THE FUTURE OF FINANCIAL SYSTEMS AND SERVICES

Also by Edward P. M. Gardener

COMPETITION AND REGULATION OF BANKS (*with Christopher Barclay and Jack Revell*)
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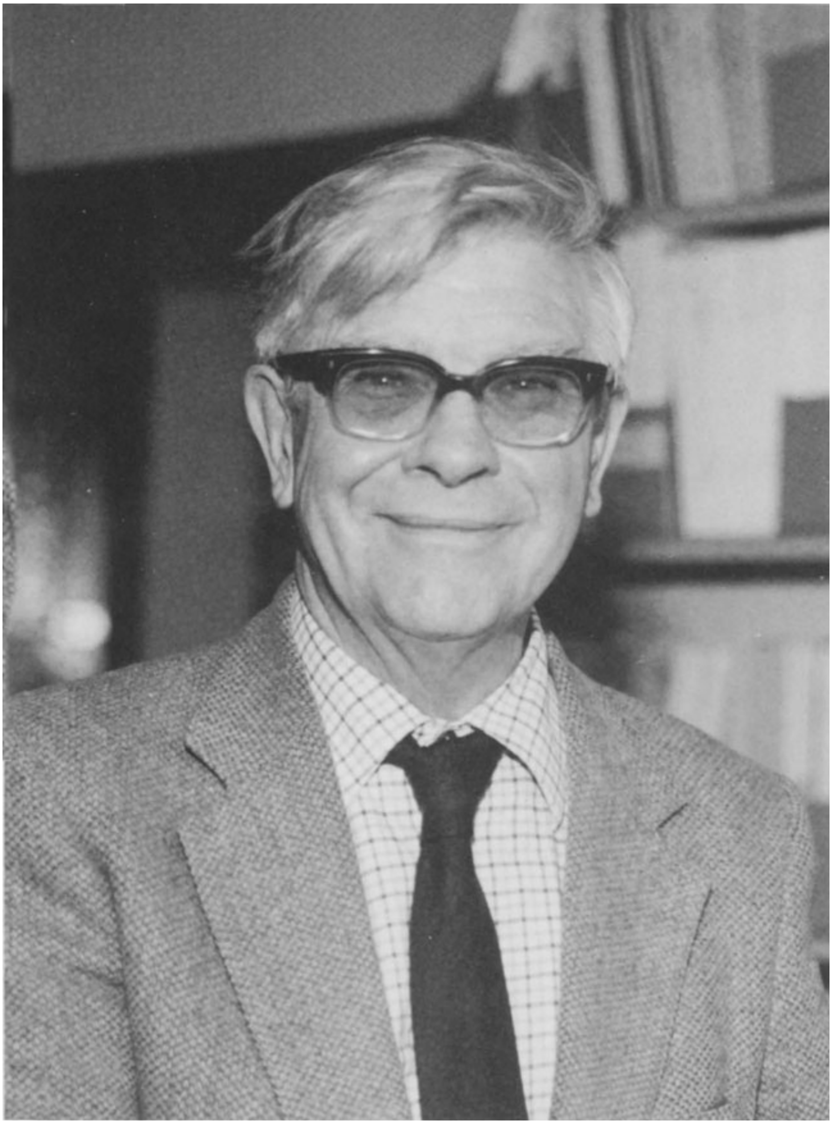

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The Future of Financial Systems and Services

Essays in Honor of Jack Revell

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Preface

Financial systems and services have changed at an unprecedented pace since the start of the 1970s. The early 1970s heralded the beginning of a new era in financial systems. Traditional compartmentalisation in national financial systems began to erode significantly. Financial institutions began to enter new fields. Some of these new fields were the historical preserve of specialist financial institutions, but others represented completely new activities. Financial innovation helped to spawn new competitors and new forms of competition.

