Change and development in international financial markets

*The **Deputy Governor** reviews[1] the major changes in the role of the banks that have taken place over the past ten years, against a background first of the rapid expansion of cross-border lending and then, in the early 1980s, of more restrictive conditions and growing debt problems. One factor behind the expansion of the banks' role in the 1970s was the dismantling of barriers to competition. This has brought major advantages but has also made it more difficult to ensure the stability and integrity of the financial system, underlining the need for adequate capital and liquidity: and the **Deputy Governor** argues that, in an increasingly integrated world, market supervisors need to strive towards convergence of prudential standards across countries.*

*The **Deputy Governor** goes on to examine the current trend toward securitisation of lending and the pressures of competition and innovation which have stimulated it. He warns that, while many of the new techniques offer potential advantages—to lenders and borrowers alike—in terms of greater flexibility, they also carry additional risks, which need to be fully understood and carefully weighed. In particular, liquidity is not necessarily improved, nor the need for capital backing diminished, by increased marketability of an asset: and the allocation of responsibility for credit risks under the new techniques has to be clearly established and properly provided for.*

The past decade—a testing period for all the international financial markets—has seen particularly important changes for the role of the banks. During the 1970s there was a tremendous upsurge in financial flows between countries, much of which was channelled through the banking system. By increasing their international exposure, most notably through syndicated credits, many banks were able to achieve spectacular increases in their overall balance sheet size. Moreover, the development of wholesale money markets made it possible to pursue ambitious lending policies without the need to develop an extensive retail deposit base.

The exceptionally rapid growth of banks' balance sheets began to falter in the changed economic circumstances of the early 1980s. The announcement of the Mexican debt moratorium in August 1982 was a watershed and, since that time, the banking system has been undergoing a period of retrenchment. The process whereby an ever-increasing proportion of international financial flows was channelled through the banking sector has certainly halted, and probably gone into reverse; and there has been a degree of disintermediation away from the banks into other channels of finance.

The banks' expansionary phase

The remarkable growth of financial flows during the 1970s can be traced back to the macroeconomic conditions of the period. The build up of inflationary pressures contributed to the breakdown in 1971 of the Bretton Woods system of fixed parities, and to the increased volatility of exchange rates and interest rates thereafter. As the 1970s progressed, a number of industrialised countries experienced higher rates of inflation and greater uncertainty over future movements in prices. Divergences in countries' competitiveness widened; and, largely as a consequence, trade imbalances between these countries tended to grow. Superimposed on these developments were two major oil price rises instigated by OPEC—the first in 1973 and the second in 1978–79—both of which exacerbated imbalances on external account. The counterparts to these imbalances in income and expenditure were financial flows between countries on an historically unprecedented scale.

During the 1970s, the banking system played a major role in recycling the oil surpluses and financing balance of payments deficits. In particular, the banks increased their share of net cross-border financial flows to ldcs—from 15% to 25%—at a time when the total current account deficit of these countries rose from 2% of their combined GNP to 4%. Much of the increase can be attributed to the development of large-scale lending by syndicates of banks—syndicated credits—to sovereign borrowers and major private institutions. The loans were denominated largely in US dollars and interest was charged on a floating-rate basis, although much of the dollar business—around 80%—was booked outside the United States in the eurocurrency markets.

In many ways the development of syndicated credits was a major achievement. In absolute terms there was some growth in fixed-rate bond finance, mainly in dollars, but

(1) In a speech at the 38th International Banking Summer School in Cambridge, on 15 July.

also in low-inflation currencies such as deutschemarks and Swiss francs. But uncertainty over inflation became a serious deterrent to fixed-rate finance and its share of the total fell from a peak of 55% of funds raised on international markets in the mid-1970s to only 25% in 1981. The relative contribution of official and inter-governmental finance for current account deficits also declined and, in contrast to the inter-war and immediate post-war periods, played a less important role in the international financial system. In the absence of a major new initiative on official finance during the 1970s, the banks successfully filled the gap at a time when the world's financing requirements had grown dramatically.

International and domestic debt problems in the early 1980s

For many countries, the unhappy experience of inflation in the early and mid-1970s led to a disenchantment with expansionary domestic policies and, at international fora, the governments of the major economies resisted pressure to act as locomotives or leaders of convoys—the role in which some of them had been cast in 1978. Most of the major countries responded to the second oil price shock by adopting restrictive policies and—during the transition to lower inflation—real interest rates rose, industrial output and demand fell, and oil and commodity prices weakened.

