UK FINANCIAL INSTITUTIONS AND MARKETS

UK FINANCIAL INSTITUTIONS AND MARKETS

**MICHAEL PAWLEY
DAVID WINSTONE
PATRICK BENTLEY**

M
MACMILLAN

© Michael Pawley, David Winstone and Patrick Bentley 1991

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, 90 Tottenham Court Road, London W1P 9HE.

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 in 1991 by
MACMILLAN EDUCATION LTD
Houndmills, Basingstoke, Hampshire RG21 2XS
and London
Companies and representatives
throughout the world

ISBN 978-0-333-55536-1 ISBN 978-1-349-21660-4 (eBook)
DOI 10.1007/978-1-349-21660-4

A catalogue record for this book is available
from the British Library.

Typeset and illustrated by
TecSet Ltd, Wallington, Surrey.

For our parents

CONTENTS

List of Figures	xii
List of Tables	xiv
1 Introduction	1
<i>Michael Pawley</i>	
2 Financial Intermediation	6
<i>Michael Pawley</i>	
2.0 Introduction	6
2.1 Financial Intermediation	6
2.2 Maturity Transformation	9
2.3 Risk Pooling	10
2.4 Aggregation of Savings	10
2.5 Reduction in Transactions Costs	11
2.6 Disintermediation	11
2.7 Flow of Funds	13
3 Interest Rates	19
<i>Michael Pawley</i>	
3.0 Introduction	19
3.1 The Spectrum of Interest Rates	19
3.2 Nominal and Real Interest Rates	22
3.3 The General Level of Interest Rates	22
3.4 The Term Structure of Interest Rates	27
3.5 Theories of the Term Structure	29
4 The UK Banking Sector	31
<i>David Winstone</i>	
4.0 Introduction	31
4.1 Banks	32

4.2	Discount Houses	38
4.3	British Merchant Banks	39
4.4	Overseas Banks	40
4.5	Prudential Supervision	40
4.6	Capital Adequacy, Bank Operations and Profitability	44
4.7	Bank Liquidity Requirements	44
4.8	Banking and Europe 1992	45
5	Building Societies	48
	<i>Michael Pawley</i>	
5.0	Introduction	48
5.1	The Effect of the Cartel on Building Society Operations	52
5.2	Competition	55
5.3	Profits/Surplus	66
5.4	Capital and Liquidity	69
5.5	1992	71
6	Insurance	73
	<i>Patrick Bentley</i>	
6.0	Introduction	73
6.1	General Insurance	73
6.2	Long Term Insurance	74
6.3	Statutory Classification of Insurance	75
6.4	Insurance Suppliers	76
6.5	The Need for Insurance	77
6.6	Factors Influencing the Price of Insurance	79
6.7	Profitability	81
6.8	Market Share	88
6.9	Asset Portfolios	91
6.10	Reinsurance and Coinsurance	94
6.11	Supervision of Insurance	97
6.12	EC and Insurance	101
6.13	Conclusion	103
7	Non-Bank Financial Intermediaries	105
	<i>Michael Pawley</i>	
7.0	Introduction	105
7.1	Unit Trusts	105

7.2	Investment Trusts	111
7.3	Pension Funds	117
7.4	Venture Capital	124
7.5	Finance Houses	128
7.6	National Savings	130
7.7	Various Schemes	132
8	The Bank of England	137
	<i>Michael Pawley</i>	
8.0	Introduction	137
8.1	Functions and Structure	137
8.2	Powers/Changing Role	146
8.3	Independence of the Bank of England	146
9	Sterling Money Markets	150
	<i>David Winstone</i>	
9.0	Introduction	150
9.1	The Discount and Parallel Markets	151
9.2	Price/Yield Relationships of Financial Instruments	153
9.3	Money Market Instruments	160
9.4	Treasury Bills—Institutional Arrangements	161
9.5	Certificates of Deposit	162
9.6	Bills of Exchange	164
9.7	Local Authority Market	169
9.8	Finance House Market	170
9.9	Sterling Inter-Bank Market	170
9.10	Central Money Markets Office	171
9.11	The Role of the Bank of England in the Sterling Money Markets	172
9.12	Money Market Interest Rates and Base Rate	180
9.13	Minimum Lending Rate	184
10	Euro-Currency	185
	<i>David Winstone</i>	
10.0	Definitions	185
10.1	Understanding Eurocurrency	187
10.2	Eurocurrency and Credit Creation	190
10.3	Eurocurrency Statistics	194
10.4	Pattern of Activity in the Eurocurrency Market	194

10.5	Eurocurrency Interest Rates and Forward Exchange Rates	198
11	The Stock Exchange	203
	<i>Michael Pawley</i>	
11.0	Introduction	203
11.1	The Role of the Stock Exchange	203
11.2	Big Bang	205
11.3	Issue Costs	208
11.4	Breadth and Depth	212
11.5	Spreads and Turnover	213
11.6	Recent Developments: Dealing Changes	219
11.7	Settlement Procedures	220
11.8	The 1987 Crash and Market Efficiency	221
11.9	Stock Market Regulation	226
11.10	Insider Dealing	227
11.11	Prudential Regulation	228
11.12	Takeover Regulation	229
11.13	Overseas/European Competition	230
11.14	The Gilt-Edged Market	232
12	The Regulatory Framework	235
	<i>Michael Pawley</i>	
12.0	Introduction	235
12.1	The Need for Regulation	235
12.2	Investor Protection	239
12.3	Over-Regulation?	243
12.4	The Core Rules	252
12.5	Prudential Regulation	254
12.6	Systemic Risk	256
12.7	Harmonisation of European Regulation	259
13	Current Issues/Trends	264
	<i>Michael Pawley</i>	
13.0	Introduction	264
13.1	Conglomeration	264
13.2	Securitisation	270
13.3	Globalisation	273

