Changes in the structure of financial markets: a view from London

*The **Deputy Governor** describes*[1] *changes that have been taking place in the regulation and structure of financial institutions—internationally and in London.*

There is a growing worldwide integration of financial intermediation, and for a financial centre such as London to compete effectively many traditional practices have to be changed. But change cannot always be gradual, and responding to it exposes financial institutions to risks. Many UK institutions will need to expand their capital and skills to cope with the new risks and greater competition. And supervisory authorities in the major centres will find it increasingly necessary to co-operate in regulating internationally-organised groups.

Integration of world markets

It is a commonplace observation that securities dealing—and indeed financial intermediation generally—are becoming increasingly footloose industries with only limited ties to particular national markets or stock exchanges. Borrowers and lenders in different countries are brought together often by intermediaries based in a third country. The major currencies are traded in most financial centres and dealing continues around the clock. There are now upwards of 250 companies whose equity is traded around the world, not to mention the growing importance of eurobond issues for companies and governments.

There are a number of reasons for the growing worldwide integration of financial markets. In some instances, off-shore markets have developed as a means of circumventing local restrictions; but this cannot be a fundamental explanation of their growth because they have often continued to flourish on their own account long after the original stimulus to their development has disappeared.

Much emphasis has been placed on the impact of technological innovations in communications. This has certainly been a factor in enabling quite different markets in quite different time zones to be linked increasingly closely. To give one example, it is now possible for a position taken in the IMM in Chicago to be closed out in the Simex in Singapore. The declining real cost of communication has meant that arbitrage now becomes possible at only very small price differentials. Treasury departments, not only in banks and financial institutions but in most large industrial companies throughout the world, are increasingly alive to the advantages of scanning money and currency markets on a worldwide basis so as to meet their requirements at least cost. The consequent competitive pressures have meant that these markets have become increasingly integrated.

Securities trading by investment institutions

Similar developments are evident in investment management. Competitive pressures have encouraged fund managers to be increasingly discriminating, and it is to the demands of these professionals that our financial services industries have increasingly to tailor their products. Most importantly, fund managers have sought to diversify their portfolios across the world's markets. And in this regard it is notable that, over the last decade, pressures on governments have mounted for the relaxation of restrictions on outward portfolio investment: US pension funds were granted the right to invest overseas in 1974; in the United Kingdom, exchange controls were removed in 1979; Japanese pension funds have been allowed to invest a proportion of their funds overseas since 1980; and in Australia there has recently been a fairly comprehensive dismantling of exchange controls, a freeing of the forward exchange market and a widening of the participants in foreign exchange markets.

As far as the United Kingdom is concerned, the removal of exchange controls has had some far-reaching effects. Prior to 1979, UK pension funds (and other financial institutions) were allowed to invest overseas by borrowing foreign currency; and they could gain a degree of overseas exposure by acquiring equity stakes in UK companies with direct investments overseas. But the constraints on their portfolio decisions were severe and the need to allow greater diversification became increasingly apparent. Once these institutions were allowed freely to make their own portfolio choices the results were dramatic. Total net external claims by the United Kingdom on overseas have grown since the mid-1970s from £2 billion to nearly £56 billion—that is 25% of UK national income; and the proportion of overseas assets in the portfolios of financial institutions other than banks now stands at around 15%.

This degree of adjustment from an artificially-controlled position is not perhaps surprising: we are seeing something

(1) In a speech at the 'Euromoney' conference in Sydney, Australia, on 27 November 1984.

very similar in Japan today. In an increasingly volatile and uncertain world, it is necessary for funds based in individual national economies to be well diversified around the world. Fund managers need to be able to hedge against periods when a particular economy and its stock market are hit either by external shocks or, for example, by the need to impose a non-accommodating monetary policy in an inflationary economy which is beset by severe labour market rigidities. The increased need for overseas exposure will require that fund management be conducted on an international basis, drawing experience from practitioners across the world.