The new macroeconomic conjuncture had important repercussions on the quality of bank loans. A wide range of countries were hit by lower demand for their exports, an adverse shift in their terms of trade, and rising debt service charges. As banks lost their appetite for additional lending, the schedule of repayments to which these countries had committed themselves over the previous decade was found to be unmanageable; and, in the two years following the announcement of the Mexican debt moratorium, thirty-three countries, with outstanding debts of over $300 billion, found it necessary to negotiate rescheduling agreements with their bank creditors.

The banks' problem loans, however, were not confined to sovereign borrowers. In the industrialised countries, the recession produced a sharp increase in the number of borrowers facing difficulties. In the United Kingdom, for example, the major clearing banks' charge for specific provisions against domestic risks rose from a negligible amount in 1979 to close to £½ billion last year—an amount equivalent to one quarter of their pre-tax profits. In the United States, the weakening of oil prices in dollar terms has had a detrimental effect on the energy sector; and US agriculture has suffered a sharp loss of profitability as a result of the strength of the exchange rate, high interest rates and low commodity prices. The problems in these sectors have been exacerbated by consequential falls in real estate values, which in some cases have undermined the banks' collateral against their lending. Similar difficulties are now beginning to be felt in the US manufacturing sector as a consequence of the delayed effect of the loss of competitiveness.

Some part of the present discomfort of the banking sector may prove to be temporary. The banks' problems are symptomatic of the transitional costs of counter-inflation policy—the deferred penalty for over-lax policies in the 1970s. There may nevertheless be a longer-term structural problem arising from the banks' success at securing an important share of the world's cross-border intermediation—with its attendant risks. One of the factors behind this remarkable growth can perhaps be traced back over a decade or more to developments within the banking sector itself.

Nature of competition in modern banking

An important change in the nature of competition in banking appears to have started with the US money-centre banks in the late 1960s, and subsequently spread to banks in other countries. The erosion of inhibitions against competition in the provision of loans and the advent of multiple banking—whereby customers maintain a number of banking relationships simultaneously—encouraged a number of US money-centre banks to revise their corporate strategies and pursue policies of asset-led growth. The marketing of loans became a major preoccupation of senior management and, at more junior levels, success as a loan officer became an important route to promotion. The interest rate ceilings on deposits imposed under the US Federal Reserve Board's Regulation Q did not apply to certificates of deposit and, partly for this reason, greater reliance was placed on the wholesale money markets to fund the banks' ever-expanding lending commitments. The end product of this change of strategy was the attainment of real growth of 20% in the balance sheet size of the US banks in the latter half of the 1960s.

The shift in emphasis to asset-led growth subsequently spread to banks in other countries. It became evident in the United Kingdom following the abolition of lending controls in 1971 and the demise of the clearing bank cartel, announced as part of a package of official measures known as 'Competition and credit control'. The intermittent use throughout the 1970s of the supplementary special deposit scheme—an arrangement which had the effect of restricting the expansion of bank lending—acted as a partial brake on banking competition in the United Kingdom; but its abolition in 1980—following the removal of exchange controls in the previous year—and the ending of hire purchase controls in 1982 have largely completed the dismantling of official restrictions against banking competition in the United Kingdom.

Increased competition between the banks has generally proved to be beneficial. For many customers there has been a significant reduction in margins between lending and deposit rates. Competition from the banks has reduced the cost of financial intermediation generally, to the benefit of savers and borrowers, and lowered the cost of holding liquidity. Arrangements for drawing down loans and making deposits have become much more flexible: loan agreements and facilities can accommodate large fluctuations in customers' cash flow, and uncertainty over future expenditure and receipts. The range of loans on offer has also become much broader: variable-rate loans with 7–10 year terms are now commonplace for companies; and there has been a revolution in the marketing of personal banking services.

In some respects, the approach to banking which evolved in the 1970s—with its emphasis on asset-led growth and flexibility in the drawing down of loans—turned the traditional view of sound banking practice on its head. Victorian exponents of prudent banking tended to view banks' balance sheets size as being essentially deposit-led: institutions of sound reputation would attract deposits from customers, the proceeds from which would be used to acquire relatively safe assets—government bonds, Treasury bills, trade bills and generally short-term secured lending. Lending to companies should, on this more traditional view, largely be restricted to the financing of working capital—fixed investment being financed by issues of equity or debentures.

The banks' commitment to meet their customers' borrowing requirements through a wide range of facilities is perhaps one of the major innovations of the last decade. The banks' ability to fund a generally increasing, but also fluctuating, demand for credit depends heavily on their ability to attract wholesale deposits and issue CDs. The capability to manage liabilities in this way is predicated on there being a highly liquid and efficient interbank market. The development of this market, and in particular the offshore eurodollar market, is rightly regarded as one of the banking success stories of the 1970s. The arrangement is eminently sensible because increased lending to customers by one bank will create—somewhere in the interbank system—a surplus of funds which, under normal circumstances, can be channelled back to where they are needed.

