Innovation in international banking

Discussing[1] *the causes and consequences of innovation in financial markets, the* **Governor** *makes the following points:*

- *new financial instruments have been introduced which offer their users lower costs and greater flexibility;*
- *many of these new instruments were not caught by the supervisory rules in existence when they were devised but still give rise to the same kinds of risk as more traditional instruments: both banks and supervisors must be able to recognise these risks;*
- *many of the new developments are international in scope and cross the traditional divide between banks and other financial firms; for reasonable competitive equality between the different types and nationalities of institution to be assured, there may be a need for banking and securities supervisors to co-operate internationally;*
- *the quality of information available on individual firms becomes less comprehensive as they enter new areas of activity and it is important that disclosure should be adequate to support well-informed market judgements;*
- *the complexity of many of the new techniques increases the difficulty of risk measurement, while making it all the more important to ensure that risks are adequately assessed and controlled and priced appropriately;*
- *the shift to marketable assets has implications for the quality of banks' asset portfolios—and perhaps, too, for the quality of long-term credit decisions—which need to be recognised.*

You will have noticed that while the Conference programme is rather precise about what most of the other speakers are going to talk about, my own slot has been left refreshingly empty, looking nearly as enticing as the coffee break. The ability to choose one's own subject may on occasions be something of a mixed blessing: sometimes one would be spoilt for choice, but often one would resort to conventional platitudes about one's existing preoccupations. But for this conference, a quick glance at the rest of the programme leaves me in no doubt that, by accident or design, there is one all-important theme that I cannot fail to address today: and that is the causes and consequences of the tremendously rapid process of innovation that pervades the financial scene today.

Bankers used to be given the advice: 'never be first'. For better or worse, this is not heard so often now. Instead, banks and other financial firms are vying with each other to enter new markets and to introduce new instruments. These instruments offer considerable advantages to many users of the financial markets, in terms of their greater flexibility and lower costs; and this is to be welcomed, for the financial sector does not exist for its own sake, but to provide a service to the rest of the economy. Alan Clements, our Chairman today, represents a particularly successful British company which is notable for the alacrity with which it has taken advantage of new financial techniques.

But the process of change and innovation in international banking and capital markets does give rise to a number of issues which are, quite properly, being keenly debated. How can risks be managed and supervised, when their nature is changing with the introduction of new techniques? How is the desire for competitive equality to be satisfied, not just between different nationalities, but also between different types of institution? And how are we to ensure that adequate information is made available when markets are changing rapidly? These are the subjects I intend to cover this morning.

Background

Successful innovation generally requires both a need and an opportunity. Opportunities have been provided, in part, by the technological developments of recent years, which have greatly reduced the cost of communications

(1) In a speech at the London International Capital Markets Conference on 7 May.

and of computing power. They have also been provided by the general move in many countries towards deregulation and liberalisation of markets. After all, not all new instruments need be complex or require major technological input. Some quite straightforward instruments may be made possible simply by the removal of regulatory or other restrictions.

The need for innovation has been generated partly by competition between financial firms. International banking is, I need hardly say, an intensely competitive business: a very large number of participants offer similar products. The bargaining power of customers—both borrowers and investors—tends to be high. And the market is a very public one, with detailed information widely available on the terms being offered to different borrowers and investors. Innovation is therefore used as a means of gaining a competitive advantage.

Activity in the new techniques is spread across a wide range of institutions. Although much of the activity takes place in the United States and the United Kingdom, this does not mean that only British and American banks are involved. In London we can see firms from all the major financial centres taking part. Innovations have helped to break down many of the traditional lines of demarcation between market sectors, and now securities houses and banks are competing head-on with similar products. Firms from countries like the United States and Japan, which preserve a legal separation between banking and securities business, are not constrained to the same degree in London, where, as in other European financial centres, such a separation does not exist.

The form that innovation has taken has been determined partly by economic developments. During the 1970s inflationary pressures left a legacy of volatile interest and exchange rates in most countries. One result was a greater demand for hedging instruments. These may exist in more than one form. In London, for example, there is an active over-the-counter market in currency options alongside those traded on LIFFE and The Stock Exchange. Again, the eurobond markets offer instruments with the same characteristics in the form of bond warrants. The fact that similar instruments are available in a variety of forms, in banking and non-banking markets, has tended to diminish the special position of banks in the financial system.

This tendency has been reinforced by fears about the creditworthiness of some banks, reflecting depositors' concern about exposure to heavily-indebted developing countries. Bank supervisors have exhorted banks to strengthen their capital; and this in turn has led the banks to look for ways to increase their income while containing the growth of exposures visible on their balance sheets.

It may seem a little ironic that so important a part of the process of financial innovation appears to consist in the rediscovery of instruments with which—in outline at least—our grandfathers would have been familiar; but it is nevertheless true that one result of the pressures on bank balance sheets has been to promote the use of marketable securities. The most obvious sign of this is the growth in the international bond markets, and moves designed to make lending more liquid through devices such as transferable loans and the transformation of mortgages into securities.