A final factor which I believe has been important in encouraging the worldwide integration of securities trading in all its aspects, is the blurring that has occurred in recent years of the distinction between bank finance and capital finance. High and fluctuating rates of inflation in the early 1970s undermined the corporate debenture market in the United Kingdom and in many other countries. In its place, companies became increasingly dependent on floating-rate bank loans to meet their financing requirements beyond the provision of working capital. Happily, in the last few years, significant progress against inflation has been made in many countries. The resultant general improvement in inflationary expectations may well stimulate a revival in bond finance for companies; but much of the issuing and underwriting business thereby generated is likely to be taken by the banks. On the other hand, a growing proportion of bank assets—syndicated credits, acceptance credits and mortgages, for example—are being written as marketable instruments which can be traded in secondary markets, not just between banks themselves but also with non-banks.

Growing integration of banking with other financial services

The growth, since the late 1960s, of marketable instruments on the liability side of banks' balance sheets may thus now be increasingly paralleled on the asset side. More and more, it may be possible for loans to be shifted on or off banks' balance sheets depending on the strength of their capital position. Properly managed, this should be an advantageous development, but it means that there will be a degree of convergence between deposit banking, issuing and market-making, at least in certain instruments. Banks and their supervisors will have to face up to the increasingly complicated task of assessing banks' exposure to risk and the capital backing required.

This is just one example of the way market forces are pressing against the division of financial markets into institutions concentrating on separate functions. Another is the growing realisation that a widely spread retail network owned by one form of financial institution may, with economy, be used to distribute as well the products of another kind of institution. Still another example is the advantage that may derive from sheer capital strength in the international market for securities trading.

Hitherto there have been barriers of a number of kinds to the agglomeration of different functions within the one institution. The amalgamation of deposit-taking and securities underwriting is, of course, debarred in the United States under the Glass-Steagall Act, and similar provisions apply in, for example, Japan. In the United Kingdom there are no statutory restrictions on cross-ownership between banks and securities dealers, and banks have long been active as dealers in eurodollar issues; but until recently the stock exchange rules effectively formed a barrier for sterling issues. Now these rules are in the process of changing and as a result we have seen, over the past year, the formation of links between banks and stock exchange members with the intention of combining the roles of issuing house, agent-broker, market-maker, and investment manager under one roof. This will be a veritable revolution in the structure of financial markets in London where there has traditionally been a strong emphasis on the compartmentalisation of practitioners.

Changes at the London Stock Exchange

It may be helpful to look for a moment at this revolution in London—to see both why it has begun, what its consequences are likely to be, and whether there are any lessons to be drawn from it in other centres. The changes now occurring in London were brought about by a powerful combination of external pressures, including technological advance and intensifying international competition. Our securities industry, centred on the London Stock Exchange, was for many years able to satisfy the needs of British investors and British industry. But a number of the Stock Exchange's arrangements—in particular the minimum commission system and the limitations on membership—meant that the British securities industry was perhaps slow to recognise and respond to the trends and pressures of international competition.

Restrictive agreements tend in time to undermine the industries that they set out to protect, and the Stock Exchange's particular brand of price-fixing—though originally justified on very good grounds—appeared, by the end of the 1970s, to be having just such an effect. It was becoming clear that the tide of change in the global securities industry that had been unleashed by the freeing of minimum commissions on Wall Street in 1975 was leading to an increasingly competitive industry in which the United Kingdom was playing only a very small part. The events that followed the abolition of UK exchange controls provided striking evidence of this. Of the very large flows of outward portfolio investment already referred to, only a negligible proportion was actually handled by UK houses: nearly all of it was channelled through the London or foreign offices of overseas securities houses, which were not bound by the commission rules of the London Stock Exchange and could make better net prices in larger sizes than London firms.

There were other problems. In its domestic operations, the London Stock Exchange is so arranged that member firms require only very small capital resources; but in the wider world market this puts them at a considerable disadvantage. Moreover, the prudential benefits of single capacity dealing, which provides an elegant and highly effective means of investor protection, tend to be irrelevant to the type of sophisticated institutional investor who is increasingly dominating securities trading. The costs of single capacity, direct and indirect, coupled with the high rate of stamp duty—2% before the last Budget and still 1% now—were in any case increasingly causing the markets to fragment. In the first part of this year a number of major UK shares were being more heavily traded in New York than in London, and at least some of this activity came from UK fund managers seeking to deal more cheaply than they could through the London Exchange.

