A Changed Landscape for Financial Services

Stephen L. Harris and Charles A. Pigott

Not much less than two decades ago regulatory limitations on financial services, as well as impediments to international trade in them, were widespread in the OECD countries. Since then, most of these obstacles have been removed in a far-reaching process that has transformed the world's financial markets.

The fundamental objective of government regulation and supervision of the financial-services industry is to maintain the integrity and stability of the financial system and to protect depositors and investors. The regulation deployed to this end requires safety-net mechanisms such as lender-of-last-resort facilities for banks and some form of insurance for depositors. It also includes standards for sound financial behaviour by individual institutions, among them: minimum amounts of capital and liquid financial assets institutions must have as a buffer against unanticipated events; requirements for effective risk-management systems and oversight by managers and directors; prohibitions on lending by management to itself or closely related entities ('self-dealing'), on insider trading, and on other transactions where there is a conflict of interest; and requirements that individual institutions disclose key information on their performance to the market. Regulations also maintain the integrity of trading systems and ensure that financial institutions carry out their fiduciary responsibilities to stockholders, depositors and others by behaving prudently.

Stephen L. Harris works in the Financial Affairs Division of the OECD Directorate for Financial, Fiscal and Enterprise Affairs and Charles A. Pigott in the Money and Finance Division of the OECD Economics Department.

E-mail: daf.contact@oecd.org
eco.contact@oecd.org

Up until the late 1960s, regulators relied heavily on direct controls, to varying degrees in the OECD countries, but usually in the form of limits on interest rates and on the activities financial institutions were allowed to pursue. The ability to offer deposits, underwrite securities or develop new financial instruments and to engage in various types of financial business were limited, with, for example, banks alone being able to offer deposits against which cheques could be drawn, and insurance business generally restricted to institutions separately licensed and regulated for that purpose. In some cases, regulatory policies were also used to promote other social goals, such as subsidised interest rates and special access to credit by particular sectors (for housing and government debt, for example). As a consequence of all these measures, many types of financial institutions were exposed only to limited competition.

Over time, market forces, combined with the exploitation of regulatory loopholes by financial institutions, progressively weakened the effectiveness of the restrictions and eroded the distinctions between various institutions, particularly among banks, investment dealers, mutual funds and insurance companies. With these developments, regulatory policy came to rely more and more on competition and market-based decision-making to achieve its objectives.

This process was substantially reinforced by the globalisation of financial markets. Globalisation had its beginnings in London in the 1960s but soon ricocheted back to national markets and gave rise to a self-sustaining process of competitive liberalisation across the industrialised democracies during the following three decades. The authorities responsible for financial regulation wanted to ensure that the financial hubs in their countries would not become backwaters because of a failure to respond to international competitive pressures. Globalisation has been the impetus for several very important international agreements to liberalise international trade in financial services: the European Single Market, the General Agreement on Trade in Services, the North American Free Trade Agreement and particularly the OECD Codes of Liberalisation of Capital Movements.

No nation-state had a grand plan to restructure its financial services industries. Indeed, these changes were often what policy analysts characterise as 'incremental'– muddling through. Some OECD countries, such as Canada, Australia, the United Kingdom, the United States and France, and more recently New Zealand, nonetheless set about reform more comprehensively than others. Financial deregulation, because of its rapidly changing landscape, is obviously affected by policy in other domestic sectors – particularly macro-economic stabilisation – but the comprehensiveness of national reforms has generally been a function of how the financial world as a whole has changed.

