chapter 1

THE BUSINESS OF BANKING AND THE ECONOMIC ENVIRONMENT

Contents

Learning objectives

On completion of this chapter, you should be able to:

- Describe types of banking activity
- Explain the evolution, purpose and functions of the banking sector as a financial intermediary
- Explain how a bank operates as a business and its requirement for both liquidity and profitability
- Describe how the political, economic and business environment influences bank operations

Introduction

This first chapter of the Study Text introduces you to the business of banking.

We will consider what a bank is, what it does, and how it makes money. We will also look at the development of UK banking and the different types of banks and other financial services organisations that operate in the current business environment.

We will conclude by considering key elements of the economic environment in which banks operate, including the role of financial markets and the UK as an international finance centre.

1 Banks and their functions

1.1 What is a bank?

The word 'bank' comes from the Italian word *banco* meaning a bench or a table at which Italian money lenders used to conduct business in the Middle Ages (approximately 1200-1500 AD). This Italian connection continues, as the oldest bank still in business today is Monte dei Paschi di Siena, founded in 1472.

QUICK QUESTION

When you hear or see the word 'bank', what immediately comes to mind?

Write your answer here before reading on.

You may have thought about the word 'bank' in terms of being a building, a company, a business, or an employer; or perhaps you thought of it in terms of storing something for safekeeping, or something completely different.

Here is one dictionary definition of a bank:

> *'A bank is a financial establishment that uses money deposited by customers for investment, pays it out when required, makes loans at interest, and exchanges currency.'*

Source: The Oxford English Dictionary

The definition provided by the British Bankers' Association is as follows:

> *'A bank is an organisation which accepts deposits, makes loans, pays cheques, and performs related services.'*

http://www.bba.org.uk/customer/glossary-entry/Bank

The **universal bank** model involves providing 'related' financial services of various kinds, including advisory services, in addition to deposit and lending services.

QUICK QUESTION

If banks did not exist, what would be the impact on you, others, and society?

Write your answer here before reading on.

Thinking about the answer to this question as you study *Professional Banker* will help you understand the purpose of the bank, what banks do, and the role they play in society.

1.2 Types of banking

Banking is the business conducted, or the services offered, by a bank. Banking in some form began as far back as the 18th century BC in ancient Mesopotamia. It subsequently developed and expanded in ancient Greece, Rome and medieval Italy.

Traditional divisions within banking have become blurred in recent decades. Retail banks have joined other types of institution in raising funds in wholesale markets, and have moved away from purely 'direct' lending to advising commercial clients on various financial matters.

A bank's business may include different types of banking activities, such as those within the spheres of:

- Commercial banking
- Investment banking, and
- Bancassurance

Each of these is described further in what follows.

These activities have evolved due to the merging of different types of banks and other financial services organisations over the years.

1.3 Commercial banking

Commercial banking is essentially about taking deposits and making loans. When a commercial bank takes deposits, it is effectively borrowing that money from the depositor because it is based on a condition that the money can be returned to the depositor on demand, that is immediately, or on expiry of a notice period.

Commercial banking includes:

- Retail banking
- Business banking, and
- Wholesale banking

Retail banking is about taking deposits (ie, borrowing) from and lending to **individuals**, through a range of delivery channels, typically including a branch network. **Business banking** involves similar activities where the customers are small or medium-sized business enterprises.

Wholesale banking is about borrowing from and lending to large corporate clients, other financial institutions, public agencies, and governments. It involves dealing in large sums of money, which can be raised in London's money markets.

1.4 Investment banking

Investment banking is about:

- Providing advice to corporate customers who want to raise finance
- Managing corporate mergers and acquisitions
- Buying and selling shares and bonds on behalf of both corporate and private customers (typically high net worth customers), as well as for the bank
- Managing customers' investments and share portfolios

1.5 The purposes of a bank

The central activities of a commercial bank involve taking deposits from and lending to individuals and companies. The bank collects money from people or companies who have surplus funds they want to deposit for safekeeping, and lends money to those who want or are short of funds.

- Customers who deposit money are the bank's **creditors**, because the bank is effectively borrowing their money.
- Customers to whom the bank lends money are the bank's **debtors**, because these customers owe them the money they have borrowed.

The bank thus acts as a go-between for those who have extra money and those who want to borrow. As customers deposit money in the bank for safekeeping, the bank has a duty to look after it on their customers' behalf.

Banks also provide mechanisms that enable customers to make payments into and out of their accounts and offer a range of other products and services to meet their customers' financial needs.

1.6 The purpose of a bank for deposit customers (the bank's creditors)

Customers deposit money in a current account to hold their cash in a form that is liquid (easily available) and to transact payments. Customers deposit money in a savings account to earn interest, that is, make a small profit at low risk.

Customers therefore want banks to:

- Reduce, or bear, the risks of their payments
- Look after their money and financial investments

The bank therefore has a duty to:

- Reduce risks for their deposit customers
- Administer customers' accounts reliably, securely and confidentially

The bank does this by:

- Facilitating and coordinating payments
- Providing safe custody for deposits under conditions that preserve their liquidity (availability)
- Creating opportunities for the investment of capital (the money available for investment), invested without risk whilst ensuring modest rates of return

1.7 The purpose of a bank for credit customers (the bank's debtors)

Customers who borrow from the bank want their bank to offer them money at an affordable price. The purpose of the bank is to make finance available. In doing so, the bank has a duty to lend responsibly. This means remaining objective, while having the courage to take some level of risk that comes with the decision to lend.

1.8 Intermediating between borrowers and savers

By providing loans to borrowers and collecting deposits from savers, the bank functions as a financial intermediary between borrowers and savers, as shown in the following diagram.

The bank as financial intermediary

SAVERS ⟷ **BANK** ⟷ **BORROWERS**

Financial intermediation is the process of pooling funds from different sources and using these to provide loans and make investments. The people and companies who supply these funds and make deposits into the bank (for example, savers), receive interest for allowing their money to be used for loans or investments. Borrowers pay interest for the privilege of borrowing other people's money.

Therefore, by channelling funds from savers to borrowers, the bank creates a mechanism for making best use of the funds it has collected and pooled from different sources. It is this that leads to more efficient utilisation of funds within the economy as a whole.

QUICK QUESTION

In what way is there a conflict between the bank's duties to its savers and borrowers?

Write your answer here before reading on.

The bank's respective duties to its savers and borrowers conflict because, on the one hand, the bank must be risk-averse and cautious with savers' money; on the other hand, it must embrace a level of risk in order to lend money.

The bank therefore needs to reconcile these duties and to intermediate between deposit customers' expectations that risk will be avoided and borrowers' expectations that there will be some risk.

1.9 Bancassurance

The development of insurance and life assurance provision by banks is known as **bancassurance** (or *all finanz*). The Association of British Insurers (ABI) defines bancassurers as 'insurance companies that are subsidiaries of banks and building societies and whose primary market is the customer base of the bank or building society'.

The UK financial services industry developed through the creation of many specialisms, with groups of financial institutions tending to stick to quite rigidly defined products and services. Therefore, as recently as the 1980s, it was quite usual for a typical household to operate a current account with a bank, a savings account with the Post Office and/or a building society, a mortgage with a building society, a life assurance policy with a life company and general insurance through a general insurance company. It was rare for banks to offer mortgages, or for building societies to offer any loans other than mortgages. Insurance companies were not interested in banking, and although it was possible to purchase insurance in the branch of a bank, the product itself would be sold on behalf of the insurance company by the banker for commission.

By contrast, the financial services industry in continental Europe tended to adopt a more integrated approach through which most of the services described above would be purchased from, and created by, a single financial services group. This bancassurance approach developed originally in **Germany** and **Switzerland** and gradually extended to many other European states. The bancassurance model is well established in Europe.

CASE STUDY

In Germany there is no strong tradition of owner-occupation and until recently it was relatively rare for a couple to aspire to buying a property until they were perhaps in their mid-thirties. Indeed, Germany had, and continues to maintain, a strong private rented housing sector, so young people naturally chose to rent rather than buy, and could do so at an affordable price. However, at household formation stage (on marriage, or leaving the parental home), young people would enter into long-term relationships with financial institutions in order to provide for current banking needs and to build up long term savings and investments that would enable them to purchase homes later.

This was not only desirable but necessary, as German banks traditionally created mortgages with much lower loan-to-value ratios than in the UK. Mortgage terms were traditionally for terms of 10 to 15 years, and customers rarely traded up – if a bigger house was required, they would build an extension or commission an attic conversion.

The merits of the one-stop shop facilitated by the bancassurance model was not lost on the UK financial services industry, but a major impediment to its development was the fragmented nature of the industry.

Each set of financial institutions had their own products and services, their own legislation and their own regulators. The deregulation of the 1980s changed that. For the first time, banks could freely enter into the insurance market, building societies could offer current accounts and insurance companies could offer mortgages and banking products. As a result, the demarcation lines between types of financial institution eroded.

It is now possible to buy a wide range of financial products and services from a single provider. All of the major banks have subsidiary companies to which they can refer business. If it is not cost-effective to do so, they enter into agency arrangements with other organisations. The availability of comprehensive product ranges under one roof lends itself to the creation of long-term banking relationships, and advances of information technology help providers to anticipate or predict customer needs quite accurately and offer suitable products to customers to meet these needs.

QUICK QUESTION

Which type of banking activity do you contribute to in your role at work – commercial banking, investment banking, or bancassurance?

In what way do you contribute to the provision of this service?

Write your answer here before reading on.

2 How a bank operates as a business

2.1 Overview

Commercial banks are operated as companies to generate profit for shareholders. They make money by dealing in money. The major functions of a commercial bank are to:

- Accept deposits
- Grant loans
- Act as an agent for payments
- Provide a range of other services

Banks make money in three main ways:

1. Lending some of the money deposited by savers to borrowers and charging these borrowers interest on the sums loaned (i.e. the bank makes money by lending at rates higher than the cost of the money they lend)
2. Charging fees for products and services
3. Investing the money deposited by savers

While some bank customers are looking for a safe place to keep their money, others want to borrow money to buy or invest in something, or expand a business, for example. If customers kept their surplus money under their mattress instead of depositing it in the bank, the bank would have little or no money to lend. The more the banks lend, the more interest and profits they have the potential to make.

