The business of financial supervision

In the Joseph Travers Lecture[1] *the* ***Deputy Governor*** *discusses the need for supervision in financial markets. He notes that there has been a veritable explosion of competition and innovation in financial markets and that ferment seems likely to continue. Against this background, the case for financial supervision is explained and the various forms it may take discussed.*

The ***Deputy Governor*** *concludes that supervisory authorities should adopt an eclectic and pragmatic approach, adapting their methods in a changing world, but continuously clear as to ultimate objectives. Financial institutions for their part must accept a continuing need for supervision, but individually must not draw from it any reassurance about the certainty of their own future.*

Ferment in financial markets

In recent years many events have combined to focus attention on the relationships between financial markets and what we may loosely call 'the authorities'.

Internationally, many people believe that a number of sovereign borrowers were lent too much money by the banking system. Questions are asked whether this could have been—and if so should have been— prevented by supervisory action. Looking ahead, further questions are asked about what the authorities' role should now be.

Domestically in many countries—but most notably in the United States and the United Kingdom—there has been a veritable explosion of competition and innovation as older regulations—or conventions or inhibitions—are removed or withdrawn.

One striking example in the United Kingdom has been the breakdown of the banks' and the building societies' inhibitions against competing in each other's markets: the banks are now heavily involved in the provision of home loans, while the building societies have started to raise funds in the wholesale money markets and provide more extensive money transmission services to their depositors.

In the United States there have been great waves of innovation both in the combinations of liquidity and interest offered on bank deposits and in the means of money transmission and payments.

Outside banking, there has been in the United Kingdom the debate over the Lloyd's Act and its subsequent implementation; and the prospect of changes in the rules of the Stock Exchange has posed a whole series of issues for securities trading.

More generally, we are in the midst of a widespread questioning of the justification for old-established institutional boundaries throughout the whole of the financial services area. Increasingly it is suggested that mergers or new forms of association between different types of specialist institutions may mean better and cheaper products overall.

Such ferment must be generally welcome. Financial services, with their relatively homogeneous products and the rapid transmission of information, can in principle provide an outstanding example of the efficiency which can result from classical competitive capitalism.

But there are of course potential problems. One of them—which is not my subject tonight—has been the consequences for the implementation of monetary policy. Others, which are of my immediate concern, relate to supervision. What role should the financial supervisor play? How best to maximise the benefits to all of us from competition and innovation while minimising the potential drawbacks and dangers?

Why supervise financial markets?

In an attempt to answer these questions, let us begin by standing back from recent detail and by asking a more fundamental question. Why should financial markets require supervision at all? What is it that makes them different from many other markets for goods and services where there is no analogy—or only a very pale one—to the supervision and regulations that are found in virtually all countries for financial markets.

I have suggested that financial markets in many ways approximate well to the ideals of classical competition. In this context there is a long-standing liberal tradition extending from Adam Smith—latterly the subject of a rather abstract, indeed abstruse, treatment by Debreu, the recent Nobel Prize Winner in economics—in which it is argued that the efficient allocation of resources can be achieved by competitive markets, the only role for laws or regulations being the determination of property rights.

In an idealised competitive economy there is no role for a third party in the supervision of voluntary transactions between buyers and sellers. Those directly involved in

(1) At the City of London Polytechnic on 9 November 1983.

the transaction merely abide by the principle of *caveat emptor*—the intervention of a third party can only be distortionary. What therefore is the intellectual case for the supervision of financial markets?

In addressing this question it is worth remembering that there are important differences between financial services. Insurance, securities trading and banking are very different activities—a fact the implications of which for supervision of conglomerates we shall return to later. Looking at them separately one can perhaps see a number of rather separate *raisons d'être* for a supervisor or regulator.

A market structure approach

The first of these might be styled the need to foster the efficiency, the breadth and the integrity of the market by minimising the disadvantages—economic, social and even moral—of conflicts of interest.

Like most goods and other services, financial services have to be distributed as well as produced. Whereas for most goods, producers and consumers are brought together by means of retailers, for many financial services —for example, securities or insurance policies—the intermediating function is performed by brokers. The economic role of the broking function in reducing the costs of information gathering for both producers and purchasers of financial services is obvious. But this function can only be properly carried out if the relationship between it and the producer or principal's function is clear or if special safeguards are in place. Otherwise, the broker, who is ostensibly finding for the purchaser the best insurance policy or the best price for a security, is also involved in selling a particular insurance policy or security, and the purchaser may not in fact get the broking service for which he is paying.

