Shifting frontiers in financial markets: their causes and consequences

The ***Governor,*** *in the keynote address to the Colloquium of the Société Universitaire Européene de Recherches Financières,*(1) *reviews the rapid structural changes in financial systems which are taking place in the United Kingdom and elsewhere; he examines the factors which have contributed to these developments and sets out some of the issues they raise both for the financial institutions and for the supervisory authorities.*

The title of the Colloquium encourages us to consider how the frontiers of financial markets may have shifted. But I wonder whether this goes far enough; indeed whether in many cases it is still possible to identify clear dividing lines between differing kinds of financial instrument, or differing kinds of financial intermediary. Is it true that recognisable frontiers within the financial system still exist?

Recent history in the United Kingdom

The extent of innovation and change within the financial system, not only in this country but in several others during the last two decades, has been virtually unprecedented. The only possible comparison, for the United Kingdom at least, is perhaps with the structural change that occurred in the mid-nineteenth century: then the development of commercial banking, particularly the joint stock banks and their expanding network of branches, the appearance of specialist mortgage lending institutions, more extensive marketing of insurance, and the shift from payment primarily by notes to transfers between bank accounts, all took place around the same time. For a century thereafter, the basic structure of the financial system in this country remained broadly constant.

Despite improvements in communications and other relevant technologies, the nature of the individual institutions, and the work of the people in them, changed little. Thackeray, if not Charles Dickens, would have had no difficulty in appreciating the nature of the work of a commerical banker, or stockbroker, or jobber, or insurance salesman.

This constancy of role began to change first in the wholesale money markets during the 1960s. The story of the growth of the eurocurrency market, and of its development in London, is well-known. Since then the tide of innovation has advanced further beyond wholesale money markets into both the retail deposit and capital markets. Let me turn first to the retail deposit market. Here the development of new technology, such as the automated teller machine, together with the increasing competition between building societies and banks, has led to a whole new range of services being offered to the public. Consequently, whereas there used to be relatively clear divisions between the characteristics of sight deposits, the clearing banks' seven day deposits, building society shares and deposits, and fixed longer-term deposits, these distinctions are being progressively eroded. Instruments offered by building societies now cover virtually the whole spectrum of maturities, while the banks, in turn, are competing by offering near market rates on a range of deposits with varying forms of transactions facilities. Moreover, the building societies are hoping to extend their facilities further by issuing cheque cards and providing overdrafts, when allowed by prospective legislation.

Part of this greater competition for deposits has gone hand in hand with increased competition in lending. After the 'corset' constraint over bank operations was abolished in 1980, the banks moved into the mortgage market. In turn, the building societies have expanded their lending facilities to the personal sector. In face of such mutual encroachment on each other's business, the distinctions and frontiers between banks and building societies are becoming more blurred.

The pace of events appears even faster in our capital markets, where, as you know, there are to be radical changes in the method of trading after the abandonment of minimum commissions and the admission of corporate members to The Stock Exchange, in which both equity shares and bonds, including government bonds, are traded. By their very nature many of these changes can hardly be made gradually: there is to be a 'big bang'. We, in the central bank, have a number of specific concerns about all this, in addition to our general concern for the good health and efficiency of the financial system. We wish to see as liquid a market as possible, with adequate protection for investors; we are also anxious to ensure the continuing successful functioning of the market in gilt-edged stocks, and our ability to sell sufficient quantities of government debt to maintain sound

(1) On 28 March.

monetary conditions. Another concern is that supervision should achieve its objectives without stifling the forces of continuing evolution in the capital markets.

Developments abroad

While the recent pace of change in this country has had no parallel for some hundred years, it has been matched by similar kinds of change in many other countries, including the United States, Canada, South Africa, Japan and Australia. In the United States, for example, the blurring of distinctions between banks and savings and loan institutions is very similar to developments in this country. Although payment of interest on demand deposits is still legally prohibited, sufficient loopholes have been found to make the distinctions between demand deposits and other short-term deposits somewhat fuzzy, again as in this country. Moreover, the development of many new financial instruments, and the markets on which they are traded, such as financial options and futures, have been pioneered there. Even so, there remain important barriers, often fixed by legislation (such as the Glass-Steagall and McFadden Acts), which constrain what the various financial intermediaries can and cannot do. The greater legislative involvement in the working of the financial system in the United States, and their preference for checks and balances, which, for example, results in many different supervisory bodies, at both state and federal level, leads in some cases to a certain immobility, though this at times may be no bad thing. Innovation then tends to be directed largely to the exploitation of legal loopholes, not always the best way forward. The difficulties of changing legislation when very strong vested interests have to be placated have been reinforced recently by a certain hesitation about the desirable extent and direction of change, partly associated with the difficulties experienced by a number of US banks over the past year or so.

