, beyond a very short period, in terms of the interests of British firms themselves. What is important is that foreign firms that come here should not, by virtue of their sheer scale elsewhere, be able to swamp their British competitors. I also believe that we should have regard to the extent to which British houses are able to participate in an even-handed way in the domestic financial markets of those who wish to come here.

Domestic perspective

Questions of international competitiveness are, however, far from being the only factors at work in this country. Increasing competition between domestic institutions also poses insistent questions about the accepted boundaries between the different activities they conduct. You will of course be well aware of the move by banks into the housing finance market, previously very much the domain of the building societies. The banks have also started—but with limited success—to seek to attract funds much more vigorously from individual savers. The building societies have responded by forays into what might earlier have been considered the preserve of banks, in some cases with the co-operation of the banks themselves. Interest-bearing accounts have been developed on which cheques can be drawn. Links have been established with bank and credit card companies. Automated teller machines are being installed, and one society has launched an electronic home banking service. Building societies are also seeking wholesale funds and, having started by tapping the yearling bond market, the largest societies have begun to issue certificates of deposit and to take large-scale time deposits on which interest can be paid gross. Proposals for other changes abound—for example that the prohibition on unsecured lending should be lifted. And a report last year by the Council of the Building Societies Association recommended among other things that building societies should be allowed to own banks, licensed deposit-takers and insurance companies. Those views have since been modified but the natural urge to diversify is still there.

But the recent event that has most dramatically highlighted the prospect of institutional change in this country has been the agreement which led to exemption of the Stock Exchange from the restrictive practices legislation. One of its principal features was that the Stock Exchange should abandon fixed minimum commissions, and you will now know that the Stock Exchange Council has decided to reduce minimum commissions on gilts next month and then to remove all remaining restrictions on commissions in one step, though not before the autumn of next year.

The significance of the undertaking to move to a system of freely negotiated commissions is the belief that the present Stock Exchange trading system of single capacity, strictly differentiating brokers who are agents from jobbers who are principals, cannot survive the change, and that a trading system must be devised in fairly short order which will allow members of the Stock Exchange to act as agent and to deal as principal. This belief, now more or less unanimous, stems from the so-called link argument, and it is interesting to note that many of those who, less than a year ago, were among the staunchest defenders of the *status quo,* are now among the strongest protagonists of early change to a substantially different dealing system. Whatever the difficulties of establishing such a system—and I do not doubt they will abound—the readiness of members of the Stock Exchange to contemplate and effect the transition in my view merits high praise. It is a very encouraging manifestation of energy and creative ability that has been released after several years in which the scope for market evolution and adaptation was severely constrained by the Court action.

In a securities trading structure in which firms are able to act as both agents and principals, a firm which wishes to operate in a dual capacity role is likely to require a good deal more capital than is available to most partnerships. Indeed, to judge from American experience over the past decade or so, it seems quite likely that the partnership form will increasingly give place to the corporate entity as the major form of business structure in the securities area. Apart from additional capital, a firm which has hitherto operated exclusively in an agency role will need—if it plans to be able to operate in future also as a principal—to have access to dealing skills. And even firms that wish to continue purely in an agency capacity may be concerned if at all possible to strengthen their own capital bases so that they are in a better position to face up to the vigorous competition that is in prospect when commissions become negotiable. Influences such as these account for the extensive discussions between stock exchange member firms and potential partners, and many associations have of course already been struck either through stakes directly in existing firms or through the formation of jointly-owned international dealerships.

The present stock exchange rules limit non-member participation in member firms to 29.9%. While this restriction is no doubt seen as a material discouragement by some who might be interested only in full ownership or, at any rate, control, for others the possibility of taking a 29.9% stake now is seen as a means of establishing a foothold, their expectation being that this will stand them in good stead as the market opens up later. I use this term 'opening up' designedly because of the growing recognition that there are powerful institutions, both foreign and domestic, which are not members of the Stock Exchange, and which are quite capable of making efficient and competitive markets outside and, to an increasing extent, are already doing so. It seems to me that the market fragmentation to which this leads is unattractive and undesirable because it tends both to make market liquidity overall less than it would otherwise be and seriously to exacerbate the problem of ensuring effective market regulation.

But compelling as these arguments are for concentrating securities activity to the maximum extent possible through the central market provided by the Stock Exchange, no central market can expect to maintain its position, and still less to draw in additional business, unless it is at least as competitive and efficient as markets outside, and is ready to accommodate participants who would otherwise have no alternative but to undertake their business outside. I know that the importance of bringing outsiders and their business into the market is well recognised and understood in the Stock Exchange, and the immediate task is to devise satisfactory ways and means of proceeding which are fair to existing members of the market, making appropriate allowance for their very substantial investment in it and, at the same time, allow new members to join on a reasonable footing. I know the Stock Exchange is preparing an important discussion document on these matters.