Structural deregulation, allowing financial institutions and markets to compete more freely, has brought new challenges and issues. The re-drawing of historical institutional boundaries has taken place in an environment of financial turbulence; the risks and uncertainties facing financial institutions and regulators have burgeoned. Periodic crises have characterised this new environment. Supervisory (or prudential) re-regulation has been a concurrent trend alongside structural deregulation.

During the 1970s the growing internationalisation of banking weakened the national sovereignty of domestic financial systems. Domestic financial markets were increasingly penetrated by foreign banks and other institutions. Technology and globalisation trends operated to link increasingly important financial centres and systems into a single financial market that spans the globe. The swaps market and other innovations have been important in this process. The ubiquitous nature of technology has helped to reduce further the traditional comparative advantage of banks in many important financial activities.

Securitisation trends have questioned the longer-term role of traditional financial intermediation, or institution-based intermediation. Market-based intermediation has grown rapidly from the early 1980s. Many domestic financial systems have moved correspondingly towards a stronger 'market orientation'. Bank-type finance has been displaced increasingly by securitised forms of financing.

These are just a sample of the challenges and issues that confront students and practitioners in modern financial systems. All of these changes have accelerated during the 1980s. In the wake of the stock market crash of October 1987 and the approach of 1992 in Europe, we now face a renewed surge of changes in financial systems and services. Many would argue that contemporary changes represent a 'watershed era' for the future of financial systems and services. We are now moving rapidly into new and untried territory from which a return will probably be impossible.

This is an opportune time to present a collection of essays from a group of distinguished students and practitioners on the general theme of change in financial systems. It is also an appropriate moment to honour a distinguished student of change in financial systems, Professor Jack Revell. The present volume attempts to do both. This collection of essays has been compiled as a token of our respect for a student who has made a singular contribution to the study of financial systems and services; Chapter 1 of the book discusses Jack Revell's contribution in some detail.

The 22 papers contributed to this volume have been organised into the following sections:

I Introduction
II Evolution and Development of Financial Systems
III Money and Capital Markets
IV International Banking and Finance
V Managerial and Micro Aspects of Financial Institutions
VI Regulation

Part I by the editor comprises a chapter on Jack Revell's academic contribution and its place in mainstream economics. Part II comprises four papers and it sets the scene for the rest of the book. The theme in Part II is on competition, innovation, risk and structural change; part III contains three papers that focus more specifically on money and capital markets. Part IV comprises four papers devoted to international banking and finance. More specific, but selective managerial and micro aspects of financial institutions are covered within the four papers that comprise Part V of the volume. Part VI contains the largest number of contributions: six papers focus specifically on regulation.

Authors were given a free choice on their contributions, and the editor compartmentalised them into Parts I–VI: there is some inevitable overlapping of papers into different sections (parts) of the volume, but this is unavoidable. For example, two of the papers (Eisenbeis and Montanaro) in Part II discuss regulation and risk in some detail, and this is the focus of Part VI. Nevertheless, the editor has taken the view that the main thrust of these two papers is on stuctural change; it is for this reason that they are included in part II. In short, the editor has exercised some subjectivity in these allocations, but this has been tempered with (hopefully) logical methodological reasoning. The reader must judge the success of this selection process. However, it is the papers themselves that are, of course, more important than the way they are compartmentalised.

The collection of papers has an interesting 'global focus'. Case studies on individual countries are provided alongside more general surveys. Contemporary theory is discussed and evaluated in many of the papers. The thread that runs throughout the volume is the future of financial systems and services; all of the contributors have responded positively to this invited theme. The variety and richness of the ground covered by these essays attest to the quality of the contributors' responses. This volume should, as a result, prove interesting to both students and practitioners.