There has also been greater interest in short-term marketable paper. In the United States issues of commercial paper have grown rapidly; the euromarkets have developed their own equivalent; and similar markets have been opened by other countries. We ourselves announced last week a framework for commercial paper in sterling. As many here will be aware, the principal constraint on sterling commercial paper has been that issues could contravene the deposit-taking provisions of the Banking Act. But given the interest expressed in issues of this type by a number of major companies, we have thought it right to put in place a framework which will exempt issues of sterling commercial paper from the Banking Act, provided certain conditions are met to ensure adequate investor protection.

In this area, the interface between the capital and the money markets, we want to feel our way in the light of experience. We recognise that further changes in the legislative framework will be necessary in due course, including adaptation of the prospectus requirements relating to such offerings. But we hope that last week's announcement will be a useful first step. I note with interest that you yourselves will be devoting a workshop to sterling commercial paper this afternoon—a choice of subject which, coming so soon after our announcement, shows that your organisers have highly developed powers of clairvoyance.

Supervisory issues

The range of new instruments which have been developed raises difficult issues for supervisors. They must try to adapt their systems to cope with the changing environment; but they must also maintain, as far as possible, a reasonably level playing field for different institutions.

As far as banks are concerned, many of the new instruments were not caught by the supervisory rules in existence when they were devised. This was probably the main reason for their creation. But they still give rise to the same kinds of credit risk or foreign exchange exposure as more traditional instruments, even if the risks are often complicated to measure and it is not always obvious who ultimately will bear them. Both banks and supervisors must be able to recognise these risks.

This, indeed, is what we in the United Kingdom have tried to do , and it is one of the virtues of our traditional supervisory approach that it can adapt quickly and flexibly to changes in banking markets. For example, in recent years we have brought currency options and note issuance facilities within our supervisory system.

However, the types of development we are talking about are not confined to a single country, or even to one or two countries. For this reason, and to preserve the level playing field I referred to earlier, an international approach must be adopted. Pursuing this objective, in March this year, the Basle Supervisors' Committee published a paper on banks' off balance sheet exposures. One of its aims was to encourage a broadly co-ordinated supervisory response to new banking techniques as they develop. There is an opportunity now for supervisory authorities to adopt a consistent approach from the outset, rather than having to work for the convergence of existing approaches. Even though the precise way in which supervisory policies are developed will inevitably vary between countries, this paper does at least provide a common framework.

The Bank of England subsequently published a discussion paper on the treatment of the credit risks involved in a wide range of off balance sheet instruments, which follows the approach set out by the Basle Supervisors' Committee. I am encouraged to see other countries considering proposals for capital ratios which take account of at least some off balance sheet items and which appear to be consistent with the approach taken by the Basle Supervisors' Committee. This is a useful start, and I hope to see further moves towards convergence of supervisory approaches.

One particularly difficult aspect of these developments for supervisors is the way they cross the divide between banks and other financial firms. This means—to extend the metaphor—that the playing field must be level not only from end to end, but also from side to side. Reasonable competitive equality must be assured, not only between banks of different nationalities, but also between banks and other types of institution. At the same time there must be adequate protection for investors. The fact that securities firms are rapidly establishing global networks raises issues very similar to those faced by banking supervisors in the early 1970s. Business is being done across borders, or by firms from one country's jurisdiction operating in another. Securities listed in one centre are being traded actively elsewhere. Borrowers are seeking to tap several markets simultaneously. All these activities raise important questions and demonstrate the need for the securities regulators in different countries to establish working relationships and means of exchanging confidential information.

In this country the Financial Services Legislation will put in place a supervisory framework under which the Securities and Investments Board will recognise a number of self-regulatory organisations which in turn will regulate the conduct of firms in different market sectors. A financial conglomerate may come under the supervision of more than one of these self-regulatory organisations and, if it is a bank, will also be subject to supervision by the Bank of England under the Banking Act.

In countries where banking and other kinds of businesses are legally separated, some of these regulatory overlaps do not arise so acutely. In most cases, however, the changes I have been describing are exerting increasing pressure on the legal distinctions. With banking and capital markets becoming closer and borrowers moving between them, I wonder whether banking and securities supervisors should not now be putting their heads together internationally. In this country, those who will have the task of supervising financial conglomerates have already been discussing mechanisms for co-ordinating their regulatory activities and responsibilities. It is important that understandings can be reached so as to minimise duplication in reporting requirements and to co-ordinate action; and to do so without overriding the statutory obligations under which individual regulators have to operate, or leaving gaps through which business might slip unregulated.

Issues for the financial system

As well as these supervisory issues, recent innovations raise some broader issues for the functioning of the international financial system. They concern the quality of information publicly available, the complexity of many of the new instruments and their associated credit risks, and the implications of the shift from bank to bond market finance. These issues were recently discussed by a central banking study group, whose report—which I commend to anyone interested in the subject—was published in April by the Bank for International Settlements.

Information flows

One consequence of the introduction of a series of new instruments and techniques is that the information publicly available on individual firms becomes less comprehensive as they enter new areas of activity, for which accounting principles do not yet generally require disclosure. As a general principle, it is desirable that banks should provide enough information about their activities for depositors and counterparties to be able to reach a well-informed judgement of their creditworthiness. Their ability to do so is obviously diminished when information on important types of exposure is not available.

