TOPIC 1

Introducing the financial services industry

LEARNING OBJECTIVES

This first topic introduces you to the UK's financial services industry.

Before we begin to look at the different institutions that make up the financial services industry, and the services they provide, we'll consider why the industry exists and what role it plays in the functioning of a modern society.

By the end of this topic you should have an understanding of:

- intermediation and its role in the financial services industry;
- the role of the Bank of England;
- mutual and proprietary organisations;
- credit unions;
- the difference between retail and wholesale banking.

This topic covers Unit 1 syllabus learning outcomes U1.1 and U1.2.

THINK . . .

Before you start work on this topic, take a moment to think about what you already know about these aspects of the financial services industry.

For instance:

- Why is using money more practical than exchanging goods by bartering in a modern society?
- What is the Bank of England?
- How is a building society different from a bank?
- What is a current account?

You won't always know much about the content of a topic before you start work – if you already knew everything, there would be no point in studying this qualification! – but if you pause to think about what you *do* already know it will boost your confidence and help to focus your thoughts.

1.1 Why do we need money?

In earlier civilisations, the process of bartering was adequate for exchanging goods and services: a poultry farmer could exchange eggs or chickens for carrots and cabbages grown by a gardener. In modern society, people still produce goods or provide services that they could, in theory, trade with others for the things they need. The complexity of life, however, and the sheer size of some transactions make it virtually impossible for people today to match what they have to offer against what others can supply to them.

What is needed is a separate commodity that people will accept in exchange for any product, which forms a common denominator against which the value of all products can be measured. These two important functions (defined technically as being a medium of exchange and a unit of account respectively) are carried out by the commodity we call money.

In order to be acceptable as a medium of exchange, money must have certain properties. In particular, it must be:

- sufficient in quantity;
- generally acceptable to all parties in all transactions;
- divisible into small units, so that transactions of all sizes can be precisely carried out;
- portable.

> **INFLATION**
>
> A sustained increase in the general level of prices of goods and services.

Money also acts as a store of value. In other words, it can be saved because it can be used for separate transactions in time: money received today as payment for work done or for goods sold can be stored in the knowledge that it can be exchanged for goods or services later when required. To fulfil this function, money must retain its exchange value or purchasing power; inflation has a negative impact on the exchange value of money.

'Money' comprises much more than cash. It includes amounts held in current accounts and deposit accounts, and other forms of investments.

The financial services industry exists largely to facilitate the use of money. The industry 'oils the wheels' of commerce and government by channelling money from those who have a surplus, and wish to lend it for a profit, to those who wish to borrow it and are willing to pay for the privilege.

Commercial financial institutions seek to make a profit from providing services, including to provide a return on capital to shareholders. Certain financial services providers, such as mutual organisations (ie organisations 'owned' by their members or customers) or not-for-profit organisations (ie charities), may prioritise other objectives, such as social value, over profit when providing products or services.

Financial institutions offer products and services that provide benefits including:

- convenience (eg current accounts enable holders to make and receive payments rather than having to do so using physical cash);
- a means of achieving otherwise difficult objectives (eg mortgages enable people to fund the purchase of a home, and investment products enable savers to achieve long-term savings goals); and
- protection from risk (eg insurance protects policyholders or beneficiaries from the financial consequences of adverse life events).

CHECK YOUR UNDERSTANDING 1

Money is:

- a medium of exchange – it can be exchanged for goods and services;
- a unit of account – a common denominator against which the value of goods and services can be measured; and
- a store of value – money received as payment today can be stored until required.

Which of these important functions enables a person to work out that they can rent four films on a streaming service for the same price as buying one physical DVD?

1.2 What is intermediation?

FINANCIAL INTERMEDIARY

An entity that acts as the middleperson between two parties in a financial transaction. Banks and building societies are the best-known examples.

In any economy there are surplus and deficit parties.

A surplus party (eg an individual or firm) is cash-rich, ie they have more liquid funds than they currently wish to spend. They are happy to lend out their surplus funds now, in order to increase the value of these funds in the future.

A deficit party is cash-poor, ie they do not have sufficient liquid funds to meet their spending needs. They are prepared to pay money into the future to anyone who will lend them funds in the present.

In this context, a financial intermediary borrows money from a surplus party and lends it to a deficit party. The intermediary charges interest to the party with the deficit and pays some of this interest to the party with the surplus. An intermediary's profit margin is the difference between the two interest rates.