Many acknowledgements are in order. First of all, the individual contributors who have responded so well to the numerous requests and deadlines imposed by the editor. It should be added that each of the papers is mutually exclusive. There is no presumption that individual contributors necessarily agree (or disagree) with other contributions to this volume. I thank Macmillan for their enthusiasm and help with the volume. I am also especially grateful to Chris Owen and Maureen Simmons who played important roles in the initial proof-reading and editing; Lesley Prendergast also proof-read corrections for the volume. Chris Owen also had the unenviable task of co-ordinating and managing the 'Festschrift project'. She carried out these tasks with her usual efficiency. I thank Helen Treece, Linda Jeavons and Karen Hickson who all typed many drafts. Finally, I thank my wife Ann Christine and our children – Michael, Emma, John and Peter – for their support and tolerance. Any errors, or omissions, are assumed by the editor.

EDWARD P. M. GARDENER

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Phil Bourke is Irish Banks' Professor of Banking and Finance at University College, Dublin. Prior to taking up this appointment in Dublin, Dr Bourke was a member of the School of Banking and Finance in the University of New South Wales in Sydney. His research interests include bank management, cognitive aspects of lending and regulation theory.

Cesare Bisoni studied at the Università Bocconi, Italy and the Harvard Business School. He is currently Professor of Banking at the Università di Modena, Italy and a Senior Faculty Member of Scuola di Direzione Aziendale, Università Bocconi. He is also Deputy Director, Dipartimento di Economia Aziendale, Università di Modena and a Member of the Board of Auditors, Cassa di Risparmio di Modena, Italy. His publications include four books.

Roger Buckland studied economics at Cambridge and at York University. Following graduate study at York in 1974–5, he was appointed Ellis Hunter Research Fellow working on the economics of technical change. He joined the Aston Management Centre as a Lecturer in 1978. His published research covers technical change in the steel industry, equity capital markets, and techniques of the privatisation of nationalised industries.

Claudia Campbell has studied for a PhD (forthcoming in 1989) at Washington University. She is an Assistant Professor of Economics and Finance at St Louis University and co-author (with Hyman P. Minsky) of *How to Get Off the Back of a Tiger*. Her doctoral research is on *Federal Deposit Insurance Risk Exposure in Commercial Banks*.

Robert Carter is Norwich Union Professor of Insurance Studies in the Department of Industrial Economics, Accounting and Insurance at the University of Nottingham. He is the author of *Economics and Insurance*, *Reinsurance*, *Success in Insurance* (with S. R. Diacon) and *Barriers to*

Trade in Insurance (with G. M. Dickinson). Professor Carter is heavily involved in the educational work of the UK Chartered Insurance Institute. He is at present a government nominee on the Insurance Brokers' Registration Council and is a member of the Council of the Insurance Ombudsman Bureau. His current research interests are the financial aspects of risk management and international insurance problems.

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Peter Cooke retired from the Bank of England, where he had been Associate Director since 1982, in November 1988 after a Central Banking Career of 33 years. He was Chairman of the City EEC Committee from 1973 to 1980. From 1976 to 1985 he was Head of Banking Supervision at the Bank of England. In 1977 he became Chairman of the Committee on Banking Regulations and Supervisory Practices of the Group of 10 Countries meeting in Basle, Switzerland, which post he held until his retirement in October 1988. From the beginning of 1989 he moved into the private sector where his principal involvement is with the international accounting firm, Price Waterhouse, as Chairman of their World Regulatory Advisory Service.

Richard Dale graduated from the London School of Economics and read for the bar at Lincoln's Inn. Subsequently he spent five years with merchant bankers NM Rothschild and Sons Ltd. More recently he was a Rockefeller Foundation International Relations Fellow at the Brookings Institution in Washington DC and is currently Professor of International Banking and Financial Institutions at the University of Southampton. Professor Dale is the author of *Anti-Dumping Law in a Liberal Trade Order*, *Bank Supervision Around the World*, *Managing Global Debt* and *The Regulation of International Banking.*

Edward Davis was educated at St Andrews and after research at Aberystwyth and Cambridge, took the Lloyds Bank Chair of Business Finance at Aston in 1971. He is co-author of *The London Clearing Banks*, *Company Finance and the Capital Market* and *Finance and the Firm.* His current research interests include the efficiency of privatisation issues, together with a major study of the Unlisted Securities Market in collaboration with R. Buckland, to be published in 1989. In addition to academic and financial articles on business finance, he has broadcast on taxation on several occasions and has worked as a financial consultant for both British and US companies.