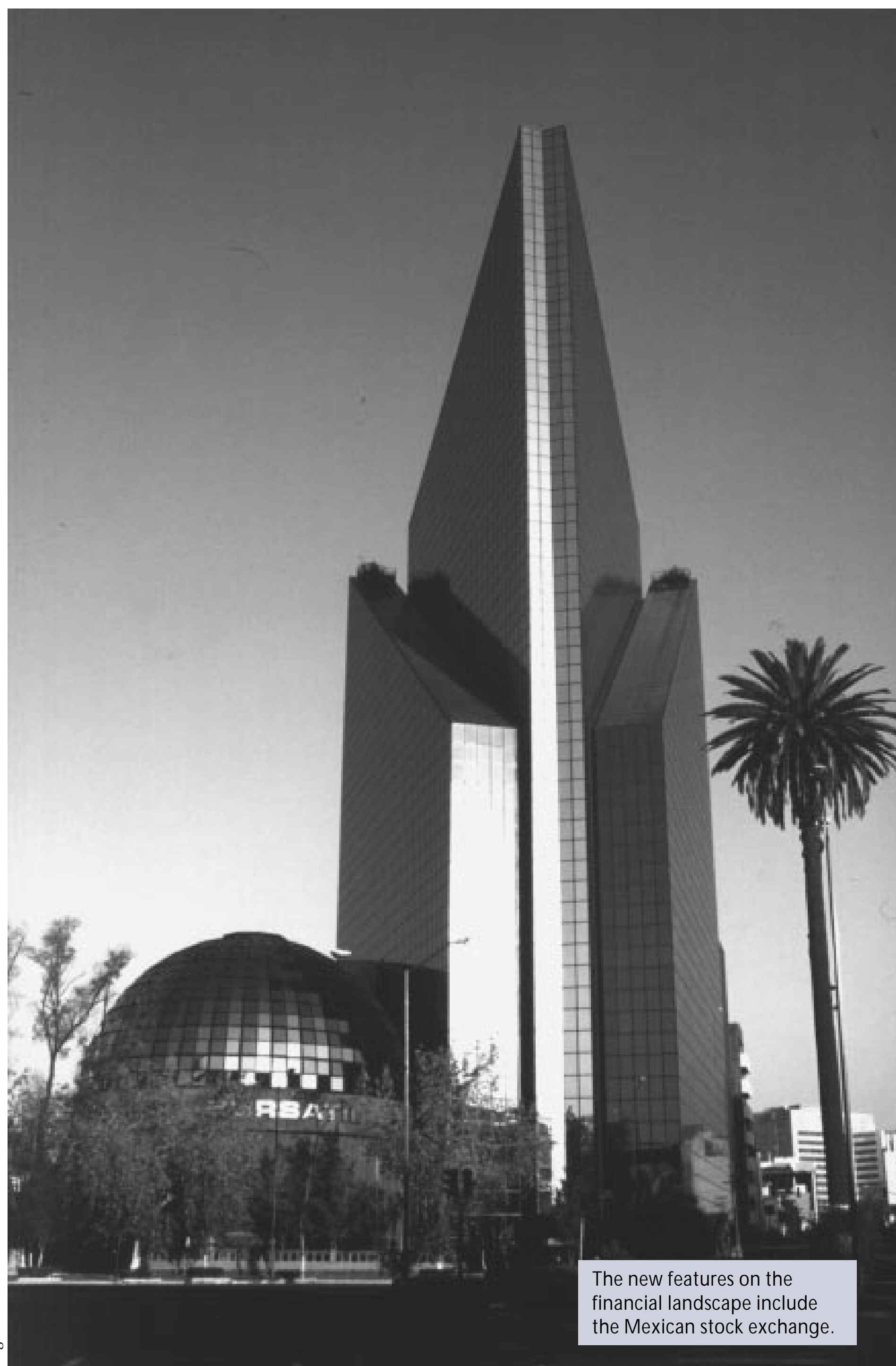
Nonetheless, the past quarter-century has seen thorough-going liberalisation in the financial services in virtually all OECD countries. There have been very similar policy initiatives in the Eng-

lish-speaking countries and Japan, which had specialised and functionally separate institutions comprising their financial structures, particularly when compared to those in Germany and much of the rest of continental Europe, for example, where the 'universal bank' offered a complete portfolio of financial services – one-stop shopping. But among OECD countries there has been a good deal of convergence – through regulatory competition – as each nation-state wanted to ensure that its indigenous industry and markets would remain viable.

Several important events provided momentum to the process of liberalisation and internationalisation. First, the development of the Eurodollar market, focused in London, combined the effects of former Eastern-bloc countries moving their US dollar balances out of the United States to western Europe (beginning in the late 1960s) with those of 'Regulation Q' in the United States, which put a ceiling on the rates that US banks could pay on deposits, whereas the Eurodollar market was not subject to constraints on interest rates. Second, the industrial activities of multinational corporations increased demand for international banking services. Third, in the 1970s there was a good deal of macro-economic instability in the industrial economies, precipitated in part by the breakdown of the Bretton Woods exchange-rate regime and by the two oil-price shocks.

In addition, a number of countries took administrative action, mostly from a defensive position, to liberalise elements of their financial-services industries, ranging from the deregulation of bank-lending and/or deposit rates, the elimination of regulated stock-exchange commissions and the restructuring of government-bond and private-equity markets to the abolition of restrictions on the intermingling of the activities of different types of financial institutions.

As a result of these reforms, the state, once an overt intruder in the decision-making of the financial industry, has largely ceded its role to market mechanisms, which are now virtually the sole determinant of interest rates, credit allocation, financial instruments and services. Distinctions between financial and market intermediaries have been eroded and competition enhanced.


Serge Attal

The new features on the financial landscape include the Mexican stock exchange.

