BANKING

BANKING

An introductory text

PHILIP MOLYNEUX

M
MACMILLAN

© Philip Molyneux 1990

All rights reserved. No reproduction, copy or transmission of this publication may be made without written permission.

No paragraph of this publication may be reproduced, copied or transmitted save with written permission or in accordance with the provisions of the Copyright, Designs and Patents Act 1988, or under the terms of any licence permitting limited copying issued by the Copyright Licensing Agency, 33-4 Alfred Place, London WC1E 7DP.

Any person who does any unauthorised act in relation to this publication may be liable to criminal prosecution and civil claims for damages.

First published 1991

Published by
MACMILLAN EDUCATION LTD
Houndmills, Basingstoke, Hampshire RG21 2XS
and London
Companies and representatives
throughout the world

Edited and typeset by
Povey/Edmondson
Okehampton and Rochdale, England

British Library Cataloguing in Publication Data
Molyneux, Philip

Banking: an introductory text.

1. Great Britain, Banking

I. Title

332.10941

ISBN 978-0-333-54120-3 ISBN 978-1-349-21153-1 (eBook)

DOI 10.1007/978-1-349-21153-1

CONTENTS

List of figures	ix
List of tables	x
Preface	xii
Acknowledgements	xiii
1 General Description of the UK Financial System	1
Institutional Structure	1
Deposit-taking Institutions	2
Reporting banks	2
Other deposit-taking institutions	7
Other institutions and markets	8
Non-bank financial intermediaries	8
UK financial markets	9
References and further reading	14
2 Analysis of the Evolution of UK Markets and Financial Intermediaries	15
Introduction	15
Role of Financial Intermediation	15
Evolutionary Forces During the 1980s	17
Market environment and demand factors	17
Supply factors	23
References and further reading	30
3 Claims, Financial Intermediation and the Development of Financial Systems	31
Introduction	31
Financial Claims and Financial Intermediation	31
Financial claims	31
Financial intermediation	33
The Development of the Financial System	36
References and Further reading	40

4	The Classification of Financial Institutions	41
	Introduction	41
	Ways of classifying financial institutions	41
	What is a bank?	46
	Different types of UK financial institutions	47
	References and further reading	47
5	The Concept of Money and how Banks Create Deposits	48
	Introduction	48
	The concept of money	48
	What is money?	48
	What function does money perform?	49
	What are the necessary attributes of money?	50
	How can we measure money?	51
	Why do people/economic units hold money?	55
	The credit multiplier or how banks create deposits	56
	The credit multiplier and leakages from the banking system	59
	How useful and how relevant is the concept of the credit multiplier?	61
6	Major Services Provided by UK Deposit Banks	62
	Introduction	62
	UK payment clearing systems	62
	The UK payments clearing system since December 1985	63
	Non-cash methods of payment	65
	Cheque payments	65
	Giro payments	66
	Standing orders	66
	Direct debits	66
	Plastic cards	66
	Electronic funds transfer	68
	Deposit and lending facilities	70
	Deposits	70
	Lending facilities	72
	Branching and delivery systems	75
	Other services	77
	References and further reading	78
7	Characteristics of UK Deposit Banks	79
	Introduction	79
	The deposit or retail banks' balance sheet structure	79
	Clearing banks' balance sheet structures	81
	Branching and staffing	83

Costs, income and profitability characteristics	85
A note on market shares	89
Current issues facing UK banks	90
References and further reading	92
 8 The Central Bank and Bank Regulation	 93
Introduction	93
Functions of a central bank	93
The Bank of England	95
Constitution of the Bank	96
Functions and organisational structure of the Bank of England	96
Banking supervision, operations and corporate services	96
Finance and industry	97
Policy and markets	97
Banking role of the Bank of England	98
National debt management	98
Production and distribution of bank notes	99
Lender-of-last-resort	99
Foreign exchange transactions	100
Monetary policy	100
Banking regulation in the United Kingdom	102
Why regulate banks?	102
Scope of bank supervision	103
Tools of supervision	104
Domestic bank supervision	105
UK bank regulation – the international dimension	111
The Basle proposals and EC legislation	112
References and further reading	119
 9 Recent Trends and Developments in Banking	 120
Introduction	120
Forces generating change	120
Competition	120
Regulation	122
Financial innovation	124
Technology	127
Current trends and strategic issues facing banks	131
Internationalisation	131
Universalisation	132
Securitisation	132
Globalisation	132
Conglomeration	133
Concentration	134
References and further reading	135