The attractions of this approach have latterly encouraged the building society movement in the United Kingdom to make tentative moves down the path followed by many banks in the late 1960s and 1970s. Increasingly, the societies are setting their deposit and lending rates in competition with each other, rather than relying on the Building Societies' Association to provide a lead. Increased use is being made of the wholesale money markets and, in particular, the larger societies are issuing CDs through the banks. Widespread queuing for mortgages has virtually ceased, and the first steps are being made toward the advertising and general promotion of mortgage lending. When buying a house, mortgagors are increasingly able to select for themselves the proportion that is borrowed and the amount of funds they provide from their own resources. This has allowed a leakage of mortgage funds for other purposes; and in the United States it has been carried to the point where a home owner can effectively use the equity in his house as security for overdraft borrowing.

In a number of ways, therefore, the behaviour of the banks and building societies would appear to be converging, although the building societies are likely to remain essentially specialist lenders for the housing market. Confining the building societies largely to the financing of owner-occupiers is certainly a central proposal in the recently published Green Paper on the societies; and this approach is likely to be retained in the Building Societies Bill due to be considered in the next parliamentary session.

Stability and integrity of the financial system

Notwithstanding the benefits, more intense competition can make it more difficult to ensure that the stability and integrity of the system remain intact and that depositors are protected. The collapse of Bankhaus Herstatt and Franklin National Bank in the early 1970s and, more recently, the problems of Continental Illinois illustrate the disruption that can be caused to the interbank market if there are doubts about the solvency of a particular institution. Fears and uncertainty about the potential impact on counterparties can cause other banks to suffer funding difficulties even if it might subsequently become evident that they were solvent and have positive net worth.

Since the onset of the banks' debt problems, the interbank market—particularly the dollar market—has become more fragile and prone to shocks. In view of the reduced confidence in the markets generally, the Bank of England felt compelled, last October, to organise a rescue package for Johnson Matthey Bankers. The Bank took the view that there was a very real possibility that a loss of confidence resulting from the collapse of JMB could spread to other British banks and ultimately threaten the health of the banking system as a whole.

In order to protect themselves and the system, banks need to ensure that they maintain sufficient liquidity to withstand disruption in the interbank market which may not necessarily be of their own making. Banks need to ensure that they maintain adequate holdings of readily realisable assets; that they are not over-dependent on particular sources of funding; that their deposit base is stable; and that any maturity mismatching they undertake is prudently managed. Most importantly, the banks need to ensure that they are backed by adequate capital so that losses can be absorbed and depositors safeguarded.

Over the last 18 months considerable progress has been made in improving banks' capital base. In the United Kingdom, the four major clearers, as well as some other banks, have raised significant amounts of capital by issuing subordinated loan stock at fixed and floating rates, and at fixed term or in undated form. Much of the loan capital issued by the British banks has been denominated in foreign currency in order to match their substantial foreign currency business. In formulating guidelines for what constitutes capital, the supervisory authorities have been presented with the difficult task of striking a balance between improving the quality as well as the quantity of banks' capital. In order to safeguard depositors, loan stock needs to be issued on terms that ensure its availability to absorb losses. But over-rigid restrictions may render it unduly difficult to sell. I am glad to say that the number of recent issues of primary perpetual loan stocks suggests that the balance may well be about right.

The protection offered by banks' capital can be undermined, however, if one bank holds another's capital, and the same capital is being used to support the liabilities of both balance sheets. In the United Kingdom, such double counting is generally disallowed and holdings of other banks' loan stock are deducted from the holder's capital base. Other countries, however, must address the danger that the strength of the international system could be undermined if this principle is not applied to their banks.

Whatever the supervisory technicalities, a central feature of a highly competitive environment is that the banks will be straining against the trade-off they face between risk and return. The banks and their supervisors will have to ensure that capital backing is maintained at levels commensurate with the risks being taken. Indeed, in an increasingly integrated world market, supervisors will have to strive towards a convergence of prudential standards across countries so that the incentive for capital to migrate to less onerous supervisory regimes is kept to a minimum. Banks earning low rates of return on their capital may have to reconcile themselves to scaling down their involvement in these areas. For the banks generally, it is important that they confine themselves to areas of financial intermediation in which they have a comparative advantage, and accept that, in some cases, it may be more cost effective for the borrower to issue paper, equity or bonds in his own name or use other channels of finance, rather than the banks as intermediaries.

