The Rt Hon Sir Edward George: The convergence of financial systems

Speech by The Rt Hon Sir Edward George, Governor of the Bank of England, at the Oesterreichische Nationalbank Economics Conference held in Vienna, 31 May 2001.

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The theme of this session is convergence of financial systems, within the context of the overall conference theme of "The single financial market – two years into EMU". What I propose to do this morning is to ask, first, what are we – or should we be – looking for from our financial systems; then to ask, secondly, what are the major driving forces that have been, and are, affecting our financial systems – including but not confined to EMU; and, finally, to offer some thoughts on how those systems might continue to evolve.

So let me begin by asking what should we look for in our financial systems. In answering that question I suppose I could give you a long list of particular payments and savings services as well as credit, investment and insurance services, provided to individuals, to private organisations and businesses of all kinds, and to various levels of government. But that would be simply a description of our financial systems which do still differ in many respects as a result of history and tradition, of particular local needs, and of the state of evolution in individual countries. We are more interested in the essential purpose of our financial systems. And at the very heart of that is their capacity to bring together financial resources not currently needed by their owners for expenditure on consumption or physical investment, and to channel those resources to wherever they can be most productively used – always allowing for risk.

The free movement of capital, like free trade in goods and services, is an immensely powerful means of promoting efficient resource allocation nationally, regionally and globally, and as such it can make a major contribution to improving economic welfare – reducing poverty and raising living standards – which is, of course, what we all want to see. Certainly the free movement of capital, like free trade, needs to be governed by rules designed to minimise distortions and unfairness, and to reduce the risks of intermediaries being unable to honour their commitments or of broader, systemic, instability. I don't pretend for a moment that it works perfectly in practice: we could all well do without the well-publicised institutional failures of recent years, for example, or the volatility which characterised the Asian financial crisis or the more recent "tech stock" bubble. But it is certainly the most effective means of financial resource allocation that we have so far discovered. The challenge is to make it work more effectively – more efficiently, both in terms of intermediation costs, and crucially in terms of the direction of the flow of resources – but also more reliably and securely for both savers and borrowers. This is largely down to financial markets themselves. But it is a challenge, too, for the financial authorities who need to balance the need for market competition with the maintenance of minimum prudential and business behavioural standards by individual financial institutions, and the need to preserve overall macro-level financial stability. How far we are succeeding in meeting this challenge is, to my mind, the essential criterion against which we should seek to assess the development of our financial systems.

Against that background let me now try to identify some of the main drivers of change that have been, and are, affecting all our financial systems to varying degrees.

The first is financial deregulation, that is to say the relaxation of controls designed to override market forces in either an overall macro-economic or a directional sense. In the case of the UK this extends back very importantly to the abolition of exchange controls and direct controls over bank lending over twenty years ago, to enabling building societies (our principal mortgage providers) to extend their range of financial services activities, to the opening up of membership of the Stock Exchange and broader capital market intermediation and so on.

Deregulation in this sense was both encouraged by, and in turn contributed to, increasingly intense competition within the financial services industry, including a blurring of traditional distinctions between different types of financial institution. They were accompanied by what I think of as "re-regulation" that is to say more formal and structured regulation of both the prudential behaviour and standards of conduct of virtually all financial services activity targeted more specifically at both institutional stability and consumer protection but, subject to that, leaving the market to do its job. Such regulation in the UK has now been consolidated in a single, over-arching, financial services regulator, the FSA (Financial Services Authority). The Bank of England remains responsible for macro-prudential

oversight, that is to say the stability of the financial system as a whole, including oversight of payments systems. But we are no longer responsible for prudential banking supervision at the micro-level.

The re-regulation process, of course, conforms with the access provisions of the WTO and with internationally-agreed standards agreed within the IMF. It incorporates the minimum standards of banking supervision agreed (and now subject to revision) under the Basel Accord. It incorporates, too, those measures that have so far been agreed at the regional, European, level relating to a wider range of financial services activity in the context of progress towards the single financial market.

Whether or not these initiatives lead over time towards greater "convergence" of our financial systems in some structural sense – as they may – taken together with national deregulation they should at least contribute to greater competition, including cross-border competition, and help to improve the effectiveness of our financial systems in terms of the key criterion which I suggested earlier in my remarks.

That is particularly true, at least potentially, of the steps proposed to advance the European single financial market, as set out in the Commission's Financial Services Action Plan, because of its broad scope. But progress has so far been painfully slow. In that context I welcome the recent emphasis on closer and more active co-operation between financial regulators within Europe, regardless of national regulatory structures. And I particularly welcome the proposals put forward by Alexandre Lamfalussy and his "Wise Men" for accelerating progress on measures that would encourage greater efficiency in Europe's securities markets. But there is clearly a great deal more that we can do in this whole area.

Such changes in national financial services regulation, and related international and regional actions, taken together with increasing awareness in many parts of the world of the potential advantages of opening national financial markets to international competition, provide an encouraging environment for a second main driver of change in our financial systems – globalisation. It is a process we are particularly conscious of in London where major financial institutions from all over the world, including, of course, from elsewhere in Europe, have long been predominant players, especially in international wholesale market activity. But international ownership of banks (including newly privatised banks) and other financial institutions has increasingly become a common characteristic of financial systems in a wide range of other countries. I will not comment further on globalisation, which is certainly very familiar to you, except perhaps to say that I have often been teased by people who talk about the Wimbledonisation of the City of London – meaning that we provide the tournament venue but the prizes are mostly carried off by competitors from overseas. I think that many of those people now increasingly understand that it is activity rather than nationality of ownership which creates a competitive market place, and in turn provides employment and income and tax revenue, which are the things that really contribute to the macro-economy. As a broad generalisation the wider the range of participants the more efficient the market place.