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Edward P. M. Gardener is a Professor at the University College of North Wales (UCNW) in Bangor, Gwynedd, Wales. Previously, he held senior finance posts with Shell-Mex and BP Ltd. He has been Director of the Institute of European Finance at UCNW since 1985 and a member of the London Board of D.C. Gardner Group plc from 1984. He has directed research projects for a wide range of bodies like the Social Science Research Council, HM Treasury, the British Bankers Association and many leading banks. His publications include *Capital Adequacy and Banking Supervision* (editor), *UK Banking Supervision: Evolution, Practice and Issues* and many articles. His current research interests include bank strategy, capital adequacy and supervision.

Charles Goodhart is the Norman Sosnow Professor of Banking and Finance at the London School of Economics. Before joining LSE in 1985, he worked at the Bank of England for seventeen years as a monetary adviser, becoming a Chief Adviser in 1980. Earlier he had taught at Cambridge, where for a couple of years he was one of Jack Revell's colleagues, and at LSE, and was an Economic Adviser in the Department of Economic Affairs (1965–6). He has just revised his graduate monetary textbook, *Money, Information and Uncertainty*. He earlier published a collection of papers on monetary policy, *Monetary Theory and Practice*, and an institutional study on *The Evolution of Central Banks*, which has just been revised and reprinted; plus a large number of articles and papers on monetary and banking issues.

Richard Harrington currently lectures in economics at the University of Manchester. In 1979 he was consultant to the Building Societies Association. He has lectured widely and produced a number of books and articles on money and banking. During 1982–6 he was consultant to the OECD and author of a monograph on asset and liability management by banks.

Mervyn Lewis is Midland Bank Professor of Money and Banking at the University of Nottingham, Co-director of the Nottingham Institute of Financial Studies, and Visiting Professor in Economics at the Flinders University of South Australia. In 1986 he was elected a Fellow of the Academy of the Social Sciences in Australia. He was a Consultant to the Australian Financial System Inquiry and Visiting Scholar at the Bank of England. Professor Lewis has published six books on monetary economics, the last being (with K. T. Davis) *Domestic and International Banking*.

David T. Llewellyn has held appointments at Unilever in Rotterdam, HM Treasury in London, the University of Nottingham and the International Monetary Fund in Washington. He is the Professor of Money and Banking at Loughborough University and Chairman of the Loughborough University Banking Centre. He is currently Consultant Economist to money brokers Butler Harlow Ueda and a member of the London Board of the Halifax Building Society. As well as many articles he is the author of *International Financial Integration, Framework of UK Monetary Policy, Evolution of the British Financial System,* and *Regulation and Supervision of Financial Institutions.*

Hyman Minsky has been Professor of Economics at Washington University, St Louis since 1965. He is the author of many articles on money, banking and finance. His publications include *John Maynard Keynes*, *Can 'It' Happen Again* and *Stabilizing an Unstable Economy.*

Joël Métais is Professor of Economics at the Universities of Grenoble and Paris Dauphine. He was formerly consultant with the UNIDO (United Nations Industrial Development Organization) on financial problems of the industrial development (1981–2). From 1985 to 1988 he was attached with the French Ministry of Economy and Finance as a consultant on the financial and banking sector matters. He has published widely and his publications include *Le marché des eurodollars et des euroobligations and Les mutations du système financier français* (co-author). His main research interests are in international capital markets, comparative banking systems and the industrial economics of the financial sector.

Elisabetta Montanaro is a full Professor in Banking at the Faculty of Economics and Banking at the University of Siena, Italy. She has been Director of the University of Siena from 1981. Elisabetta Montanero is also Professor of Banking Management at the University of La Plata (AR), which has been promoted by the Department of International Cooperation of the Italian Government. She is the author of many articles and seven books on banking.