Securitisation and risk packaging

It is now widely recognised that, for many banks, the era of rapid balance sheet growth has come to a close. However, this is not the end of the story. As a means of enhancing or at least maintaining their earnings many banks are placing greater emphasis on off balance sheet business and they have stepped up their role as intermediaries in the capital markets.

Changes in the pattern of capital flows have also encouraged the redirection of funds through the securities markets rather than across banks' balance sheets. By comparison with the recycling associated with the oil shocks in the 1970s, capital movements now tend to be principally between industrialised countries, with the United States being the largest recipient of funds, and the largest outflows coming from Japan. This has been accompanied by greater use of the bond market, both because the key borrowers in industrial countries have a better credit rating than the ldc borrowers of the 1970s; and because the present holders of surplus funds have a stronger preference for investment in securities than in bank deposits. The shift away from bank deposits may also have been reinforced, since the onset of the debt crisis, by the apparent deterioration in the credit quality of banks relative to prime non-bank borrowers.

These developments have given rise to what has become known as the 'securitisation' of lending. FRNs and bonds are now in greater evidence, often being issued in place of syndicated credits. Moreover, in value terms, a quarter of the new syndicated credits publicised so far this year are in transferable form. In the United States an increasing proportion of mortgage lending is being packaged into marketable securities, and it appears that the same packaging technique is also being extended to consumer receivables. As yet, the packaging of lending into marketable securities has been undertaken only on a very small scale by the British banks, but there is some evidence that the practice may spread.

The switch towards securitised channels of finance has also been encouraged by the wave of innovation that has swept through the capital markets. One of these innovations—which by now is really quite mature—is the interest rate or currency swap, which effectively arbitrages between the differing preferences of investors in the various markets. They have contributed to the growth in the use of the bond markets by enabling borrowers to make issues in a variety of markets, and to swap the proceeds into whatever form they actually require. They have led to an increasing integration of markets as borrowers have been encouraged to turn to a widening circle of markets to meet their needs.

The technique known as the note issuance facility—or NIF—is another example of innovation whereby conventional instruments are being unbundled and reassembled in a novel form. For the borrower, a NIF offers essentially the same features as a traditional revolving credit, but the component functions can be carried out by several rather than by one institution: one party can arrange the loan, a second can provide the funds and a third can be responsible for the maturity transformation whereby the borrower is assured of medium-term funds from a sequence of short-term borrowings. As the technique has developed, it has been possible to offer borrowers increasing flexibility. In its most general form—known as the multiple component facility—it allows the borrower to make drawings for a wide range of maturities, in a wide range of currencies and in a multitude of different forms, including short-term advances and bankers' acceptances as well as euronotes.

An important consequence of securitisation has been that the commercial and investment banks now face each other head-on across the same ground, and are competing to provide the same services to the same customers. Indeed there has been a blurring of distinctions between traditional commercial banking and the functions undertaken by the securities houses and merchant or investment banks. This has been evident both in the way that the commercial banks have been stepping up their capital market activities, such as managing bond issues, and in the way that the investment banks have been offering products such as note issuance facilities which are close substitutes for traditional bank borrowing.

Implications for the banks

The changes currently taking place on the asset side of banks' balance sheets can be regarded as analogous to the changes that occurred on their liability side in the late 1960s. The asymmetry between the two sides of banks' balance sheets may have encouraged the pursuit of asset-led growth. But latterly, reduced profitability on traditional bank lending and increased pressure on capital ratios has redirected the focus of attention away from on balance sheet growth towards risk packaging and trading in loan instruments.

With proper systems of control, many of the new techniques should enable the banks to manage their risks more flexibly. In combination with financial futures or forward rate agreements, interest rate and credit exposures can be managed independently. Banks may find that there is some scope for fine-tuning part of their loan book so as to reduce concentrations of exposure and improve their credit mix. It may become possible to redistribute credit risk, not just within the banking sector, but also to non-banks, thereby providing an opportunity to achieve a wider spread of risks.

Having stated some of the potential advantages, it is nevertheless important to be alive to a number of possible misunderstandings and pitfalls. The ability to manage assets as well as liabilities may offer added flexibility, but the banks will still face a credit risk on their holdings of marketable assets; they will still be undertaking a credit transformation between secure deposits and assets—while they hold them—with varying degrees of credit risk. The apparent liquidity of a marketable bank asset is likely to disappear quickly if the borrower gets into trouble. The asset will certainly move to a discount and, in view of the uncertainties involved, the margin between the bid and offer price of the asset may become so wide that it is rendered unsaleable.

