Mr Clementi comments on UK financial services following the launch of the euro

Speech by Mr David Clementi, a Deputy Governor of the Bank of England, at the Economist Conference in London on 23 April 1999.

It is a great pleasure to be here this morning. My announced topic – UK financial services following the launch of the euro - is obviously a large one. But ambition is a fine thing, and so not content with just that, I want also to say a little about the wider forces – especially technological change – which are shaping changes in financial services markets and institutions everywhere, not just in Europe.

The importance of financial services to the UK economy is enormous, and I do not need to devote much time to underlining it. Financial services are a major invisible export and contribute a substantial proportion of GDP. The UK does more foreign exchange business, more OTC derivatives business, more international bank lending, more bond origination and trading, and more equity fund management than any other country. Personally, I have no doubt that – provided we are not complacent - the UK will retain its dominant position for the foreseeable future. But that said, the nature of the financial markets in which UK–based practitioners have to operate will certainly continue to change.

The plan for my march through this difficult terrority is as follows. First, by way of background, I want to say a bit about the "new" Bank's role in relation to the financial services sector. Following the arrival of monetary independence, and the departure of banking supervision and debt management, what exactly is our interest, as central bankers, in the way financial services evolve? After that I will talk a bit about some of the forces which are working to produce fairly rapid change in the financial services landscape.

One of these forces – and certainly one of the most prominent just at this moment - is the advent of the euro. So I will undertake a spot of crystal ball gazing, and try to assess how financial markets in Europe may develop over the next ten to fifteen years, and what this means in terms of opportunities and challenges for UK financial services. It is in the nature of an assessment of this kind that a good deal of it may turn out to be wrong. But making judgements about an uncertain future is part of any business, and there is no reason why central bankers should shy away from it more than anyone else, so long as the uncertainties involved are acknowledged from the start.

Another, almost certainly more persistent, factor is the pace of technological change. Related to that, we are seeing a trend towards consolidation – at first nationally, but now also internationally – amongst financial services providers. So I also want to make a few remarks about these factors.

Before I go into these issues in more detail, I just want to sketch out how the Bank stands in relation to UK financial services. Obviously the changes in the Bank's remit announced in May 1997 by the incoming Labour Government, and largely enshrined in the 1998 Bank of England Act, were profound ones. The arrival of monetary independence meant that the work of the MPC – of which I am one of the nine members – has scarcely been out of the news. Less obtrusively, the departure of banking supervision to the new FSA meant the end of one substantial – though actually comparatively recently acquired – function; and the shift of debt management to the DMO brought to an end another, much older one.

So does the "new" Bank have a new relationship with the financial services sector?

Let me first say that, though the Bank has been through a period of profound change, its core purposes remain the same. One is obviously to promote monetary stability; and there our role is now much more substantial and overt. But the Bank has two more core purposes, and both relate directly to the financial services sector.

The first is to promote the overall stability of the UK financial system. This role is not new, though it has recently been set out explicitly in the Memorandum of Understanding between the Bank, HMT and the FSA. Broadly, promoting systemic stability means working to ensure that the financial system continues to perform its key roles in support of the wider economy – settling transactions, providing liquidity and allocating savings. In pursuit of this we look at factors affecting the underlying robustness of the financial system, as well as potential "triggers" which, especially at times of structural weakness, could bring on a crisis. Our remit is of course in relation to the UK financial system – but this work has a substantial international dimension, given the openness of the UK economy, and the international character of much of the City.

What does this mean in practice? The Bank's financial stability work include such things as overseeing the UK payments systems; analysing broader developments in the banking, securities and insurance sectors, and the evolving strategies of London's securities exchanges; looking at developments in emerging market economies; and contributing to the debate on the reform of the international financial system. In short, the Bank's financial stability team has to analyse and respond to any developments – market or institutional; structural or temporary – that could threaten financial stability.

Our second relevant core purpose is to promote the competitiveness of the UK financial services sector. This is not a lobbying function; we are concerned with the promotion of effectiveness and efficiency, not the acquisition of favours. Nor is it a responsibility exercised only in respect of UK owned firms. The UK financial services sector is more truly international than that in any other country in the world. The Bank, and the other authorities in the City, have an unwavering commitment to openness, and the provision of a level playing field to all firms regardless of nationality.

Finally, it is worth underlining that the Bank of England has an interest in the evolving structure of financial markets because, as well as being a policy body, it is also a bank. We have a fairly substantial and diverse balance sheet to manage, and that balance sheet is the basis for our financial market operations in support of our policy responsibilities.