13.4	1992	275
13.5	Financial Innovation	285
13.6	Short Termism	290
Index		296

LIST OF FIGURES

2.1	Financial intermediation	7
2.2	The risk/return trade-off	8
2.3	Disintermediation – inter-company market	11
2.4	Disintermediation – pre-Big Bang	12
2.5	Disintermediation – post-Big Bang	12
2.6	Financial intermediation and flow of funds	12
3.1	Loanable funds	23
3.2	Loanable funds: excess supply	24
3.3	Loanable funds: excess demand	24
3.4	Liquidity preference theory	26
3.5	Liquidity preference theory: a fall in the supply of money	26
3.6	Representative yield curves (gilts)	28
3.7	Yield curves and expectations	28
5.1	Effect of the cartel on mortgage supply	54
8.1	Organisation of the Bank of England	138
9.1	Treasury bill prices	157
9.2	Treasury bill prices following a change in yield	158
9.3	Creation of a bill of exchange	165
9.4	Creation of a bank bill	169
9.5	Liquidity Adjustment, closed economy	175
9.6	Liquidity Adjustment, open economy	175
11.1	Commission rates 1980–9	215
11.2	Average best touch 1987–9	216
11.3	UK equity average daily turnover customer business 1965–89	218 222
11.4	Settlement procedure (stylised)	
12.1	Regulation (simplified)	238
12.2	Evolution of the Financial Services Act	239
12.3	Investor protection framework	244
12.4	Regulators framework (simplified)	245

13.1	Off and on-balance sheet banking	271
13.2	Globalisation of financial markets	273
13.3	Competitive matrix 1992	283
13.4	Competitive matrix 1992	284
13.5	Financial innovation	286
13.6	A 'classical' swap	289

LIST OF TABLES

2.1	Personal sector financial transactions	14
2.2	Selected transactions of industrial and commercial companies	15
2.3	Other financial institutions' sources and uses of funds	16
2.4	Selected overseas sector financial transactions	17
4.1	The UK banking sector	31
4.2	Deposit balances end-June 1990 of groups of institutions within UK banking sector	32
4.3	Retail banks	33
4.4	Balance sheet (selected items) banks in the UK	34
4.5	Lloyds, Natwest, Barclays, Midland	38
4.6	Members of the London Discount Market Association	39
5.1	Building societies' assets and liabilities	49
5.2	Loans for house purchase	50
5.3	Personal sector liquid assets	51
5.4	Building societies: progress	52
5.5	Regulatory matrix for banks and building societies 1974	58
5.6	Building society retail and wholesale funding	61
5.7	Regulatory matrix for banks and building societies 1980	63
5.8	Market share of personal sector liquid assets	65
5.9	Loans for house purchase: market share	66
5.10	Minimum acceptable capital ratios	70
6.1	Statutory classification of insurance	75
6.2	Overall trading profit of world-wide general insurance ABI member companies	82
6.3	Non-life underwriting losses	82
6.4	Companies' investment income	84
6.5	Lloyds' capacity and profits	85

6.6	Lloyds' profitability by class	87
6.7	Lloyds' global accounts 31.12.84	89
6.8	Largest UK companies' world-wide premium income	89
6.9	Proportion of all company premiums controlled by largest companies	90
6.10	Investments life and general insurance 1988–9 ABI member companies	92
6.11	Sample of life reinsurers premium incomes	97
7.1	Unit trust industry statistics	108
7.2	UK unit trusts: assets and liabilities	109
7.3	UK unit trusts: asset distribution holdings	110
7.4	UK property unit trusts: aggregate assets	110
7.5	Investment trusts: aggregate assets	113
7.6	Investment trusts' asset distribution	114
7.7	UK investment trusts: medium and long-term liabilities and capital	115
7.8	UK pension funds: assets portfolio holdings	120
7.9	Selected asset holdings of pension funds	121
7.10	UK pension funds: analysis by type of fund	122
7.11	Venture capital investment in the UK (numbers)	126
7.12	Venture capital in the UK (amount)	127
7.13	Non-bank credit companies: aggregate balance sheet	131
7.14	National Savings	133
8.1	Assets and liabilities of the Bank of England	139
9.1	Discount market and parallel market	152
9.2	Treasury Bill prices according to maturity	156
9.3	Calculation of new Treasury bill prices following a change in yield	159
11.1	Total sums raised via initial public offers	209
11.2	Initial public offers 1985–9	210
11.3	Direct costs of initial public offers	210
11.4	Admission requirements for ISE markets	211
11.5	Average spreads	217
11.6	History of UK equity market makers	217
11.7	Financial results of all ISE member firms	219
11.8	International market statistics	231
11.9	Share classifications	233
13.1	Percentage differences in prices of standard final products in EC	276-277