DISINTERMEDIATION

Why do the surplus and deficit parties need the services of a financial intermediary? Why can they not just find each other and cut out the intermediary's profit?

Actually, there are some cases where this does happen, and the process is known as disintermediation. It involves lenders and borrowers interacting directly rather than through an intermediary. An example of disintermediation is 'crowdfunding', where a company that is looking to raise funds to invest in the business establishes a website to promote itself and find investors who are willing to lend money to it.

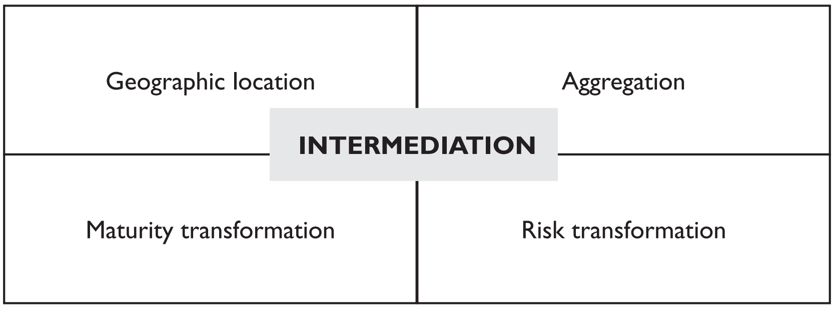
1.2.1 The four elements of intermediation

There are several reasons why both individuals and companies need the services of intermediaries. The four main reasons relate to the following factors.

- **Geographic location** – first, there is the physical problem that individual lenders and borrowers would have to locate each other and would probably be restricted to their own area or circle of contacts. A small business in Surrey that wants to borrow money is unlikely to be aware of a person in Edinburgh with money to lend, but each may have easy access to a branch of a high-street bank.
- **Aggregation** – even if a potential borrower could locate a potential lender, the latter might not have enough money available to satisfy the borrower's requirements. The majority of retail deposits are relatively small, averaging under £1,000, while loans are typically larger, with most mortgages being for £50,000 and above. Intermediaries can overcome this size difference by aggregating small deposits.

- **Maturity transformation** – even supposing that a borrower could find a lender who had the amount they wanted, there is a further problem. The borrower may need the funds for a longer period of time than the lender is prepared to part with them. The majority of deposits are very short term (eg instant access accounts), whereas most loans are required for longer periods (personal loans are often for two or three years, while companies often borrow for five or more years and typical mortgages are for 20 or 25 years). Intermediaries are able to overcome this mismatch by offering a wide range of deposit accounts to a wide range of depositors, thus helping to ensure that not all of the depositors' funds are withdrawn at the same time.
- **Risk transformation** – individual depositors are generally reluctant to lend all their savings to another individual or company, mainly because of the risk of default or fraud. However, intermediaries enable lenders to spread this risk over a wide variety of borrowers so that, if a few fail to repay (ie default), the intermediary can absorb the loss.

FIGURE 1.1 FOUR ELEMENTS OF INTERMEDIATION



1.2.2 Risk management

Risk transformation is one way of minimising (or 'mitigating') risk. Another way is insurance, which can be defined as "a means of shifting the burden of risk by pooling to minimise financial loss". Insurance involves individuals contributing – via their insurance premiums – to a fund from which the losses of the few who experience certain adverse circumstances are covered. Without the services of a central organisation – the insurance company – individuals would struggle to find a convenient way of sharing their risks in this manner. Insurance companies therefore provide another form of intermediation.

1.2.3 'Product sales' intermediaries

There is a further type of intermediation, slightly different in nature from those defined above. This is the intermediation that brings together the product providers (such as banks and insurance companies) and the potential customers who wish to purchase the providers' products and services. These product sales intermediaries include financial advisers, insurance brokers and mortgage advisers.

1.3 Financial institutions

This section introduces some of the types of financial institution that make up the financial services industry in the UK. Regulatory organisations are mentioned only briefly here because they are described in more detail in Unit 2.

Prior to the 1980s, there were more clearly defined boundaries between different kinds of financial organisation. Some were retail banks; others wholesale banks. There were life assurance companies, providing term or whole-of-life assurance, and general insurance companies, providing household and motor insurance (although a few offered both types of insurance and were known as composite insurers). There were also investment companies.