Regulation and supervision

I turn now to matters of conflict of interest and of regulation and supervision, for the easing of institutional barriers in this country will not, of course, be able to proceed completely unchecked by any consideration other than expediency and commercial advantage. Some of the changes which have been suggested are at present prevented by specific statutory barriers, and cannot therefore come about without appropriate legislative action by government. This would be the case, for example, if the building societies were to be allowed to undertake unsecured lending. In other areas, however, there are no absolute statutory bars to change. But other considerations may in fact set some limits to the extent to which barriers might be eased, and we plainly need to identify and determine how to deal with these as an integral part of the process.

One major consideration is that different financial services are subject to prudential supervision and regulation by different authorities, some statutory and others non-statutory. The Department of Trade and Industry regulates the insurance companies; we in the Bank of England regulate the banks and deposit-takers; and City markets such as the Stock Exchange, Lloyd's, the commodity markets and the London International Financial Futures Exchange each regulate their own members. Indeed, if anything like Professor Gower's recommendations on investor protection were to be accepted and implemented, the network of external regulation by self-regulatory agencies could be substantially increased.

Clearly, no one institution can simultaneously provide an array of financial services if the regulatory requirements applying to each are mutually incompatible. In some cases, the potential difficulties of overlapping jurisdiction could be solved by an appropriate degree of separation of each activity within the institution concerned. But in others, where different activities require different capital, liquidity or asset structures, the necessary degree of separation may well entail entrusting each of the activities in question to a separate company within a group. Even this, however, will not necessarily provide the answer to all worries. There may, for example, remain a concern about the risk of cross infection—that is, that difficulties experienced by one company within a group may have an undesirable impact on another, either because financial worth is drained from it as a consequence of a decision taken at group level, or because the difficulties of one company might undermine public confidence in its sibling.

In addition to incompatibility of regulation, there may also be circumstances in which incompatibility of function will limit the scope for liberalisation. Let me give you an example. One of the important operational responsibilities of the Bank of England is the management of the money market. In fulfilling this function, we prefer to operate through intermediaries rather than directly with banks, and our chosen intermediaries are the discount houses, with whom we necessarily have close relationships. Quite clearly, we could not continue to use them as our

intermediaries if, as the result of their involvement with other financial activities in the wake of institutional liberalisation, their solvency and operational integrity were put at risk so that they could no longer be relied upon to perform continuously the functions we require of them in the money market. Somewhat similar considerations might arise if events in the Stock Exchange led to a radically different structure for the gilt-edged market. In both cases our principal concern would be to ensure that our capacity to carry out the operations necessary for the implementation of monetary policy was not impaired.

The risks of cross infection and of conflicts of interest are naturally of concern to the Bank of England in administering the Banking Act, under which most deposit-taking activity in this country is regulated. But they are not the only considerations. Before granting recognition to a bank, or giving a licence to take deposits, we need to be satisfied that the business will be carried on with integrity and prudence. We also need to be satisfied that it will maintain adequate capital. When a bank or licensed deposit taker changes hands, we examine carefully the standing and financial strength of the acquiror and its plans for the enterprise it is acquiring. Where a non-bank proposes to acquire a bank, we pay particular attention to any potential conflicts of interest which might be created and the steps which might be taken to resolve them. We also need to be satisfied that any non-bank acquiror appreciates the extent of the moral commitment which we expect from the owners of a deposit-taking company, which may exceed the degree of commitment required by law.

The possibility of abuses which can arise from conflicts of interest was much in the mind of Parliament when it determined that Lloyd's brokers and underwriters should divest themselves of any significant interest one in the other. The process of implementation of this decision that is now in train has prompted many to wonder whether single capacity should not be enforced by law in all financial markets. The question clearly has great relevance to the sort of changes in prospect in the Stock Exchange, to which I referred earlier. There is, however, no particularly compelling reason for supposing that the arrangements best suited to avoiding conflicts of interest in one market are equally appropriate to all. Lloyd's and the Stock Exchange differ from each other as markets in many ways. For instance, in Lloyd's the underwriter effectively generates the product which the broker sells, whereas in the Stock Exchange, the jobber trades in, but does not generate, the product which is the subject of dealing.

Financial markets take a wide diversity of forms, and arrangements for investor or user protection need to be tailored to the activity in question, having regard in particular to the need of the market or activity concerned to be able to compete successfully. In the realm of financial services, competition is increasingly becoming international and there is a delicate but vital balance to be struck between maintaining the high standards of integrity for which our financial service industry is renowned while adapting to market developments that are necessary if we are to continue to be players in these markets.

It would in any event be mistaken to disregard the extent to which the process of institutional liberalisation and other changes that I have described may in fact help to ease some regulatory problems. New problems will undoubtedly arise, for example as possible conflicts of interest are enlarged, but I believe that the greater competition which is likely to be generated can itself play an important part in promoting the interests of investors and others. In an environment in which financial intermediaries are in direct and open competition, the pressures on them, above all to ensure that their product is both what their clients want and competitively priced, could themselves serve to strengthen the position of the client compared with a situation in which competition is less, or at any rate less overt, and there is consequently less freedom of choice.