There are various ways of attempting to ensure that conflicts of interest either do not arise, or that if they do, they do not do economic damage. In the United Kingdom there has been a strong tradition in favour of achieving this by 'single' or 'separate capacity'. Thus for trading in domestic securities on the Stock Exchange the broking function has been separated from the market-making or jobbing function. Stockbrokers can act only as agents for their clients and jobbers cannot deal directly with the investing public. Similarly in the currency and sterling money markets, banks and brokers are kept firmly separate by Bank of England rules. Separation of capacity does not, however, apply in the eurobond market in domestic securities trading outside the Stock Exchange, or in commodity and financial futures markets.

Insurance is another exception to this rule: one party can have an interest in both broking and underwriting. But in the case of Lloyd's, concern was aroused over the existence of conflicts of interest and the possibility of their abuse. For this reason the 1982 Lloyd's Act requires the dissolution of existing associations between brokers and underwriters within five years and prohibits the formation of new associations. Moreover, greatly increased levels of disclosure are planned.

A further exception in the United Kingdom exists in relation to the various activities of the banks: for example, fund management and stock-issuing involve potential conflicts of interest, but the banks have been able to maintain the confidence of their customers that a Chinese wall of silence exists between their different activities.

Disclosure—an alternative approach

This very brief account indicates that there is more than one way of safeguarding investors' interests. Institutionally separating capacity is a conceptually simple and rather convincing way of ensuring that the market not only works efficiently but is seen to do so. But there are other approaches. If one does not institutionally ensure that conflicts of interest do not exist, it is necessary to ensure that where they do exist they cannot be used to exploit others. For this, disclosure of what is actually going on is essential. Thus an efficient and uncorrupt securities market without single capacity will require full disclosure of prices and deals done so that customers can check that they are getting the going price.

Which approach is best will naturally be a matter of argument—and will partly depend on the consequences in other aspects. For example, it is often argued that abolition of single capacity could lead, through agglomeration, to substantial economies of scale. On the other hand, the information required to make any other system work may be very costly both to produce and to consume.

One way of looking at the appropriateness of any particular form of supervision for any particular market is, indeed, in terms of cost and effectiveness of the information system which it provides. Superficially one might assume that the best approach was for the authorities simply to require total disclosure from all participants and then rely on *caveat emptor.* But a little thought shows that this can become an unworkable concept. In a very active securities market, an investor who has nothing to rely on except disclosed prices and who wants to be reassured that he has got the best price will want to know not just the price in the market on that day, but the price at that hour—or perhaps even that minute. And, he will wonder, what and where is the market? Have the prices that I have seen been all that are relevant? Or are there deals being done off this market in other markets of which I am not aware? This suggests that, in the absence of single capacity, adequate client protection may require not only full disclosure but also some provision to give assurance that all business is at least exposed in the market place.

Similarly, to rely on publicly disclosed information alone for confidence that Chinese walls within merchant banks were being maintained would require a very sophisticated assessment of a large number of deals and decisions—which in the nature of things could only be made known imperfectly and with considerable delay.

Supervision through personal knowledge

It is perhaps because of the difficulty and costliness of presenting and assessing a full array of factual information about financial institutions that both supervisors and self-regulating markets themselves have tended to encapsulate information in various ways.

The most traditional of all was to rely on one's knowledge of the people concerned. In their origins, markets like the Stock Exchange or Lloyd's were able to function because those concerned broadly knew each other and knew whom to trust and for how much. To know the man did duty for knowing his balance sheet or seeing whether his left hand knew what his right hand was doing. This personal knowledge could—and can—be further extended by the development of a club or market, membership of which would only be granted to those who were believed on direct evidence to be trustworthy— and which, once granted, provided a form of encapsulated information for others who had no direct knowledge of the man concerned.

For small markets this form of information dispersal may well be the most effective; as it can also provide the most effective basis for supervision by an outside authority. It has traditionally formed the basis of the Bank of England's supervision of the British banking system; and though in this case the vast increase in the number of people and institutions involved in banking has required that it be supplemented by more formal information requirements, we still regard knowledge of the people concerned as the most important supervisory tool.

To take this approach a step further, the supervisor himself may be seen as an efficient way of encapsulating some of the information necessary for the market concerned to work. He may do this partly by requiring particular forms of public transparency; but it may be at some points more efficient for him simply to make his own judgements on the basis of qualitative assessments which he then transfers to the markets in the form of a seal of approval, a licence or a recognition.

To sum up so far then, an essential requirement for orderly, efficient and uncorrupt markets is the provision of information about the participants and their transactions. But there is a whole spectrum of ways in which the necessary information can be provided, whether by an outside supervisor or by the market authorities themselves, and whether in terms of numbers and ratios or in more qualitative ways. As markets grow and develop so the most effective form of supervision is likely to have to change and develop too.