Pause for thought …

Imagine you are a merchant in ancient times. You make your living selling exotic oils and spices. You want to tap into new markets and dream of setting sail for foreign shores in a ship laden with precious cargo. You are confident that when you reach your destination, you will be paid well for your cargo. There's only one problem – you need money to get a ship and crew together. You've heard that there is a particularly wealthy group of people in the town who have loads of money sitting idle so you seek them out and tell them about your exciting new business venture. They agree to give you the money to fund your voyage in exchange for a share of the profits when you return. Yet, in your view, they want too large a share of the profits because, if your calculations are correct, not only would they be getting all of their money back, they would also be getting a hefty sum on top of that. When you object, they say that your voyage is perilous and, should something happen to you and the ship, they risk losing all the money they'd be giving you. They're not going to give you the money for nothing – there's a price to pay. Looking at this from the lender's perspective, there is no guarantee that they'll get their money back, so why take the risk? They take the risk because lending the money provides an opportunity to make even more money – and the bigger the risk, the higher the price.

Adapted from: Banking Basics, Federal Reserve Bank of Boston (2011)

What do you do?

QUICK QUESTION

What do you understand by 'liquidity'?

Write your answer here before reading on.

2.2 Liquidity and profitability

In a bank's **balance sheet**, the money a bank lends to its customers and other banks appears as assets because this money is a source of income and profits. The money deposited by customers appears as liabilities because this money is repayable to customers, either immediately on demand or on expiry of a notice period.

In accounting terms, liquidity is a measure of the ability of a debtor to pay their debts as they fall due. This suggests that the bank, which has effectively 'borrowed' the money its customers have deposited, must keep enough cash available to repay this money to customers who want to withdraw it. Yet, as a business, the bank needs to make a profit and if it were to keep enough cash available to meet all likely withdrawals, it would not be able to invest it to make a profit.

Retail banks are therefore pulled in opposite directions – on the one hand towards liquidity (holding enough cash on hand to meet the immediate demands of customers) and, on the other, towards profitability. As operators of the payments system, the retail or 'clearing banks' (so-called because of their role in clearing cheques and payments), cannot allow their liquidity to fall too low, even though liquid assets offer a poor return.

2.3 Assets held by banks

Look at your own bank's **balance sheet** in the annual report and accounts. What does it include?

The main types of asset we would expect to see a bank holding are as follows.

Notes and coin: this is the physical cash that is held in tills, branch safes, cash machines and in centralised cash-handling areas of the bank. It is up to each bank to decide how much cash to keep to meet customers' withdrawal demands.

Balances with the Bank of England: there is a statutory requirement for banks to hold non-operational, non-interest bearing deposits with the Bank of England. The amount of these deposits is a percentage of 'eligible liabilities' – these are sterling deposit liabilities of less than two years until maturity, net foreign currency liabilities and some inter-bank liabilities. Banks also hold non-interest bearing operational balances with the Bank of England to meet both cash needs and make inter-bank settlements.

Loans and advances to banks: these are short term loans made by one bank to another.

Bills: these are promises to pay money on a stated date – often three months (13 weeks) after the date of issue, although maturities could alternatively be one month (4 weeks), or six months (26 weeks). Once one of these bills is purchased by a bank, it becomes a short-term loan from the purchasing bank to its customer. These bills are negotiable, which means that they can be bought and sold in the market. The bills may be Treasury bills, or other bills. Treasury bills, as the name implies, are issued by the UK Treasury as short-term loans to the Government. Banks will often buy these bills on the secondary market when they are near to their maturity date. Other bills include local authority bills and trade bills.

Investments: these can consist of Government stock (gilts) and shares in other companies, as well as shareholdings in subsidiary companies of the bank, such as a finance house.

Advances: it would be expected that this would be the biggest asset of a bank – it represents the loans made by the bank to its customers.

Premises and equipment: these are the properties owned by the bank to conduct its operations – branches, processing centres, contact centres and regional/head offices. Equipment would include, for example, computers and vehicles.

Cash and operational balances at the Bank of England pay no interest. In fact, when we take account of the cost of protecting cash from theft, it can be said to have a negative yield. Having said that, 70% of deposits are virtually payable on demand (at least in theory) and so the banks must keep enough cash or its equivalent (for example, balances at the Bank of England) to meet all likely withdrawals. This does not mean that banks keep 70% of their deposits in cash. If they did, they would earn very little profit indeed.

From experience, banks know that only a small proportion of deposits will actually be withdrawn at any given time. Provided the banks maintain sufficient cash to meet these likely withdrawals and a margin of liquid assets which can be converted into cash rapidly to meet any unexpected demands, they can lend the remainder of their funds for longer periods.

As with any company, profit is important to a bank as profit provides for future growth and a return for shareholders. A bank considered to be earning inadequate profits could find itself subject to a takeover bid by a competitor. A management team unable to earn sufficient profit could well be replaced. This pursuit of profit conflicts with the need for liquidity since the most profitable assets (loans) tend to be the least liquid. The asset structure of a bank is a compromise between the desire for profit and the need for liquidity. Success depends on striking the right balance between the two.

Liquidity thus represents the ability of a bank to convert its assets into cash quickly and without loss. Government securities can be speedily converted into cash via the stock exchange, but the price of these securities fluctuates and so losses might be incurred if some of these need to be sold at the wrong time.

Advances are slow to realise, because it is not normal practice to call them in as this might force the borrower into liquidation or bankruptcy. The usual way of contracting advances is to slow down the granting of new advances while allowing repayment of existing advances to continue, thereby reducing the total amount of advances outstanding. Advances are thus slow to convert into cash for the purpose of repayment.

2.4 The bank's role in society

In conducting its business, a bank also has an important role to play in society as a whole, in the following ways.

The bank:

- Acts as a financial intermediary between savers and borrowers which results in efficient use of pooled resources
- Facilitates the creation of money by expanding the supply of money through deposit and loan transactions
- Creates financial products and services that benefit its customers
- Develops mechanisms for transferring money
- Contributes to the development of the banking industry

We consider the social responsibilities of a bank in more detail in Chapter 6.

3 Development of banking in the UK

3.1 Banking in England

In the early 19th century, English private banks were restricted to six partners. This was due to an Act in 1708 which gave the Bank of England a monopoly in joint stock banking (a bank with a large number of shareholders) in England. Most banks were small, local and unregulated. In 1825 over 60 private banks failed in England, the outcome of which was the Country Bankers Act 1826. This Act represented a milestone in the development of English banking. It broke the Bank of England's monopoly and permitted the creation of joint stock banks outside a 65-mile radius of London with the right to issue notes. New banks could raise more capital than the old ones to open branches and thus lend to a variety of industries, thereby spreading their risks.

In 1833, a Bank Charter Act authorised joint stock banks to open branches within the 65-mile radius provided they did not issue notes. In 1834 the London and Westminster Bank was established; ultimately through mergers it became the National Westminster Bank plc, which in turn became part of the RBS Group. The number of joint stock banks increased during the next few decades while the number of private banks diminished through mergers and takeovers. Barclays Bank grew out of a series of mergers by private banks from 1896 onwards.

The period 1890 – 1918 witnessed the increased concentration of banking in England whereby a few banks dominated deposit taking and lending business. This trend was encouraged by the public's greater confidence in large banks, a view also held by the authorities.

Bank mergers were seen as strengthening the financial system. In 1918 a Treasury Committee was set up to examine bank mergers as fears began to be expressed about the size and influence of large banks.

A proposed legal ban on mergers was dropped, but the banks did agree to consult the authorities before proceeding with any further amalgamations. For the next 50 years the pattern of banking in England remained stable. Five banks dominated the banking scene – Barclays, Lloyds, Midland, National Provincial and Westminster, plus six smaller joint stock banks.

A strong argument for bank mergers in the 1960s was that English clearing banks faced increased competition from both home and abroad, from finance houses, building societies and foreign banks. In 1968 Barclays merged with Martins Bank while the National Provincial, District and Westminster Banks became the National Westminster Bank.

These mergers resulted in three major benefits:

- Strengthening of bank balance sheets and thereby greater lending capacity
- Cost savings via branch mergers and reduced staff requirements
- More funds available for investment in new technology available at that time

3.2 Banking in Scotland

The Bank of Scotland was established in 1695 to meet the needs of commerce and began by issuing notes and making loans. In 1727, the Royal Bank of Scotland was established; thus, Scotland gained two joint stock banks to England's one. Both were legal corporations with limited liability for their shareholders. Fierce competition ensued over the issue and presentation of notes until both realised the mutually destructive nature of such competition.

As time passed, more banks were set up in Scotland to meet the needs of expanding industry and commerce. The prohibition of having more than six partners did not exist in Scotland and so, by the 19th century, most major Scottish towns and cities had joint stock banks issuing their own notes. For example, Clydesdale Bank was set up in Glasgow in 1838. Similar to the situation in England, a process of amalgamations took place which reduced the number of Scottish banks to eight by 1907. The 1950s and 1960s witnessed further mergers until there was only the Bank of Scotland, Royal Bank of Scotland and Clydesdale Bank.

The following innovations originated from the Scottish banking system.

Overdrafts – the overdraft developed from the cash credit introduced by the Royal Bank of Scotland in 1728. Under this system, the bank agreed to honour claims against a person's account up to an agreed amount. The sum was debited against the customer's account and interest was charged on the outstanding balance.

Branch banking – Scotland developed a network of branches which added to the stability of the banking system and allowed banks to tap a wider source of funds and spread risks associated with lending over a wider geographical area.

Joint stock banking – this form of banking meant that shareholders in a bank were protected from personal liability for the bank's debts should it fail. Limited liability encouraged a greater number of people to become investors in banks, thus providing them with a larger capital base.

The clearing house – in 1771, the Scottish banks introduced a note exchange in Edinburgh which meant that each bank's notes were more acceptable to the public. This example of interbank cooperation encouraged the concept of a clearing house for cheques.

The Chartered Banker Institute – established in 1875, the Institute was the world's first professional body for practising bankers. It dedicated itself, as it does today, to the training and educating of bankers and other financial services practitioners both in the UK and globally.

Note issue – a distinctive feature of Scottish banking is the right of Scottish banks to issue their own notes. The *Bank Charter Act 1844*, which gave the Bank of England an eventual monopoly of the note issue in England and Wales, did not apply to Scotland. Thus the Scottish joint stock banks retained the right to issue their own notes.

Under the Bank Notes (Scotland) Act 1845, each bank was granted an authorised circulation based on its average circulation for 1844; thereafter any notes issued above this figure were backed by gold.

Today, that privilege appears very small for the three Scottish banks which issue their own notes, as only £3m out of over £2,000m in circulation does not need to be covered at the Bank of England. Scottish clearing banks must meet the cost of printing and security for their own notes. However, the banks appreciate the prestige, advertising and appeal to Scottish patriotism of issuing their own notes. There are also sound financial benefits from maintaining the separate Scottish note issue. These stem from the fact that Scottish notes do not need to be covered until in circulation with the public; this reduces the cost of till money. If the Scottish note issue were abolished, Scottish banks would have the expense of holding all their till money in the form of Bank of England notes for which a fee is payable.