But there are still a number of important obstacles. Many countries have quantitative restrictions on the portfolio composition of both pension funds and insurance companies. That limits portfolio choices and reduces the ability of the institutions involved, and those who place funds with them, to achieve the highest available return for a given degree of risk. Some restrictions on the international holdings of pension and insurance funds may be justifiable on the basis of the 'prudent person' principal that requires portfolio managers to maintain adequate safety and liquidity in their holdings. But existing restrictions often go well beyond such considerations. Some countries, moreover, when imposing constraints on the composition of portfolios, limit holdings not only of foreign assets but also impose a minimum requirement for holdings of government debt – thus providing the government with an assured source of funds.

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In some countries, especially Japan and Korea, there remain effective restrictions on financial activities that arise from structural considerations, such as the discretionary power of regulators and other officials to intrude into business decisions of institutions, or from accepted business practices such as accounting and reporting conventions or from the degree of transparency or opacity in the regulatory apparatus. These barriers are coming down. In November 1996, the Japanese government announced its intention to introduce a series of structural reforms designed to revive the Japanese financial market and thereby Tokyo's importance as a world financial centre after the 'hollowing-out' of that market over the past several years. And in many respects the situation in Korea currently mirrors that which existed in Japan before the liberalisation of its financial market began. Korea is also studying ways of reducing state intrusiveness.

Finally, there are also a number of barriers to cross-border trade in investment funds and to portfolio-management services. These rigidities arise from differences in business practices, withholding taxes on dividends and interest paid to overseas investors, and differences in tax treatment of earnings.

The Benefits of Deregulation

The OECD economies have benefited considerably from financial deregulation, mainly in three ways. First, deregulation has raised productivity in the financial-services sector itself, leading to lower costs and reduced prices. For example, the volume of transactions and amount of total assets per employee has increased nearly three-fold since the early 1980s in banking alone; and spreads between buying and selling prices in the euro-currency and other major wholesale financial markets have dropped considerably.

Second, the users of financial services are enjoying considerable improvements in the quality, variety and accessibility of new financial services. Consumers now have access to accounts that pay interest rates closer to those prevailing in the market, have a wider range of maturities, and provide more flexibility for withdrawals. Household access to mortgage credit has expanded substantially in Japan, the United Kingdom and several other European countries. The development of markets for 'financial derivatives', such as options and the ability to convert loans into marketable securities ('securitisation') fostered by deregulation, has considerably increased the ability of firms to manage risks and to tailor their transactions to their individual requirements.

Third, the allocation of resources has improved, not only among various sectors of the economy but also by limiting disruptions to spending from fluctuations in income or cash flow. For example, there are far fewer of the disruptions to construction activity that used to arise when market interest rates rose above those that banks (the main suppliers of funds to construction) were allowed to pay on their deposits. Evidence also indicates that the sensitivity of household spending to transitory fluctuations in income has fallen in a number of countries, such as the United States, Japan and Canada, with financial deregulation.[1]

Among the most important gains in resource-allocation from deregulation stem from the dramatic improvement in the international mobility of capital arising (in large part) from reductions in official controls. By facilitating the channelling of funds to countries where capital is relatively scarce, but where returns to investment are comparatively high, this growth in mobility has helped to improve the global allocation of resources and increase the growth rates of emerging market economies. The OECD countries have also benefited from access to higher returns on savings than would be available from domestic outlets – a gain that becomes potentially all the more important as OECD populations age. Indeed, some estimates suggest that the gains from international capital mobility may be as high as 1% of GDP or more annually for OECD countries.[2]

The overall economic gains derived from these benefits are difficult to quantify precisely but almost certainly have been quite substantial. Virtually all segments of the economy – consumers, businesses, governments – have shared in them, although not always to the same degree.

Problems – and Lessons Learned

In spite of these benefits, a number of developments associated with financial deregulation have raised concerns that it encourages imprudent financial behaviour and makes financial markets more volatile: marked credit booms, excessive debt accumulations and severe fluctuations in real estate and stock markets that occurred in some countries, chiefly Japan, the United Kingdom, Sweden, Norway and Finland after deregulation in the 1980s; extended swings in the foreign-exchange value of major currencies (not least the rise and fall of the dollar during the 1980s); widespread financial problems in banking sectors, such as those in the Nordic countries and Japan during the past decade; and the balance-of-payments crises of Mexico, Turkey and a number of non-member countries in the mid-1990s.