10 Money Markets and International Banking	136
Introduction	136
London sterling money markets	136
Characteristics of money market activities	136
The London money markets	136
The discount market	137
The parallel sterling money markets	139
Treasury bill market	139
Local authority market	139
Sterling acceptance market	141
Sterling interbank market	141
Other markets	142
The Eurocurrency markets	143
Historical development	143
Nature of the eurocurrency markets	145
A note on the development of the eurobond market	146
Regulation of the eurocurrency markets	147
International banking	148
Foreign exchange markets	150
Why is the market so large?	152
International financial centres	153
The international debt problem	154
References and further reading	155
11 European Financial Services and 1992	156
Introduction	156
EC Legislation and 1992	156
Financial services in the EC – the impact of completing the internal market	158
Banking products and services	161
References and further reading	166
12 Banking in the European Community and the Role of Large Banks up to 1992	167
Introduction	167
Banking in the European Community	167
EC banking markets: an overview	167
The role of large banks	171
The structure and performance characteristics of the largest banks in the EC	171
Ownership of the top banks in the EC	172
Conclusion	176
References and further reading	177
Glossary of terms	178
Index	188

LIST OF FIGURES

3.1	The link between borrowers and lenders	34
3.2	Financial intermediation	35
3.3	Primary and secondary securities	39
5.1	Relationships among the monetary and liquidity aggregates and their components prior to May 1987	53
5.2	Relationships among monetary aggregates and their components after May 1987	54

LIST OF TABLES

1.1	Reporting banks' total assets and sterling deposits, December 1979 and December 1989	3
1.2	Total assets of the major non-bank financial intermediaries, December 1983–December 1989	8
1.3	Share ownership by investor type, 1963, 1984 and 1987	11
2.1	Net lending for house purchase by retail banks and building societies, 1978–87	19
2.2	Distribution of deposits: holdings of UK residents with principal institutions in the United Kingdom	19
2.3	Clearing banks and UK merchant banks after 'Big Bang'	24
2.4	Top 20 UK building societies: profile of services (excluding mortgages)	26
2.5	'Retail banking' and other consumer financial services of non-bank financial intermediaries	27
5.1	The case of a single bank under a 10 per cent cash ratio	56
5.2	The banking system under a 10 per cent cash ratio	58
6.1	Membership of APACS and the operational clearings, July 1987	64
6.2	Growth in payments, 1980–87	65
6.3	Sources of consumer funds	71
6.4	Commercial lending share in Europe by 1995	74
6.5	Growth in the number of ATMs installed in Europe	75
7.1	Retail banks' balance sheet, 31 December 1987	80
7.2	Total assets of main UK banks	81
7.3	International assets as a percentage of total assets	82
7.4	Balance sheet breakdown of individual UK banks, 1987	83

List of tables

xi

7.5	Staffing levels and branch numbers of the UK clearing banks	85
7.6	Non-interest income as a percentage of total income	87
7.7	Profits of the UK deposit banks	88
7.8	Market shares: sterling deposits and sterling advances	90
8.1	The Basle proposals – definition of capital included in the capital base (to apply at end-1992)	115
9.1	Banking services based on electronic technology	130
9.2	Assets and deposits concentration measures	134
10.1	Important features of sterling money market instruments	140
10.2	Average daily foreign exchange turnover by currency in 1986	151
11.1	Economic aspects of the European financial services sector	159
11.2	Estimate of potential falls in financial product prices as a result of completing the internal market	161
11.3	Estimated gains resulting from the indicative price reductions for financial sectors	162
11.4	Estimate of potential falls in individual financial product prices as a result of completing the internal market	163
11.5	Attractiveness of European markets	164
12.1	Market concentration and size of banking sectors in the EC, 1986	169
12.2	Structure and performance characteristics of the top banks in the EC for 1987	170
12.3	Statistical summary of the ownership of top banks in the EC, 1987	173
12.4	Potential big bank acquisition targets in the EC up to 1992	174

PREFACE

Banking markets have witnessed considerable change over the last decade and the pace of change will no doubt continue given 1992 and the inevitability of a single European banking market. The aim of the text is to provide a detailed coverage of the UK banking and financial system together with an overview of various theoretical issues relating to banking. In addition this text analyses the main trends and developments affecting UK and European banks. The first half of the book concentrates on the UK financial system and various theoretical issues whereas the second part places greater emphasis on various international aspects, especially the implications of 1992. In particular, Chapter 8 examines the main regulatory issues facing UK and European banks, Chapter 9 covers recent trends and developments in banking, Chapter 10 looks at money markets and international banking and the final chapter examines in detail the main characteristics of European Community banking markets.

The bulk of this book is based on my first-year undergraduate lecture notes for banking and finance students at the University College of North Wales, Bangor. Many thanks to Helen Treece for doing an effective job on a difficult manuscript and to the staff of the Institute of European Finance for the time and resources they afforded on work relating to this text. Finally, I wish to thank Delyth, Lois and Rhiannon, without whose encouragement and understanding this text would never have been completed.

PHILIP MOLYNEUX

ACKNOWLEDGEMENTS

The author and publishers are grateful to the University of London External Advisory Service for copyright permission to reproduce some of the author's lecture notes that have appeared in a different form in their *BSc (Economics) Degree Banking One Study Guide*; and to the editors of *Regional Studies* for use of part of an article that appeared in the December 1989 issue (used in the final chapter of this text).