4 The business environment

4.1 Introduction

The UK clearing banks share numerous characteristics. They are all large financial institutions, offering a wide range of services within their respective banking groups. Their deposits have a fixed monetary value and so, unlike investments in stocks and shares, they cannot lose their capital value.

What if a bank cannot pay back its depositors? There is always the potential for this to happen, as the banks are commercial organisations that utilise their deposits to create loans and other assets. If enough depositors asked for the immediate withdrawal of all their funds, all at once, the banks would not be able to meet these demands. In practice, banks can usually predict the level of withdrawals over time and can also call upon funds from other institutions should the need arise. Unusual conditions can however arise, for example if people fear a banking crisis and no longer consider that their money is safe with the bank. This is called a 'run on the bank'. Governments and central banks should generally try to avoid a situation in which there is an unfounded loss of confidence in banks but, if a run on the banks does occur, in these extreme circumstances banks may have to stop allowing withdrawals and close their doors. As we shall see in the Case Study that is described a little later, in September 2007, thousands of customers of the UK bank Northern Rock queued for hours at branches of the bank in the hope of withdrawing funds. The run on deposits slowed after the Government issued an emergency pledge to Northern Rock customers to assure them that their money was safe.

4.2 Regulation of deposit takers

The Banking Acts 1979 and 1987 established a formal system for the supervision and control of **deposit taking institutions (DTIs)** in Britain. The Bank of England became responsible for granting recognition to banks. A bank deposit protection fund which was also established under the 1979 Act has been replaced by the Financial Services Compensation Scheme. In 1998, responsibility for the authorisation and supervision of banks was transferred from the Bank of England to the Financial Services Authority (FSA).

In April 2013, the FSA was superseded by two separate regulatory authorities, the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). The FCA's primary role is to regulate conduct in the financial services industry: its aim is to protect consumers and promote competition between financial services providers. The PRA is the prudential regulator, responsible for ensuring the safe and financially sound operations of over 1,000 DTIs, as well as insurers, investment banks and some other institutions.

4.3 Late 2000s credit crisis

The safety of deposits with banks was once rarely questioned, but the credit crisis that started in 2007 caused severe difficulties, both in terms of pressure on their capital resources and customer confidence. Given the importance of public confidence in the banking sector, the Government stepped in during 2008 to ensure that the banks had access to capital. At the same time, the Government reinforced the protection provided to personal customers by increasing the deposit guarantee threshold to £50,000 (from £31,700). At the end of 2010, this limit was increased to the sterling equivalent of 100,000 euros, and now stands at £75,000.

CASE STUDY

Northern Rock

In July 2007, Northern Rock announced a set of upbeat results and stated that the outlook for their business was 'very positive'. However, within a month of this announcement, the Governor of the Bank of England was made aware by the FSA (now the FCA) and the Treasury that the developing global credit squeeze was having an effect on Northern Rock. Soon after, the Governor announced that the Bank of England would be willing to provide funds to any bank that encountered short-term difficulties as a result of temporary market conditions. On the following day, the BBC announced that Northern Rock had received funding from the Bank of England in the Bank's role as lender of last resort.

On the next day, Northern Rock announced that the 'extreme conditions' on the financial markets had forced it to turn to the Bank of England for assistance and a statement was issued by Northern Rock, the Bank of England and the Treasury to the effect that Northern Rock was solvent. However, this cut little ice with many customers who formed queues outside the bank looking to withdraw their deposits.

Over the next few days, the queues continued and the bank's share price continued to plunge, causing the Chancellor of the Exchequer to guarantee all of the bank's deposits – even those in excess of the legal compensation limit. This move seemed to appease depositors.

One week later, the bank cancelled its proposed dividend and stated that it had commenced talks with parties interested in buying all or part of the business.

In the weeks and months that followed, Northern Rock was rarely out of the news as others sought to buy the bank, before it was eventually nationalised. The FSA was heavily criticised for its part in the process. For most people, the abiding memory of the Northern Rock story was television pictures of customers queuing to get their savings out of the bank. Then, on 1 January 2012, Northern Rock was acquired by Virgin Money.

4.4 The retail market

The public regards the products offered by banks as close substitutes for each other. This public perception has recently come even closer to reality, as the old differences between clearing banks and building societies have now largely disappeared. All now provide a range of payment facilities including money transmission, cash dispensers, direct banking and credit cards as well as lending facilities which, although they are not identical, do overlap, particularly in personal lending and mortgages. This operating environment has resulted in intense competition between deposit-taking institutions (DTIs).

The UK clearing banks are mostly involved in retail banking, although they also have some wholesale activities. Retail banking implies a large number of customers generating volume business on standard terms and conditions. The interest rates payable on the different varieties of deposits are normally advertised and thus are widely known. Lending rates are widely publicised and rates to borrowers are based on these.

Competition among clearing banks and between them and other DTIs takes the following forms:

- Range of services available online and over the telephone line
- Extent and location of branch networks
- Interest rates charged on loans and paid on deposits
- Fees charged for arranging loans
- Range and quality of additional services provided

- Perceived stability and trustworthiness of the organisation

Although clearing banks vary in size, to some extent they all enjoy economies of scale, the particular advantages being that:

- The branch network makes the clearing banks accessible to a wide range of customers
- A comprehensive direct banking service can be offered
- Risk is spread over a range of sectors of the economy and parts of the country (a bank is much more vulnerable when it is involved with only a few customers)
- A larger bank can afford to employ experts and have specialist departments and services, or they can afford to outsource some operations
- Larger banks require proportionally lower levels of liquid assets as risk of unexpected withdrawals is spread more widely
- Larger banks can maximise use of modern technology

A clearing bank's cash inflow consists of customers' deposits and loan repayments (including interest) while cash outflow is customers' withdrawals and new loans. The amount of loan repayments will be fixed at any given time, depending on the amount of lending in previous periods, but the inflow of deposits and the amount of lending and withdrawal of deposits will depend on prevailing interest rates and other conditions attached to deposits and loans.

Rates and terms can be varied, consequently varying the level of inflows and outflows. As clearing banks are very similar in the range of services offered, altering interest rates would appear to be the main variable, but they do not choose to actively compete through interest rates, although they are free to do so.

They do not operate an interest rate cartel, although the tendency to simultaneously adjust interest rates might suggest otherwise. This apparent coordination of rate adjustments, the banks would claim, derives from them all operating in the same money markets and thus being subject to precisely the same market forces.

Interest rates on loans and deposits are adjusted to give each bank a desired level of liquidity – a balance between inflows and outflows. They will not normally be keen to alter these rates relative to each other, unless the existing balance appears to have been permanently upset – an abundance or shortage of liquidity within a bank.

The distinction between retail and wholesale banking has become blurred in recent years. Most of the UK clearing banks are now banking groups which provide through subsidiaries a wide range of services, for example, deposit taking, share issues, leasing. The key distinction of clearing banks from other DTIs is that they play a major role in money transmission services and hold a high proportion of demand deposits in the economy.

Banks are not the only financial institutions to accept deposits from the public. Some **finance houses** are authorised by the FCA to accept deposits. Others, such as **building societies**, **credit unions** and **National Savings & Investments (NS&I)**, are covered by separate Acts of Parliament which authorise their acceptance of deposits from the public. A feature of most of these institutions is that they accept deposits for small sums of money from large numbers of personal customers.

A final group of financial institutions comprises those which do not accept deposits from the public but instead provide facilities for long-term saving and investment, comprising:

- Investment trusts, unit trusts and Open Ended Investment Companies (OEICs)
- Insurance companies, and
- Pension funds

4.5 Recent developments

The period since 2007 has been turbulent for the UK banking sector. It was characterised by a tightening of credit conditions brought about largely by international factors, notably the credit crisis in the USA.

During the crisis of the late 2000s, several banking institutions had to seek government support and some were taken wholly or partially into public ownership. There was also significant rationalisation in the UK financial services sector.

A credit crunch is defined as 'a severe shortage of money or credit'. In August 2007, bad news from French bank BNP Paribas triggered a sharp rise in the cost of credit, causing the financial world to realise just how serious the situation was. Lehman Brothers was the first major bank to collapse in the credit crisis.

The crisis had a major impact on all organisations that relied to any extent on the wholesale markets, and as many UK-based financial institutions were heavily reliant on wholesale funds from the USA, deteriorating conditions in the US economy quickly had a major impact in the UK.

Until 2007, the housing market in the USA had enjoyed a period of sustained growth, fuelled by low interest rates and readily available funds, including buoyant inflows from Asian economies and oil-producing countries.

Much of the growth was based on the belief that mortgage assets were generally safe. Many US lenders leveraged their growth by issuing mortgage-based securities, which raised funding based on the perceived quality of existing mortgage assets. In addition to the burgeoning mortgage market, demand for other types of loans, such as credit cards and car finance, was extremely strong. Most economists agree that the UK credit market peaked in late 2006.

The US economy inevitably overheated. Default rates started to increase and lenders became increasingly nervous. The costs of funding started to increase. As recession loomed, the banks in the USA became reluctant to make wholesale funds available. Alarmingly, the five largest investment banks in the USA, major players in the wholesale and derivatives markets, all ran into difficulties. Lehman Brothers collapsed in September 2008. Goldman Sachs and Morgan Stanley became commercial banks. Bear Stearns and Merrill Lynch were bought out. Also in 2008, the Federal National Housing Association (Fannie Mae) and the Federal Loan Mortgage Corporation (Freddie Mac) were placed into conservatorship of the Federal Housing Finance Agency.

All of these developments put pressure on many of the larger banks in the UK, who had to make their lending products competitive but could not secure funding at the right price. The crisis in the UK was triggered by fundamental problems affecting many major players in the market.

Other financial institutions quickly found that they needed government support. In autumn 2008, several large banks were supported by public funds when the Government decided to take shares in these banks in return for capital injections. Further funds were provided by the Government in Spring 2009. These measures – which amounted to part-nationalisation – were intended to be temporary, in that the capital will be repaid to the Government when markets eventually recover.

As previously mentioned, the Government also sought to increase confidence in the banking and finance sector by reinforcing the compensation available to customers of failed organisations, increasing the level of protection for individual (personal) investors.

CASE STUDY

Icelandic banks

The international dimensions of the crisis were brought home by the collapse of the Icelandic banking system, and in particular the failure of Landsbanki. This bank had been offering attractive interest rates for deposits through its subsidiary, Icesave, which provided easy access, online retail banking services to retail customers in the UK and the Netherlands. In October 2008, Icesave stopped processing withdrawals. Initially the Government of Iceland announced that it would only protect domestic depositors, causing diplomatic tensions between the UK and Iceland. Eventually, in October 2009, the Icelandic government announced that it would be making compensation available for non-resident and personal customer account holders.