A third major driver of change in our financial systems – as elsewhere in our economies – is, of course, information technology. This has clearly transformed transactions processing, putting a premium on throughput, and encouraging some forms of specialisation and consolidation. It has made possible entirely new – and typically much cheaper – means of delivering financial services making it easier for new entrants to contest existing franchises. It has facilitated the development of new financial instruments and investment strategies, and it has radically changed trading mechanisms. It should also have made it easier for both financial institutions and their regulators to measure, monitor and manage risk. But the electronic revolution, as it applies to our financial systems, has clearly had a very positive impact on the efficiency of all our financial markets and no doubt still has a long way to go.

Other major drivers include: the effects of rising living standards and the associated increase in financial wealth; and the consequences of ageing populations in many of our countries with a related emphasis on private pension provision. They include also the impact of fiscal policies which are now typically directed to limiting budget deficits and reducing public sector debt and of monetary policies directed at consistently low inflation as a necessary condition for sustainable economic growth. Many of these trends seem likely to encourage a continuing relative shift in savings and investment patterns towards private sector capital market intermediation, although such intermediation will often be carried out by banks or within banking groups. I've no doubt that you can all think of other important drivers of change in our financial systems.

And all of this before we even come to EMU!

Now, let me be clear, I agree with those who argue that the single currency – by eliminating exchange risk within the participating countries – can make a significant contribution to increasing the depth and liquidity of financial markets and reducing transactions costs within the Eurozone. And indeed it already has had that effect, particularly in money and bond markets, especially the corporate bond market. It has no doubt also been a factor encouraging the tendency to, mostly national, consolidation as financial institutions prepare for greater competition from other euro-based institutions in their national markets. All of this is very positive for the competitive efficiency of Euro-zone financial systems both nationally and within the Eurozone as a whole. It is in fact one of the two main potential economic benefits of the single currency, the other, of course, being the positive effect of nominal exchange rather certainty within the Eurozone on trade flows of goods and other, non-financial, services and its impact in more efficient resource allocation. It is also the field in which the UK, through London, has been able to make a positive contribution to the development of the Euro even from outside the Eurozone.

So I do not at all underestimate the contribution that the euro has made, and is making, to improving the efficiency of the Eurozone financial systems. But the point I have tried to emphasise this morning is that it is just one important factor among a number of others affecting our financial systems, so that one should not perhaps expect that it would have had a dramatic overall impact – certainly not in so short a period of time. And my message is that there are many other things beyond the introduction of the single currency that we can and should do, whether from inside or outside the Eurozone to improve the functioning of our financial systems.

Nationally, certainly within the UK, apart from continuing to try to find the right balance generally between competition and necessary regulation, we need also – through the authorities and the financial markets working together – to continue working to ensure that the financial system reaches those parts of the economy that are traditionally most difficult to get at, including particularly the encouragement of smaller and medium-sized businesses and new enterprises as well as community development and regeneration.

Regionally, within Europe, as I said earlier, we need to work away at developing the single financial market, pressing on with the Financial Services Action Plan. Most immediately, in line with the Lamfalussy recommendations, we need to address some of the regulatory obstacles to greater integration of securities markets. And we need to encourage the markets to find more efficient solutions to trading, clearing and settlement systems, particularly in securities markets, but also more generally.

The main driver in this last context, certainly from the point of view of those who use these systems, is the wish to reduce costs. It is often pointed out that there are thirty plus exchanges in Europe and probably at least as many settlement systems – which are linked to a greater, but often to a lesser, degree, which operate under different legal and regulatory regimes and which all incur their own running and development costs. The fragmentation also means that market participants incur indirect costs because it is harder for them to manage their liquidity and collateral efficiently. So the general message, which commands wide support, is that some serious consolidation would be in order. The question however is how to bring this about.

I will not go into the technical debate about horizontal versus vertical integration, nor into the distinctions – which are nevertheless important – between trading, clearing and settlement. And there are other, less technical, influences too, including perceptions of national interest. But whatever the reasons it is proving difficult for the markets to make real progress in these areas. In the face of this, there are those who argue for some outside party to intervene and enforce consolidation. The outside party some seem to have in mind is the authorities in one guise or another. I have to say that I have doubts about the wisdom of such an approach. There is little reason to suppose that the authorities are likely to be any better than the private sector at finding the way forward. Nor is it obvious that national authorities have the locus or leverage to insist on a particular model. Much the same reservations would apply to any European level intervention. That said, what the public sector can contribute, in this area as in financial markets more generally, is a removal of barriers to competition, requirements on the provision of information and the easing of constraints on the effective functioning of the market. If consolidation does indeed take place, the public authorities may also have a role in ensuring that heavily concentrated market infrastructure providers do not exploit their position. But at a European level we are at present still some way from this situation.

And internationally we need to work together, within the WTO and the IMF, as well as within the various international regulatory and professional bodies, to promote the global free movement of

capital, because in this context – as in the case of free trade – the potential benefits are not confined to national or even regional boundaries but increase within wider international participation.

Mr Chairman, we have come a long way in improving the effectiveness of our financial systems, and there are powerful forces at work pushing us in the right direction – including, within Europe, the introduction of the euro. But we still have a very long way to go. I have no doubt that the effort will prove to be worthwhile.