The City Revolution

Mr E A J George, an Executive Director of the Bank, discusses[1] *the changes now taking place in the financial services industry, and particularly in the securities market. He argues that, while such major changes will necessarily involve uncertainty and risk, standing still is not an option: the question is not whether change should occur but how best it can be managed—a task which will require measured and detailed responses from both market participants and regulatory authorities. Mr George then reviews in greater detail the management of change in the gilt-edged market, in terms of the Bank's proposals for gilt-edged market makers in the new structure of that market.*

The revolution in financial services

The title chosen for today's conference—'The City Revolution'—seems to me to be especially appropriate, because it properly emphasises both the scope and the pace of the changes currently affecting the financial services industry.

Many of us tend to think most immediately of the changes occurring in the securities industry—and that is indeed very much the present focus of attention. I will myself be concentrating on that area—particularly on the gilt-edged market, with which I have been most directly concerned—for the most part in my subsequent remarks. But we would do well at the outset to remind ourselves that the changes taking place are very much broader than this, touching the whole range of financial services, and beyond, for example to the retail and industrial and commercial sectors. Importantly, they affect the whole variety of mechanisms for bringing borrowers and lenders together—for example, through the deposit and loan markets, or through markets in money instruments, as well as through the securities markets. And they affect the whole range of what have, hitherto, in this country been in some degree specialist intermediaries operating in particular markets—for example, building societies, commercial and investment banks or discount houses, as well as stockbrokers and jobbers.

The various developments are not, of course, unconnected. Increasingly, under the impact of competition, and often stimulated, both by the dramatic advances in communications and computer technology, and by comparable developments internationally—especially in the United States—intermediaries have refined their particular products in order to broaden the market for them. And they have extended their activities into adjacent areas to offer complementary services. There are countless examples. Banks, freed from lending controls, went heavily into mortgage lending; while building societies are looking, under their new legislation, to be able to provide money transmission services and unsecured consumer loans. To meet the needs of borrowers, banks developed term loans some years ago as an alternative to capital market finance. Now competition for deposits—including competition from money funds—is producing more favourable terms and greater liquidity for depositors, but it is also raising the cost of money to financial intermediaries, encouraging them to look to fee income from trading or from the arranging of finance, rather than interest income from direct lending on their balance sheets. And a whole battery of new instruments and techniques have emerged—such as futures and options, interest and exchange rate swaps, and so on—which have increased both the interconnections between different markets and the range of competing facilities which financial intermediaries of different kinds can offer.

It would be wrong to exaggerate either the degree of specialisation in the past, or the pace of change in some of those areas. Pressures of this sort may come in fits and starts, but the direction is clear—it can only increase. One result must be changes in the traditional ways in which business is done in particular areas. Another is that the areas of overlap, both between one market and another, and between one intermediary and another, will continue to multiply and expand, and the traditional boundaries between them will continue to break down. More specialist intermediaries—and there seems no reason to doubt that there will always be a role for the skilled specialist—will be under constant pressure to keep abreast of the best in their field; and there is likely to be something of a kaleidoscope of diversified groups of different sizes and different configurations which may well change from time to time.

One is bound to ask oneself whether or not this development is necessarily a good thing.

In the long run there can be little doubt that the constant search by competing intermediaries to provide new and better services will result in an improvement in market efficiency in a broad sense, to the benefit of both lenders and borrowers. Most people with a bank account or building society deposit and many borrowing companies will have seen some of the effects already.

(1) In a speech to a conference arranged by The Financial Times and The Banker, on 12 July.

But, given the extent of the changes, to what is trusted and familiar, it is difficult not to have some misgivings.

There are bound to be bumps—to participants in the markets, possibly even to users of them—along the way. But to recognise that there are dangers—even serious dangers—does not take one very far. There are, of course, different perceptions of the potential risks and benefits. Yet no one—as far as I am aware—has seriously argued for seeking to call a general halt to the process of change; and if it is allowed to occur in some areas it is all the more difficult to obstruct in others. Standing still is not an option. The forces of competition are too strong. To try to hold them back would involve a degree of restriction which would stifle what we have and actually make markets less effective than they are now. And that too would carry dangers—of inefficiency in our own financial services, leading to the loss both of domestic business abroad and of opportunities for our own firms to do overseas business. These different dangers could be just as great. One must look at both sides of the equation, which sometimes we forget to do.

In so far as one can characterise an official attitude to financial change generally, it is still a long way from 'anything goes'. But it is probably true that the burden of proof is now more heavily on those who would want to prevent it. (That, as a general principle, seems to me how it should be. It is so much easier in any organisation to avoid sticking one's neck out by saying no; and having to produce specific reasons for saying no can help to overcome this bias.)