Some banks took the more conventional route of seeking merger partners and were effectively taken over. Some of the former building societies that had become public limited companies during the 1980s and 1990s had some of their business taken over by other financial organisations.

Ironically, in a sector in which size had become important, some of the smaller institutions with less dependence on wholesale markets were less seriously affected by the crisis. Some observers have commented that none of the former building societies that relinquished their mutual status to become public limited companies survive as independent institutions. By contrast, few of the building societies were seriously affected by the crisis, though there has inevitably been some rationalisation.

The crisis has led to an inevitable restructuring of the financial sector, with several mergers and acquisitions as well as the total demise of some companies. The government has forecast that recovery will be gradual and prolonged, which suggests that there will be further significant developments to come.

The events of 2008 and 2009 focused attention on the ways in which banking organisations conduct themselves, with perhaps an overdue re-evaluation of corporate governance, values and ethics. It was inevitable that regulation of the financial sector would be reformed. Banking institutions will therefore be faced with new compliance challenges, and will also have to consider the extent to which their corporate social responsibility policies go further than simply obeying the law. In building their business models for the future, the larger institutions may have to undergo a period of consolidation and perhaps even fundamental restructuring of the ways in which they do business in order to compete with new challenges, including entirely new players that enter their markets.

A significant outcome of the crisis is the reinforcement of the long-held view of some economists that some institutions are '**too big to fail**'. The financial sector in the UK did much to generate wealth in the quarter century that followed the Second World War, giving successive governments the confidence to deregulate and permit banking institutions to compete with each other, largely without external interference. This led to more innovation and greater choice for consumers, but perhaps also complacency that if and when things were to go wrong, the industry would be able to deal with any problems as they arose. The fact that many financial institutions came to rely on government (and therefore taxpayer) support is a timely reminder that banking has always been, and will remain, a risk business.

As the Government now has substantial holdings in some of the major banks, public scrutiny of banks has probably never been greater.

4.6 Independent Commission on Banking (Vickers Report)

In June 2010, the Chancellor of the Exchequer announced the creation of an Independent Commission on Banking (ICB), chaired by Sir John Vickers. The ICB was asked to consider structural and related non-structural reforms to the UK banking sector to promote banking stability and competition.

With regard to stability, the ICB stated in an interim report that making the banking system safer required a combined approach that:

- Makes banks better able to absorb losses
- Makes it easier and less costly to sort out banks that get into trouble
- Curbs incentives for excessive risk taking.

The two ways to make banks safer were:

- Firstly, by increasing their ability to bear losses, by requiring them to hold a great deal more capital
- Secondly, to alter their structure.

The final Vickers Report (2011) made recommendations on the future of UK banking, in the wake of the late 2000s financial crisis. Stopping short of advocating a full-scale **separation** of **'High Street' banking** from the banks' high-risk 'casino'-style **investment banking** activities, the Report recommended that the main UK banks be required to **'ring-fence'** their retail banking operations within separate entities from their investment banking arms. ('Retail' banking for this purpose can include straightforward banking services provided to corporate customers.)

The Financial Services (Banking Reform) Act 2013 (the 'Banking Reform Act') implements the Report's recommendations. The ring-fencing of retail and investment banking, which will be implemented along with stricter capital requirements for the banks, is intended to avoid financial losses in investment banking from de-stabilising a retail bank and thus possibly requiring a rescue at taxpayers' expense. The banks have until 2019 to complete the ring-fencing process.

The ICB also stated that UK retail banking needs to be more competitive and that the **ability of customers to switch banks** could be greatly facilitated.

5 Other financial services providers

5.1 Introduction

In addition to the clearing banks, other types of banks and financial services organisations include the following:

- Building societies
- Credit unions
- National Savings & Investments (NS&I)
- Investment banks
- Insurance companies
- Pension providers
- Investment trust companies
- Unit trusts and OEICs
- The central bank

5.2 Building societies

A **building society** is a financial institution that offers savings accounts and mortgages as its main business. In recent years a number of building societies have diversified and now offer a wide range of personal financial services.

A building society is a mutual institution. This means that most people who have a savings account, or mortgage, are members and have certain rights to vote and receive information, as well as to attend and speak at meetings. Each member has one vote, regardless of how much money they have invested or borrowed or how many accounts they may have. Each building society has a board of directors who run the society and who are responsible for setting its strategy.

Building societies are different from banks, in that banks are companies that are usually listed on the stock market and therefore owned by, and run for, their shareholders. Societies, which are not companies, are not driven by external shareholder pressure to maximise profits to pay away as dividends. This can sometimes result in building societies offering products at competitive prices. The other major difference between building societies and banks is that there is a limit on the proportion of their funds that building societies can raise from the wholesale money markets.

Building societies originated in the late 18th century among working people who wished to build their own homes. The oldest society for which records survive was Keltey's Building Society founded in Birmingham in 1775. Others were to follow and by 1800 there were 23 building societies.

It was in the Midlands and the north of England, in the rapidly expanding towns of the Industrial Revolution, that the new movement took root and prospered. The names of the towns or regions where the societies began are still to be seen in the titles of today's societies such as the Skipton or the Yorkshire.

Compared with today's financial giants, the early societies were simple. A group of working men would pool their financial resources to purchase some land and build houses for themselves and their families. Each member paid a regular subscription to the society. As each house was completed, lots would be drawn to decide the member to whom it should be allocated. When every member was housed, any loans repaid and all other expenses met, the society would be dissolved. For this reason the early societies were known as **'terminating' societies**.

Modern building societies are 'permanent' societies which means they were not to be dissolved once their founding members are housed, but have a continuing existence. The first permanent society was established in 1845. This development opened up membership to those who wished to save rather than to build or buy a house. The Building Societies Act 1874 made building societies corporate bodies with full legal powers similar to limited companies and it provided the legal basis for their activities over the next 100 years.

The inter-war period. The 20th century saw the growth of the building society movement, particularly in the inter-war period. Even the economic depression of the 1930s failed to halt this expansion; indeed, the building societies were able to benefit from the prevailing low interest rates. This depression was predominantly a regional problem hitting the traditional heavy industries of the north of England, south Wales and central Scotland.

The new consumer goods industries were concentrated in the south and Midlands of England. For those in work, real incomes grew as did the volume of savings and the demand for home mortgages. This period of substantial growth ended with the outbreak of war in 1939.

The post-war period. When the Second World War ended in 1945, the immediate problems were reconstruction and repairing wartime damage. Government housing policy concentrated on building public sector houses to let, which offered little scope for the building societies. In the 1950s, the emphasis switched back to the private sector and there was a rapid increase in the number of houses built for owner-occupiers. This began a new period of growth for the building societies.

The last 25 years. The number of building societies has reduced since the start of the 20th century.

QUICK QUESTION

Why do you think this happened?

Write your answer here before reading on.

Underlying the decline are the following factors:

- The closure of some of the very small permanent societies
- The process of amalgamation by mergers has reduced the number of societies.

While this has occurred over a number of years, you will be aware that some of the smaller societies merged with some larger ones as a consequence of the banking crisis in 2008; for example, the Derbyshire Building Society and the Cheshire Building Society both merged with the Nationwide at the end of 2008.

Under the Building Societies Act 1986, a building society has the right to convert from mutual to company status. The Abbey National converted in July 1989, and other major societies – Halifax, Woolwich, Alliance & Leicester – converted in 1997. Once company status is achieved, the building society is reclassified as a bank (or mortgage bank). Obviously this trend has reduced further the number of building societies and their share of personal sector financial assets and mortgages.

Building Societies Acts 1986 and 1997

The Building Societies Act 1986 provided an entirely new legal framework for the building society movement and replaced all earlier building society legalisation. It removed many of the restrictions which had limited their activities and gave them a much broader remit to enable them to extend their range of financial services. The Act was part of the wider move towards deregulation/liberalisation which affected all financial institutions in Britain in the 1980s. The Act has since been amended and revised by the Building Societies Act 1997 and the Financial Services and Markets Act 2000, but the main provisions of the 1986 Act relating to the constitution, governance and principal purpose of building societies remain in place.

The principal (but no longer the sole) purpose of building societies remains that of raising funds from personal savers to lend out for house purchase to owner-occupiers. To this was added a range of new services such as money transmission, house purchase, non-mortgage lending and other financial services such as share dealing.

The development of building societies in Scotland was quite different to that south of the border. Although some building societies existed in Scotland in the early 19th century, they have always done proportionately less business in Scotland than in the rest of the UK. Unlike banks, none of the large building societies was founded in Scotland. The lack of a major Scottish-based building society can be explained by a number of interrelated factors:

- The dominance of other savings institutions – commercial and savings banks – may have inhibited the development of an indigenous building society movement
- The relative poverty of the working class and lower middle class in the past made house purchase more difficult in Scotland
- The former availability of social housing (council houses) with subsidised rents that bore no relation to the actual interest cost associated with their construction
- The Scottish tradition, up until the 1980s, of renting rather than purchasing a home – in the early 1990s, about only 55% of Scottish homes were owner-occupied as opposed to almost 70% in England
- A previous inadequate stock of suitable housing in Scotland for purchase or acceptance as security for advances by building societies.

In the 1980s and 1990s there was increased home ownership in Scotland, encouraged in part by the sale of council houses, the near cessation of new council house building and higher council house rents. Mortgage business generated by this trend was won mainly by building societies and mortgage banks in England. At the same time, the main building societies, such as Nationwide and the Yorkshire, had branches and agencies in Scotland, the savings deposits of which have partly financed their mortgage operations in Scotland.

CASE STUDY

Dunfermline Building Society

The largest Scottish-based society is the Dunfermline Building Society. It was established in 1869, incorporated in 1887, and is now part of Nationwide. The Society's profitable core business was bought by Nationwide in 2009 when the Dunfermline came close to insolvency due to its exposure to the commercial property market.

Shares and deposits. Personal savings accounts with building societies are share accounts. Holders of share accounts are members of the Society with a right to attend and to vote at general meetings, typically subject to them having a minimum of £100 balance in their account.

Since 1986, those with mortgages have the same membership rights and are referred to as 'borrowing members'. Minimum balances are specified for both types of customer in order to enjoy voting rights.

Unlike members of limited companies, each member of a building society has one vote, irrespective of the sum deposited or owed.

Under the provisions of the 1986 Act as amended, building societies must raise at least 50% of their capital from retail sources, and at least 75% of their commercial assets must be represented by loans secured on land for residential use. Building societies are permitted to accept corporate deposits and engage in lending other than mortgages, subject to the statutory limits. However, deposits from corporate customers must be designated as 'deposit accounts' and not as shares, so the investor has no constitutional rights.

