Economics

Theme 4: A global perspective

Course companion 6

The Financial Sector

2019-2020

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4.4.1 The role of the financial sector

Specification:
4.4.1 The role of the financial sector:
a) To facilitate savings
b) To lend to businesses and individuals
c) To facilitate the exchange of goods and services
d) To provide forward markets in currencies and commodities
e) To provide a market for equities

Financial market: any convenient set of arrangements where buyers and sellers can buy or trade a range of services or assets that are fundamentally monetary in nature.
Capital markets: financial markets which provide long-term borrowing and lending, usually defined as over one year.
Money market: financial markets that provide short-term borrowing and lending, usually defined as up to one year.

Retail banks: banks that provide services to individuals.
Commercial banks: banks that provide services to businesses.
Investment banks: banks that engage in a variety of activities in different financial markets, such as the foreign exchange market, the money markets, the capital markets and the derivatives markets.

Saving: is what is not spent out of disposable income. This could take the form of increasing the stock of cash, money in bank or company shares.
Equity in a company, is the value of the assets owned by the shareholders.
Derivatives: financial instruments based on the values of other financial instruments.

The role of the financial sector:
a) To facilitate savings
Explain reasons for savings by:
Households:

Firms:

Governments:

b) To lend to businesses and individuals
Explain reasons for borrowing by:
Households:

Firms:

Government:

Money markets provide short term financing of up to one year, e.g.

- UK Government borrows by issuing Treasury Bills repayable after 91 days.
- Companies issue Bills of Exchange, i.e. promises by companies to pay for goods and services they have already received, at a fixed point in the future, such as 91 days later. The supplier of the good/service can then sell on the bill of exchange to a third party, if they want to get their money immediately.
- Banks borrow overnight from each other.

Capital markets provide longer-term financing, greater than one year, e.g.

- Bonds issued by firms & government, e.g. UK government bond redeemable for £100 in 25 years' time, paying £2 interest per year. These bonds can be traded and sold in the "second-hand" bond market.

c) To facilitate the exchange of goods and services

Financial institutions create payment systems for goods & services, e.g.

- Central bank mints coins & prints bank notes
- Retail banks offer cheque services, debit & credit cards
- Visa, Amex & Mastercard offer credit card services to banks, retailers & individuals
- Banks & bureau de changes buy & sell foreign currency

d) To provide forward markets in currencies and commodities

Forward markets exist in food commodities e.g. wheat, cocoa, soya bean

- Farmer can agree to sell crop at agreed price on future date
- Food producer can agree to buy raw materials on future date at agreed price
- Forward markets exist for hard commodities (e.g. copper, nickel) and foreign exchange (e.g. US $)
- Forward markets are an example of a **derivative**

http://www.tutor2u.net/economics/blog/cocoa-futures-war

Watch the video clip and note the benefits of future contracts in cocoa for:

Farmers	Chocolate manufacturers

https://www.youtube.com/watch?v=dIYs01neCBU&t=38s

Watch the clip and note who Buys Britain's government debt and how much needs to be sold.

Foreign exchange markets are where different currencies are traded:

- Spot markets where the currency is traded now.
- Forward markets where currency contracts are made for some time in the future.

Commodity markets are where commodities are traded, e.g. London Metal Exchange

- Contracts may be spot or future
- Some contracts are for delivery of real commodities e.g. 10 tonnes of Nickel available in 6 months' time
- Some contracts are bets on future prices

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e) To provide a market for equities i.e. company shares

- A company sell shares to finance expansion, and the shareholder becomes a part owner of the company, receiving a dividend (share of profit)
- Stock markets provide a 'second hand' market for shares, so that shareholders can sell shares to others. This flexibility makes share ownership more attractive.

Anderton: Unit 77: Financial Markets

4.4.2 Market failure in the financial sector

Specification:
4.4.2 Market failure in the financial sector, consideration of:

- Asymmetric information
- Externalities
- Moral hazard
- Speculation and market bubbles
- Market rigging

Asymmetric information: where buyers and sellers have different amounts of information, with one group having more information than the other.

Production externalities: when the social costs of production are different from the private costs of production. If social costs exceed private costs, then there are negative production externalities.