The management of change

In this environment the relevant question is not so much whether change should occur, but rather how best the process of change can be managed. This is a very much more difficult question, demanding precise, detailed responses, in relation to each specific area of change, from both market participants and from the relevant regulatory authorities.

More specialist market intermediaries and more narrowly diversified groups will have to decide, in response to the changing pressures and opportunities facing them, whether or not to extend their activity, and into which areas. Diversification will involve parallel decisions about the appropriate organisation and management structure, to provide—to the satisfaction of customers, and of regulators—for proper control of both the financial risks of operating in different markets and new conflicts of interest which might arise. And all firms will need new methods of risk appraisal to handle new markets or new instruments or techniques.

And broadly comparable responses will be required from the various official and self-regulatory authorities. The traditional institutional specialisation has meant that financial market regulation too has tended to be organised on institutional lines. Just as diversification can raise organisational questions for the individual firm, so it can also raise questions about the organisation of the regulatory structure. Increasingly, different regulators will be concerned with different parts of a diversified group on functional lines, overlaying the basic institutional structure. Such arrangements will inevitably be complex, reflecting the increasing complexity, and variety, of financial service firms. If they are not to frustrate the initial purpose of the diversification, unduly onerous overlapping regulatory responsibilities will need to be avoided, and that, in turn, will require a greater interchange of views and information between different regulators, both in the United Kingdom and abroad, than hitherto. Yet to be effective, the arrangements must avoid 'underlapping' responsibilities, which comprehensive legislation like the Banking Act (in relation to all takers of 'deposits') and the Financial Services Bill (in relation to all 'investment businesses') are designed to prevent. Within this evolving regulatory structure, of course, the regulators, like the regulated, in each particular area, will need to keep their techniques for risk appraisal, for ensuring investor protection, and so on, abreast of new developments in their particular market.

It would be idle to pretend that the many different authorities affected have satisfactorily resolved all the questions that can arise, any more than individual firms have reached definitive solutions to their own future development in a fast changing environment. There is an immense amount of work still to be done in all these areas and new issues are arising all the time.

Change in the securities market

It is such detailed questions, about how best to manage the process of change, that have to be at the heart of the debate; but they are difficult to handle in the abstract. So I should now like to shorten the focus somewhat and talk rather more specifically about the changes in the securities market, and especially about the Bank's proposals for the gilt-edged market makers in the future structure of that market, which have been my particular responsibility.

It is the changes in the securities market, centring on the changes in The Stock Exchange's rulebook by 'Big Bang' day, sometime next autumn, which above all account for the 'revolutionary' part of today's theme.

The proximate cause certainly was the Office of Fair Trading's reference to the Restrictive Practices Court, and the subsequent agreement between the Government and the Council of The Stock Exchange. There are those who think that it could all have been—and some who think it should all have been—avoided, perhaps with a little more flexibility on rates of commission. I do not myself share that view. Although the timing might have been different, I think that the commercial pressure of competition from outside The Stock Exchange—in the context of the wider changes I have described—would have made changes necessary in any event; and given the nature of the commercial pressure, for example from banks, and from overseas securities houses, accustomed to dealing directly with customers as principals in other markets, it seems to me likely that the nature of the changes would in the end have been much the same.

The aspect of the changes in The Stock Exchange which many people find most disturbing is the jarring suddenness of Big Bang. However carefully prepared—and the thought and effort being put into the preparation by all who are involved is in my view the City operating at its best—there are necessarily great uncertainties and risks involved in this kind of step change from one structure to another.

In the situation we had, it is difficult to see how a Big Bang could be avoided. It is clearly vital that there should be sufficient time for the new arrangements to be adequately thought through and debated, and for the new market infrastructure—the necessary mechanisms for settlement, for trade and prudential reporting and monitoring, for price dissemination and so on—to be put in place. Rapid progress has been and is being made on all these fronts. But beyond that I do not believe that further delay is the answer: there would be different dangers, of disorder and fragmentation, if all those waiting ready for the start were kept waiting about for any longer than is demonstrably necessary.

The inevitable risks can be limited by not piling Pelion on Ossa, making changes, which might in due course become desirable, but which are not strictly necessary to the successful carrying through of the unavoidable changes during this difficult period. We should, for the time being at least, be prepared to ration ourselves to 'one miracle at a time' in this field.

But the main conclusion I draw is that we must for the future try to avoid getting into a situation where pressure for change is held back and allowed to build up behind a restriction, so that it breaks out with unnecessary disruptive force once the restriction is removed. We should aim, in the financial system generally, to build in sufficient flexibility to enable it to evolve.

Gilt-edged market makers

Let me now turn finally to the proposed new arrangements for the gilt-edged market makers.

