The Rt Hon Sir Edward George: Changes in the financial services industry

Speech by The Rt Hon Sir Edward George, Governor of the Bank of England, at the 16th European Finance Convention, London, 6 December 2002.

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Mr Chairman, Ladies and Gentlemen.

May I begin by congratulating you, Claudio - and your colleagues - on organising such a remarkable 16th European Finance Convention here in London, spread over the past five days. I don't think I've ever seen such a distinguished and comprehensive list of speakers - ranging from politicians, central bankers and financial regulators and representatives of the international financial institutions, as well as representatives of private sectoral and specialist financial services trade associations and experts from commercial companies - all assembled on one program.

I gather that the attendance has not been all that it might have been during the week. But perhaps that's not surprising: anyone with the stamina to attend even half of your proceedings is certainly a chronic insomniac. But those who have been here will have been rewarded by knowing everything there is to know about the recent development and current state of the financial services industry and how it might evolve.

And they still have to listen to me! But don't despair - it's the last lap - and I'll try to keep it short!

You have certainly had a great deal to discuss. The financial services industry - globally and not just regionally within Europe or nationally - has been going through a prolonged and continuing period of unprecedented change.

There are to my mind two main drivers of that change - first, the progressive shift - within the industrial world but increasingly also over the past decade or so in emerging markets and transition economies - away from varying degrees of centralised economic administration towards an increasingly open, market-based approach; - and, secondly, the revolution in information and communications technology.

The potential economic advantages of free market competition nationally, and its logical counterpart in free trade and the free movement of capital internationally are now pretty well taken for granted just about everywhere. While no-one would pretend it's a perfect guide, profitability is the best guide we have to allocating limited real and financial resources to wherever they can be most productively used. So it is - potentially - the most effective means we have of generating the wealth, and employment and rising living standards we all want to see. And liberalisation or deregulation - including liberalisation in the financial sector - needs to be seen in this context.

Of course it cannot mean simply a free-for-all. Markets need to be fair as well as free if they are to function efficiently in practice - they need rules which minimise artificial or non-commercial distortions and the related resource misallocation that would otherwise arise. And they need rules that reflect public policy concerns, relating particularly in the case of financial markets to systemic stability, consumer protection and fair competition. I will come back to that.

The second main driver of change in the financial services industry in particular is, as I say, the ICT revolution, which has made possible new financial instruments and investment strategies, new means of measuring, monitoring and managing risks and new - and cheaper - delivery, trading and settlement mechanisms and so on, all of which facilitate the greater competition and greater efficiency we need.

These global influences are of course at work within Europe, like everywhere else. But change in Europe in particular is being driven also by two Europe-specific factors - the single European market program, which is essentially an advanced, regional, form of the broader international shift towards free trade and the freedom of capital movement; - and the introduction of the euro, which, by eliminating currency risk between the participating countries, is making a substantial further contribution to increasing the depth and liquidity of European financial markets, including the (small-E) euro markets here in London.

These four key elements provide the context for the ongoing current debate on how best we can promote the single, integrated, European financial market - and I mean by “we” not just the authorities, who have an interest in the macro-economic efficiency of the market, but also market participants themselves, who stand to benefit at the micro-economic level from the new opportunities it will provide.

But before I move on to that question perhaps I might go off at what may seem something of a tangent, and reflect briefly upon our own experience here in the UK as we moved - in fits and starts certainly but in the same general direction - from a heavily administered economic and financial system to one which is now very much market based.

Even before I started at the Bank 40 years ago post-war controls had largely been dismantled. But the economic and financial system was still governed by all kinds of direct controls - exchange controls, credit ceilings - coupled with directional guidance, business restrictions - on the activities of building societies for example, the queuing of equity issuance, prices and incomes policies, public ownership of large parts of industry, and so on - all of which have now gone. It's true that plenty of regulation remains - reflecting public policy concerns relating essentially to competition, consumer protection and systemic stability. Indeed it has intensified in these areas. It's hard now to imagine that we had no formal banking supervision at all in this country until about twenty years ago. But for the most part such regulation today does not tell us what we can and cannot do, rather it sets the criteria that we must meet, and the behavioural standards we are expected to observe, in doing whatever it is that we choose to do. It leaves much more room for both consumer and producer choice, including producers from overseas, and much more room, and more incentive, therefore for competition and innovation. And, in that less prescriptive, more permissive, environment, the new technologies have brought about massive changes in traded instruments, in the way in which markets operate and are organised and in payments, settlements and delivery arrangements and so on, which, while not without occasional problems, have overwhelmingly on balance brought massive benefits in terms of market efficiency.

In reflecting on this whole process in the UK, there are a number of characteristics of the general approach that I think have been important.

The first relates to the extent to which it was market-driven. No attempt was made as far as I am aware - certainly not by the Bank - to tell market players what they should do individually or in organising themselves collectively. Of course we followed what they were getting up to very closely, and always stood ready to help when we were called upon by the markets to do so, as we occasionally were, intervening on our own initiative only to ensure that the public interest was properly respected. For the most part we took the view that market participants know better than we do what will work and what won't; it is after all their salaries if not their jobs that are on the line.