Moral hazard: when an economic agent makes a decision in their own best interest knowing that there are potential adverse risks, and that if problems result, the cost will be partly borne by other economic agents.

Market bubble: a market bubble occurs when the price of a particular asset is driven to an unsustainably high level and then collapses.

Market rigging: Where a group of individuals or institutions collude to fix prices or exchange information that will lead to gains for themselves at the expense of other participants in the market.

The Banking Crisis 2008 https://www.youtube.com/watch?v=bx_LWm6_6tA
Watch the Crisis of Credit Visualised, and take notes on what happened using the prompts below:

Abundance of cheap credit from

Leverage is

Collateralised debt obligation (CDOs)

Ratings Agency

Sub-prime mortgages

Why home owners defaulting on mortgages can lead to more home owners deciding to default

Describe examples of market failures which occurred before / during / after the crisis:

Market bubble: a market bubble occurs when the price of a particular asset is driven to an unsustainably high level and then collapses.
Example:

Asymmetric information: where buyers and sellers have different amounts of information, with one group having more information than the other.
Example:

Moral hazard: when an economic agent makes a decision in their own best interest knowing that there are potential adverse risks, and that if problems result, the cost will be partly borne by other economic agents.
Example:

Production externalities: when the social costs of production are different from the private costs of production. If social costs exceed private costs, then there are negative production externalities.
Example:

Question 1: **The PPI (Payment Protection Insurance) scandal**

The PPI (Payment Protection Insurance) scandal occurred during the 1990's and 2000s. UK banks were selling very highly priced insurance to cover loan, mortgage and credit card debt against illness or unemployment. Many customers were unaware that they were even buying the product when they took out a credit card or a loan. For others, such as the self-employed, it was not explained that the insurance did not cover them if they could no longer gain an income. Some were told that they could not get a loan or credit card unless they bought the insurance. Very few customers realised that they could have bought the insurance at a fraction of the price from another supplier. In 2011, the banks lost their fight in the UK courts to prevent customers claiming compensation. By 2014, banks had paid out £16 billion in compensation on 13 million customer complaints accepted.
Source: Adapted from Financial Times 2014/15 (Anderton)

(a) Explain how banks were able to exploit asymmetric information to sell PPI.

(b) Explain why market failure might occur if a bank puts 'pressure on staff' to sell financial products to customers without finding out whether they are suitable for clients.

Question 2: Market rigging

Five banks including Barclays and Royal Bank of Scotland have been fined more than €1bn (£875m) by the European Union for rigging the multitrillion-dollar foreign exchange market. The European commission said the banks, which also include Citigroup, JP Morgan and MUFG (Mitsubishi UFJ Financial Group), formed two cartels to manipulate the spot foreign exchange market for 11 currencies, including the US dollar, the euro and the pound.

The commission's penalty adds to the £1.3bn in fines imposed by the UK Financial Conduct Authority in 2014 over the same case. While the FCA's penalty focused on the lender's breach of regulations, the EU's fine deals with how their behaviour dampened competition. "These cartel decisions send a clear message that the commission will not tolerate collusive behaviour in any sector of the financial markets," the European competition commissioner, Margrethe Vestager, said in a statement. The banking industry has been hit with billions in fines worldwide over the last decade for rigging benchmarks used in many day-to-day financial transactions.

Vestager said most of the traders involved in the manipulation knew each other on a personal basis and set up chatrooms with names such as "Essex Express 'n the Jimmy" because all of them except "James" lived in Essex and met on their train commute to London. One cartel ran between December 2007 to January 2013, while the other operated from December 2009 to July 2012, it added.

A group dubbed the "Three-Way Banana Split", made up of traders at UBS, Barclays, RBS, Citigroup and JP Morgan, was handed a fine totalling €811.2m, with Citigroup taking the biggest hit at €310.8m. The Essex Express cartel, involving UBS, Barclays, RBS and MUFG, was handed a €257.7m fine, with the penalty against Barclays the largest for this cartel at €94.2m. Swiss bank UBS dodged a fine from the commission, having alerted the two cartels to the European commission.

The revelation that traders colluded to move around currency exchange rates was particularly embarrassing for the banks because it occurred after they had paid billions of dollars to settle claims that their traders had tried to rig the London Interbank Offered Rate (LIBOR). **(Sourced adapted from Guardian article 16.05.2019)**

(a) Explain how the banks rigged the foreign exchange markets

(b) Explain why individual traders have an incentive to rig markets.