The lower level of dependence on wholesale funding was one reason why the majority of building societies escaped some of the more serious effects of the credit crisis. However, some societies did come under pressure and this led to further rationalisation, such as the takeovers of the Cheshire, Derbyshire and Dunfermline building societies by Nationwide.

5.3 Credit unions

Credit unions are mutual savings and loan societies providing a basic low-cost banking service. Members finance their personal borrowing from their own combined resources.

In many ways credit unions are like the early building societies with the provision that members must share some common bond, such as attending the same church, living in the same locality, or working for the same employer. One possibility is for a firm to support a credit union for its employees and deduct savings automatically from their salary.

Credit union services are common in North America. About 25% of Americans bank with credit unions which offer a wide range of banking and financial services. In the UK, the movement was established first in Northern Ireland, and Irish and West Indian people who were already familiar with the benefits of credit unions brought them to mainland Britain.

Each credit union is a self-governing club owned by the members themselves and run on cooperative principles. Administration is through a board of directors, a credit committee and a supervisory committee elected by and from the members. Many credit unions rely to some extent on voluntary support. Members must be regular savers and can apply for small loans at moderate rates of interest to meet such expenses as holidays, weddings or even, in the winter, high fuel bills. Borrowers must continue to save while repaying their loans. Loan requests are treated in confidence and dealt with by the credit committee.

Part of the strength of credit unions is their size. Managers and members should be known to each other and loans can be granted on the basis of personal knowledge of the borrower. This is important for low income families with no financial assets to offer as security. It is also important for those groups whose needs and culture are outside the experience of the established financial institutions.

Unlike building societies, the demutualisation of credit unions into bank plcs is not possible under current legislation. The operations of credit unions in the UK are governed by the Credit Unions Act 1979.

5.4 National Savings & Investments (NS&I)

The idea of a national savings bank operating through the post office was proposed as long ago as 1807, but it was not until 1861 that the Post Office Savings Bank (POSB) was established. The POSB had a number of advantages over retail and trustee savings banks in that:

- It could provide national coverage through an established network of post offices
- Deposits and interest of 2.5% per annum at the POSB were guaranteed by the state so there was no risk of default
- All deposits were placed in an account at the Bank of England and subsequently invested in government securities

These perceived advantages encouraged the closure of small local savings banks in the south of England as customers transferred their accounts to the POSB, which continued to expand in the first half of the 20th century, reaching a peak of almost £2 billion in deposits in 1946.

Various improvements were made to the service such as the payment of small sums on demand, payment by crossed warrant through a bank, a method of making periodic payments and the sale of savings stamps, although the basic service remained essentially unchanged. POSB accepted deposits at 2.5% and reinvested the funds in government securities.

The subsequent decline in the POSB's popularity in the 1950s and 1960s may be explained by:

- **Reluctance to provide competitive services**. At a time when other savings institutions were broadening their range of services, the POSB continued to offer its one basic account; the management showed no enthusiasm for introducing a payments system such as a giro, nor was the management prepared to offer an investment account.
- An **uncompetitive interest rate**. In the 1930s and 1940s, the 2.5% offered by the POSB was competitive; with rising/fluctuating interest rates from the mid-1950s onwards, the POSB steadily lost ground to its more aggressive competitors who offered higher interest rates.

Reform and revival

In the 1960s a number of developments took place:

- The POSB headquarters was moved from London to Glasgow in 1966
- Also in 1966, investment accounts were introduced offering higher interest rates to long term savers
- In 1969 POSB changed its name to the National Savings Bank (NSB) although it continued to operate through post offices.

The investment account reversed the overall decline of funds held in the NSB. All the funds raised by the NSB were made available to the UK Treasury. Around 2000, NSB was absorbed into the National Savings & Investments (NS&I), a department of the UK Treasury.

NS&I is an **Executive Agency** of the **Chancellor of the Exchequer**. HM Treasury uses the money invested in NS&I to manage the national debt cost-effectively, contributing to the Government's financing needs. NS&I is responsible for providing cost-effective financing to the Government by issuing and selling retail savings and investment products to the public.

The powers governing the way in which NS&I products are structured and managed are derived from specific NS&I legislation and all strategic decisions affecting our products require Ministerial consent. NS&I is expected by HM Treasury to comply with Financial Conduct Authority (FCA) requirements where applicable and appropriate, but this is on a voluntary basis, since NS&I does not formally come within the FCA's regulatory remit.

NS&I raises funds for the Government by offering a broad range of savings products to the general public, including fixed interest savings certificates, index-linked savings certificates, capital bonds, its own Individual Savings Account (ISA) product, and retirement bonds.

About 4,000 NSB staff were transferred to Siemens Business Services as part of a ten-year public private partnership agreement which gave NS&I access to new technology and expertise.

In 2004 the ordinary account facilities were terminated and customers were asked to transfer their business to a more flexible savings account. At this time, 13 million people had ordinary accounts but many of these accounts were dormant. The interest rate was only 0.25% per annum and more than 4 million accounts had less than £10 as a balance.

It was this situation that encouraged NS&I to introduce a new, easy access savings account while continuing to provide an investment account, along with the NS&I Direct Saver account which offers access to funds either online or over the telephone.

5.5 Investment banks

Investment banks have their roots in what used to be known as merchant banks.

Some merchant banks (formerly known as accepting houses) can trace their origin to the overseas trading houses of the 19th century. Banking in many cases developed as a sideline to the main activity of merchant houses which was dealing in commodities. With their knowledge of commodity trading and banking, the merchant houses developed a market for bills of exchange in London.

As Britain grew as an international power during the 18th and 19th centuries, it was necessary for those engaged in international trade to find ways of financing their transactions. The most popular method of doing this was the bill of exchange.

A **bill of exchange** is a document drawn up by a bank on behalf of an exporter. It sets out the amount to be paid on or before a future date by the customer. The bill of exchange is sent to the importer's country and is then accepted by a bank, confirming it as good for payment. The bill can then be endorsed (or indorsed) to facilitate further payments to a third party, or even a series of third parties. Although this function is much less important today, the role of the merchant banks as accepting houses was enormously significant in Victorian times.

Modern investment banks typically have the following functions:

- **Accepting deposits**. As wholesale banks, investment banks deal in large deposits mainly from the corporate sector (industrial and commercial companies) rather than the personal sector. Investment banks' wholesale activities now predominate. Although much of this business is with other banks through the London inter-bank market and with banks abroad, lending to corporate customers in both sterling and foreign currencies remains significant.

  Investment banks do not operate a chain of retail branches or provide the general public with money transmission accounts. While this saves the expense of a branch network and the cost of administering numerous small accounts, it means that the bulk of an investment bank's liabilities are market interest rate bearing deposits.

  Some investment banks provide deposit and money transmission services for high net worth personal and corporate customers. Such services are often provided through subsidiaries set up as private banks.

- **Finance**. Apart from accepting trade bills and thereby providing a source of finance to firms, investment banks often provide their own clients with acceptance credits which enable a customer to issue bills drawn on an investment bank up to an agreed amount. These bills are then discounted to raise finance. The bank pays the bills on maturity and debits the client's account with the bills' face value. Clients pay investment banks for the use of such facilities.

  Investment banks also provide term loans in sterling and foreign currency to companies and institutions. Like finance houses, they also provide leasing and factoring facilities to their clients, but on a larger scale.

- **New share issues**. As issuing houses, investment banks advise companies on the most economical way to raise capital for expansion; this might often take the form of a new share issue to the public. If an issue of shares is considered appropriate, most investment banks will be able to provide the necessary expertise, such as the issue of a share prospectus, and compliance with Stock Exchange requirements, to help their corporate client raise the necessary finance.

  There are several ways that new shares may be issued. The most usual is an **offer for sale** where the issuing house buys the shares from the company trying to raise finance and offers them for sale to the general public at a higher price. Advising on the price at which to issue the shares is another responsibility of the issuing house which will also arrange underwriting to ensure that all the shares are sold. For a commission, an underwriter undertakes to buy any of the shares not taken up by the public.

- **Financial advice**. An area of investment banking activity that sometimes receives considerable publicity is their work in mergers, acquisitions and takeovers. Investment banks advise companies on the tactics and strategy to employ in carrying out a merger or for resisting an unwanted takeover bid.

- **Investment management**. Investment banks provide investment management expertise to a large number of pension funds, investment trusts and funds (unit trusts and OEICs). Some investment banks operate their own unit trusts.
- **Other activities**. Investment banks deal in foreign currencies, gold bullion and other commodities, either on their own account or for clients. Their range of activities is not uniform, dealing only with certain industries or sectors.

QUICK QUESTION

What is the purpose of insurance?

Write your answer here before reading on.

5.6 Insurance companies

5.6.1 Overview

Insurance is about the transference of risk from one party (the **customer**, that is the '**insured**') to another party (the **insurer**, typically an **insurance company**) who pools together the risks taken on from different parties – usually in return for the payment of a fee or premium.

Forms of transference of risk were practised by Chinese and Babylonian traders as early as the second and third millennia BC. If Chinese merchants were travelling across dangerous waters, they would carry their goods in a number of vessels so that, in the event of the loss of a ship, not all of their goods would be lost – in other words, they were spreading the risk. The Babylonians developed a system whereby if a merchant received a loan to fund a shipment, and if he paid the lender an additional sum, then, should the shipment be stolen, the lender would write off the advance – rather like financial protection products in use today.

The concept of life assurance was introduced by the Greeks and Romans when they organised 'benevolent societies' where the societies cared for dependants and paid the funeral expenses of deceased members.

At the end of the 17th century in Britain, London's growing importance as a trade centre increased the demand for maritime insurance. In the late 1680s, Edward Lloyd opened a coffee house which was frequented by ship owners, merchants and ships' captains and, as a result, became a reliable venue for shipping news. Later, people who were interested in insuring cargoes and ships would gather there and thus Lloyds of London was born. After the Great Fire of London, Nicholas Barbon started to insure buildings against fire and, in 1680, established 'The Fire Office' to insure houses.

The business of insurance companies falls into two main categories:

- The spread of risks between persons and organisations – general insurance
- The spread of risk over time – life assurance.

5.6.2 General insurance

General insurance provides cover against certain agreed risks such as fire, theft or accident which may occur during a specified period of time. The types of general insurance you will be most familiar with are motor insurance, holiday insurance and property (house and contents) insurance.