We have had three principal objectives in mind in framing our proposals for this part of the market:

(i) to open the gilt market up to greater competition;

(ii) to ensure a high standard of investor protection; and

(iii) to maintain a high degree of liquidity.

I should like to say something about how the proposed arrangements seek to achieve each of these objectives in turn. But before I do so, let me comment briefly on the interrelationship between them.

Some people see competition, and perhaps market liquidity, on the one hand as being in conflict with investor protection on the other, and vice versa. That need not necessarily be the case. They can be mutually reinforcing.

Importantly, competition—or so it seems to me—is the absolutely fundamental underpinning of investor—or indeed more generally of user—protection. The need for competing intermediaries to develop continuing relationships with their customers if they are to establish a long-term, profitable, presence in the market place is, I believe, much the most powerful incentive to high standards of service, of professional conduct and of prudential behaviour—far more powerful, in my judgement, than any rules or regulations that could possibly be imposed from outside. But though I think competition is a necessary condition for effective investor protection in its broadest sense, the fact that things can go wrong in even the best regulated market, and the rumpus that occurs when they do so, makes it clear that competition on its own—pure *caveat emptor*—is not regarded by society generally as sufficient. Sadly, not everyone maintains the standards of the best, especially when the competition gets tough; and some degree of regulation, to provide such additional protection as can be achieved, is a feature which society has come to expect in financial markets very generally.

Regulation, in the interests of consumer protection, can of course be so heavy-handed that it damages the underlying commercial activity. But it clearly does not need to be in order to be effective. In the ideal world the aim should be to generalise the business standards of the best, so that regulation does not impose unnecessary restrictions or burdens upon sound managements. Of course we all fall short of our ideals but, if we can keep them in front of us and come even reasonably close, regulation—by contributing to user confidence in the market as a whole—can make a valuable addition to its liquidity; and that in turn will help to provide the climate within which competition can flourish.

Fundamentally it ought to be the case that participants in financial markets have a vested interest in the prosperity and reputation of the market as a whole, as well as their more immediately obvious interest in the prosperity and reputation of their own firm.

Competition

Looking at the principal objectives separately, there is not very much to be said about competition. As far as the market-making core of the market is concerned, the Bank made it clear from the outset that we would in principle provide the necessary facilities to all those who could demonstrate the capacity—in terms of capital and of management and operational resources—to undertake the market-making role. That is what we have done in practice. And we will be prepared to do it again once the initial market structure has settled down.

I have seen it suggested that the resulting twenty-nine prospective initial market makers are too many—that the market will be over-competitive. If that means that not all of the twenty-nine will prove to be profitable I would not wish to contest that view. But I would resist any suggestion that we either could or should have cut down the numbers to accord with our own—necessarily arbitrary—view of the market's capacity. All the participants have made their own assessments in full knowledge—or perhaps more appropriately full ignorance—of the facts, just as we would have had to do. But they had the added incentive to realism that it is their money which is being put at risk. Competition certainly will be intense; and by definition that implies the risk that some participants will lose money. Our aim will be to do everything we possibly can to ensure that it is their own money that they lose rather than that of their customers or other counterparties.

Investor protection
This brings me on to one aspect of investor protection, protection against loss arising from default.

Such protection in the case of a gilt-edged market maker will be on three distinct levels.

First, there is the prudential supervision which the Bank will exercise over the gilt-edged market-making entities. These will be required to have their own dedicated capital and will not be permitted to have operating subsidiaries, which could involve them in liabilities outside those which we will be monitoring. By this means we will be doing all that we can to ensure that the gilt-edged market makers are adequately capitalised in their own right, and immune from infection from other entities within the group. I do not pretend that such supervision can wholly exclude the risk of default. In fact it is a dangerous mistake to suggest that any form of supervision can achieve that.

As a second line of defence, substantial shareholders have been required to provide written assurances that they stand behind their gilt-edged market-making subsidiary. Such assurances, or letters of comfort, are not legally binding guarantees, and there are some who question their value. In this instance they are, without exception, being provided by large financial institutions with their own business reputation to protect. In such cases at least, we believe that they will be taken very seriously by the controlling board, which will as a result be encouraged to recognise its responsibility towards the gilt-edged market maker both at the outset and as its business develops. It can be said that the comfort letter is simply an acknowledgment of an underlying commercial reality, which would exist in any case. While this may be true, we believe that such an explicit acknowledgment of that reality also serves a purpose, for the reasons I have given.

Finally, as a long stop, there is the Stock Exchange Compensation Fund which will be available to compensate the outside customers of all member firms in case of default, and to which all member firms contribute, reflecting their interest in the reputation of the market as a whole.