(c) Explain how consumers and other firms lost out from the behaviour of these banks

Question 3: Externalities

Royal Bank of Scotland warned of a tough year ahead as it aims to clear the bulk of misconduct and litigation charges in an attempt to return the bank to profitability. The bank is 80% owned by the government, having been taken into public ownership during the financial crisis of 2007-8. It has now had seven successive years of losses. It has been forced to set aside £856 million to cover the costs of fines relating to illegal market rigging in foreign exchange markets. Restructuring costs, as the bank shrinks its unprofitable operations, have been set at £453 million for the year. This includes the bank withdrawing from 25 of the 38 countries in which it operates. It will cut a significant number of employees in its investment bank based in London. Analysts at Barclays warn that a potential fine against RBS for mis-selling mortgage-backed debt is a major concern, noting that the ultimate settlement could be 'substantially higher' than the £2 billon the bank has set aside to cover the problem.

Source: Adapted from The Financial Times, 2015 (Anderton)

'All-powerful bully': Former Royal Bank of Scotland boss Sir Fred Goodwin

(a) Use the key terms section on page 3 to explain what is meant by an 'investment bank'.

(b) How has Royal Bank of Scotland created significant externalities for the UK economy since 2007?

4.4.3 The role of central banks

Specification:
a) Key functions of central banks:
- Implementation of monetary policy
- Banker to the government
- Banker to the banks – lender of last resort
- Role in regulation of the banking industry

Central bank: the financial institution in a country or group of countries, typically responsible for the printing and issuing of notes and coins, setting short-term interest rates, controlling monetary policy, managing the country's gold and foreign currency reserves and issuing government debt.

Lender of last resort: usually a function of a central bank, it occurs when financial institutions can obtain money from the central bank to balance their accounts when they are unable to do this from the financial markets in which they operate.

Shadow banking: parts of the financial market that are either much less regulated than the norm or are completely unregulated.

Systemic risk: in the context of financial markets, the danger that the failure of parts of the financial system will lead to the collapse of the whole of the financial system.

Regulatory capture: An example of government failure, it occurs when firms in an industry are able to influence to their advantage a regulatory body which is supposed to be regulating the behaviour of those firms.

The role of the Bank of England

1. **Issue Money**

Money: any item, such as a coin or a bank balance, which fulfils four functions: a medium of exchange, a measure of value, a store of value and a method of deferred payment.

Theme 1 revision: The functions of money:

- **A medium of exchange**: Money is used to buy & sell goods, avoiding the need for barter, and therefore promoting specialisation.
- **A measure of value**: Money acts as a **unit of account** e.g. if a dress costs £30 and a skirt costs £15, we know the value of one dress equals 2 skirts.
- **A store of value**: It can be saved, retrieved & exchanged at a later time and be predictably usable as a medium of exchange when it is retrieved. The value of the money must also remain stable over time.
- **A method of deferred payment**: an accepted way to settle a debt.

As we watch the 7 short video clips from the Bank of England Youtube site you will make notes https://www.youtube.com/watch?v=dI0MVV5UjKc

How does the Bank of England ensure that its bank notes fulfil the functions of money?

2. **Prices & the value of your money**

Why is it important to maintain the value of money?

3. **Controlling spending**

Explain the action the Bank of England might take it they believe inflation will be:

- Above target:

- Below target

4. **The financial system**

Explain functions performed by the financial system:

What are the risks in banking?

Why do banks need the following:

- Shareholders' capital

- Liquid assets

5. The money-go-round

Explain how the banks depend on each other and the Bank of England

What problems occurred in 2008?

6. Keeping confidence

Explain the Bank of England’s role:

- As ‘Lender of last resort’

- In dealing with failing banks

- In preventative action to avoid bank failure

7. **How the bank works**
   Take notes on the functions of:
   MPC: Monetary Policy Committee

   PRA: Prudential Regulation Authority

   FPC: Financial Policy Committee

   FCA: Financial Conduct Authority (not part of Bank of England)

Banker to the government

- Bank of England handle accounts of government departments
- Make short term advances to government

Banker to other banks

- Force largest banks operating in country to deposit money with them, which is used to balance the accounts of banks at end of each day, e.g. if Bank X owes Bank Y £50 million then £50 m debited from Bank X's account at central bank and credited to Bank Y's account.