Neil Murphy is Professor of Finance at the School of Business, Virginia Commonwealth University, USA. He has held appointments on the research and policy staffs of the Federal Reserve Bank of Boston, the Federal Deposit Insurance Corporation, and the President's Commission on Financial Structure and Regulation (Hunt Commission). He was also a Faculty Member at the Universities of Maine, Oklahoma and Connecticut, and has been a Senior Vice President of Payments Systems Inc., then a research and consulting subsidiary of the American Express Co. He has also held visiting academic assignments in Israel and the Netherlands. He has written several books and articles for professional periodicals. He has served as an associate editor of the *Journal of Finance*, a member of the editorial board of the *Journal of Bank Research*, and was a founding co-editor and first executive editor of the *Journal of Financial Services Research*.

Marco Onado is Professor of Banking in the University of Bologna and he has been Visiting Professorial Fellow at the University College of North Wales. He is a member of the Scientific Committee of Prometeia (Association for Econometric Research) and a member of the Editorial Committee of the journals *Bancaria* and *Banca Impresa Società e l'Industria*. He has written many articles and book contributions.

Leo Schuster is Chair Professor in Banking and Director of the Institute of Bank Research at the University of Saint Gallen, Switzerland. From 1964 to 1971 he held academic posts at the University of Nuremberg; he came to St Gallen in 1971 where he completed his habilitation in 1975. He was Dean of the Business Administration Department at Saint Gallen from 1983 to 1985. He is a member of the advisory board to the Marketing Association of Cooperative Banks, Stuttgart, Germany; of the German Federation of University Professors in Business Administration; and of the Société Universitaire de Recherches Financières, Tilburg, The Netherlands. He is co-editor of the *Zeitschrift für das gesamte Kreditwesen* (*Bankers Magazine*) Frankfurt, Germany and of the *Bankwirtschaftliche Forschungen* (*Research in Banking*); editor of *Schriftenreihe Bankrevision* (*Auditing in Banks*) and of the *Beiträge zur Bankbetriebslehre* (*Research Papers in Banking*). He has published some 20 books and more than 120 articles in German, French, Italian and Spanish in banking, business finance and corporate strategy.

Ray Shaw is a Senior Executive of TSB Group working as a management consultant to Group companies. He was formerly Director of the TSB Group Management College from 1983 to 1987 and Director of Banking

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Synopsis of the Contributions

Chapter 1 is devoted to an examination of Jack Revell's contribution to the study of banking and financial systems. Ted Gardener examines this contribution from a number of different perspectives. Charles Goodhart – in the summary of his paper for the Festschrift – summarises succinctly Jack's methodological stance:

> Theoretical analysis, and policy advice, should be underpinned by thorough empirical knowledge of institutions and history, as Jack Revell has always emphasised.

Ted Gardener suggests that in one sense Jack has carried forward the methodological torch carried for many years by Professor Richard Sayers. Nevertheless, Jack has also emphasised strongly the importance of applied industrial economics and micro aspects of banking in his studies on financial systems. These and other related characteristics are discussed in Chapter 1.

In Chapter 2 David Llewellyn considers the recent structural developments in the British financial system which have changed the system from its historical structured and specialised basis to one of financial conglomeration. In particular, emphasis is given to competition which has been the major factor behind structural change. A series of propositions are made about the likely effect on an industry subject to more competition and these are found in many recent examples in the financial system. The chapter concludes with a review of how structural change might have contributed to increased efficiency in the financial system.

Chapter 3 takes as a starting point that in banking the process of change is at least as important as change itself. Jean-Paul Abraham analyses the processes of internationalisation, (de)regulation and automation in Belgium under the small open economy hypothesis. In Belgian banking, international and domestic markets interact very strongly; the importance of tax incentives and tax deterrents is striking. Financial deregulation has occurred mainly by undermining or eroding the existing regulations, but he argues that this process requires stronger stimuli. Finally, he suggests that the problem of adequate scale becomes crucial in the context of 'Europe 1992'.