The Bank is banker to the government, and to the banking system as a whole, and maintains an operational presence in various key financial markets. In the sterling markets, the Bank obviously stands at the centre of the short term money markets, providing liquidity to the banking system and thus maintaining control over short term interest rates. We are also, as managers of the nation's foreign exchange reserves as well as various currency assets and liabilities on the Bank's own balance sheet, active in the foreign exchange and some foreign bond markets. Finally, although no longer responsible for debt management, we retain an operational capability in the gilts market, again primarily to manage our balance sheet and provide services to customers. Being close to developments in these markets provides a vital source of information used in the pursuit of our financial stability, as well as monetary policy, objectives. And any operations that were, in a crisis, needed in support of our financial stability objectives could take place in any of these markets.

Now I will turn to some of the various forces for change in the financial services industry.

First, the euro. The arrival of the euro marks a profound and almost certainly irrevocable change to the financial landscape – perhaps the most important event in the international monetary system since Bretton Woods in 1944. Instantly, a major new reserve currency has appeared; indeed the euro is already being used in international transactions more extensively than any currency other than the dollar.

As the most international financial centre anywhere in the world, London's business has already been profoundly affected by the euro. This is because, although the UK is 'out', London is 'in'. The conversion weekend – the changeover from participating national currencies to the euro in wholesale markets at the beginning of this year – was one of the biggest logistical operations that the London market has ever undertaken. It was also arguably more complex in London than in some countries in the euro area, because London traded in all the euro area national markets, and they all changed over to the euro in slightly different ways. And, though hard numbers are difficult to come by, we are confident that London is maintaining its market share. In exchange traded short-term interest rate derivatives – one of the few areas where we have precise figures – LIFFE has around 80% of euro business. On the London Stock Exchange, over 40% of turnover in the first two months of this year was in stocks of firms in the euro area. Similarly, in other markets, London's dominance in foreign exchange trading, OTC derivatives, fund management and bond origination means that London is the financial centre for euro wholesale financial services. Even in the area of payment systems the UK accounts for a significant proportion of the euro payments flowing through TARGET, even though for us the euro is a foreign currency.

But these are just the immediate, first round effects of the euro. The more substantial challenges are posed by the more uncertain outlook as to just how the euro markets will develop in the medium term. So I want now just to say a little about how the euro markets may develop over the next ten to fifteen years.

One thing to keep in mind here is that some of what may happen, though driven by events in the EU, will reflect factors beside the single currency. I think we may well see more privatisation, greater reliance on private provision of pensions, and other structural reforms. If we do, it will significantly affect European, and hence, euro financial markets. But such trends have their roots in the more general process of creating a single market, rather than EMU itself. Considerable progress towards a single EU market for financial services had been made long before the euro. A considerable number of directives are already in place, perhaps most significantly the Investment Services Directive, which was implemented in 1996 and gave regulated firms and exchanges from one Member State a 'passport' to do business in another Member State. I will now turn to possible developments in particular markets.

First the market for euro area bonds. In aggregate, the euro area government bond market is of a broadly similar size to the US Treasuries market. So it is one of the largest securities markets in the world. It is of course not yet as fully integrated as the Treasuries market. Substantial further progress in that direction probably depends on how quickly the various initiatives to link together Europe-wide trading and settlement systems come to fruition. And there are, and will remain, credit differences between particular issuers. But I would nevertheless expect the market to become increasingly integrated and, with other bond markets, more sophisticated over time.

This 'cash' market is of course important in its own right; and London based market participants will remain very big players in it. But as far as the development of UK financial services business is concerned, the other interest rate markets which spin off the government bond market may be the ones where we see the most rapid growth, and the greatest scope for innovation. Good examples would be the markets for repo, swaps, and other interest rate derivatives.

I think that in terms of new market opportunities, one of the most important areas in the evolving euro-denominated markets could be that for corporate bonds. At the moment, although the European and US government bond markets are of comparable size, the non-government bond market in Europe is 'only' a third to half the size of that in the US; and much of that is bank issued debt.

I would expect the euro corporate bond market to develop significantly in the medium term. And with it, I would expect to see other product markets develop, as they have elsewhere (in the UK, but especially in the US) – for instance markets for asset backed securities and commercial paper. As part of this I think we will see a trend to greater issuance at the lower credit end of the market (or 'high yield', as it is politely named). In the euro area around 70% or corporate bond issuance is by issuers rated Aa2 and above. In the US, it is around 30%. I would expect that gap to close a bit, and I think there are already signs of life in the European high yield market.