Lender of last resort when:

- **Short term liquidity problems**: a bank has plenty of assets by they are illiquid (i.e. difficult/impossible to turn to cash) so it borrows from central bank (or sells illiquid assets to central bank) to get cash needed to make urgent payments.
- **Serious insolvency problems**: a bank has suffered serious losses, its assets have fallen greatly in value, (e.g. due to many bad debts), so that its liabilities exceed its assets, central bank lends money to avoid the bank collapsing, giving the government time to organise a bailout. To avoid business failure, the bank will ultimately need new share capital, i.e. in 2008 this was a gift of money from the UK taxpayer.

Evaluation of bank bailouts

Class work: Should the Bank of England act as Lender of last resort, when a bank has serious insolvency problems? i.e. should they 'bail out' a failing bank or let it collapse?

Arguments in favour of 'bailing out' an insolvent bank	Evaluation: Arguments against, disadvantages, depends on…

Anderton: Unit 78: Central banks and financial market regulation

Regulation of the banking system

Reasons for regulation

Regulation required to avoid the **market failures** we have discussed, e.g.

- **Asymmetric information**: to avoid exploitation of consumer with high cost/low quality products.

- **Negative externalities**: to avoid banks engaging in risky activities leading to bank failure, which imposes costs on third-parties e.g. tax payer.
- **Avoid systematic risks**, as collapse of financial sector will impose external costs on whole economy.

Changes to regulation since the financial crisis

1. New structures to monitor and regulate

Bank of England enhanced supervision of financial markets

The Financial Conduct Authority is NOT part of the Bank of England. Its role is to protect the interests of consumers and promote competition. It replaced the FSA

FPC: The Financial Policy Committee

Role: identify/ monitor/ take action to reduce systemic risks & promote resilience of UK financial system, e.g. by ensuring regular stress tests conducted.

PRA: The Prudential Regulation Authority

Role: Sets standards & supervises individual firms:

- Promote safety / soundness of firms i.e. so they don't collapse
- In the case of insurers, to contribute to securing an appropriate degree of protection for policy holders.
- Facilitate effective competition

FCA: The Financial Conduct Authority

Role: Ensure financial institutions provide customers with appropriate products and services & act with integrity / fairness.

It has the power to fine institutions for misconduct such as market rigging.

2. Stress Tests

A hypothetical scenario to see what would happen to a financial institution if certain events happened. E.g. what would happen to a bank if interest rates rose to 7% and house prices fell by 30%?

The FPC, alongside the Prudential Regulation Committee (PRC), contributes to the design and calibration of the Bank's stress testing framework. Stress tests allow the FPC and the PRC to assess banks' resilience and make sure they have enough capital to withstand shocks, and to support the economy if a stress does materialise.

Banking stress tests examine the potential impact of a hypothetical adverse scenario on the individual institutions that make up the banking system, and the system as a whole. We also require insurers to carry out stress tests. (https://www.bankofengland.co.uk/stress-testing)

Bank failing moderate test asked to take action e.g. increase share capital.

https://www.youtube.com/watch?annotation_id=channel%3A5623e049-0000-29ae-9f36-94eb2c05f2fe&feature=iv&src_vid=X182ULoFrHw&v=XtihtTHVXTE

What the video clip and take notes on the stress tests being used by the Bank of England:

3. Ring-fencing of retail banking from investment banking from 2019

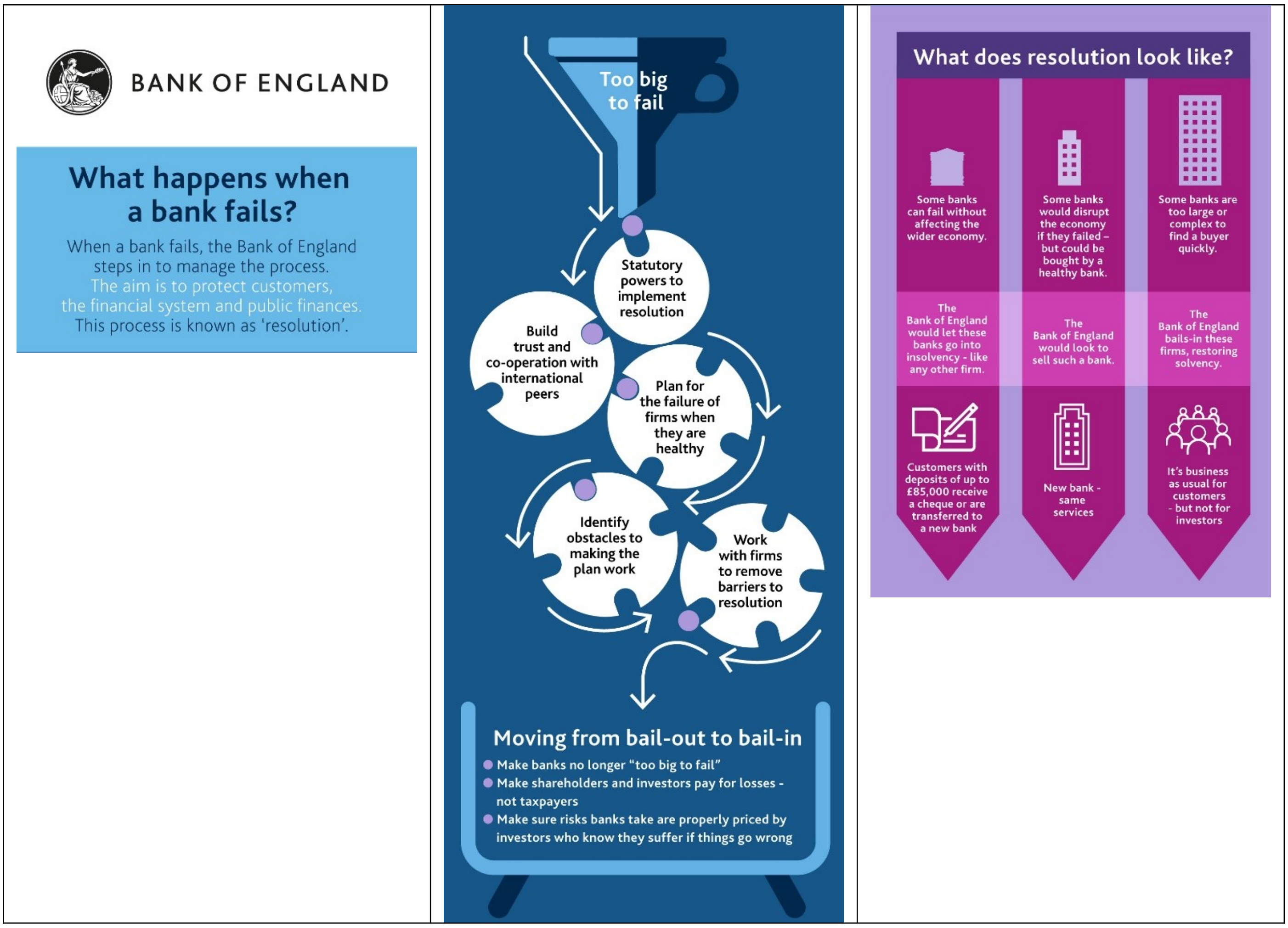
The largest UK banks are required by UK law to separate core retail banking services from their investment and international banking activities by 1 January 2019. This is known as ring-fencing.

The aim of ring-fencing is to protect the core retail banking services on which customers rely from risks associated with activities outside the ring-fence, such as investment banking.

Ring-fencing is intended to improve the resilience of the largest UK banks. It also seeks to ensure that if a large bank was to fail, there would be minimal disruption to banking services used by individuals and small businesses in the United Kingdom.