It was thus clear that if the UK securities industry could not adapt, and fairly quickly, its future was bleak. The process of adaptation began last year: the date—27 July—can be fixed precisely and the event that triggered the process was the Government's decision to stop a Restrictive Practices Court case against the Exchange in return for an undertaking to abolish minimum commissions by the end of 1986. The Exchange gave no other undertaking—for example, it did not promise to change its dealing system or its membership arrangements—and for a while there were those who thought that it might be possible to keep single capacity and possibly even to retain the membership system while removing minimum commissions.

But this was to ignore the realities of the outside world, and in particular the inescapable fact that securities trading is now an international activity, so that, if London is to play a significant part in the global market, it must be equipped to compete. There is no point in playing by the rules of cricket when professionals in the rest of the world are playing baseball. Moreover, as a technical matter, it was by no means certain that single capacity would actually work without minimum commissions. Certainly the reason why minimum commissions were first introduced in London (in 1912) was quite explicitly because the single capacity system had proved unworkable without them. Whatever the merits of this 'link' argument, enough people believed in it to make the ending of single capacity a virtual certainty.

Changes to the regulatory system

Once the link between negotiated commissions and dual capacity had been conceded, it became clear that the introduction of negotiated commissions had other implications for the membership of The Stock Exchange. The new broker-dealers, acting as principals in the market, would have to be adequately capitalised. But most of the existing participants, many of whom were partnerships, had little capital. It became clear that it would be necessary to allow the development of sizable companies to provide capital backing for the new market-makers. For this role the banks seemed to be prime candidates.

The removal of minimum commissions therefore gave rise to pressure for the removal of the institutional demarcation, not just between principals and brokers, but also between banks and broker-dealers. Thus perhaps the first lesson which can be drawn from our experience is that the interrelationships within markets are such that once one major rule is changed, the equilibrium of the system is disturbed and it is often necessary to change other rules as well. It is therefore important that individual rules are not assessed in isolation: regulatory systems need to be looked at as a whole, rather than on a piecemeal basis.

For this reason I think that it is misleading simply to describe recent changes in our financial markets as deregulation. What we are seeing is the replacement of one type of regulation with another; indeed, in some areas, new developments may actually require more regulation than in the past. The traditional form of regulation in the London capital markets has been based on restrictions on entry to various types of business, and limitations of one kind or another on competition. This approach—the compartmentalisation of market participants—can often be very effective in maintaining high standards of behaviour and can facilitate prudential supervision. But it can be abused and is often difficult to justify. In any case, for good or ill, it is now undeniably disappearing and we are going to have to find new approaches to supervision and new solutions to the problems of conflicts of interest.

This process of regulatory change has already gone some way in our banking and foreign exchange markets, but is still in the very early stages in the securities markets. Following a report by Professor Gower, there has been much thought, discussion and work on the possible structure of a new regulatory system and the main elements are now becoming clear; they will be fleshed out in a government White Paper later this year.(1) In summary, investment businesses will be subject to common standards for entry, more open and consistent rules for conduct, and there will be much emphasis on disclosure and transparency. Regulation will be conducted by a practitioner-based body to be created by the private sector itself—thus retaining many of the advantages of the self-regulatory system on which the City has depended in the past—but recognised by government and subject to clear statutory criteria.

An early task of the new securities authority will be to devise rules for the better control of conflicts of interest which recent developments in the City have thrown into sharp focus. The public disclosure of the prices at which deals are done and requirements that market-makers expose their orders to the market will provide an

(1) *Financial services in the United Kingdom: a new framework for investor protection*. Cmnd 9432, HM Stationery Office, January 1985.

important source of protection against malpractice. In some cases, there may need to be a degree of institutional separation between functions—for example, Chinese walls between investment management and dealing on own account—or even separate incorporation.