Within the European Community discussions are continuing on the proposed Bank Accounts Directive. The intention is to prepare a format which would secure a minimum level of disclosure of a bank's off balance sheet exposures; which would be flexible enough to cater for instruments that may be introduced in future; and which would allow member states to require additional disclosure appropriate to the development of their markets. This directive will, we hope, make a valuable contribution to the quality of information available on banks in the European Community, and may make possible better comparisons between these banks and those from countries with similar standards. Other countries may wish to consider their own positions if they are not to fall behind.

The comprehensiveness of official statistics compiled and published by central banks and international bodies such as the Bank for International Settlements has also been affected. For example, there has been a gap in the detailed coverage of banks' holdings of securities, which have been growing in relative importance because of the shift from banking to securities markets. To fill this gap we in the United Kingdom have started to collect information on banks' holdings of securities, broken down by the country of issuer, and these are now included in our published statistics. Nevertheless, it is unfortunate that two major contributors to the BIS statistics are still unable to provide similar information.

Difficulties of risk measurement

If the complexity of many of the new techniques makes it more difficult for outsiders to evaluate the exposures of a company, it may also make it more difficult for the management and directors to do so. Many instruments pose very considerable technical and conceptual problems in measuring exposure; a mistake in an abstruse mathematical formula may turn out to be costly; and in many cases the technical issues involved will be understood by only a few specialists. Yet it is still important—indeed more important than ever—for management to have in place an adequate system for measuring and controlling a firm's exposures across the whole range of instruments.

Some of the instruments I have been discussing make it possible to 'unbundle' the different elements which are combined in traditional banking transactions. Their use may enable a firm to adjust its exposure to changes in interest or exchange rates, while accepting a limited exposure to credit risk. As a result it is possible for a firm, with some precision, to fine-tune exposures according to its objectives and expectations, either to hedge existing positions or to take new ones. This is an obvious benefit to the consumers of financial services, but I would make two observations on this unbundling process.

First, there may be a tendency for new instruments to be underpriced. Certainly, the unbundling process should lead to some reduction in the aggregate costs of financial services being supplied, because it allows risks to be redistributed to those best placed to bear them. But in some cases the reduction appears to go beyond what is justified. This is a signal to supervisors to ensure that institutions recognise risks and carry a sufficient cushion of capital to cover them.

Second, hedging instruments almost always give rise to some credit exposure for one or both of the parties involved. Swaps are an example. Offsetting transactions may close the interest or exchange rate exposure, but leave behind a chain of credit exposures. In the case of currency swaps these may be relatively large.

In all financial markets there has been a much greater emphasis on trading, resulting in enormously increased turnover. These transactions usually give rise to a buildup of exposures between market participants at settlement. This is manageable for so long as settlement systems continue to function smoothly. But this may be an area of increasing vulnerability for the financial system, as it relies more and more on sophisticated technology to handle a growing volume of increasingly complex international transactions.

The shift to marketable assets

The desire for tradable assets has generally encouraged the growth of the securities markets at the expense of direct bank lending. The United Kingdom until recently has been an exception to this trend, however. Our domestic corporate bond market has only just begun to revive after being dormant for more than ten years, largely as a consequence of the inflation we have suffered. The increase in bond market finance is therefore welcome, representing as it does a return to a traditional pattern of financing.

However, if the best quality borrowers progressively turn to the securities markets for finance, as has been happening in the international markets, this must have implications for the quality of banks' asset portfolios. The banks could increasingly be left with the residue of borrowers which are unable to gain access to the securities markets at reasonable cost.

I also wonder whether the quality of long-term credit decisions may be weakened by the shift to the securities markets. A small group of bank lenders may be better placed to monitor the performance of a borrower than a diffuse group of bond investors. If the markets are driven by traders, long-term credit decisions may be taken on the basis of short-term market opportunities. A bank expecting to hold a long-term credit to maturity may apply different criteria from a bond investor who may not regard himself as being locked in to the same extent. But for many of the new instruments, there has not yet been any test of the belief that because they are marketable they are liquid. Clearly they are liquid only to the extent that purchasers can be found. If one party is to be assured of liquidity, this implies that another must accept the obligation to provide it. For example, banks' commitments under note issuance facilities involve liquidity commitments—as well as potential credit exposures—which need to be recognised.

Conclusion

Financial innovation has brought undoubted benefits to the consumers of financial services. The markets have shown that they can adapt quickly and flexibly to changing circumstances; they will probably continue to do so. In my remarks this morning I have tried to focus on some implications of these developments, and on the need to ensure that the immediate benefits to individual firms are not offset by an increase in the risks to the financial system as a whole. Achieving this requires continued alertness to ensure that risks are adequately assessed and controlled and are priced appropriately. The technology which has nurtured these innovations is also available to help in controlling them, for efficient markets require not only the absence of distorting restrictions, but also good information on which to base decisions and allocate resources. These are the thoughts I should like to leave for you to ponder during the next day and a half of this conference.