Yet there is little evidence that it was deregulation itself that has made the financial system less stable. In particular, there has been no lasting increase in the daily or monthly variability of domestic stock or bond prices; and although exchange rates did become more variable after they became free to float in the early 1970s, there seems to have been no further increase in their volatility since then. Moreover, extended swings in asset prices and other apparent instabilities in financial markets, although undoubtedly costly and troublesome to economic performance, can be traced to macro-economic policies. For

1. Adrian Blundell-Wignall, Frank Browne and Steven Cavaglia, 'Financial Liberalisation and Consumption Behaviour', Working Paper, *No. 81, March 1991, available free of charge from the OECD Economics Department.*

2. M. Brennen and B. Solnik, 'International Risk Sharing and Capital Mobility', Journal of International Money and Finance *Vol. 8, No. 3 (1989); and Harold L. Cole and Maurice Obstfeld, 'Commodity Trade and International Risk Sharing: How Much do International Financial Markets Matter?',* Journal of Monetary Economics, *Vol. 28 (1991).*

What price prudence? Restrictions on financial institutions go beyond the requirement to maintain adequate safety and liquidity in their holdings to the point where the rules impede efficiency.

example, much of the rise in the dollar during the first half of the 1980s resulted from fiscal policies that were relatively expansionary in the United States compared to those in Europe and Japan. Similarly, the external financing problems encountered by several OECD countries, most notably Mexico and Turkey, in recent years can be traced in large part to over-expansionary macro-economic policies, the failure to maintain sufficiently competitive exchange rates and the unsustainable current-account deficits which followed.

Admittedly, financial 'excesses' (in the form of excessive debt accumulation, over-investment in real estate, or imprudent risk-taking by some financial institutions and inadequate governance by some institutions) have occurred during the process of deregulation. In part, these events can be viewed as mistakes made during the transition from a regulated to a deregulated financial system, during which individuals and institutions had to learn to deal with new and initially unfamiliar circumstances. More importantly, there were serious flaws in the implementation of deregulation itself. Too often, it occurred in an inflationary environment or when macro-economic policies were giving too much stimulus to economic growth. These surrounding conditions encouraged individuals and institutions to accumulate too much debt and over-invest in real assets just as restrictions on their access to credit were being relaxed; in some cases, this behaviour was further encouraged by favourable tax treatment of borrowing and of capital gains from the appreciation of those real assets. The rapid expansion of credit encouraged by these conditions was a major factor in the boom-and-bust cycles in the prices of domestic real estate and (in Japan) the stock market that were the source of the subsequent financial problems of the banks.

But some of those financial excesses can also be traced to the legacy of past regulation as well as to the failure of supervisory authorities to keep adequate pace with the changes in markets and financial institutions induced by deregulation. For example, the positions of banks in many countries had been weakened by overstaffing, too many branches, and other inefficiencies fostered by past regulation. The problems of US savings and loan banks (S&Ls), for instance, arose first from regulatory restrictions on their deposit interest rates combined with limits on their ability to diversify out of mortgages. The subsequent crisis arose after near-insolvent S&Ls 'gambled for redemption' by taking on excessive risks – encouraged by the fact that losses in the event of failure would be paid out of deposit insurance – that supervisory authorities proved unable adequately to monitor or restrain.

The problems that have arisen show that financial deregulation, as with any major transition, inevitably involves costs and risks. The problems that have arisen during deregulation underscore the importance of complementary reforms in other policies to ensure that the incentives for prudent financial behaviour are sustained as deregulation proceeds. Maintenance of a stable macro-economic environment, structural reforms to reduce distortions to financial incentives, and adaptations to supervisory policies that strengthen market discipline and incentives for prudent management of financial institutions are all essential if financial stability is to be maintained during deregulation, and to ensure that its full benefits are realised.

The reform process in the OECD is now well advanced. Indeed, it has so transformed the domestic and international financial environment that, to any practical purpose, deregulation is now irreversible. The benefits, in terms of lower costs of financial services, more variety and flexibility, and improvements in resource allocation, have been clear and they are continuing to be felt. Moreover, the gains that have already been harvested suggest that it is in the interest of countries where deregulation is not so far along to pursue further reforms and that, elsewhere, remaining restrictions on the activities of financial institutions, particularly on their ability to hold foreign securities, should be eliminated except for those clearly necessary for prudential purposes. And although flaws in the implementation of deregulation have raised the costs and reduced the gains that have been expected, financial reform itself does not make financial markets any less stable.

Deregulation does not make effective supervision of financial institutions by government redundant. The authorities have to ensure that institutions have the incentives and capabilities to manage the risks they can now take on in a deregulated environment, and that they deal with the expanded opportunities from deregulation in a sound and prudent fashion. But no supervisory regime can eliminate their failures. Indeed, if there has been a recurring theme in regulatory reform over time and countries, it has been the failure of the supervisory officials to recognise portfolio excesses. The responsibilities of the regulators must always take account of the economic and financial circumstances of the moment of change, including the international environment, and the potential ability of liberalisation to magnify problems should be recognised very much earlier than has been the case to date. That requires the development of standards for sound business practice, monitored by strong corporate governance provisions, auditing and reporting to regulators. Over two hundred years ago, Adam Smith warned of the dangers of colluding producer interests. The warning stands: caution flags should be raised by the regulatory authorities when financial-market participants begin to assemble on the same village green. ■

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