The common feature of these different classes of insurance is that the probability of the risks involved actually happening can be calculated reasonably accurately. These calculations are based on past experience, therefore, for any given group seeking insurance cover against a particular risk, an insurance company can estimate with a high degree of certainty the total value of claims likely to arise. What the company cannot do is predict which of the insured will be the ones to suffer the loss covered and so be the ones to claim. If such risks could be identified, they would be uninsurable.

The service an insurance company offers is to spread a risk of loss over all those who wish to insure against it. The insurance company charges each of its clients a fee or premium based on the degree of risk contributed by that particular client. The fees are paid into a common pool which is used to meet subsequent claims. The aim of an insurance company is to produce sufficient income from its premiums and its return on assets to meet all expected claims, to cover administrative costs, to make a profit and to add to its reserves.

QUICK QUESTION

What is the difference between insurance and assurance?

Write your answer here before reading on.

5.6.3 Life assurance

The difference between insurance and assurance is:

- Insurance offers cover against an event such as theft or an accident which may or may not happen.
- Assurance provides payment of a benefit on an occurrence, such as death or survival to a particular date, which will take place but the time of which is uncertain.

It would be possible to offer life cover for a limited period of say a year, in the same way that general insurance is offered. A problem with this approach is that, as a person grows older, the mortality risk increases and so the premiums would need to increase each year to match this. For older people, the costs of insurance could be prohibitive.

The solution to this problem is the use of **mortality tables**, which indicate the life expectancy of groups by age, sex and possibly other criteria, and so provide the basis for life assurance schemes, the main features of which may be that:

- Premiums are fixed for the duration of a policy – in the early years a policyholder pays a higher premium than is necessary, but the rate remains the same in later, high-risk years.
- Premiums are paid into a professionally managed life fund; income generated is for the benefit of the policyholders; claims are met out of this life fund.

Most assurance companies (or life offices) have a variety of policies available. The main types are as follows.

- **Term assurance**. The assurance company pays a benefit only if the assured person dies within a specified time. There is no payment if the assured survives beyond that date. In view of the limited benefits and the fact that most policies do not result in claims, this is the cheapest form of life assurance.
- **Whole of life assurance**. The company promises to pay a sum of money when the assured person dies, which is a useful way of providing further protection for dependants. It remains in force for the whole of the assured person's life. Premiums may be fixed for an agreed period of time or may be payable throughout the life of the assured. This is more expensive than term assurance since all the policies eventually end in claims.
- **Endowment assurance**. The assurance company pays the benefits of the policy at an agreed date when the policy matures or earlier, on the death of the assured. Benefits may be a lump sum or an annual sum to be paid for a specified number of years or even for life.

  Endowment assurance and whole of life assurance are available with profits or without profits. With profits policies are more expensive, but the benefits are increased to give the policyholder a share of the profits earned by the fund.
- **Annuities**. Annuities are concerned with survival benefits rather than death benefits. On survival to a certain age, the benefits are paid to the policyholder him/herself either in the form of a lump sum or, more usually, a guaranteed income for life. Pension plans offer a form of annuity and life offices are heavily involved in this type of business.

5.6.4 Investment policy

Investment is an important part of insurance business and insurance companies hold a variety of assets including company securities, public sector securities, property and various mortgages and loans. Investment decisions and the range of assets held are greatly influenced by the liabilities incurred.

Insurance companies can reduce their risks by matching assets with liabilities and by holding a broad spread of investments. Life assurance and pension business is concerned with long-term liabilities and so life funds contain mostly long term assets.

5.6.5 Investment-based life policies

An endowment life assurance policy is a financial asset of the customer and represents a claim to future payment. It is not conditional in the sense that payment will be made by the maturity date at the latest. This is not the case with an insurance policy since payment is conditional on the insured event occurring and will not be made if that event does not take place. The longer an endowment policy runs, the more it increases in value which can be calculated.

Such a policy is mainly a long-term savings contract and is designed to run to its maturity date. Early withdrawal is possible, and there are the following several ways this can be done.

- **Convert the policy into a paid-up policy** – the policy continues in force until the original maturity date, but the sum assured is reduced and no further premiums are paid.
- **Surrender the policy for cash** – the policy is discontinued and the holder receives its surrender value based on the current value of the policy's share of the life fund, less all expenses such as commission and administration involved in setting up the policy. Surrendering a policy is a breach of the original contract and is not always allowed. As the early repayment of the policy might interfere with a life office's investment strategy and cause some disorientation of risk, the surrender value will be less than the accumulated premiums in most cases, in the early years considerably less.
- **Sell the policy** – the policyholder sells the policy to another party who will continue to pay the premiums and obtain the benefit at the end of the life of the policy. Although this may be a more lucrative way for the policyholder to raise cash, there will be qualifying criteria to meet, such as the length of time the policy has run for and a minimum level of current surrender value.

- **Use the policy as security for a loan** – most life offices would consider one of its own life policies as excellent security for a loan and would be willing to lend up to 90% of its surrender value. Most offices charge a commercial interest rate linked to banks' base rates. Banks are also willing to grant loans on the security of life assurance policies.

5.7 Pension funds

Pension funds have experienced a tremendous growth in the last forty years. Payments from these funds are used by the beneficiaries to supplement their state pension. In many respects, pension fund management is very similar to the life assurance business discussed earlier in this chapter since both are concerned with building up a substantial fund of assets to meet long term liabilities.

A fund's income consists of contributions from employers and employees as well as earnings from investments. Expenditure, apart from administration, consists mainly of payments to pensioners.

An important principle of a work-based ('occupational') pension fund is the separation of the fund's liabilities from those of the employer. A pension fund is established with a legal identity separate from the employer particularly so that, should the employer run into financial difficulties, the creditors would have no claim on the assets of the pension fund and pensions would be protected.

There are two types of funded pension scheme.

- **Insured schemes** – pension contributions are paid to a life assurance company which guarantees the future pensions. The life assurance fund is responsible for investing the funds and carries the actuarial risk. This is perhaps most attractive to small firms which do not wish to establish their own funds.
- **Self-administered schemes** – the pension fund itself carries the actuarial risk and is responsible for the level of pensions paid. Sometimes the management of a pension fund will be contracted out to professional investment managers such as life assurance offices or investment banks. In other cases, the trustees of a large pension fund may prefer to employ their own staff and manage investments themselves.

Registered pension schemes receive some tax concessions, thus it is not surprising that there are limits on the benefits which may be received. Although personal pension plans (which are **defined contribution** schemes) operate by different rules, the maximum pension which can be received in a final salary (or **defined benefit**) scheme is two thirds of final salary which is reduced if a lump sum is paid. The lump sum itself may be no more than one and a half times final salary. There are also limits on the amounts of **contribution** which may be paid into a pension scheme, generally based on the individual's income, subject to an overall limit.

5.8 Investment trusts

Although called 'investment trusts', these are public limited companies ('plcs') whose business is investment. As a plc, the company must comply with the same rules as other plcs: for example, it will have a Memorandum, and Articles of Association; it will also publish annual financial statements, which will be reported upon by an external auditor.

An investment trust raises funds by offering its own shares to investors. With the money raised, the trust will trade on the market with the aim of making a profit which can then be passed back to the investment trust's own shareholders by the payment of a dividend. The price of the investment trust's shares on the market is determined by the supply and demand for its shares on the market, just like any other company.

Investment trusts are called 'closed-ended funds' as the number of shares issued by the investment trust is fixed and can only be increased if the trust arranges a fresh issue of its own shares.

5.9 Unit trusts and OEICs

A **unit trust** is a trust in the strict legal sense and the idea behind it is that it pools the resources of many people and from this open-ended pool, the manager place the funds in a wide range of investments. Depending on the level of their contribution, investors will be given a registered certificate which shows that they have purchased a stated number of units in the trust.

Unit trust schemes operate under a **deed of trust**. The deed appoints a trustee, such as a bank, to oversee the operation of the scheme. The fund investments are controlled by a fund manager who is responsible for the investment and for valuing the assets in the portfolio and calculating the prices of the units.

There are no limits to the number of units that can be created, therefore unit trusts are often described as 'open-ended funds'. An **Open-Ended Investment Company (OEIC)** is similarly an open-ended scheme for collective investment, and unit trusts and OEICs are often together known as '**funds**'.

QUICK QUESTION

What is a central bank?

Write your answer here before reading on.

5.10 The UK's central bank

5.10.1 The UK's central bank

A central bank is responsible for overseeing the monetary system for a nation, or a group of nations. Central banks have various responsibilities, ranging from overseeing monetary policy to implementing specific goals such as currency stability, low inflation, and full employment. Central banks also generally issue currency, function as the banker of the Government, regulate the credit system, oversee commercial banks, manage exchange reserves, and act as a lender of last resort.

The central bank of the UK is the Bank of England which was established by Royal Charter in 1694 and was promoted by a Scot, William Paterson, who believed that a large joint stock bank with its greater capital would have a considerable advantage over the existing banks, which were actually goldsmiths who also provided banking services. The original intention was to operate as an ordinary commercial bank on a larger scale; only gradually did the Bank assume the functions now associated with central banking.

Under its Charter, the Bank of England was authorised to:

- Accept deposits and make loans
- Discount bills
- Issue notes.

In return for its Charter, the Bank made a loan to the Government of £1.2 million at 8% which was added to Britain's National Debt. The loan took the form of notes issued by the Bank. The Bank thus issued notes and made a profit by making loans in the form of bank notes which it persuaded the public to accept and to hold. In this respect the Bank of England was similar to the other banks of the time. For its part the Bank tried to get a monopoly of the right to issue notes. At various times, the Bank's Charter needed to be renewed which provided opportunities for the Government to increase its borrowing and for the Bank to strengthen its position.

Although the Bank of England was founded as a commercial bank, it differs from other banks in a number of ways.

- **A joint stock company.** The Bank of England was established as a joint stock company and its capital was raised by public subscription which gave the Bank an advantage over the existing private banks which were restricted to six partners and so limited in potential size. An Act in 1708 made the Bank the only joint stock bank allowed to issue notes in England. The Bank did not operate in Scotland and by 1746 Scotland had three joint stock banking companies issuing notes – Bank of Scotland, Royal Bank of Scotland, British Linen Company.
- **Limited liability.** The Bank of England was given the privilege of limited liability which limited the shareholders' liability for the Bank's debts in the event of failure to the amount they had paid for their shares. This reduced the risk of investing in the Bank and so made its shares more attractive.
- **The government's banker.** By granting a loan to the Government, the Bank of England established a special relationship which developed over the years as the Bank undertook new responsibilities such as the circulation of Exchequer bills and the issue of government securities. In 1751, the Bank undertook the administration of the National Debt. Despite the competition that the Bank posed, private bankers in London found it convenient to keep an account with it for their surplus funds, thus the Bank took a step nearer to becoming a central bank by acting not only as the Government's banker but also as the bankers' bank.