Where public policy issues were involved, we established a tradition of extensive consultation right across the relevant sections of the market - a tradition which the FSA has certainly maintained. In the UK's relatively well-developed markets - particularly the wholesale markets - we recognised early on that where intervention was judged to be necessary - in the interest of market transparency or of prudential or behavioural conduct for example - it needed to be informed by those who properly understood the subtleties of the market if we were to reduce the risk of unforeseen consequences which could either frustrate the purpose of the intervention or unnecessarily obstruct market innovation. In some instances this approach, which I suppose might be described as market-sensitive, involved encouraging the market itself to address the particular issue in question as a preferable alternative to official action. I think of the Takeover Panel, for example, or the work of people like Adrian Cadbury - under the auspices of the Stock Exchange - in developing corporate governance standards, or of the professional organisations which set and police accountancy rules. A similar approach was followed in relation to many commercial banking issues - through approved codes of conduct in relation to their dealings with customers accompanied by an ombudsman scheme. We were in this country sensitive to the need to distinguish between different aspects of financial market activity - very obviously in the case of the distinction between wholesale and retail activity - in trying to find the most appropriate ways of reflecting legitimate public concerns.

Where there has been official intervention, it has, again by now well-established tradition, sought to avoid discrimination - whether between different types of financial institution or in the form of protective nationalism in favour of British-owned businesses, provided everyone undertaking a particular activity played by the same rules. That approach has not necessarily always been popular, I have to say, with some of those who might have benefited from such discrimination! But it is certainly one of the reasons for London's attraction as an international financial centre including its attraction to so many financial companies from elsewhere in Europe. And that international presence in turn contributes enormously to the efficiency of the London market - and indeed the European market of which we are very much a part.

Chairman, I could go on reflecting on our own experience of all this - but I'm conscious that the weekend beckons - and the relevant question is how it all relates to the development of the single financial market across Europe.

The potential benefits of integration I take for granted. The continuing debate is about how - given that we all start from different positions and with different traditions and with different public policy priorities, we get from here to there. It may well be that continuous public pressure for higher and higher standards in financial markets everywhere are leading to greater official intervention any way. But integration was itself always bound to involve more intervention as the EU member states moved towards some degree of harmonisation of standards, requiring legal agreement at the European level and then reflected in national legislation. And a great deal of progress has, of course, already been made in that direction through the Financial Services Action Plan which is due in principle to be completed in 2005. But everyone accepts that a great deal remains to be done - in the context of the integration agenda - and in fact it is bound to be an ongoing process as markets evolve and new issues arise. In that context the recent agreement on Alexandre Lamfalussy's proposals for a faster track procedure in securities markets has been generally welcomed.

But the on-going debate extends beyond that to where more precisely we want to get to. At one extreme - and I exaggerate to make the point - some appear to have a vision of maximum harmonisation across the EU, with uniform regulation and centralised oversight at some point in the future, whereas others lean more towards harmonisation only to the extent to which it is demonstrably necessary, with mutual recognition, and an EU-wide passport based primarily on the removal of barriers to cross-border activity. Of course that approach leaves plenty of room for debate about what exactly “demonstrably necessary” means. Underlying the debate at that level are legitimate differences in priorities as between the different public policy concerns - how much weight to put upon consumer protection as against systemic stability or freer competition, for example, which are not necessarily easy to resolve even at the national level. And there may - just possibly - also be, less legitimate, differing perceptions of national self interest.

The truth is that there are no easy answers, and I think myself that we are bound to move forward in a pragmatic, incremental, way - recognising the different considerations that apply in different areas of the markets rather than on the basis of a grand design.

In this context, I am actually rather encouraged by the recent discussion papers put out by Eurofi and the Wicks group, which stand back a little from the more immediate issues and look at the way forward in a broader - and longer-term - perspective.

They seem to me to have quite a lot in common in terms of immediate priorities, although there are important differences in terms of where we may ultimately end up. I welcome in particular their shared emphasis on involving practitioners in consultation on the way forward at every stage - indeed we might have made more progress if that procedure had been more generally adopted hitherto. I welcome also the emphasis in the Eurofi paper on evolution - which is implicit too in Wicks - but I am less sure about the Eurofi presumption at this point of necessary and inevitable progression towards eventual centralisation. But, whatever one's views about the particular suggestions and proposals in the two papers the really important thing is that the issues they raise should be debated and discussed - by market participants as well as by the relevant authorities. And that's why I think that conferences of this kind are important, Chairman.

I very much hope that following on from your Convention the important issues that have been raised will continue to be explored in the various trade associations and professional organisations that have been represented here, and that they will make their voice heard in the councils of Europe on the way forward, as indeed they traditionally have in the context of developing our own markets here in the UK. I will have every confidence that they will.

I'm grateful to you for giving me the opportunity to join you this afternoon and I wish you and the European single market in financial services every success.