CHARLES R. GEISST

A GUIDE TO FINANCIAL INSTITUTIONS

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A GUIDE TO FINANCIAL INSTITUTIONS

By the same author

A GUIDE TO THE FINANCIAL MARKETS

FINANCIAL FUTURES MARKETS (*with Brendan Brown*)

RAISING INTERNATIONAL CAPITAL: International Bond Markets and the European Institutions

For Margaret the Elder

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Introduction

In the late 1970s and early 1980s, the major topic of discussion within and among financial institutions was high interest rates, especially those in the United States, and the various problems they created. When worldwide rates did begin to subside, the discussion shifted to institutional changes that were becoming necessary as a result of the changes in the financial climate of the previous decade. The net result has been a significant change in the attitudes of regulatory authorities that direct financial institutions as well as structural changes in the institutions themselves.

The methodological problem that immediately presents itself to anyone interested in these changes is that they are essentially international in character. It is no longer possible to classify developments in the American or British banking industries as purely domestic in nature. The free flow of capital between the major international capital centres, prompted by foreign exchange and real rate of return motives, has made what were once international counterparts now international competitors in the quest for commercial or investment banking fees. While it may still be a bit early to draw conclusions concerning the end effect of these multitudinous institutional changes this book does attempt to begin its discussion of financial institutions with the international sector.

This present volume is intended to be a companion volume to this same author's *A Guide to the Financial Markets*, first published by Macmillan and St. Martin's in 1982. The treatment of the subject matter also follows the same *modus operandi*. This volume is intended to be an introduction to the topic; it does not attempt nor pretend to cover it exhaustively. Therefore, readers more accustomed to textbook presentations will find a distinct lack of familiar pedagological devices such as the

T-account or other accounting considerations when discussing the basic mechanics of banking or of money creation. But it should not be implied that textbook presentations are not of value; they have, however, been done so many times before that this author has decided to rely only upon prose given the introductory nature of the book.

Although the content of this book is intended to be Anglo-American, the latter institutions tend to take precedence over the former in many examples. The reasons for this are purely practical, given the size and breadth of American financial institutions. Nevertheless, many of the practices and procedures of commercial banking, investment banking, and building associations are very similar in both countries and general descriptions, with obvious qualifications, can be made without constantly referring to one country or the other. The historical reasons for this similarity are fairly complex but if one generalisation may be permitted it would have to do with the British ability to invent and the American ability to develop. After a century and a half of such cross-fertilisation, it becomes increasingly obvious that many original British financial practices have become Americanised, developed further, and exported back to Britain through the new, fast-developing international marketplace.

Of course, this Anglo-American exchange of ideas and practices is certainly not new. As early as the latter part of the eighteenth century, Samuel Slater imported the idea of the spinning jenny into the United States and successfully set up shop in Rhode Island, spinning cotton yarns which, until that time, had been a cherished and closely-guarded British invention. The same process occurs today but the products involved probably would bewilder Mr Slater. The British banking practice of lending on an adjustable, or floating, basis has been incorporated by American investment banks into securities called floating rate notes. Similarly, American commercial banks have developed merchant banking units in order to compete for fee income (non-deposit/lending income). Their name is an explicit reference to the group of British institutions performing the same function, only having done so for the last two hundred years.

Developments in the early and mid 1980s have proceeded at an almost staggering pace. The de-regulation of the American banking industry has seen interest rate ceilings on deposit accounts crumble, commercial banks expand by buying up other commercial banks and depository institutions across state lines, and the expansion of insurance companies into other lines of financial services, not to mention the influx of foreign banks into the American brokerage business. In Britain, foreign institutions have bought up British brokerage houses and become dealers in UK government securities, once the traditional preserve of British firms. Similarly, pressure from other stock exchanges has caused the London Stock Exchange to abandon its old commission structure, while the increasing pressure from the international marketplace has led to several large proposed bank mergers.

All of these changes, and the interest rate and other economic conditions that prompted them, have spawned a new financial services industry quite different from the one preceding it. Rationalisation, or centralisation, has become the byword as many large, full-service financial institutions have replaced smaller, single function institutions. Both international and domestic competitive pressures have become so great that the small, less capitalised firms find themselves at a distinct disadvantage to the larger offering their services on a global scale. But whether or not this trend succeeds in the long run depends upon the individual, who has for decades been accustomed to shopping for his financial services on a shop by shop basis rather than visiting a financial superstore offering all sorts of services and products under one roof. Whether he is willing to purchase insurance, personal pension plans, equities and bonds, and perhaps even consumer goods, from the same institution remains to be seen.

While this book has been written in such an environment, it still seeks to stress the basics of the major financial institutions rather than emphasise innovation. 'Revolutions' as such are difficult periods in which to write although the present 'financial services revolution' appears to be more structural than functional. Commercial banking will still be practised by commercial banks and investment banking will still be practised by investment banks. Their ownership may change significantly as time goes on but the basic functions they perform will probably remain the same.

1 International Financial Institutions

At the very heart of the international financial system are several institutions whose main purpose is to aid in the international payments mechanism. Because of their diverse natures, these entities are difficult to categorise but they do nevertheless share common traits. In a structural sense, their common denominator is a transnational character that spans national boundaries.

Occasionally, the term 'supranational' is used to describe such institutions. However, this is not a correct generic term, for supranational is a name used to describe the second sort of institution described here: those organisations whose everyday business is to aid international or regional development of, or on behalf of, their member states. Sometimes, these institutions themselves are considered sovereign. But supranational is not an appropriate term to describe those two institutions at the very top of the system – the Bank for International Settlements and the International Monetary Fund.