Role and limits of investor protection

I come now to a second *raison d'être* of supervision which one might perhaps characterise as more social than economic: the protection from substantial loss of the ordinary individual who deposits money in a bank or buys an insurance policy. How far such protection should go is of course a matter of judgement. Certainly there should be an initial presumption of *caveat emptor* to be overcome. In many contexts it is healthy to require individuals to make their own judgements, enjoy their own successes and suffer their own mistakes. A strongly competitive and innovative environment will be of great value; but in an uncertain world this will inevitably mean that mistakes will be made and money be lost.

But problems arise where it is inherently difficult for the individual consumer to assess the good or service he is buying—or where the learning process for the society may be judged too costly or too difficult. Thus we have safety regulations for cars and for some foods and drugs. Similarly there seems to be a case for laying down minimum standards or guidelines for some activities where an individual would find it hard to assess for himself the risk of loss in a particular transaction and where, at the same time, the cost of being wrong might be relatively severe. These criteria taken together might suggest that there was a relatively weak case for serious supervision of say the mail order industry but a strong case in respect of life insurance business and banks.

The aim of the guidelines or regulations or whatever form the supervision takes in these cases will be to try to ensure that the institutions concerned are well and soundly run; and that consequently they are likely to meet whatever obligations they undertake when called upon to do so. However, a further complication then arises. The fact that the institutions concerned are regulated or supervised may be taken, even if inappropriately, as in some sense meaning that they have been given an official seal of approval. Some may then wish to draw a further inference that the supervisory authorities carry some responsibility towards those members of the public that have put their trust in, and their money with, the institutions. There may grow up the belief that either the authorities will not allow the institutions to fail, or that if they fail the depositors or policy holders will be 'bailed out'.

This is the so-called moral hazard problem and it is clearly something which the authorities must be careful to minimise. However rigorous the standards he lays down and however strictly he demands that they be met, the supervisor must never get into the position of being directly accountable for the running and thus the ultimate health of any private sector institution that he is supervising. He cannot second guess all the decisions and all the risk-taking of management. There must and should remain the possibility that errors or bad luck can lead to a clearly perceived failure of a particular management. In such circumstances the management and shareholders must be subject to the normal consequences of business failure—dismissal from office, loss of capital and income etc. This fundamental tenet of the supervisors' creed was put most succinctly by the former Chairman of the Federal Reserve System, Dr Arthur Burns, when, being asked by a bank what the Federal Reserve would do in the event of a banking collapse, replied that he would be glad to discuss that question with their successors as management.

But all this still leaves open the question of what happens to those unconnected with the bank or insurance company who have placed their money with it. I shall have more to say of banks in a moment. But in many other cases, the question is primarily a political or social one. It may be felt that some degree of protection should be available to the small man. If so, schemes can be devised to insure this. Both in the United Kingdom and the United States there are in fact deposit protection or insurance schemes in operation. In this country, in the event of failure of a bank or licensed deposit-taker, the Deposit Protection Board provides compensation, but only in respect of 75% of deposits for total deposits of up to £10,000; and this compensation is funded by contributions from the banks themselves. This obviously preserves some degree of *caveat emptor*. In the United States, where the bank failures of the 1930s proved a traumatic experience, the depositor is more fully protected. Deposits of up to $100,000 are protected to their full amount.

The limitation of protection in the United Kingdom, however, reflects the surely sound principle that even the small man, and *a fortiori* the rich or professional investor, should not be fully compensated for losses due to mismanagement. In a competitive market depositors can earn a higher return if they place their funds with somewhat higher risk institutions. With full compensation, there might be an undue incentive to place funds with institutions with high risk/high return corporate strategies.

It is sometimes suggested that privately run contractual insurance schemes could provide a market solution instead of an official one to the problem of depositor protection and indeed of supervision itself. But it is quite clear that moral hazard and other problems are too pervasive for this sort of risk. The possibility of a claim does not depend just on acts of God but also on the management of the bank; and the incentive to behave with due care may be reduced if deposit insurance can be purchased. Private insurers might try to counter this problem by varying their premium rates, depending on the perceived riskiness of the deposit-taker. But any attempt to assess the riskiness of each bank would require an organisation not too dissimilar, both in its organisation and in the demands it made on the banks, from the Bank of England's own Banking Supervision Division. Moreover, in relation to the banking system there is a further problem to which I now turn.

The risk of contagion

The last and most subtle need for financial supervision is what one might style the risk of contagion. This danger is particularly acute for the banking system. If one car manufacturer, for example, or one travel agent should fail, the ill effects are likely to be felt most by those who have had dealings with that institution; the repercussions for the industry as a whole—and still more for the economy as a whole—will tend to be much less serious. Indeed, competitors may actually gain some of their late rival's market share.