5.10.2 Bank Charter Act 1844

The principal aim of the 1844 Act was to control the money supply by regulating the issue of banknotes. This was achieved by placing a limit on the Bank of England's ability to issue notes unbacked by gold and by the gradual phasing out of private bank note issues in England and Wales.

To ensure the proper operation of the note issue, the Bank was reorganised into two departments:

- An Issue Department solely concerned with the note issue
- A Banking Department to carry out the Bank's normal commercial activities.

The Bank was required to redeem its notes for gold at a fixed price (£3.87 per ounce of gold), thus linking the pound sterling to gold.

5.10.3 The Bank and financial crises

During the 19th century, the Bank assumed another function of central banking by acting as the lender of last resort which involved the Bank in providing support to the banking/financial system when major financial panics occurred. In many instances this support resulted in the Bank discounting bills or extending loans against bills offered by banks in need of liquidity. This function of the Bank of England was seen in more recent times during the banking crisis of the late 2000s.

5.10.4 Nationalisation

In 1946, the Bank of England was nationalised and thus passed into public ownership. The Bank's shareholders were compensated with government stock. Public ownership was the culmination of years of close cooperation between the Bank and government.

The Bank often appeared to be as much the Government's agent as an independent bank. With the Government playing a much greater role in the management of the economy after 1945 it seemed inappropriate that the Bank should remain in private ownership.

5.10.5 The Court of Directors

Responsibility for governance of the Bank lies with the Court of Directors which consists of the Governor, two Deputy Governors (both appointed for a term of five years) and sixteen non-executive members (three-year term) appointed for their expertise and drawn widely from industry, commerce and finance. The non-executive members' main role is to review the performance of the Bank as a whole, including the work of the Monetary Policy Committee (MPC) (which sets the base interest rate).

The Bank is managed on a day-to-day basis by the Governor and the two Deputy Governors – one deputy works with the Governor on monetary stability and the other on financial stability. The Governor keeps a close liaison with the City – financial institutions and markets – and represents the Bank at international financial and monetary meetings.

5.10.6 The Bank of England's mission

The Bank has had **monetary stability** and **financial stability** as two core purposes. However, the Bank takes the view that these are not ends in themselves, but necessary pre-conditions for delivering the public good. For that reason, the Bank's previous commitment to two core purposes has been recast into one all-embracing mission which emphasises the contribution that delivering the Bank's statutory responsibilities makes to the end goal.

The Bank has re-stated its single **mission** as being: 'to promote the good of the people of the United Kingdom by maintaining monetary and financial stability'. This is just as it was in the Bank's original Charter of 1694 ('Now know ye, That we being desirous to promote the public good and benefitt of our people…').

The Bank's **monetary policy** objective is to deliver price stability and, subject to that, to support the Government's economic objectives including those for growth and employment. Monetary stability means stable prices and confidence in the currency. Stable prices are defined by the Government's inflation target, which the Bank seeks to meet through the decisions delegated to the Bank's **Monetary Policy Committee (MPC),** explaining those decisions transparently and implementing them effectively in the money markets.

The remit of the MPC, including the definition of the inflation target, is re-confirmed each year by the Chancellor.

Financial stability requires an efficient flow of funds in the economy and confidence in financial institutions.

This is pursued through:

- The Bank's financial operations, including as lender of last resort
- Decisions of the Financial Policy Committee (FPC)
- Prudential regulation of financial institutions by the PRA
- The Bank's role as resolution authority, and
- Bank oversight and regulation of key payment, clearing and settlement infrastructure.

The **FPC** takes action against systemic risks to protect and enhance the resilience of the UK financial system. This Committee of the Bank has a secondary objective to support the economic policy of the Government.

We have already outlined the role of the **Prudential Regulation Authority (PRA)**, which is a **subsidiary** of the **Bank of England**. The PRA is responsible for the supervision of around 1,700 banks, building societies, credit unions, insurers and major investment firms. The PRA has a general objective to promote the safety and soundness of these firms and – specifically for insurers – contributes to the protection of policyholders.

The Bank's accountability is ensured by the fact that the decision-making process is fully transparent and by the Government's overall accountability to Parliament for economic policy. The Bank makes reports and gives evidence to the House of Commons through the Treasury Select Committee.

QUICK QUESTION

What are the main functions of the Bank of England?

Write your answer here before reading on.

5.10.7 Functions of the Bank of England

As the UK's central bank, the Bank undertakes a number of important domestic and external functions on behalf of the Government and other financial institutions, are as follows.

- **Government's banker**. The Bank of England keeps the Government's bank accounts. The main government account is the Exchequer Account into which nearly all government receipts are paid and out of which nearly all payments originate. The Bank also keeps the accounts of government departments.

  Revenue flows very unevenly into the Exchequer and on occasions is inadequate to meet current government expenditure. The Treasury has then to make arrangements to bridge the gap between the inflow of revenue and the outflow of expenditure by advances from the Bank or by the issue of Treasury bills.

  The Bank provides temporary finance at market interest rates to the Government by 'ways and means advances' which are often not very large and are provided as an overnight facility. The Bank also advises the Government on economic, financial and monetary matters.

- **Bankers' bank**. The main clearing banks find it convenient to keep part of their cash reserves in operational accounts at the Bank of England. These banks constantly need to make and receive payment from one another due to the operation of the clearing system and these payments are made through the banks' accounts with the Bank of England. The banks need to keep these balances large enough to cover their needs and are expected not to overdraw.

- **Issue of notes**. The Bank is the sole bank of note issue for England and Wales. Scottish and Northern Ireland banks issue their own notes under strict regulation and, once in circulation, must be covered by Bank of England notes.

  There is now no gold backing of notes issued which means that the UK note issue is a fiduciary one, as the note issue is based purely on faith that notes will be acceptable to UK residents in settlement of debts at all times. Notes cannot be exchanged at the Bank of England for gold coins or bullion. As is to be expected with inflation, the note issue has increased over the years.

- **Implementation of monetary policy**. Since 1997, the Bank has implemented interest rate policy which takes account of the current/prospective inflation rate, the level of monetary demand and money supply growth in the economy. Apart from influencing base interest rate changes, the Bank can alter the cash deposit ratio on banks in order to effect changes on credit supply (loans) and/or terms made available by banks to their customers. Ultimately all deposit takers are affected by such action.

- **Lender of last resort.** The Bank occasionally acts as a lender of last resort to individual banks or the banking system which generally involves the provision of liquidity, sometimes at a penal interest rate, secured by first class bills and securities. By undertaking this role, the Bank endeavours to stabilise the banking and financial system and thereby prevent financial panics and depositor runs on banks.

- **International relationships.** The Bank cooperates with the principal central banks of the world, such as US Federal Reserve Banks, European Central Bank and others, and takes part in the work of the International Monetary Fund, Bank for International Settlements and the World Bank.

  It also provides services (gold and foreign exchange business) for the central banks of some Commonwealth countries. The Bank can arrange loans from overseas when necessary in order to add to the UK's foreign currency reserves, thereby increasing confidence in sterling on the world's foreign exchange markets.

- **Manages the Exchange Equalisation Account (EEA)**. The EEA was established in 1932 to stabilise the pound's exchange rate in relation to other currencies and consists of the UK's gold and foreign currency reserves (US dollars, euros, Japanese yen) which technically belong to the Treasury. The EEA is managed on behalf of the Treasury by the Bank.

  If there is a temporary fall in the pound's exchange rate, the Bank can buy pounds using its foreign currency reserves on the foreign exchange market to bid up the pound. When the pound is too high, the Bank can sell pounds for foreign currencies and so force down sterling's exchange value. This process is known as official intervention in the foreign exchange market.

- **Private banking**. The Bank has some old-established private banking customers, as well as staff members and pensioners as customers. The general public cannot open accounts at the Bank.

5.10.8 The Bank of England Act 1998

The main provisions of this Act are as follows.

- The monetary policy objectives of the Bank as set out in statutory form are to maintain price stability and support the Government's economic policy.
- A Monetary Policy Committee was established which has responsibility for formulating monetary policy within the Bank.
- A new accountability framework for the Bank based on its statutory duties. The need for greater transparency in the Bank's operations was also identified.
- The Bank's function in relation to the supervision of UK banks was transferred to the FSA.

These were quite sweeping changes and marked a fundamental shift in the Bank's operational and supervisory roles from the position it occupied prior to this Act. Apart from the Bank's statutory responsibility for monetary policy, the most significant step was the transfer to the FSA of responsibility for bank supervision.

6 The economic environment

6.1 Introduction

Traditionally, governments will focus on the well-being of the people that they govern, the idea being that if the electorate is happy with its lot, it will re-elect the existing government. An important indicator of how people are faring is the state of the economy, as a strong economy indicates that the households and firms within the economy are enjoying a good standard of living and, to maintain this, the Government will do all in its power to stimulate economic growth.

6.2 The role of government

Macroeconomics is the study of how a national economy works and the interaction between economic growth in output and national income, employment and the general level of prices. A macro-economy consists of all the different markets for goods and services, labour, finance, foreign exchange and other traded items. Changes in the behaviour of producers and consumers in individual markets will therefore have an effect on the macro-economy and the rate of economic growth, inflation, employment and trade.

Most national governments share similar macroeconomic objectives:

- Low and stable price inflation
- A high and stable level of employment
- Economic growth and prosperity
- Favourable balance of international payments

Governments use policy instruments, including taxes and regulations, to help achieve their objectives through the impact they have on the actions of producers and consumers.

Government has a key role in the regulation of the financial services industry, with the key regulatory bodies being the Prudential Regulation Authority, the Financial Conduct Authority, the Bank of England, and HM Treasury.

6.3 Fiscal policy and monetary policy

There are two types of policy that the Government uses to control the economic environment.

- **Fiscal policy**. This covers the Government's spending activities, for example through capital projects, welfare payments, and defence spending. To do this, the Government must collect money in, through levying tax and borrowing funds. The annual budget outlines this policy. If the Government spends more than it collects, this is a **budget deficit**; if the Government spends less than it collects, this is a **budget surplus**. Another factor to consider is that if the Government collects tax from firms and households, this reduces the purchasing power of these firms and households.
- **Monetary policy**. This is where the Government or the central bank seeks to control the price and the supply of money circulating in the economy. **Interest rates** represent the cost or price of money. The movement of base rate will affect other interest rates and thus can affect the demand for money in the economy.

  To encourage economic growth, the central bank may create or 'print' more money to stimulate spending and the economy but, if this is not controlled, it can lead to higher inflation. The Bank of England eased monetary conditions in 2009 and subsequently under the banner of 'quantitative easing'.