Today, many of the distinctions have become blurred, if they have not disappeared altogether. Increasing numbers of mergers and takeovers have taken place and now even the term bancassurance, which was coined to describe banks that own insurance companies (or vice versa), is inadequate to describe the complex nature of modern financial management groups. For example, a provider might offer the range of services illustrated in Figure 1.2.

KEY TERMS

RETAIL BANKS

Banks that provide payment services and savings and loans to personal customers or smaller businesses.

WHOLESALE BANKS

Banks that provide funding for other financial institutions or very large corporate clients.

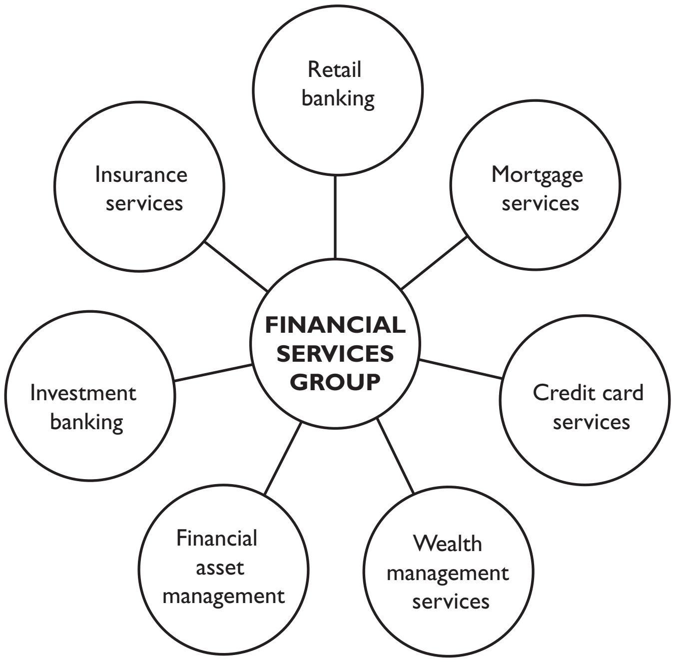
LIFE ASSURANCE

Insurance that provides payment, generally as a lump sum but possibly as an income, on the death of the person covered by the policy. It is sometimes referred to as life insurance or life cover.

GENERAL INSURANCE

Insurance designed to protect policyholders from the financial consequences of adverse life events. Examples include household insurance, motor insurance, travel insurance and commercial property insurance.

FIGURE 1.2 POTENTIAL RANGE OF SERVICES OFFERED BY FINANCIAL SERVICES GROUP



1.3.1 The Bank of England

A central bank is an organisation that acts as a banker to the government, supervises the economy and regulates the supply of money. In the United States, for example, these tasks are the responsibility of the US central bank, which is known as the Federal Reserve. Within the European Union, the European Central Bank (ECB) acts as central bank for those states that belong to the eurozone (ie use the euro as their currency). In the UK, the central bank is the Bank of England.

The Bank of England has a mission "to promote the good of the people in the United Kingdom by maintaining monetary and financial stability"; in pursuing this mission, it performs a number of important roles within the UK economy. Its main functions are as follows.

- **Issuer of banknotes** – the Bank of England is the central note-issuing authority and has a duty to ensure that an adequate supply of notes is in circulation.
- **Banker to the government** – the government's own account is held at the Bank of England. The Bank provides finance to cover any deficit by making an automatic loan to the government. If there is a surplus, the Bank may lend it out as part of its general debt management policy.
- **Banker to the banks** – all the major banks have accounts with the Bank of England for depositing or obtaining cash and other transactions. In this capacity, the Bank can wield considerable influence over the rates

of interest in various money markets, by changing the rate of interest it charges to banks that borrow or the rate it gives to banks that deposit.

- **Adviser to the government** – the Bank of England, having built up a specialised knowledge of the UK economy over many years, is able to advise the government and help it to formulate its monetary policy. The Bank's role in this regard was significantly enhanced in 1997, when full responsibility for setting interest rates in the UK was given to the Bank's Monetary Policy Committee (MPC). This committee meets eight times a year and its mandate in setting the base rate is to ensure that the government's inflation target is met.
- **Foreign exchange market** – the Bank of England manages the UK's official reserves of gold and foreign currencies on behalf of the Treasury.
- **Lender of last resort** – the Bank of England traditionally makes funds available when the banking system is short of liquidity, in order to maintain confidence in the system. This function became very important in 2007–09 following a run on Northern Rock and subsequent liquidity problems for a number of other banks.
- **Maintaining economic stability** – the Financial Policy Committee sits within the Bank of England. It looks at the economy in broad terms to identify and address risks that affect economic stability.