Recent proposals to reform the US financial system arising from concerns about bank and thrift failures, increased competition and narrowing spreads appear to be rooted in assumptions about the nature of banking which may no longer be valid or relevant in today's international banking environment. In Chapter 4 Robert Eisenbeis emphasises that market developments are eroding the imperfections which gave US commercial banks their advantages over intermediation in direct credit markets such that they no longer perform their same unique functions in the nation's payments system. Moreover, because of globalisation and the ability of financial institutions to engage in structural arbitrage, one can no longer ignore the international considerations in financial engineering. The thesis is developed that regulation can no longer restrain domestic institutions without stimulating various distortions. Additionally, it is argued that concerns for maintaining the safety and soundness of the dollar payments system differ significantly now from those that were relevant when the present US regulatory structure was put in place. These structural considerations suggest that US policies designed to insulate domestic institutions and markets from those of the rest of the world, or to insulate affiliates or subsidiaries from risk taking in the rest of the institution, are doomed to failure.

In Chapter 5 Elisabetta Montanaro analyses the various phases of the present banking crisis in Argentina from 1981 until 1987. This crisis is one of the most sustained in banking history, but it lacks rigorous study. The argument advanced is that the crisis is the unavoidable epilogue of banks' operating inefficiencies. These inefficiencies are largely the result of many different policies of monetary and credit control against inflation and hyper-inflation. The enormous quantity of financial national resources destroyed in the course of the protracted banking crisis, together with the consequential mounting loss of credibility in the solvency of the banking system (the central bank and commercial banks) in the eyes of national savers and foreign lenders, are amongst the main determinants of the dramatic problems posed by Argentina's external debt.

In Chapter 6 Charles Goodhart is concerned with a general theoretical issue, i.e. why practitioners have usually been opposed to indexation (whereas academics have favoured it), in the context of a particular historical decision, that of the UK authorities to introduce indexed gilts in 1981. Theoretical analysis, and policy advice should be underpinned by thorough empirical knowledge of institutions and history, as Jack Revell has always emphasised. In this chapter Goodhart seeks to contribute by providing a more detailed historical account of the various arguments, pro and con, influencing the authorities' decision in this case.

Ray Shaw in Chapter 7 reviews – in the wake of the 'Big Bang' – the changes which have occurred in the London money markets since 1983. He emphasises the developing role and changing structure of the discount market, the various aspects of monetary policy and the resulting market and institutional relationships with the Bank of England.

Chapter 8 examines the behaviour of new entrants to the Unlisted Securities Market in the 1980s with specific reference to bank borrowing.

Roger Buckland and Ted Davis consider in particular the question whether such firms use the new issue market to raise new equity in order to reduce excessive bank borrowing and whether such an effect is more pronounced for smaller firms. The authors find the variability of entrants by gearing ratios dominates the size effect which can be observed. But the authors conclude that if alternative methods of raising capital were available from the banking sector, then such firms might not have sought quotation at all, or done so at a later stage of their growth and at inevitably lower costs.

A theme of Chapter 9 is that the theoretical understanding of the functioning of banks and banking systems outside the United States is comparatively underdeveloped. Phil Bourke examines the theory and expirical evidence on the determinants of international bank profitability. He discusses the results of research that he conducted on large banks in fifteen countries or territories around the world. Within this survey he examines market structure, regulation and several of the internal determinants of profitability.