Of itself, increased marketability of an asset does not reduce the size of capital backing required to absorb potential losses. Indeed the banks may tend to lose their best quality assets to non-bank holders, thereby reducing the average asset quality of the banking sector as a whole. Moreover, banks are likely to find that, with marketable securities, loan losses could crystallise more rapidly: the downgrading of the credit rating of a borrower is likely to be reflected in a discount on its securitised debts which, in turn, may require a write-down at an earlier stage than may hitherto have been the case. The banking system may well become crunchier, if that is the right metaphor.

The allocation of responsibilities for credit risks will also have to be clarified. In the case of NIFs there has been considerable debate, not to say confusion, as to where the credit risk lies—with the noteholder or with the underwriter. It also seems that British banks that have sought to package mortgage loans have found it difficult to do so on a wholly non-recourse basis. For the new techniques to be successful, it must be established beyond doubt whether the selling bank is retaining any residual risk against default by the original issuer. End investors must be protected from erroneously thinking that all paper sold by banks will have a bank guarantee; and it must be clearly established whether the credit risk is insured in some other way, or whether the instrument is essentially single-name paper. Conversely, when a bank does offer a guarantee, its contingent liability must be included in its risk asset calculations for supervisory purposes. Attempts to avoid the spirit of the regulatory requirements by arrangements which purport to move risk off balance sheet but which, in fact, are more cosmetic than real will rapidly bring the new techniques into disrepute; and will have to be strenuously resisted by supervisory authorities.

Over-dependence on securitised finance may make it more difficult to achieve a restructuring of a company's or a government's finances. For first-class corporate names securitised finance may carry a lower coupon than bank borrowing, but it may also be fair-weather finance. The banker has long been described as a man who lends you an umbrella when the sun is shining: it may well prove that the joke will apply more strongly to the capital market. Many companies, including a number which would certainly have been described as first-class names before the onset of the past recession, were only able to survive as a result of the support of their bankers. This support depended on close monitoring and regular contacts to give banks sufficient confidence to lend to companies with serious problems. I find it difficult to see securitised lending being able to offer comparable support in time of difficulty. Such understanding in relatively risky conditions will, however, no doubt only be offered to companies which are established customers. Companies will need to weigh the advantages of cutting borrowing costs to the bone in good times against the problems which will arise in future times of trouble if there is not a happy history of relationship-banking to fall back on.

A parallel point can be made on the international scene. One of the advantages of the recent negotiations over the rescheduling of syndicated credits has been that the major banks form a reasonably cohesive group. In contrast, the bond holders of problem country debtors in the pre-First World War and inter-war periods were dispersed and exercised little leverage. In fact, it is likely that the Advisory group system for problem country debtors—or at least some arrangement for bilateral negotiations—will be with us for many years. Last year, payments of interest and principal by the seven major ldc debtors exceeded the provision of new money by $34 billion and, taken as a whole, the net cash outflow from these countries to the banks is likely to continue. In the medium term, it is highly desirable that these countries reduce their dependence on the banks, but outflows on this scale are likely to be unsustainable. It is therefore most important that borrowers take steps to encourage other forms of finance, most notably direct foreign investment. In the short term, however, spontaneous finance through normal market channels is unlikely to be forthcoming, and for some countries 'new money' will have to be provided by the banking system.

On the other hand, greater, but not total, emphasis on securitised lending may encourage borrowers, where necessary, to restructure earlier rather than wait until it is too late. At present, borrowers often find that they suddenly shift from a position of having relatively easy finance, at reasonably fine terms, to virtually none at all at any price—at least from normal market channels. The underlying position of borrowers—be they corporate or governmental—does not change so rapidly and, in any case, it is difficult for borrowers to achieve large changes to the balance between their income and expenditure in a short space of time. It is much to be preferred if market pressures for restructuring rise steadily as the viability of the borrower deteriorates; and under a system in which debt is marketed, and rated by credit agencies etc, the scope for earlier pressure may be greater.

Conclusions

In conclusion, therefore, I would suggest that the fusion of traditional commercial banking and the issuing, distributing and making of markets in debt instruments opens up a number of opportunities. London is already well placed as a financial centre to take advantage of these trends. Unlike the United States or Japan, there is no statutory division between deposit banking and securities underwriting; and the City is already a major centre for eurobond underwriting by banks. The recent Stock Exchange vote has set the course for a closer integration of banking and trading in domestic securities. But there are also a number of risks and difficulties which will need careful consideration. The banking community's enthusiasm for the new instruments and techniques is all too evident but, for the enterprise to be successful, practitioners will have to show equal enthusiasm for developing the necessary safeguards and protections for themselves and the system. Self-discipline will continue to be the supreme banking virtue.