Foreign ownership

I turn now to the matter of foreign ownership of UK financial institutions and foreign participation in our financial markets, neither being novel but both becoming much more lively issues in the present environment. Foreign-owned intermediaries may, of course, come into existence as the result of take-overs or because they are established here by the foreign parent. I do not propose to address in any detail policy on take-overs or establishment. But I do want to address the concern that, in association with and perhaps because of institutional liberalisation, a bigger share of what may broadly be called financial intermediation in this country may, by one means or another, come into the hands of foreign holders. There would in fact be nothing altogether new about this. Many foreign banks are established in this country, as are many foreign securities traders and futures traders. Foreign insurance groups make a significant and welcome contribution in the Lloyd's insurance market. London would not be the international financial centre that it is, still less able to look forward to the substantial further development that could now be a real prospect, without the presence and participation of the leading foreign institutions in our various market places.

The question of foreign ownership has, however, been given particular topicality by developments in the Stock Exchange. I believe that greater foreign involvement in our securities industry could bring substantial benefit, in particular through enhancing market liquidity and trading volume. But such participation needs to be properly accommodated in a way that has regard to the stake of existing British firms in the Stock Exchange structure and does not permit any firm to establish, by virtue of its size elsewhere, a dominant position that could then be exploited in an anti-competitive way. With this last point in mind, it would seem important to ensure that firms that wish to play an active role in whatever market structure is in due course devised do so through a separately capitalised subsidiary that is solely involved in that particular market activity.

Recognition of the benefits that foreign participation can bring does not of course imply indifference to where control of major participants in our markets lies, and we would not contemplate with equanimity a stock exchange in which British-owned member firms played a clearly subordinate role, any more than we would like to see Lloyd's or any other City market dominated by overseas interests. If this is to be avoided, and yet the door to foreign participation—and the vigour and fresh experience that it brings—is to be open, it will be necessary for British firms to be substantially strengthened so that they can compete on an even-handed basis. We have already seen a number of promising moves in this direction and the Bank, for its part, will continue positively to encourage the development of a British securities trading capacity better able to compete in world markets. I have little doubt that we have in this country the wits and skills to take on the keenest competition that the rest of the world can offer on a fair basis, but that wit and skill needs to be supported with adequate financial muscle.

Closing remarks

I would now like to draw the main threads together. I have referred to the currents of change that are eroding and in some areas sweeping away traditional barriers between different types of financial services, with developments in the Stock Exchange providing, particularly, an important reason and focus for change. For many of those engaged in these activities, the process will be neither wholly smooth nor comfortable, as established ways of doing business and many traditional protections succumb to technological and competitive pressure which is no respecter of these things but whose influence, one way or another, is pervasive and unavoidable. This is, of course, far from saying that there should be no parameters and that all constraints in the way of institutional liberalisation should be abandoned, and it may be helpful to register in summary form some basic criteria that will guide us in our response to proposals for change in areas which are the particular concern of the Bank.

I list five in number, not in any particular order of priority; not all of these criteria will be relevant in every case, and they will not necessarily all carry the same weight in different cases where they are relevant:

- We will want to foster healthy, vigorous, competitive markets in financial services.
- We will seek to ensure the observance of suitable prudential standards in the interest of those who entrust their funds to financial intermediaries.
- We will expect to see overt and credible arrangements to avoid the risks of abuse arising from conflicts of interest.
- We will be concerned to ensure that our capacity to operate monetary policy is unimpaired.
- As a major international financial centre, we will continue to welcome foreign participation, while at the same time encouraging the development of soundly capitalised British-owned institutions.

It will be observed reasonably enough that these criteria are very broad in scope, and they are indeed deliberately so. The financial service industry is going through a phase of very rapid change, generating insistent competitive pressures, both domestically and internationally, that oblige those who wish to remain effective participants to respond. The response cannot come from a rigid blueprint drawn by government or the Bank of England but has to come through adaptation in markets themselves. The authorities can help to provide a favourable environment, but they cannot in the end substitute for the responses of market participants themselves. I believe that the most constructive contribution that can be made by the authorities is to be liberal in their approach, ready to accept that the convenience of many traditional demarcations and ways of doing business may need to be set aside so that new energies and enterprise can be released.

Many constraints will of course need to be kept in place, and new methods of supervision and regulation will need to be devised as new potential strains and conflicts of interest emerge. But I believe that the problems here are manageable, and that the atmosphere of keener competition that is likely to develop will itself make a contribution to resolving them. What is clear is that our financial services, and the British securities industry in particular, face some very exciting opportunities which, if they can be effectively grasped, will greatly benefit both the firms concerned and the nation.