From the 1970s onwards the financial sectors in the main industrial countries entered an internationalisation process, the outcome of which will probably be the emergence of a global financial industry along the lines already experienced by other industries. In Chapter 10 Joël Métais provides, first, an overview of developments during the past fifteen years. Two important sub-periods are identified from this overview. A tentative theoretical analysis is developed which stresses the importance of analytical tools and the framework of industrial economics in order to interpret important features of the contemporary financial industry like innovations, deregulation, the emergence of financial conglomerates, the entry of non-financial actors in the sector, and mergers and acquisitions (especially between banks and non-bank financial intermediaries). In this respect special attention is devoted to key areas like the existence of economies of scale and/or scope, the production and cost functions, the pricing of the multiproduct financial firms and barriers to entry in the financial sector.

In Chapter 11 Leo Schuster examines the role of Swiss banks in international finance. He emphasises the importance of the globalisation phenomenon to Swiss banks, and he discusses the role of Switzerland as an international financial centre; the 'strategic success' position of the Swiss financial centre is examined. In his conclusion he identifies the future challenges for the Swiss financial centre and discusses the modern role of innovation compared to tradition.

The first part of Chapter 12 explains the two ways in which insurance and reinsurance operations are conducted internationally, the reasons why governments have sought to restrict such trade and the variety of measures that have been adopted to achieve that objective. In the second half of the chapter, Robert Carter outlines briefly the moves that have taken place within the OECD and the GATT to reverse the trend of protectionism and initialise the liberalisation of international trade in insurance. After examining the case for liberalisation, the steps taken in the European Community towards the creation of a single market in insurance are discussed as providing a framework for negotiations on a wider plane. The chapter ends with a suggested programme for liberalisation.

In market economies, a series of institutions has evolved for sharing and shifting risks. Firms providing insurance services come immediately to mind. But the financial system as a whole performs a risk sharing function, and the management of risk lies at the heart of all financial intermediation. Mervyn Lewis explores in Chapter 13 the idea that banking can be viewed as a form of insurance. This conception provides a framework which enables him to compare retail banking, wholesale banking, international and off-balance sheet banking, and explore the implications for bank safety and deposit insurance.

During the past 20–30 years, banking has become more complex as banks have diversified by product, by currency and by geographical area. Such diversification has contributed to and, in turn, benefited from the growth of financial markets. Banks, nowadays, regularly bid for funds in, and offer funds to, a range of such markets. But rates of interests and other conditions can change fast and banks operating in a wide range of markets need to manage carefully their balance sheet in order to control any gaps or mismatches which could lead to unforeseen losses. In Chapter 14 Richard Harrington describes how banks' awareness of the new risks has grown and how they have responded by developing the technique of asset and liability management.

In Chapter 15 Ted Gardener examines the strategic challenges of financial conglomeration in London. A primary aim is to explore important strategic dimensions of these challenges that are apparently neglected in the contemporary literature on the microeconomics of banking. He uses Porter analysis as a framework to discuss the competitive challenges of investment banking in the deregulated London market. Chapter 15 emphasises the managerial challenges associated with the 'organisational design' of bank financial conglomerates. Selected macro and general regulatory implications are also highlighted. The subject matter of this chapter is closely related to Chapter 10 (Joël Métais), but the emphasis is more on managerial and strategic aspects of bank financial conglomerates.

In recent years bankers in the United States have encountered the problem of paying depositors a competitive, deregulated rate of interest while simultaneously maintaining a costly delivery system of branch offices. The branch office system was established in part as a substitute for explicit interest payments when the latter were constrained by regulation. One approach to this dilemma is the more intensive use of the branch system to market more services, i.e. spreading the cost over expanded product lines. However, a parallel trend is the development of automatic teller machines (ATMs), effectively pulling customers out of the branch offices. In Chapter 16 Neil Murphy investigates the behaviour of a sample of households in the United States. In particular, the characteristics of those customers who use the branch intensively are compared with those who are active ATM users. It is concluded that those customers most likely to be candidates for more financial services are also most likely to avoid using the branch office, preferring the convenience and flexibility of ATMs.