But, of course, the design of new market arrangements is not solely concerned with containing conflicts of interest. Allowing cross links between different institutions gives rise to the added problem that a loss of confidence in a member of one market can more easily contaminate participants in others: losses suffered by a market maker could affect confidence in its banking parent—or indeed its banking child, cousin or uncle—with the possibility of further contagion to the rest of the banking system. Designing safeguards which provide reassurance and help to contain these problems is a delicate matter. The component parts of financial conglomerates can be separately capitalised and, to this end, it is proposed in the Bank of England's recently published discussion document that primary dealers in the gilt-edged market be backed by dedicated capital. The Bank of England also proposes to supervise these dealers and require that they abide by guidelines which place upper limits on the magnitude of the risk they can undertake in relation to their capital backing. Likewise, The Stock Exchange proposes to introduce various requirements for market makers in equities, although the nature of the problem is recognised to be less severe in equities than in the gilt-edged market, where the spreads are narrower and the positions taken by market makers are generally much larger. There is, however, a potential tension between the desire to isolate market-making risks, and the well-established principle that parent banks have a moral obligation to stand behind their subsidiaries to cover losses, even when they exceed their limited liability in law. The involvement of a bank in a group which contains a market maker is therefore likely to have implications for the assessment of its own capital adequacy.

My final point on the design of markets is that consideration needs to be given to the maintenance of adequate liquidity. Two-way prices at reasonable spreads need to be available on a continuous basis if the market is to operate efficiently. For this to be possible there must be adequate incentives to become committed market makers, willing and able to deal in bad times as well as good. For dealing in certain securities—most notably the equities of the larger companies which are traded relatively heavily—it is expected that market makers will generally be able to earn a sufficient return from the spread on their dealing prices. In the gilt-edged market, however, competition between broker dealers is likely to be intense and spreads small. Gilt-edged dealers will therefore be more dependent on earning profits from the positions they build up in trading. For these market makers it is important that their positions are not immediately revealed to the market for all to see and trade against. But with this caveat there seems to be little reason for there to be any conflict between the need for liquidity and the disclosure requirements intended to protect customers against malpractice.

Conclusions

I have devoted most of my remarks to an account of what has recently been happening in London. This is partly of course because it is what I know most about; and partly because change is proceeding in London at a very exciting pace. But in conclusion it is perhaps worth asking whether there are any general lessons to be drawn from our experiences so far.

The first, which I have already mentioned, is that the forms of regulation and institutional structure and the degree of competition and innovation are closely linked. If one important constituent is changed, the whole system may have to adapt before a new and acceptable structure can appear. Change cannot therefore always be gradual in a way that we might find desirable. We in the United Kingdom are going to have to move, for example, from one kind of gilt-edged market to a completely different kind. Financial institutions are having to make decisions—for example, major acquisitions—on the basis of judgements about a future financial environment at a time when many features of that environment are still unclear and undecided. All this means, of course, is that it is a time of considerable risk. All concerned need to think very hard about the decisions they are taking, some of which—in the nature of things—will turn out to have been wrong.

A second general conclusion might be that the extremely competitive environment now existing in the financial markets throughout the world is attracting very large resources of capital and skills—in many cases at the expense of the traditional goods and services industries, where the process of competitive and adaptive change is typically much slower. Instead of its traditional role as a service to the rest of the economy, finance is perhaps increasingly becoming a self-sustaining industry on its own as well as an increasing source of profit or value. One may wonder how far this process can or should go. It must be likely—and indeed it is a perfectly natural aspect of the competitive process—that there will be periods and places where there will be over-investment of resources leading to sharply diminished returns.

Here the United Kingdom may not be a model for all other countries. London has always been a major financial centre, deliberately seeking to attract offshore as well as domestic business. Financial services have long been important in earning Britain's bread and butter—even jam. And we intend that that will continue to be the case. But there is likely to be a limit to the number of countries which will wish to aspire to being fully-fledged international centres. Many may wish to seek more limited objectives. All countries will surely want their financial services to be fully capable of meeting the requirements of local industry; and to this end it is likely to be important to encourage some foreign competition. Whether such liberalisation and invigoration of the domestic financial services market should extend further, to the development of offshore markets, must be a question of judgement, of weighing up the extra net income brought to the country against the increased risks and increased needs for supervision.

My final conclusion is that the increased integration of the world's financial markets calls for increased co-operation between the competent authorities with responsibility for each financial centre. Differing national approaches to supervision and regulation, especially in countries aspiring to be international financial centres, can give rise to disruption and inequity in the international markets. The two traditional international financial centres, the United States and the United Kingdom, have, I think, generally operated in a pragmatic and open way, and thereby managed to minimise the difficulties created by differences in domestic regulatory arrangements (for example the Glass-Steagall Act). We now look to the emerging third great financial centre, Japan, to play its part in genuinely opening up its markets to all comers, in substance as well as in form.