Funding options widen as finance goes international

In many countries, financial systems are in an important phase of structural change, as David Llewellyn explains.

In many countries, financial systems are in a phase of major structural change. Although the detail varies, there are powerful parallels between countries both in terms of the form of change taking place and the underlying forces generating change. Three related pressures influencing the current evolution of financial systems are common to all: a greatly intensified competitive environment in which financial institutions and markets operate; new technology being applied to finance; and various forms of financial de-regulation. While the precise pattern of change varies between national financial systems, again three common themes seem to be emerging:

A trend away from specialised financial institutions and the erosion of traditional demarcations as financial conglomerates emerge; An acceleration in the process of financial innovation as new markets and instruments are created which widen the range of funding, lending and investment options; A growing internationalisation of finance as suppliers and demanders of financial intermediation and other financial services become less restricted to their domestic financial systems.

All of these elements have an important bearing on the funding operations of retail financial institutions which have changed significantly during the 1980s.

In the context of this new competitive environment funding operations of both banks and specialist housing finance institutions have changed. Both have been influenced by the pace of financial innovation and for both the growing internationalisation of finance has had a powerful impact.

One of the features of the new competitive environment is that funding structures of different types of institution are moving closer together. Traditionally, British building societies, for example, have funded exclusively in the retail deposit market and first entered wholesale money markets only in the early 1980s. On the other hand, banks developed their liability management techniques in the 1970s predominantly in the wholesale markets rather than the personal sector savings market.

This has now changed as building societies have entered both the domestic and international wholesale money and capital markets while banks are seeking to increase the proportion of funds secured in the retail sector. This in turn has inevitably had a powerful impact on the structure of interest rates (in particular raising the relative cost of retail funds compared to wholesale funds) and must be a factor to be taken into account by building societies.

There has therefore been a significant competitive change in what has traditionally been the societies' major source of funding: the retail deposit and savings markets. There are many reasons why societies have, and should continue to, reduce their dependence upon the retail deposit market and should widen the source of funds.

Because of the competitive environment the retail sector is no longer a comparatively cheap source of funds (for either banks or building societies), the volatility of retail deposits has increased for the same reason and the average maturity of retail deposits has declined. In general it is difficult to secure long-term funds in the retail sector, and wholesale market funding also frequently offers more flexibility in terms of maturity and amount.

However, overwhelming the detailed considerations is the fundamental issue of portfolio diversification. In addition to the advantages—in terms of cost, maturity and other special characteristics—to be secured through mixing the different characteristics of alternative funding is the general presumption that the greater the variety of sources...
capitally if this involves different sectors of funding, where market conditions may vary and change differently, the more stable will be the total volume of liabilities to any institution.

This is equally true for building societies which are seeking to reduce their exposure to the retail market as it is for banks, which are seeking to reduce their dependence on wholesale funding. Standard portfolio analysis recognises that just as an institution is generally more secure with a diversified asset structure, so too a diversified liability structure involving less dependence on a particular source of funds or sector enhances the stability of the balance sheet.

This is a particularly powerful consideration when market conditions in the dominant component have changed adversely, as has been the case with building societies in the retail deposit market. Prudence requires a diversified liability structure, and this advantage has been increased recently due to a new competitive environment influencing conditions in the societies’ dominant funding market.

This represents a powerful case for building societies to continue to widen the source of funds and the methods and instruments used in their funding operations.

Financial innovation has greatly increased the range of financing facilities and instruments available to all institutions. The development of new instruments, techniques and markets has accelerated over the past few years. Developments in technology have also widened the range of services and instruments on offer.

Overall, the range of financing options and techniques now available in financial systems is infinitely wider and many of the techniques (such as interest rate and currency swaps) were not heard of only a few years ago. Financial systems have proved to be exceptionally innovative and in some cases new markets have been created.

All of these considerations have an international as well as a domestic dimension. One of the central characteristics of structural change in financial systems noted earlier has been the general internationalisation of finance. As the operations of financial institutions and funding and investing options become less restricted to domestic financial systems, so national systems become sub-sets of a global financial system with a consequent increase in efficiency of financial intermediation.

In the broad sweep of the history of finance, a clear, long-run trend has been for the domain of financial intermediation to widen; regional displaced local mechanisms in the early stages of the development of financial systems and in turn national mechanisms became dominant.

The current phase of evolution, extending the process to its logical conclusion, is the international dimension. International options (for both funding and investment operations) are becoming increasingly viable for an ever-widening number of transactors through the effects of technology in reducing transactions costs, and offering more efficient access to information and communications systems.

Historically, the role of technology in offering cheaper and more efficient access to information, communications and trading systems, with the effect of reducing transactions costs, has been a major factor in the widening geographical domain of financial operations. What technology does in finance is to make location an increasingly irrelevant consideration in the pattern of funding and investment operations of financial institutions and their customers.

The international dimension of finance emerges at three levels: (i) neither savers or borrowers are restricted to mechanisms located within their own country; (ii) the suppliers of financial intermediation services are not restricted to business within their domestic economy, and (iii) financial institutions have the option of locating outside their own country. In all three respects finance has become increasingly internationalised.

In the process national financial intermediation and financial systems are becoming sub-sets of a global financial system. Competition in finance has become global and there is no longer a presumption that funding operations are most efficiently or cheaply conducted within the domestic financial system.

New markets, instruments and facilities have been developed in international markets, and techniques (such as swaps and options) have been refined to eliminate the extra risks incurred when institutions borrow in foreign currencies.

In effect, given the variety of techniques and instruments available in international markets, funding operations are likely to be more efficient the larger is the number of options considered.

It was indicated at the outset that financial systems in many countries are in a phase of structural change, in some cases as powerful as ever before experienced. The common theme is integration and an erosion of traditional demarcations.

This has been identified at three levels: retail and wholesale markets are becoming less segmented; different types of financial institutions are becoming less rigidly differentiated; and national financial systems are developing as sub-sets of a global and increasingly integrated financial system where national boundaries are becoming less constraining.

All financial institutions are affected by these trends not least with respect to the development of efficient funding operations.

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