While I am on the subject of European bond markets, I would like to make just a few remarks about the proposed EU withholding tax. The stated objectives of the scheme – reducing tax evasion and reducing structural unemployment – are clearly desirable ones. But in thinking about any kind of withholding tax a judgement has to be made about the trade off between the efficiency of tax collection and the efficiency of capital markets. In this particular case, I think the open nature of the EU economy sets very serious limits on the proposal's potential impact on the collection of tax, since the same scope for avoiding tax would continue to exist outside the EU as it does at present; and it seems unlikely that countries outside the EU area would voluntarily follow the same policy. So I think there is a very real danger that legitimate business would relocate, not just outside London, but outside the EU, thus further undermining any economic rationale for the proposal. This does not mean that work should not continue to see whether there are amendments to the scheme that could satisfy the interests of all the parties involved. But the Bank continues to believe that it is important to avoid any scheme that would damage EU financial markets.

Turning to equities, I expect to see growing emphasis on analysis and investment according to European sectors, not countries. Thus you would expect to see investment banks' research departments focusing more on pan-European sectors, rather than dividing their teams on national lines. In many firms this is happening already.

More generally, I think we can expect to see greater "equification" in continental Europe. In the UK, the equity market's capitalisation is around 165% of GDP. Among the "ins" it is generally much lower: in Germany and Spain it is perhaps 35%, in France 40% and in Italy 25%. Only the Netherlands really stands out, at around 130%.

This is partly a reflection of cultural investment differences; greater reliance on bank finance; greater state and family ownership (still equity of course, but not easily marketable); and reliance on public rather than private pensions. As a result equities form rather less than 20 % of institutional portfolios in France, Germany and Italy. In the UK they represent more than 70% of portfolios.

In the medium term, I would expect to see more equity issuance; and much greater institutional holdings, especially cross border. The latter is one area where the euro may have a fairly rapid impact on institutional portfolios, since many institutions remain unable to diversify into foreign currency assets. This process of equification will of course take time – but there are signs that it is under way, especially in the relatively strong growth in the market for continental high technology stocks.

What about the traditional banking market? I leave this to last because some of the likely changes are just the counterpart of factors I have already mentioned. But for instance, greater reliance by capital users on equity as opposed to debt capital, and bond as against bank finance, would, other things being equal, be expected to lead to some shrinkage in banks' balance sheets in relative terms. The extent to which this may happen is of course uncertain. It will depend on many factors, including the impact of any changes to the Basle Accord. But even if there is substantial disintermediation, it does not mean that banks will cease to be dominant players. My point is just that as euro securities markets develop and deepen, more of the finance banks arrange will be off balance sheet. I'm inclined to think also that we will see further consolidation within the European (and indeed global) banking sectors, though I think that will not primarily be a function of the euro, and is something I will touch on in a minute.

Now, all these developments offer opportunities for financial services firms globally. This is not a zero sum game. I expect to see financial centres within the euro zone growing in size over the next few years. But London will grow too, and I think it is significant that many of these potential developments depend on market practices and techniques pioneered in London.

I see London as the engine for growth and innovation in the European capital markets. This is not a narrow parochial point. As I have already emphasised, UK financial services are highly internationalised and many of the UK–based beneficiaries of this process are owned elsewhere – in the US, Europe, Asia and elsewhere. Nor does it reflect complacency. Although London has tremendous critical mass – especially in the crucial area of human capital – one major implication of what I will say in a minute about technological innovation is that certain aspects of financial services – especially trading and settlement – are potentially more geographically mobile now than in the past. We are already in a market where it is possible for a trader in London to deal on a German exchange, call for delivery in Luxembourg and make payment in Paris.

So, the advent of the euro is just one factor transforming the environment in which UK based financial services firms must operate. I would now like to talk about a few others.

First and foremost, technological advances. Even from just a few years' perspective it is clear that financial services have been transformed by technological innovation. Arguably we are moving to a world in which more and more trading and settlement processes will use automated, electronic systems. And the pace of change is probably increasing. The LSE moved away from a trading floor in 1986. It has since moved to electronic and largely dematerialised share settlement in CREST in 1996, and to the electronic order book SETS for its largest 100 or so stocks in 1997. Last year LIFFE decided to switch from floor trading to its new electronic CONNECT system.