The Bank of England was also formerly responsible for managing new issues of gilt-edged securities. This function has now been transferred to HM Treasury's Debt Management Office in order to avoid conflicts of interest that might arise from the Bank's responsibility for setting interest rates.

LIQUIDITY

Assets (eg cash) that can quickly be made available to meet an institution's liabilities, without affecting the market price of those assets.

GILT-EDGED SECURITIES

Gilt-edged securities, commonly known as gilts, are loans to the government. There is a wide variety of gilts in issue offering loans at different rates of interest and for varying periods. These securities are called gilt-edged because they used to be issued in the form of paper certificates with gilt edging.

There is more information about gilts in Topic 6.

THE BANK OF ENGLAND'S ROLE AS A REGULATOR

The Bank of England previously held responsibility for the supervision and regulation of the UK banking sector; in 1998 this responsibility was transferred to the Financial Services Authority (FSA). The financial crisis that began in 2007–08 brought the UK banking system close to collapse, and as a result the government took steps to strengthen regulatory structures.

The Financial Services Act 2012, effective from 1 April 2013, divided responsibility for financial stability between the Treasury, the Bank of England and two new regulators: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

The Bank of England and Financial Services Act 2016 modified the Financial Services Act 2012 to give more powers to the Bank by bringing the PRA within it, ending its status as a subsidiary, and establishing a new Prudential Regulation Committee (PRC). You will find out more about the Bank of England and regulatory bodies in Topic 17.

FACTFIND

The Bank of England, alongside other central banks, is exploring the concept of a Central Bank Digital Currency (CBDC). In the UK, a CBDC might be thought of as a digital version of the pound; it would be an electronic form of central bank money that could be used by households and businesses to make payments. CBDC would be introduced alongside, rather than as a replacement for, cash and bank deposits. Find out more at the following link.

Bank of England: www.bankofengland.co.uk/research/digital-currencies

1.3.2 Proprietary and mutual organisations

The great majority of the large financial institutions are proprietary organisations, which means that they are limited companies. They are owned by their shareholders, who have the right to share in the distribution of the company's profits in the form of dividends. They can also contribute to decisions about how the company is run by voting at shareholders' meetings.

By contrast, a mutual organisation is one that is not constituted as a company and does not, therefore, have shareholders. The most common types of mutual organisation are building societies, friendly societies and credit unions; some life assurance companies are mutual, too.

A mutual organisation is, in effect, owned by its members, who can determine how the organisation is managed through general meetings similar to those attended by shareholders of a company. In the case of a building society, the members comprise its depositors and borrowers; for a life assurance company, they are the policyholders.

DEMUTUALISATION

Since the Building Societies Act 1986, a building society has been able to demutualise – in other words, to convert to a bank (with its status changed to that of a public limited company). Such a change requires the approval of its members, but this approval has generally been readily given, not least because of the windfall of free shares to which the members have been entitled following the conversion of the building society to a company.

A number of building societies demutualised in the late 1980s and early 1990s as a result of the change in the law. Among some of the most well-known were:

- Abbey National and Alliance & Leicester, which were eventually taken over by Santander;
- Halifax, which initially merged with Bank of Scotland to form HBOS and then became part of Lloyds Banking Group; and
- Woolwich, which was taken over by Barclays.

The possibility of a windfall for members led to a spate of 'carpetbagging' in the 1990s. This refers to the practice of opening an account at a building society that is expected to soon convert, purely to obtain the subsequent allocation of shares. In response, societies considering conversion sought to protect the interests of their long-term members by placing restrictions on the opening of new accounts.

In the past, some mutual life assurance companies, including Aviva and Standard Life Aberdeen, have also elected to demutualise.

1.3.3 What is a credit union?

A credit union is a mutual organisation. Credit unions are run for the benefit of their members. In the past, the members had to be linked in a particular way – in other words, they had to share a 'common bond', for example, by working for the same organisation, living in a particular area or belonging to a particular club or other association. Changes to the Credit Unions Act 1979 that came into force on 8 January 2012 mean that credit unions no longer have to prove that all members have something in common with each other. As a result, they can now provide services to different groups of people, such as housing associations and employees of a national company, even if some of the tenants/employees live outside the geographical area that the credit union serves.