Similarly in Japan the financial system has for some time been undergoing a process of gradual change, which has recently accelerated in response to both external and internal pressures. One particular aspect of change in Japan—the relaxation of exchange controls at the end of 1980—has had a major effect on international macroeconomic developments within the last couple of years. Thus the ability of Japanese savings institutions to diversify a proportion of their assets abroad has combined with a sizable interest rate differential in favour of the United States to give rise to a portfolio outflow amounting in 1984 to almost $50 billion—almost half as much again as Japan's current account surplus—a large part of which has been invested in US bonds.

Further change in Japan, both actual and in prospect, involves a gradual breaking down of the segmentation of financial institutions, the establishment of a more market-oriented interest rate structure, the introduction of new monetary instruments, the greater international use of the yen and freer access for foreign institutions to Japan's financial markets. Their system has underpinned a remarkable economic performance and I find understandable the wish of the Japanese authorities, in the face of the broad range of change which is in the air, and which conflicts with the hitherto highly regulated nature of Japan's financial markets, to seek to control its pace and avoid the dangers of monetary instability.

In comparison with this scene of rapid structural change in the United States, United Kingdom and Japan, there is much less sign of fundamental change in most continental European countries. There are no doubt a number of reasons, which will differ as between countries. In some respects, Germany, for example, may be ahead of the game which we are starting to play. All, or most, financial services are already available in German universal banks, so there may be less pressure for structural change there. The German financial system has already reached an advanced stage of integration but the variety of financial instruments available to German investors domestically is relatively limited. The reasons for the relatively slow pace of change in some other European countries may be rather different. In a few of these, government regulations, in the form, for example, of exchange controls and direct controls over the allowable business of the various intermediaries, may have had some restraining effect on innovation. I do not, however, have the time today to examine, in any depth, why the present pace of institutional change seems to be slower in most of continental Europe than in the Anglo-Saxon countries, but it remains an intriguing question.

Causes of structural change

What are the main explanations for the recent acceleration in structural change among the Anglo-Saxon countries? One reason why it may have been greater in the United States and the United Kingdom is that the thrust of policy there has moved particularly towards a greater reliance on markets, which in turn has pointed towards deregulation. A second, more economic, factor distinguishing them from Germany, is the greater volatility and level of both interest rates and inflation in the last twenty-five years. Some of the changes in instruments, markets, and financial behaviour, have been primarily defensive, to allow financial intermediaries to protect both themselves, and in some cases their clients, against the worsening uncertainties and risks caused by such volatility. For example, the risks inherent in having a mismatched maturity or currency structure of assets and liabilities clearly increase with more volatile interest and exchange rates. This has led some financial intermediaries to make innovations enabling them to achieve a more closely matched book, and to shift risk to those who are more prepared to absorb it. These include a switch to variable-rate lending, replacing fixed-rate loans, and the development of instruments such as options, futures and swaps. There is also the development of a secondary market in such instruments as mortgages, and a recent more general trend towards making loans, especially in the international context, in a manner which enables them to be subsequently sold in a secondary market. All these

are developments which better enable the individual intermediary to adjust its own liquidity and risk position through market operations.

While these developments are generally welcome and may help to reduce risk overall, some caveats should be mentioned. Although these developing markets do generally enable risk to be transferred from those who wish to hedge to those who are prepared to assume additional risk, the overall level of risk within the financial system is not necessarily reduced. Moreover, while these new developments allow intermediaries to reduce their exposure to certain kinds of risk, they may increase other kinds of risk, which, being less familiar and less well understood, may be more insidious. For example, the transformation of much lending on to a variable-rate basis, while protecting the lending financial institution from unpredictable changes in interest rates, by the same token imposes unpredictable fluctuations in cash flow onto the borrowers. Borrowers' credit risk may thereby worsen. That this is no mere hypothetical possibility is demonstrated by the debt problems of certain less developed countries.