The global stock market crash in October 1987 has intensified the debate over regulation of the financial services industry in general and stock market activity in particular. Richard Dale in Chapter 17 addresses the various regulatory issues raised by the prospect of increased stock market volatility and examines the implications for the stability of the banking system.

In Chapter 18 Peter Cooke provides a detailed, 'insider-view' narrative of the intensive international discussions over the last few years which led ultimately in the summer of 1988 to an international agreement between the Group of Ten major industrialised countries on the measurement of the capital adequacy of international banks and on a minimum international capital standard. He describes the reasons why a momentum developed to achieve this agreement and sets out the major issues and national circumstances which had to be reconciled in order to arrive at a framework which was at the same time practicable and intellectually coherent and credible to the banking and regulatory community worldwide. Chapter 18 outlines the main stages in the debate which began seriously around the time of the Mexican debt crisis in 1982 and which concluded with the publication of the Basle Supervisors Committee paper of July 1988, which sets out the agreed international framework of capital adequacy measurement and standards which countries round the world are currently being encouraged to put into effect by the end of 1992.

It is explained in Chapter 19 that deposit insurance in the United States is not insurance in the sense of an actuarial sound policy as issued by private insurers. There are reasonable contingencies in which the assurance of deposits involves a pledge of the full faith and credit of the Federal government. The financial instability hypothesis interpretation of Keynes details the endogenous processes of capitalist economies through which the integrated financial and real market structures become incoherent, and intervention by lenders-of-last-resort whether by the central bank, the Treasury, or through the instrumentality of deposit insurance is necessary. The financial instability hypothesis holds that environments change and the structure of regulation and intervention needs to evolve in order to adapt to the changes. Throughout the 1970s and 1980s the deposit insurance agencies as the agent and the federal government in the principal in the pledge of the full faith and credit in support of deposits, failed to adjust to the new risk environment. As a result the problem of funding the government's guarantee has become ever greater, so that major Treasury spending, which grows with every delay, will be necessary to fulfil the guarantee. If poorly done this spending can be disruptive of the relative relaxed inflation we have enjoyed. Claudia Campbell and Hyman Minsky suggest that the regulatory agents are astride a Tiger and getting off not only requires care but also knowledge and understanding.

All financial systems currently show an urgent need to redefine their overall framework. In Chapter 20 Marco Onado points out the necessity for a uniform regulatory structure, taking the Italian case as a leading example of a country where barriers between intermediaries have crumbled and where it is necessary to strengthen prudential controls instead of structural regulation.

Francesco Cesarini analyses the structure and rationale of the regulations of large loans exposures in the Italian banking system, with a view to measuring their distance from the standards set out in the EEC Recommendation of 22 December 1986, to which Italian regulators are expected to comply within a relatively short period of time. He explains in Chapter 21 that the control of large loans exposures is a field of prudential regulation in which Italian banks are subject to rules far more permissive than those usually applied in other industrial countries. His analysis of the several sets of available data on large loans exposures – in order to get an idea of the dimension of the concentration problem and of its intrinsic riskiness – leaves little doubt that Italian regulations currently in force would need to be revised.

Economic doctrine has dealt extensively with the capital of credit institutions and the related problem of capital adequacy. During recent years the supervisory authorities of various countries have designed instruments – mainly balance sheet ratios – to ensure that banks maintain their capital at required levels. In Chapter 22 Cesare Bisoni discusses recent Italian supervisory experiences with capital adequacy. The Italian authorities refrained until March 1987 from imposing compulsory ratios. The two ratios that have been introduced are described, and some of their possible effects are examined.

Glossary

CHIPS	Clearing House Interbank Payments System
EC	European Community
FDIC	Federal Deposit Insurance Corporation
FHLBB	Federal Home Loan Bank Board
FSLIC	Federal Savings and Loan Insurance Corporation
GATT	General Agreement on Tariffs and Trade
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
SOFFEX	Swiss Options and Financial Futures Exchange
TSA	The Securities Association
UNCTAD	United Nations Conference on Trade and Development