As will be seen in this and later chapters, the premier financial institution in any national economy is that which performs the ultimate banking function – that of lender of last resort. Usually, this function is reserved for the central bank of a country to which other financial institutions can turn for assistance in times of need. During the international financial crisis that developed in the early 1980s, however, several financial institutions stepped into the natural breach that exists in the international system so that some Third World debt repayments and re-schedulings could be facilitated without damaging the structure and confidence of the international financial community as such. The reason that this effort was concerted was simple: the international system as it is presently constituted does not have an original lender of last resort.

Although this system is composed of diverse institutions, they are not all official organisations with clearly defined cross-national functions. The international network of commercial banks and, to a lesser extent, investment banks that regularly transact business such as foreign exchange dealings, security issues, and international payments, generally also plays a crucial role in international trade. Without these banks, the larger official institutions would have to play a much larger role than they do currently. However, in structural terms, the official institutions are those facilitating the efficiency of the system as such and deal with the larger problems posed by international trade and trade-related problems.

In many ways, the international financial system and the institutions dominating it have much in common with institutions of public international law, if only by analogy. Critics of international political institutions often contend that they actually have little real effect other than to serve as international debating bodies that otherwise pack little, if any, coercive power. Given that there is no official lender of last resort in international terms or any central set of regulations or laws governing sovereign debt, some critics have contended that the system is more nomenclature than reality. However, in practical terms, experience has shown that the system has developed well over the last several decades, especially since the end of the Second World War. It was in the financial chaos caused by the war and its aftermath that the idea of modern international financial institutions was implemented. The idea itself was somewhat older, having been attempted after the First World War but it crumbled during the intervening years.

BRIEF HISTORY OF INTERNATIONAL FINANCIAL INSTITUTIONS

The need for a banking institution that could transcend the limitations of both central banks and the larger internationally-oriented commercial banks was felt after the First World War, especially after it became obvious that a return to the pre-war gold standard was impractical. But it was not until 1930 that the concept became reality with the establishment of the Bank for International Settlements (BIS). The BIS was established in order to expedite German war reparations by reducing and commercialising German payments.

The BIS was established in Basle on 17 May 1930 with a hybrid legal structure. Organisationally, it was structured as a limited company with its members holding capital shares; its members being sovereign states. Legally, its personality is that of an international organisation created by the Hague convention of 1930, meaning that its legal character is a document of international law rather than Swiss law. Although it is a bank, it is not subject to Swiss federal law governing banks. Neither is it subject to Swiss company law; its shareholders are actually the central banks of its members rather than individuals or companies.

Simply, the BIS is the central bankers' bank. Its clients (also its shareholders) are associated central banks; it does not deal with the commercial banking community except in the case of investments for its own portfolio. Over eighty central banks deal with the BIS on a day-to-day basis in order to manage their reserves. In this respect, it buys and sells currencies, depending upon demand from its clients. According to the Bank itself, almost 10 per cent of world foreign exchange reserves are managed through its facilities.

Functioning as a central bank in this respect, the BIS is at the very heart of the international system in much the same way the Federal Reserve is at the heart of the American financial system or the Bank of England is in Britain. Its other major functions include being a forum for international monetary cooperation, acting as agent in certain international agreements, and providing international banking research and statistical services. But one major central banking function, that of controlling currency or money supply, is not carried out. This function, if actually appropriate in the international arena, is carried out in a sense by the other central, public financial institution, the International Monetary Fund, or IMF.

While the BIS successfully helps central banks manage their reserves and performs trustee functions for government loans, the aftermath of the Second World War helped create a new class of financial institutions whose major function was to aid in the allocation of monetary reserves on a regional and worldwide basis. The BIS performed, and still performs, an international management function but events in the post-war era signalled a new period in the international monetary order which demanded new types of institutions able to cope with rapidly changing financial events on a global scale.

During the Second World War, currency stability was seriously undermined by balance of payments disequilibria among the major trading nations. As a result, the United Nations Monetary and Financial Conference held in Bretton Woods, New Hampshire, in 1944 created two new organisations designed, in different ways, to cope with the attendant problems – the IMF and the International Bank for Reconstruction and Development (World Bank). In general terms, both were able to complement the BIS's activities on a grand scale that had ironically been envisioned at the Hague Conference of 1930 but never fully implemented.

The IMF's principles sound similar in theory to those of the BIS in that both institutions seek to promote international financial cooperation, facilitate payments, and promote balanced growth in trade. Where they differ is in the IMF's ability to make temporary financial resources available to members in order to enable them to correct payment imbalances without resorting to potentially destructive actions such as competitive currency depreciation, imposing exchange controls, or resorting to trade protectionism.

Also of primary importance is the IMF's ability to promote exchange rate stability. An example of this principle and how it operates in practice can be found in the monetary history of the post-war period. Originally, members of the IMF were required to establish what was known as a 'par value' for their currencies in gold terms through the US dollar as of 1944 and thereafter maintain the market rate of their respective currencies within a margin of one per cent on either side of that value. This par value could only be changed if the member proposed it after consulting with the IMF. This system worked adequately for about ten years because many countries still protected their currencies through exchange controls and restrictive practices as an aftermath of war. Gradually, as many countries improved their balance of payments positions after the war, the IMF began to take new monetary initiatives.

In 1969, the IMF created the Special Drawing Right (SDR)