Investor protection, of course, goes well beyond the question of default, to such questions as fairness, conflict of interest and professional competence. It is essentially to help ensure that standards are preserved in these areas that the Bank has wanted—subject to reasonable terms of entry to support the objective of greater competition—to see the gilt-edged market remain located within The Stock Exchange, which has always enjoyed a reputation in such matters which is second to none.

For these purposes a gilt-edged market maker will be subject to regulation by the stock exchange authorities, alongside the prudential regulation to be exercised by the Bank; and where the firm is a subsidiary of a bank, or of a securities firm, either in this country or abroad, the parent's supervisor will normally expect to look through to the subsidiary in exercising its supervision on a consolidated basis. This illustrates the complexity of the regulatory structure to which I have already referred, and points clearly to the need for close liaison and co-operation between the different authorities involved, if over-regulation is to be avoided. Provided we can keep the different functional responsibilities sufficiently clear, as I believe they are in this case, I am confident that this can be achieved.

To deal with dual capacity, The Stock Exchange is having to develop new systems which will enable it to monitor all bargains with non-members for 'fairness' and to pursue, or initiate, complaints if bargains appear to be at prices outside the normal trading range at the time. But I am encouraged too by the intention of so many of the market makers to maintain a presence on the floor of the Exchange, where they will operate, in effect, in much the same way as single capacity jobbers under the present arrangements. We will ourselves certainly be maintaining a presence there, as well as 'upstairs'. This will mean that, for some considerable time at least, investors should continue to have the option of having their business transacted on an agency basis, through a broker, and so, if they choose, of enjoying the present form of protection enhanced by time stamping of contracts and the publication of time-related prices in the Stock Exchange Official List, as well as the price monitoring I have just mentioned.

Liquidity
Gilt market liquidity, which is crucial if investors are to be able to get a 'good' price as well as a 'fair' price, will be underpinned essentially both by the degree of competition within the market place and by the arrangements for investor protection, as well as by the credit quality of the gilts as the traded asset. Further support to the liquidity of the market will be provided by the market makers' basic commitment to make continuous and effective two-way prices in any trading conditions, which we will monitor rigorously. The market makers will be helped in fulfilling this obligation by the inter-dealer broker

networks, through which they may effectively trade with each other and try to manage their individual risk positions; and they will be helped too through the stock exchange money brokers, who will facilitate the financing of market makers' positions in both stock and money, operating in effect a regulated repurchase market.

The final element in these arrangements for ensuring liquidity is the settlements mechanism, the importance of which is perhaps not sufficiently appreciated. The market could find itself inhibited by the purely physical problem of moving paper transfers sufficiently quickly around the system. More importantly the daylight credit exposure—for both market participants and their settlement banks—which the present arrangements for cheque settlement, and the use of temporary cheques in place of security, necessarily involve could, in the new environment, limit the willingness of major market participants to trade with each other, especially on a 'blind' basis through the inter-dealer brokers.

As you will be aware, the Bank, jointly with The Stock Exchange, is actively pursuing solutions to these problems, through the Central Gilts Office (CGO) project. Phase 1 of that project, which will computerise stock transfers between the core market participants, is planned to come into operation—on the basis of the present market structure—at the beginning of next year. Phase 2—which will provide for assured cash payments against stock movements across the computerised accounts—is under very active development with market participants and the banks, and we are determined to have it in place in time for Big Bang. And we hope to be able to extend membership of the system more widely—including other members of The Stock Exchange and major investors—soon thereafter.

I find this an exciting project, involving as it does a wide range of people in many institutions who may not normally be thought of as being in the front line of the City Revolution but whose work is quite vital to its success.

Conclusion

It would be foolish to claim that in making these various plans for the gilt market—albeit after very extensive discussion with market participants—we have arrived at all the right, or necessarily final, solutions. As in all other areas of change in the City, detailed discussion of specific proposals has to continue precisely to enable the arrangements to evolve and improve. What is important is that such discussion should not stop simply at identifying problems and dangers, but should be directed at overcoming them.

The City as a whole has taken enormous strides along many paths in a short period, so far without serious upset. The period ahead, particularly in the securities area up to and over Big Bang, is bound to be a nervous one. It will take immense good sense—and immense hard work—if, individually and collectively, we are to avoid the major pitfalls.

But the opportunities are huge if we can find the right answers. The City starts with great advantages as a financial centre, and, properly managed, the far-reaching changes which are now taking place can secure the consolidation of a pre-eminent world position. There are those who argue that services, including financial services, can never be an adequate alternative to other productive activity, and that may well, in some sense, be true. But I find it hard to believe that the improvement in services, and the increase both in invisible earnings and in employment, of resources of all kinds, which the present Revolution can bring, can in any sense be detrimental to the wider economy.