In order to join a credit union, the member must meet the membership requirements, pay any required entrance fee and buy at least one £1 share in the union. Credit unions can choose whether to offer ordinary shares (which are paid up and bring all the benefits of credit union membership), or deferred shares, which are only payable in special circumstances. All members of the credit union are equal, regardless of the size of their shareholding.

Traditionally, credit unions operated in the poorer sections of the community as an alternative to 'loan sharks', providing savings and reasonably priced short- and medium-term loans to their members. In more recent years it has been recognised that credit unions have a strong role to play in combating financial exclusion and delivering a range of financial services and financial education to those outside the mainstream. The government has therefore supported a number of initiatives and enacted legislation to widen the scope of the movement.

Credit unions are owned by the members and controlled through a voluntary board of directors, all of whom are members of the union. The board members are elected by the members at the annual general meeting (AGM). Although the directors control the organisation, the day-to-day management is usually carried out by employed staff. Credit unions are authorised and regulated by the Financial Conduct Authority (FCA), and savers are protected through the Financial Services Compensation Scheme.

What products and services does a credit union offer?

Credit unions offer simple savings and loan facilities to members. Savers invest cash in units of £1, with each unit buying a share in the credit union. Each share pays an annual dividend, typically 2–3 per cent. The maximum rate of 8 per cent for dividends was removed by the 2012 changes to the Credit Unions Act; these changes also allowed credit unions to pay interest on savings instead of dividends. Credit unions that choose to pay interest must show that they have the necessary systems and controls in place and have at least £50,000 or 5 per cent of total assets (whichever is greater) in reserve.

Members' savings create a pool of money that can be lent to other members; the loans typically have an interest rate of around 1 per cent of the reducing balance each month (with a legal maximum of 3 per cent of the reducing balance).

In order to compete in today's financial services marketplace, many credit unions offer additional services, often in conjunction with partners, including basic bank accounts, insurance services and mortgages.

LIFE ASSURANCE

A unique feature of credit unions is that members' savings and loan balances are covered by life assurance.

This means that any loan balance will be paid off on death, and a lump sum equal to the savings held will also be paid, subject to overall limits.

1.3.4 Retail and wholesale banking

The main distinction between retail and wholesale transactions is one of size – wholesale transactions being generally much larger than retail ones. Because of this, the end-users of retail services are normally individuals and small businesses, whereas wholesale services are provided to large companies, the government and other financial institutions.

Retail banking is primarily concerned with the more common services provided to personal and corporate customers, such as deposits, loans and payment systems. It is largely carried out by high-street banks and building societies, which deliver their products through traditional branch networks, call centres or the internet.

These institutions are acting as intermediaries between people who wish to borrow money and people who have money that they are prepared to deposit. The price of borrowing and the reward for investing is, of course, interest.

INTERBANK MARKET

A very large market which recycles surplus cash held by banks, either directly between banks or more usually through the services of specialist money brokers.

Wholesale banking refers to the process of raising money through the wholesale money markets in which financial institutions and other large companies buy and sell financial assets. This is the method normally used by finance houses, but the main retail banks are also heavily involved in wholesale banking in order to top up deposits from their branch networks as necessary. For example, if a bank has the opportunity to make a substantial profitable loan but does not have adequate deposits, it can raise the money very quickly on the interbank market.

Wholesale banking operations are riskier than retail banking. Following the 2007–09 financial crisis, regulators sought to ensure that banks involved in both retail and wholesale banking did not expose their retail customers' deposits to risk as a result of their wholesale operations. This approach is referred to as 'ring fencing' and was implemented in the UK banking sector on 1 January 2019.

Building societies are also permitted to raise funds on the wholesale markets, but are restricted to 50 per cent of their liabilities; the remainder must come from deposits. For banks, there is no restriction.

Some organisations are clearly based at the wholesale end of the market, notably product providers such as life assurance companies and unit trust managers. Other organisations and individuals, such as insurance brokers and financial advisers, are purely retailers of the products and services offered by the providers. That said, the distinction between 'retail' and 'wholesale' in financial services is much less obvious than it used to be, with many institutions operating in both areas. Product providers that sell direct to the public or through their own dedicated sales forces are, in effect, operating in both a wholesale and retail capacity.