Even though this kind of market innovation was essentially a reaction to worsening inflation and more volatile interest and exchange rates, I doubt whether the restoration of more stable prices and interest rates would restore the *status quo ante*. Some risks arising from the unpredictability of interest rates, equity prices and exchange rates will always remain with us, even if to a lesser extent than recently. There are also large set-up costs in founding a new market. Once those costs have been incurred, an established market is likely to continue to operate, even when the incentives that led to its foundation become less pressing. And once customers become used to the wider range of services and better yields available they will not want to revert to the previous state.

Important though this essentially defensive response to worsening risk may have been, I do not regard it as the main factor underlying the recent structural changes; for many of the new initiatives have been undertaken by firms striving for a larger share of the market. The erosion of barriers between different classes of business induces new participants to seek to fight their way into markets which had hitherto been closed to them. One way of doing so is to offer a product which is, or could at least be described as, a new product. In the international bond market, for example, much ingenuity is currently being expended on innovative instruments. Furthermore, I would place a lot of weight on the extraordinary development of communications generally. These have brought about, during the last two decades, virtually a one-world integrated money and capital market encompassing the large multinational banks, companies and sovereign country borrowers. The pressure of competition in these markets is now worldwide. Even beyond the effect on the international offshore markets themselves, this inevitably provides a spur to efficiency in each individual country's markets, except where blunted by exchange controls or other barriers. Perhaps the primary reason for change in our own capital markets is to provide a stimulus for competition. There is, I am confident, a great future for the City of London, but that future will depend, in this acutely competitive world, on our institutions and methods being as cost efficient as any in the world.

Similar competitive pressures in domestic markets are leading to the development of new technologies to extend more efficient, lower cost methods from large customers in wholesale markets to smaller customers in retail markets. Thus corporate treasurers of large companies can now be linked electronically to information on yields available on assets, both domestically and internationally; and can initiate financial transactions virtually instantaneously. But these kinds of electronic wizardry are not going to remain available only to the large customer. The electronic provision of information to the retail market, together with the possibility of initiating financial transfers at the point of sale, at work or at home, is already technically available. The costs and difficulties of extending such electronic banking to all will be considerable, and the process may well be protracted, but it will surely take place. May these developments imply a further proliferation of financial transactions remote from the reality of productive activity? How confident can we be that the direction of causality runs only from volatile financial markets to sophisticated innovation and not, at least in part, the other way?

Economies of scale and scope?

I hope that this Colloquium will consider whether the factors that have led to the recent surge of innovation might also influence the pattern of economies of scale and scope within the financial system, and thus affect the size and structure of financial institutions. There are already many who believe that these new developments are changing the nature of the industry. Some believe that the future lies with the very big battalions, the huge conglomerates, able to offer their clients comprehensive financial services ranging from banking to access to all the main financial markets, at home or abroad. On this view the future financial system would comprise relatively few such giants, together with a fringe of small specialists confined to a particular locality or skill. There is a fear that medium-sized institutions, whether building societies, banks or stockbrokers, are going to face a difficult future. I am not myself convinced that this is going to be the case. Some of the technological developments, for example home banking, may by their nature reduce, rather than increase, economies of scale, in this case by contracting the branch network needed. Again, some forms of inter-firm linkages and associations may enable financial institutions to provide comprehensive services without having everything in-house. While there is now something of a fashion for financial intermediaries to take on an ever-widening range of function, beyond their original field of specialisation, there remain certain

advantages to maintaining some degree of specialisation. In particular, managers are ordinary mortals, and not supermen. One advantage of the specialist organisation is that its managers can more easily be fully appraised of the business, and competent to direct it in every respect. As the scope and scale of financial conglomerates increase, especially if financial activities are combined with non-financial businesses of quite another kind, will the management have quite the same competence, insights and understanding of the business done by the various segments? It is widely recognised that the potential conflicts of interest in a financial conglomerate will require restrictions on information flows between their constituent parts, and regulators may require dedication of capital to particular functions in free-standing subsidiaries. Under these circumstances one needs to think carefully about how much synergy remains to give the whole conglomerate advantages over the mere sum of its parts.

Competitive pressures on profitability

I also wonder whether the structural changes now in process in this country may be leading some of those involved to anticipate opportunities for profit that might in practice not be realised. Indeed, the pressures of competition are already paring profit margins severly in some areas. For example, the operating margins being earned by building societies have shrunk recently to levels that are both historically low, and low in comparison with other institutions. Admittedly, the building societies operate in a special context: but are their circumstances, and the circumstances of the housing market more generally, such that one can view this development with equanimity?