To implement ring-fencing, banks will need to significantly restructure their activities during 2017 and 2018, with implications for their customers, counterparties and suppliers. It will also have a potential impact on the costs of operating banks. (Bank of England Quarterly Bulletin 2016 Q4)

4. Resolution,- From Bank Bail-Out's to Bail-In's



5. Greater intervention to protect consumers by the Financial Conduct Authority (FCA)

Financial markets need to be honest, fair and effective so that consumers get a fair deal. We aim to make markets work well – for individuals, for business, large and small, and for the economy as a whole. We do this by regulating the conduct of more than 58,000 businesses. We are also the prudential regulator for more than 18,000 of these businesses. Over the last 4 years, we've made a lot of changes to the consumer credit market. (https://www.fca.org.uk/about/the-fca

- **Payday loans** market,- We've taken strong action to protect people – introducing a price cap and new rules on payday lending that are saving borrowers around £150 million a year, and restricting the way credit brokers can charge fees.
- **PPI**,- Firms that haven't met our expectations have given over £900 million in redress back to customers.
- **Credit Cards**,- Under our rules firms must lend responsibly and treat customers fairly – our changes to credit cards are set to save billions of pounds for millions of people by making firms do more to help customers repay debt more quickly, and we are looking closely at unarranged overdrafts.
- **Rent to own**,- We've made rent-to-own companies, who sell household goods for a weekly or monthly fee, be more transparent about charges and improve their standards, and supported nearly 350,000 of their customers in receiving £18 million in compensation. https://www.fca.org.uk/news/news-stories/consumer-credit-4-years-fca-regulation)

The FCA – a watchdog too nice and chummy to bark or bite
The Guardian 25 Jun 2019

Nobody fears the Financial Conduct Authority. Nobody fears its genial boss, Andrew Bailey. Not really. Or at least not enough to worry about doing jail time or even being banned from working in the City if they do something wrong.

The FCA might be the main regulator of the financial services industry on behalf of Britain's vast army of consumers. It might have a wide range of powers to bring financial services companies to heal when they rip off individuals. Yet it appears to be a creature of the establishment, overly keen to join the Treasury and the Bank of England in protecting the industry when questions arise about the bad behaviour of companies flogging financial products.

Bailey is ex-Bank of England and the relatively new FCA chair, Charles Randell, spent the bulk of his career in the City as a lawyer, latterly helping piece together the battered banks he now regulates. So it's no wonder Bailey used his time before MPs on the Treasury select committee to explain why it was that his organisation couldn't do much about one claim of wrongdoing after another.

A case in point was the well-documented efforts of staff at Royal Bank of Scotland to suck dry many of the small businesses caught up in its Global Restructuring Group. Their activities lay outside the FCA's remit. It didn't regulate small business customers. And anyway, there wasn't any evidence of outright fraud, even though many victims argued there was enough systemic wrongdoing to sanction the bank's top brass, which included Nathan Bostock, who oversaw GRG and now runs Santander UK.

The Labour MP Rushanara Ali asked if Bailey was too nice to bankers. He disagreed and then interestingly Randell leapt to his defence, warning the committee the FCA was coming under even greater strain. With 60,000 firms, 3,200 funds and 150,000 approved persons to regulate, the job is immense, he said.

Bailey added that the dramatic changes of the way we all save, especially for retirement, played a part. No longer are we looked after by our employers and the insurance industry, which in a previous era took on the risks of falling investment returns and increasing life expectancy. In the switch to self-invested personal pensions (Sipps) and other forms of direct investment, which place the onus on savers to understand the market and the risks they are taking, scandals are likely to proliferate.

He probably had in mind the case of the fund manager Neil Woodford, who manages more than $3bn (£2.3bn) in an Equity Income fund that is now frozen due to the sheer weight of investors seeking to move their money elsewhere.

MPs had already expressed concern at the way institutional investors quit the fund, leaving the smaller investors trapped.

Bailey looked forlorn when he said Woodford had broken the spirit and not the letter of the FCA's rules in the way he moved shares around to avoid a regulatory clampdown. If only the regulator could police the City's ethics armed with a set of principles rather than a code. Then he might catch out wrongdoers.

Bailey, though, doesn't display any urgency or passion for punishing wrongdoers. Woodford and the financial advice industry have extracted tens of millions of pounds in fees while knowing the fund was suffering. If Bailey is disgusted by the way the industry behaves, he should say so, and say so loudly.

(a) What limitations of regulation are suggested by the text above?

Regulation of the financial sector

Analyse the advantages of regulating the banking sector	What might be the disadvantages / limitations of regulation? What might it depend on?