1.3.5 What are Libor and Sonia?

The rate of interest charged in the interbank market used to primarily be the London interbank offered rate (Libor). Libor used to act as a reference rate for the majority of corporate lending, for which the rate is quoted as Libor plus a specified margin. Libor rates were fixed daily and varied in maturity from overnight through to one year.

Libor was an average calculated using the information submitted by major banks in London regarding the interest rates they were paying to borrow from other banks. It was supposed to be an assessment of the health of the financial system, and the confidence felt by the banks as to the health of that system was reflected in the rates they submit.

THE LIBOR SCANDAL

In the summer of 2012, it was discovered that banks were falsely inflating or deflating the rates they claimed to be paying so as to profit from trades, or to give the impression that they were more creditworthy than they were.

A review of Libor was carried out by Martin Wheatley, managing director of the then regulator, the Financial Services Authority. The review recommended that banks submitting rates to Libor must base them on actual interbank deposit transactions, and not on what rates should be or are expected to be. It also recommended that banks keep records of the transactions to which the rates relate and that their Libor submissions be published.

The activity of "administering and providing information to specified benchmarks" came under the regulation of the Financial Conduct Authority (FCA) from April 2013. Under the Financial Services Act 2012, knowingly or deliberately making false or misleading statements in relation to Libor-setting became a criminal offence. Responsibility for administering Libor passed from the British Bankers' Association to Intercontinental Exchange Benchmark Administration in 2014

In 2016, the EU developed a Benchmarks Regulation, which the UK retained post-Brexit and now forms the backbone of the UK's regulatory framework for benchmarks such as Libor and Sonia.

As a result of the Libor scandal, a shift has been made to Sonia (sterling overnight index average). Sonia was introduced in 1997 and has been administered by the Bank of England since 2016, with calculation and publication responsibilities also passing to the Bank following a reform of Sonia in 2018 (Bank of England, 2021). It is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors. Sonia is an important benchmark used by financial businesses and institutions to calculate the interest paid on swap transactions and sterling floating rate notes.

FACTFIND

Find out more about Sonia from the following link.

Bank of England: www.bankofengland.co.uk/markets/sonia-benchmark

CHECK YOUR UNDERSTANDING 2

How can a bank involved in wholesale banking raise money quickly in order to finance business activities?

a) By a further issue of shares.

b) By borrowing from the Bank of England.

c) By calling in their debts.

d) From the interbank market.

THINK AGAIN …

Now that you have completed this topic, how has your knowledge and understanding improved?

For instance, can you:

- explain the functions that money performs in society and the economy?
- explain what is meant by 'intermediation'?
- summarise the different roles carried out by the Bank of England?
- outline the differences between a retail bank, a wholesale bank, a building society and a credit union?
- explain what is meant by the London interbank offered rate (Libor) and the sterling overnight index average (Sonia).

Go back over any points you don't understand and make notes to help you revise.

Test your knowledge before moving on to the next topic.

References

Bank of England (2021) *Sonia interest rate benchmark* [online]. Available at: www.bankofengland.co.uk/markets/sonia-benchmark

Test your knowledge

?

Use these questions to assess your learning for Topic 1. Review the text if necessary.

Answers can be found at the end of this book.

1) What are the four main reasons why individuals and companies need financial intermediation?

2) What is the key difference between a mutual organisation and a proprietary organisation?

3) A financial transaction that is carried out directly between an organisation with surplus funds to lend and one that needs to borrow is an example of:

   a) demutualisation.

   b) disintermediation.

4) Which one of the following is not a role of the Bank of England?

   a) To regulate the supply of money and manage gold reserves.

   b) To act as financial ombudsman in resolving customer complaints about banks.

   c) To act as adviser to the government.

   d) To set interest rates.

5) Which institution issues UK banknotes?

   a) The Bank of England.

   b) The Treasury.

   c) The Royal Mint.

6) Credit unions cannot pay interest on savings. True or false?

7) Freshfood Ltd supplies fruit and vegetables to market traders and small shops. The banking transactions it carries out are an example of:

   a) wholesale banking.

   b) retail banking.

8) Who is responsible for administering Sonia?

   a) The FCA.

b) The Bank of England.

c) The Monetary Policy Committee.

d) The Prudential Regulation Authority.