This could also occur with an isolated bank failure, especially when the reasons for the failure can be clearly seen to be specific to that bank. But in certain circumstances, the collapse of a bank could, in the absence of any official action, lead to a loss of confidence in the system as a whole and a massive withdrawal of funds. The reason is perhaps twofold. Individuals may be unable to judge quickly whether the failure of the individual bank is due solely to its own shortcomings or whether the factors that brought it down are more general. At the same time, they can withdraw their deposits not just from one bank but from the whole banking industry and turn them into cash with great speed and at little cost. In this context, formal disclosure requirements are unlikely to be of much practical assistance. Irrespective of the strength of a bank's balance sheet on objective grounds, it may still be rendered insolvent by the actions of other depositors. As a result, banks which are perfectly solvent, and hold sizable liquid reserves, can suffer a liquidity shortage which might cause them to fail.

The provision of liquidity to the banking system during times of crisis should be distinguished from the day-to-day role of the Bank in alleviating cash shortages in the money markets. This activity is directed toward meeting the objectives of monetary policy rather than according to prudential considerations. Under normal circumstances, the authorities ensure through their money-market operations that adequate liquidity is available to the banking system at a price. Imbalances between the banks are adjusted by trading surpluses and deficits of liquidity with each other through the interbank market.

During times of acute stress, however, parts of the interbank market can seize up, as occurred in the euromarkets following the Herstatt closure in 1974. Like personal customers, lenders in the interbank market may lack reliable information on the implications of a shock for the solvency of other banks. This may lead to attempts by banks to withdraw or reduce lines of credit to other banks, not necessarily because they regard the borrowing banks as unsound, but in order to protect themselves from a liquidity crisis precipitated by the withdrawal of loans from other banks. In the absence of co-operation between creditor banks, there can be a tendency for those who cut-and-run to bring down the rest.

From time to time it has therefore been necessary to secure the co-operation of the banks to avoid disruption in the interbank market. During the secondary banking crisis in 1974, very large sums of money flowed out of the secondary banks to the clearing banks, funds which were essentially recycled back to the secondary banks through the clearing banks under the 'lifeboat' scheme. More recently, attempts have been made to curb the withdrawal of interbank lines to the overseas offices of banks based in countries with debt rescheduling problems.

The problem of contagion leading to systemic failure and the impossibility for the authorities to specify precisely what actions they would take in such hypothetical circumstances would present a further difficulty for private insurance schemes. The capital base of the insurance industry is hardly sufficient to cover a complete failure of the system and were such an eventuality excluded from cover in much the same way that buildings insurance excludes damage due to war or nuclear incidents, the reassurance provided to depositors would be much diminished.

The problem of contagion is also a reason for preventing those who fail to achieve club membership as banks or licensed deposit-takers from taking deposits. If the problem of contagion did not exist, there might be a case for confining supervisory action to the labelling of deposit-takers, without going on formally to bar those who failed to become accredited from carrying on business: depositors would place their funds with institutions so labelled at their own risk. The difficulty of isolating contagion resulting from an insolvency in the non-accredited sector may alone disallow such an option, though there is also a case for protecting unsophisticated depositors from unreliable operators.

Conclusions

What then can we conclude from all this? My first conclusion is on the need for an eclectic and pragmatic approach. I have tried to indicate that there are different purposes which supervisors may try to achieve and that the differences between markets may indicate differences in supervisory approach. It is also true, though I have not dwelt on it, that different markets are looked after by different authorities. This striking variety carries a number of implications for the period ahead during which we are bound to see great changes in all the financial markets—not least in their institutional organisation—as the boundaries between building societies, banks, securities dealers, insurance companies and others become increasingly blurred.

As supervisors, our first obligation will be to ensure that we continue to serve and help beneficent economic development rather than direct or restrict it. We shall have to be alert to the problems created by the merging of institutions hitherto supervised in different ways—sometimes even by different authorities. We shall have to be undoctrinaire in adapting our methods in a changing world and continuously clear as to what our ultimate aims should be. While we must always be prepared to prevent a systemic failure, it remains crucial that no particular degree of comfort or support be promised or implied for any individual or institution.

Equally there are implications for the financial institutions themselves. However their circumstances and activities change, they must expect a continuing supervisory regime. They will inevitably find that there is no simple dichotomy between prohibition and freedom or free markets and dirigisme. If institutional straitjackets are loosened, for example, disclosure or other supervisory obligations may grow more heavy.

I hope and believe that UK financial markets will continue to find the supervisory regimes helpful in the reassurances they give about the rules of the games being played and the behaviour of the other players. The one reassurance an institution cannot draw from its supervisor is about the certainty of its own future.