Taking stock on issues facing the banking community

*The **Governor**, reviewing progress and prospects on international financial matters,*[1] *makes the following points:*

- *the authorities' resolve to conquer inflation remains unchanged notwithstanding recent gyrations in the money and foreign exchange markets;*
- *solid progress has been achieved on international debt problems, although risks undoubtedly remain;*
- *new risks in international business need to be recognised in relation to emerging forms of lending;*
- *new structures in the provision of financial services will also bring new risks and problems, which supervisors will need to confront;*
- *efforts must be maintained to improve the capital strength of banks and other providers of financial services.*

Gyrations in the money and foreign exchange markets

This banquet every year provides an unrivalled opportunity for that very international body which constitutes the London banking community to review its opportunities and prospects. It also gives those of us in the central bank the opportunity to take stock of the market and its participants, and to assess its health and soundness. But you will perhaps expect me to comment first—even if briefly—on the recent extraordinary gyrations in the money and foreign exchange markets.

The first point to make is that those gyrations—which must seem bewildering to anyone outside the financial world, and indeed to many inside it—do not have their origins in developments in the real economy, where we continue to make steady progress.

In part the setback of the last fortnight or so reflected a concern in financial markets that the authorities were changing or were about to change their declared course. In perhaps larger part it reflected outside developments, notably the persisting strength of the dollar and uncertainties about the price of oil—the implications of which for the United Kingdom have, in my view, been greatly exaggerated. These factors together produced a weakening in the exchange rate against other currencies generally, which could have endangered continuing progress against inflation and so made necessary some tightening of domestic monetary policy to offset that threat. What has occurred can, I think, leave no doubts as to the authorities' continuing resolve to conquer inflation.

Further progress on international debt

I turn now to the international banking situation. A year ago, I spoke to you of the rather more hopeful position on the problems of international debt. We can now look back on another year of solid progress: the first substantive agreements with Argentina and the Philippines have taken shape, setting the basis for further progress there; a multi-year rescheduling of Mexico's debts has been agreed in principle, which should help a return to market financing in due course; and both Mexico and Brazil, the two largest troubled debtors, have achieved remarkable improvements in their balance of payments positions. In short, the atmosphere of foreboding and uncertainty—which still lingered a year ago—is now much less in evidence.

We can all take satisfaction and encouragement from this progress. But risks undoubtedly remain. Major debtors' adjustment may not in future be so significantly aided either by a burgeoning US trade deficit or by a further decline in the dollar interest rates which largely determine debtors' interest burdens. Inevitably, progress will be uneven, and countries will differ in their speed of recovery. Some are only now beginning to tackle their problems with full seriousness. And for all debtors sustained progress towards a resolution of their debt problems remains crucially dependent—as it always has been—on a fundamental adjustment of their domestic economies. As yet, significant success with internal adjustment is less evident than that which many have achieved in turning round their external accounts. Many IMF programs are inoperative because they are not being observed; and arrears to the IMF are growing.

(1) In a speech to the Overseas Bankers' Club on 4 February.

As I have just said, however, the general picture is of an improvement in the situation of the major debtor countries. As creditworthiness returns, so will voluntary financing by banks, not only of trade but also of investment needs. But I hope that lending by banks will form no more than one part of a more balanced mix of external flows: as I pointed out to you last year, there are many benefits to be gained from direct investment and other longer-term types of financing. Banks are themselves showing greater caution in their international lending, and I think that prudence will in future dictate a circumspect approach by them to this form of business.

Competition and innovation in lending

This cautious approach finds its reflection in the very subdued growth now evident in the international assets of banks of nearly all nationalities. Yet there are some worrying trends. Competition to lend to good names is intense. Margins have narrowed as banks and other financial intermediaries compete for this business, and much ingenuity is lavished on devising new instruments, many of them off balance sheet, to tempt both borrowers and investors.

Some changes in the forms of lending undoubtedly have their advantages. But there are aspects of them which give me pause. The slim margins on some of this business may not adequately reflect the medium-term credit risk sometimes involved. In addition, banks may be paying insufficient regard to the need for adequate capital to support all this activity. Bankers would be well advised to examine closely the extent of these risks and to consider carefully the appropriate price to charge for them.

Supervision of financial services groups

These questions of new types of risk are of course not confined to international business. A particularly topical example is the new risk which arises from developments in the structure of financial business where banks and other intermediaries come together in single institutions. I imagine that many of you who operate in London are still digesting the White Paper on investor protection which the Government published last week. I should like to mention here one issue which is of especial concern to us at the Bank: the appropriate supervisory arrangements for complex financial groups—although I must emphasise that, alongside such groups, we still see a role for the specialist.

London has always been an open market. We have sought to ensure that supervision and regulation are effective in the interest of depositors, investors and the financial system as a whole and also give scope for practitioners to evolve and develop new techniques and new business activities. After all, a hide-bound and overregulated market will soon be an uncompetitive one. This is not of course to argue for laxity. On the contrary, it is in everyone's interests that high standards should be maintained, and sound supervision does much to encourage this. This means that the authorities must chart and follow a difficult course between the dangers of inadequate supervision and the constraints of excessive regulation.

With complex financial groups many different bodies will inevitably be involved in supervision. Each has, or will have, responsibilities for parts of the groups which are emerging. To ensure that supervision is appropriately collaborative, and that differences of view between the supervisors do not occasion problems, will require considerable skill and will present a particular challenge to us at the Bank of England. I have no doubt that a satisfactory supervisory system will be arrived at, but we must not underestimate the range of practical problems which will have to be overcome.

I should also express my own view—and I am sure that many here will agree with me, if slightly uneasily—that the process of change is likely to involve some accidents. It would be wrong to expect the authorities to guarantee to convoy everyone safely through the uncharted waters ahead. To attempt to do so would be to interfere in individual businesses and in the market as a whole to a degree which would be both unacceptable and undesirable. In a world of change, the price of relative freedom is some risk. I do not think we do anyone a service by playing this down. But we are of course prepared to play our part in guiding the development of the new world which is emerging.

Adequate capitalisation of financial businesses

Taking one specific example of our stance, I should like to finish my remarks with a word about capital adequacy. As you know, the Bank of England has indicated that it is expecting primary market makers in gilt-edged securities to maintain a certain gearing in relation to their dedicated capital, and we will monitor this closely. More generally, we see a need for all investment businesses to have appropriate dedicated capital. We have also for some years been pressing the institutions we supervise to build up higher levels of capital. We are generally pleased with the progress made so far, but there is still some way to go before we can relax our efforts. We are also very concerned to maintain the quality of banks' capital—hence the paper we issued in November on various aspects of subordinated loan capital, aspects of which are currently under discussion with the banks.

These pressures on our part may seem onerous to individual banks; in particular there may be problems of competitiveness arising from the very significant differences in the supervisory, legal, tax and accounting regimes in banks' countries of origin. I hope we in the Bank are always alive to the effect changes may have on competitive equality, but we do not think that it can be in the long-run interests of our banks for us to be other than rigorous. We firmly believe that, if we watered down our approach, our banks would suffer in the long term. Capital strength and prudent provisions, though costly, have their own rewards.