Example exam questions

1. The UK government nationalised Northern Rock (then the country's fifth-largest mortgage lender) in February 2008. Discuss the arguments for and against government nationalisation of banks. (15)

2. Examine the advantages of making a central bank independent (8)

3. Examine the arguments for and against inflation targeting (8)

4. To what extent have central banks been effective in addressing the consequences of the Great Recession? Refer to both monetary policy and regulatory action. (25)

Edexcel financial sector delivery guide

Essay questions

1. With reference to the information provided and your own knowledge, evaluate the likely microeconomic and macroeconomic effects of market failure in the financial sector.

2. 'Many voters would like to see the government promoting a stronger UK manufacturing base as a means of rebalancing the UK economy. If there is a case for the UK government and central banks spending billions propping up the financial sector during the Global Financial Crisis of 2008, then there is a strong case for the government increasing its spending to support the manufacturing sector in the UK.'

   To what extent do you agree with this view?

Edexcel 2019 paper 2

Extract A

UK companies use forward currency market

The Norfolk-based picture frames maker Nielsen Bainbridge recently made forward contracts in the foreign exchange market to reduce the impact of currency fluctuations. The pound's post-Brexit referendum depreciation has been a test of nerve for Nielsen Bainbridge and many other importers. At present the company's suppliers are located in Europe or China. "Currency therefore has a big impact on our business and the margins we can obtain," says Ms Burdett, the Finance Director. Forward contracts enable institutions, businesses and individuals to lock in an exchange rate over a certain period of time regardless of how the rate moves during that time. Ms Burdett buys currency as soon as Nielsen Bainbridge confirms a large order as a way to fix costs. One third of UK business managers are considering shifting from EU to UK suppliers.

Extract B

Bank of England seeking to prevent future bank bailouts

The Bank of England has ordered big lenders in the UK to find £116 billion of funding to ensure that taxpayers will never again have to bail out the banking sector. The Bank intends to publish details of how each of the big lenders would cope in the event they find themselves in a situation similar to Royal Bank of Scotland and Lloyds Banking Group, which needed £65 billion of taxpayer bailouts during the 2008 Global Financial Crisis. This had a significant negative impact on the UK government's national debt and, many would argue, increased the need for contractionary fiscal policy. Having said that, the UK government sold all its shares in Lloyds Banking Group in 2017 and, according to the Chancellor of the Exchequer, "recovered every penny of its investment in Lloyds".

Sir Jon Cunliffe, the deputy governor at the Bank responsible for financial stability, said regulators needed to let banks fail in a similar way that traditional companies collapse. This has not been possible in the past because of the risk that savers lose their money and because a system did not exist to allow banks to be put into insolvency.

"Just like when other businesses fail, losses arising from bank failure would be imposed on shareholders and investors. This protects the public from loss and incentivises banks to operate more prudently," said Cunliffe.

Extract C

Bank of England tells lenders to increase capital reserves

The Bank of England has told lenders they will need to build a special reserve worth £11.4 billion by the end of 2018 as it tries to make banks more resilient to the risk posed by mounting consumer debt. This reserve of assets that can be readily turned into cash is a way of forcing banks to set aside capital reserves in good times in order to keep lending to the wider economy at a steady level, even during an economic downturn. In 2017 the Bank of England told UK banks it would raise the reserve ratio, relative to all assets, from zero to 0.5% and also forecast a further increase to 1% by the end of 2017.

The move is not intended to directly reduce consumer demand for credit, which in 2017 grew by 10.3% on an annual basis, but it may well lead to banks becoming less willing to lend to consumers. Since the Bank of England has recently become increasingly concerned about consumer borrowing, including rising car loans and credit card debt, this may be no bad thing as far as the Bank of England is concerned, even if it does have a negative impact on the wider economy.

Analysts are concerned about the impact on consumer confidence of rising inflation, partly caused by a falling pound. With falling real incomes consumers could become more vulnerable to falling behind with their credit card and personal loan repayments. Despite these concerns the UK economy recently recorded the lowest rate of unemployment since 1975.

6 (a) With reference to Extract A, explain the role of forward markets in currencies.

(5)

(e) Discuss whether providing substantial government financial support to banks is the best policy response during a financial crisis.

(15)