Indeed competition is now quite generally holding down the profitability of financial intermediaries. In many ways such competitive pressures are healthy, providing the incentive for dynamism, efficiency, and innovation. Yet these come at a time when markets have been exhibiting considerable, perhaps unprecedented, volatility; so the riskiness of intermediation is raised. Moreover, the structural changes we are witnessing have so changed the nature of the game that the risks many are now facing are less familiar, and so, perhaps, more troublesome.

Prudential implications

Such circumstances make supervisors uneasy. The combination of greater competitive pressure, together with unfamiliar and perhaps more serious risk, enhances certain inherent dangers. Gilbert claimed that a policeman's lot was not a happy one, but he could just as well have been referring to a supervisor. The supervisor must try to balance an acceptance, even an encouragement, of competition, and with that, innovation which leads business into new and unfamiliar territory, against the various risks of financial difficulties, whose eventuality may bring down obloquy upon his head. Indeed, there are those who believe that the incentive on the supervisor to avoid financial collapse is so strong that over-regulation will tend to ensue. I do not know how far that charge would stick in the United States, but I do not think that in this country the supervisory authorities have unduly delayed and prevented developments and innovation in recent years. Trying to get the right balance between safety on the one hand and experimental growth and development on the other is never easy.

There are other, somewhat similar, points of tension in a supervisor's life. If the supervised institution would voluntarily undertake every measure that the supervisor would wish, the supervisor would then be superfluous. Supervision is only intrusive when it requires institutions to do something that they do not presently accept the case for doing anyhow themselves. In that sense all effective external supervision represents an additional burden, and usually an additional cost, at least in the short run, on the financial institutions being supervised. Faced with such an extra burden, the financial institutions are likely, understandably, to try to avoid it. I would not want to exaggerate this. In many ways, of course, there is a common interest between the supervised and the supervisors. Both are concerned to maintain the good reputation of the system. Both are concerned that fly-by-night operators should not take advantage of the good reputation of existing intermediaries to defraud the public. Moreover supervision, though on occasions resented by the supervised, may be willingly accepted in the broad as a necessary concomitant for other measures, such as deposit insurance, or central bank lender of last resort action, which, in the absence of supervision, would be prone to provide an incentive to banks to assume additional risk; that is the standard problem of moral hazard. Yet, despite this general coherence of interest, there must remain an inherent tension between supervisor and supervised. In seeking to avoid the extra burdens that supervisors impose upon them, the business, and the exposure to risk, of the supervised institutions may change. So the supervisors are led in turn to seek to extend their supervisory activities to cope with such consequential changes.

Let me take a case in point. Concern about increased risk, and profit margins being squeezed by stronger competition, have led the supervisory authorities in most countries to encourage banks to raise their capital ratios. The need for extra capital was, from the viewpoint of the banker, seen as an additional burden. It has recently led banks to try, among other things, to develop more of their business off balance sheet. Thus there is a growing tendency for banks to transfer part of their loan books to separate financial vehicles. There is a saying 'out of sight out of mind'. Perhaps the institutions feel that this applies to operations off balance sheet: but does it? In some cases the risk associated with the business is formally transferred away from the bank but in all cases the

transactions in question depend on the reputation and standing of the financial intermediary initiating them; and the reputation of that financial intermediary continues to be at stake, even though the asset may not be on its books.

Some might view this tendency for supervision to generate attempts at avoidance, leading to more supervision, as an argument for abandoning supervision altogether. There are those who would take the same argument and develop it to argue for the establishment of general, and tight constraints, or indeed public ownership, over the whole system of financial intermediation. This is a field, however, where I believe that common sense and compromise, which we sometimes like to think peculiarly British virtues, will continue to pay dividends.

Peroration

The speed at which institutional structures are currently changing presents us with a number of difficulties not only as supervisors but also as managers of the money supply. While the right answers to these problems are seldom easy to identify I am quite sure that it would be wrong to try to avoid difficult choices by stifling change. As the form which change takes will depend on policy and supervisory practices, the process becomes one of interactive give and take between the supervisors and the supervised. Change might be allowed to proceed more freely the greater the degree of self-imposed prudential restraint exercised by the participants both in structuring their balance sheets and in their conduct of competition. I will be most interested in the conclusions of your deliberations on these particularly difficult questions. I am sure that you will contribute to the illumination of the way ahead for us all.