  The central bank can also seek to dampen the economy by taking money out of the system, for example to reduce inflation and raise currency values, although this risks leading to economic slowdown.

6.4 Inflation and interest rates

Inflation is an increase in the general price level over time. The term describes the situation where the prices of goods and services increase in a sustained manner.

Inflation can be measured by a range of indicators. The most commonly used measure in the UK is the **Consumer Prices Index (CPI)**. This is calculated by sampling the prices of various goods and services each month. As we all buy different baskets of goods and services from one another, and indeed our patterns of expenditure change over time, inflation has different effects on different people, as well as on our own situation over time.

Consider the effects of inflation on savers. If the amount of money we have is falling in value, theoretically we should save less and hold more in assets that will retain their value. This may or may not be the case:

- Those who hold savings for precautionary reasons, that is 'for a rainy day', may anticipate that their savings will no longer be able to cope with future needs and will therefore top up their savings.

- Those who hold savings in order to buy something in the future may save less and spend immediately, as they anticipate that they may not be able to afford the intended purchase later on.

Until 1977, successive UK Governments were committed to full employment in the economy. The UK came out of the Second World War with fresh memories of the great depression of the 1930s, so governments took it on themselves to ensure that the mass unemployment of those times would not recur.

However, during the 1970s the UK economy nearly collapsed due to problems of failing competitiveness, increasing industrial and social unrest, and rising inflation. The level of inflation during the 1950s had been typically 2% per year, but this rose to 24% in 1973 and peaked at 32% shortly afterwards. This destroyed the value of savings balances, created massive uncertainty and exacerbated the problems confronting the already ailing economy.

An economic crisis from 1975 to 1977 meant that the Government had to take a radically new approach to economic policy. Controlling inflation became the main economic target, and full employment as a primary goal was sacrificed. At the time of the general election of 1979, inflation remained at 18%. The 1980s saw a steady decline in the level of inflation but also a worrying rise in unemployment.

The shift in the focus of government policy away from full employment and towards controlling inflation is of direct relevance to financial institutions. Many of the products and services of financial institutions are priced by interest rates. In turn, the general level of interest rates in the economy is set by the Bank of England's Monetary Policy Committee on behalf of the Government: this has a direct impact on the prices that can be charged by financial institutions, or paid to investors.

Today, the Government sets a **target for inflation** and it is the role of the Monetary Policy Committee of the Bank of England to try to bring inflation close to the target.

- Currently, price stability is defined by the Government's inflation target of **2%**. The inflation target of 2% is expressed in terms of an annual rate of inflation based on the Consumer Prices Index (CPI). The remit is not to achieve the lowest possible inflation rate. Inflation below the target of 2% is judged to be just as bad as inflation above the target. The inflation target is therefore symmetrical.
- If the target is missed by more than **1 percentage point on either side** – ie, if the annual rate of CPI inflation is more than 3% or less than 1% – the Governor of the Bank of England must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent and what the Bank proposes to do to ensure inflation comes back to the target.

Interest rate policy is particularly important in the UK because most savers and borrowers enter into contracts that are subject to variable rates. Even 'fixed rate' mortgages are fixed only for an initial period of time. By contrast, savers and borrowers in continental Europe and in the US are much more used to fixed rate products. This is one reason why the Government would be taking a significant political risk in joining the Eurozone, as control of interest rates would pass to the European Central Bank.

QUICK QUESTION

What is a common measure used to report the state of the economy?

Write your answer here before reading on.

Pause for thought ...

In what ways do changes in the inflation rate affect your daily living?

In what ways do changes in interest rates affect your daily living?

6.5 Gross domestic product (GDP)

One way of gauging the state of the economy is through the growth in gross domestic product (GDP). GDP is a measure of the market value of all the goods and services produced within a country during any given year. If GDP is growing, the economy is said to be expanding; on the other hand if GDP is falling, the economy is contracting. If an economy has two or more quarters of negative GDP growth it is said to be in recession. A sustained recession is called a depression.

GDP can be measured in total terms or total GDP may be divided by the number of people in a country to give GDP per capita. For example, in 2005, the US topped the global GDP charts with 28% of the world's total GDP. However, if we look at GDP per capita, then the US drops to eighth on the list, with Luxembourg topping the list.

The performance of an economy can be assessed by such indicators as:

- Unemployment – what percentage of the population is out of work?
- Payrolls – how many jobs are being created? Are these permanent, full time jobs or more temporary positions?
- Industrial production – are factories producing more or fewer products?
- Retail sales – are households more or less economically active and what are the reasons behind this?
- New housing developments – the building trade is an important indicator of economic activity. Usually the demand for new housing falls as the economy enters a recession (due to low levels of consumer confidence) and the subsequent recovery can be well advanced before demand for housing begins to pick up again.
- Trade deficit – do imports exceed exports?
- Budget deficit – is the Government overspending?

- Consumer confidence – do households plan to keep spending?
- Business confidence – do firms plan to expand?

7 Financial markets

A market is simply where buyers and sellers of goods and services come together. The world-famous street market in Portobello Road in London's West End is an example of a market, where buyers and sellers physically come together to trade in an eclectic range of goods. There are many markets today where the buyers and sellers do not normally conduct transactions while they are in the same physical location – examples would include the stock market, and eBay.

Financial markets provide for buyers and sellers of financial products come together to trade in financial securities. The players can be the Government, or institutions from the private sector, or individuals, all sharing a common interest in trading, whether to raise or buy capital, and thereafter to trade in them.

Within financial markets, there are two different types of market:

- Primary markets, and
- Secondary markets

A **primary market** is where new issues of shares or other forms of security are offered to the market for the first time. For example, if the Government is seeking to fund a road building project, it may choose to finance this project by borrowing the necessary funds on the market. To do this, they will issue Government securities. Perhaps you have heard of Treasury Stock or Exchequer Stock: these are examples of Government securities. These are often referred to as 'gilt-edged' securities or 'gilts'. The probability of the Government defaulting on their obligation to repay such stock is effectively nil, and so the risk of default is deemed to be negligible. This method of raising funds has been used since 1693. Similarly, if a business is seeking to raise capital, it may choose to do this by either issuing new shares (equities) or bonds to the market, usually by using the services of an investment bank or issuing house.

A **secondary market** is where these securities are traded after their initial issue. It is easiest to think of the secondary market as a 'second-hand' market, where securities that have already been issued through the primary market are traded in again. The Stock Exchanges in London, New York and Tokyo are all examples of secondary markets.

Pause for thought …

In what ways does your bank interact with the UK financial markets?

8 The UK and the City of London in Europe

The UK – and the City of London in particular – is a key player in the global financial market. The City is host to a huge number of overseas banks and plays an important role in facilitating the flow of capital around the globe, in both the developed and the developing world.

There are a number of reasons why the UK has developed to play such a pivotal role, including its history of being an open market economy with a pool of talented people available. Its regulatory, accounting and legal frameworks have also contributed to this development, as well as the long term-stability and predictability of its tax regulations. Key sub-sectors include banking, insurance, and asset management. The fact that English has developed as the international language of business has also been a contributing factor.

While the UK is a significant player in the global financial market, it does not operate alone. In recent years global financial markets have grown considerably. As a result, a number of overseas companies raise capital in the UK and have this capital traded in London. On the other hand, some UK companies will choose to seek capital from overseas markets, for example, by raising Eurobonds.

Now that many trade barriers between European countries have been removed, individuals are free to choose the financial products and services from any providers in the EU. UK-based financial services providers can either set up European subsidiaries or market their products directly.

Much UK financial services regulation originates in the EU. The EU is also very active in developing rules for Europe's financial markets that are designed to deepen the internal market. Since the UK has to give effect to European law, active engagement with Europe is essential. Indeed, around 70% of the policymaking effort of the UK Financial Services regulators, currently the FCA and the PRA, is driven by European initiatives, including the Financial Services Action Plan (FSAP).

It is crucial that the standards developed in international forums are proportionate and informed by economic analysis. Otherwise, better regulation domestically would be more difficult to achieve.

There has been specific EU legislation promoting the single market since the 1980s. However, there was a step change when the FSAP was launched in 1999. It consists of 42 measures, including 24 EC Directives to be transposed into the law of each Member State, and Regulations, which apply directly in all Member States.

The FSAP has three specific objectives:

- To create a single European wholesale market
- To achieve open and secure retail markets
- To create state-of-the-art prudential rules and structures of supervision

These objectives are designed to promote Europe's wider economy by removing barriers and increasing competition among financial services firms, thereby making markets more efficient and reducing the cost of raising capital to industry generally.

Since 1999 the EU has adopted or updated requirements concerning, amongst others:

- The amount of capital which firms should hold
- The rules they must comply with when carrying on business with their customers
- The controls they must apply to counter the risk of money laundering and terrorist financing
- The tests to apply when assessing the suitability of new controllers or large shareholders
- The requirements they must impose to counter the risk of market abuse
- The disclosures which companies must make when seeking new capital

Completion of the FSAP within a tight deadline was accompanied by a new legislative approach to developing and adopting EU financial services legislation.

Pause for thought …

In what ways does your bank interact with the EU and international markets?

KEY WORDS

Key words and phrases from this chapter are given below. Make sure you know what they mean and add any other words or phrases that you want to remember. You can use the space provided to write your own revision notes.

- Definition of a bank
- Commercial banking
- Investment banking
- Bancassurance
- Purpose and functions of a bank
- Financial intermediary
- Liquidity
- Profitability
- Other providers of financial services
- UK central bank
- Fiscal and monetary policy
- Gross domestic product
- Financial markets

REVIEW

To help you reflect on and review the content of this chapter, give some thought to the following questions.

- What is the difference between commercial banking and investment banking?
- What is the difference between retail banking and wholesale banking?
- What is meant by 'bancassurance'?
- What is the purpose of a bank for deposit customers?
- What is the purpose of a bank for credit customers?
- In what way does a bank function as a financial intermediary?
- In what way is there a conflict between the bank's duties to its savers and borrowers? (Consider the need for both liquidity and profitability.)
- What are three ways that a bank makes its money?
- What role does the bank play in society?
- How did banking in the UK develop?
- In reviewing the content of this chapter, and reflecting on your own role and experience, what do you consider to be key features of the business and economic environment in which your bank operates?
- Apart from banks, what other types of financial services organisations operate in the business environment?
- What are the main functions of the Bank of England?
- What role does government play in the economy?
- What is the difference between fiscal and monetary policy?
- What is meant by inflation?
- What impact might changes in interest rates have on savers?
- What is the significance of Gross Domestic Product in an economy?
- What are the key indicators that can be used to assess the performance of an economy?
- What is the difference between a primary and secondary financial market?