More broadly, electronic trading systems have been, or are being, introduced in a whole range of government bond, repo, Eurobond and foreign exchange markets. Initiatives are well advanced to introduce electronic 'straight-through-processing' in various markets, allowing the transaction process to be automated from the initial trade right through to settlement.

On top of all this there is the as yet unknown potential of the internet. In the US, there has been an explosion of retail investment activity through the internet; in Europe we are still way behind. Much of the internet business that is already taking place – here or in the US – is essentially substituting for speaking to a broker, and the brokers that have adjusted most quickly to this change in the US have benefited accordingly. But use of the internet has already led to a change in retail investor behaviour in the US. And if the internet is eventually to have a really profound impact on the investment landscape – wholesale as well as retail – it may come through its capacity, as an almost completely open system, to link investors of all types directly into order and execution systems. But that is much easier said than done. There are a whole range of factors – technological limitations, regulatory issues, settlement and the like – which mean that the eventual impact of the internet is very uncertain.

What are the implications of all this?

First, electronic trading widens access to markets. It removes any need for geographical proximity to an exchange and relaxes any limit on the number of firms that can participate directly (subject to any credit or regulatory constraints). Greater participation in a market increases liquidity and makes that market more attractive still.

Second, since firms can switch from one electronic trading platform to another, and since they can also often access exchanges cross border, broadly speaking any exchange can potentially compete for the business of any firm. This creates greater competition between exchanges to maximise their trading volumes and realise economies of scale. It also means that an exchange which offers a more advanced trading system can win business, even from established rivals, provided it can reach a critical level of liquidity. So electronic trading makes markets more contestable and puts greater pressure on exchanges to update their technology and offer an attractive overall 'package' to users.

Third, technological change means that distinctions between exchange traded and OTC markets are becoming more blurred. As exchanges adopt electronic trading platforms, and in some cases demutualise, they become less akin to associations of particular types of firm and closer to being competing providers of trading, and perhaps even clearing and settlement services. At the same time, many traditional OTC markets are moving away from pure, decentralised bilateral trading to establish some common market infrastructure. So for example, in the foreign exchange market, most trading now occurs over electronic platforms provided by Reuters or EBS. Another example is that the London Clearing House is establishing Swapclear as a central counterparty clearing house for OTC derivatives.

Another factor transforming the financial services landscape, and quite closely related to the technological factors I have just mentioned, is the globalisation and consolidation of the main market participants. The last decade has seen a global consolidation of the main intermediaries in the world's capital markets to leave a relatively small number of large players, with large balance sheets and operations spanning each of the world's major markets. Since these firms are the major users and, in some cases, owners of the market infrastructure in each country, their interests have a strong influence on market structure. Now I think that big is not always best, and actually smaller niche players have more of a future than is sometimes imagined. But that said, in twenty years I think that it is quite possible that the financial world will be dominated by perhaps twenty truly international wholesale banks, including a few genuinely pan-European ones.

Now it is possible that these large banks will want to use their own balance sheets to offer a full range of services to their customers, so that they rather than an exchange-based central market become the focus for liquidity. If so, such firms would be in competition with infrastructure providers: for example, when offering in-house trading or custody services to their clients. On the other hand, such firms will also want to continue to trade with each other, in order to manage their own risks and inventory. For that purpose, they will still want low cost trading and settlement mechanisms that minimise their exposure to counterparty risk and the impact on their balance sheets.

So there are perhaps some tensions between the various forces at work here. To take another example, economies of scale in trading, clearing and settlement suggest that to minimise costs firms should encourage consolidation and integration of these activities within a market. Yet the major firms have, understandably, been very reluctant to allow the dominance of a single supplier. For example, EBS (Electronic Broking System) was set up by the major banks to offer an alternative system for foreign exchange trading.

Ladies and Gentlemen, let me finish by saying that it is difficult to draw firm conclusions about the future structure of the financial services industry. If it was, strategic decision making would be easier than it seems to be. But financial service businesses based in the UK start from a strong position, and are well placed to thrive in an environment that will evolve at an increasing pace, become even more competitive, and place an even greater premium on innovation. The Bank of England will monitor and analyse the developments very carefully – both because we want UK financial services to thrive, and because in the pursuit of our financial stability responsibilities we need to be able to spot potential problems as quickly as possible.