

# Financial Restructuring: The United Kingdom Experience

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The City of London underwent a much publicized revolution on October 27, 1986, the so-called "Big Bang", which consummated far reaching changes in the structure and operation of our securities industry, based on a few highly significant changes in the rule book of our domestic stock exchange. It was, however, the culmination of many changes that had been taking place in the City since the 1960s, beginning with the growth of the Eurodollar market. While the changes in the securities market have been abrupt and discontinuous, those in banking have been evolutionary. This paper looks at the developments in both fields of financial activity and in their regulation, the linkages between the two and the prospects for the future.

In analyzing a process of restructuring, it is helpful to have a clear idea of what the original structure was, and how it had become so. The most convenient source for a description of the structure and operations of financial institutions in the United Kingdom in the 1970s is probably that contained in the Report of the Committee to Review the Functioning of Financial Institutions (Crmd 7397), known as the Wilson Committee, published in June 1980. For purposes of this paper, however, I shall confine myself to discussion of the banking system on the one hand and the securities markets on the other, for these are the areas where the greatest changes have taken place and where some of the most difficult supervisory problems arise.

## The banking system

As in the United States, the British financial system developed in the 19th century and into the second half of the 20th century along the lines of the provision of separate financial services and functions by separate institutions. This is in contrast to developments in continental Europe that have tended toward the evolution of the universal bank, providing a wide variety of financial services under one roof, in particular both banking and investment services. In one major respect, however, British and U.S. development has diverged. Since 1933, the Glass-Steagall Act in the United States has provided a statutory bar to the taking of deposits and the underwriting and trading of corporate securities within the same financial institution or group. There has been no legal requirement in the United Kingdom for such functional separation, and the operation of a wholesale banking business combined with the issuance and underwriting of securities has been the stock in trade in particular of the group of institutions known as merchant banks.

There was no particular theory or philosophy underlying this development—it was the result of the accidents of history. One of the most important influences, no doubt, was the development of London in the 19th century, following the Industrial Revolution, as the financial and commercial center of the world. This was an international environment in which the provision of specialist financial services was demanded and could flourish.

On the domestic side, developments were perhaps a little slower. Our existing clearing banks are, in the main, the product of a series of amalgamations of provincial banks in the 19th and early 20th centuries. They were amalgamations of disparate banks which, because of their growing geographical coverage within the United Kingdom as the Industrial Revolution spread, had evolved from partnerships into limited companies. In fact, for many years the alternative name to "clearing" banks was "joint stock" banks, to distinguish them from the traditional City of London-based merchant bank that continued to be operated as a partnership by the proprietors of the business, in most cases until after World War II. Because so many of the major houses, with illustrious names such as Rothschild, Baring, **Lazard**, and **Schroder**, originated as merchants from continental Europe whose expertise was rooted in foreign trade and its financing,

the orientation of such houses remained international. From merchanting, through the finance of trade by accepting "bills of exchange," they moved to the provision and mobilization of capital for development and investment overseas through the arrangement and underwriting of stock issues and finally, often through the need for an organization to deal with the investment of the personal wealth of the proprietors, into the world of investment management.

The clearing banks long remained domestically oriented. Overseas activities were carried out through separate subsidiaries. The clearing banks provided money transmission services. Their speciality was the collection of bills of exchange and checks. The idle balances that were available were used to provide working capital for all sectors of the economy, but their need for liquidity led them to concentrate on short-term lending, although it became increasingly apparent that the overdraft system of lending contained within it a significant core of medium to long-term lending.

The differences in function between the clearing banks and merchant banks led to the development of two very different cultures: that of the **clearing** banker, domestically oriented, relying on a **long**-established and geographically widespread system for the collection of retail deposits and the making of credit judgments on the basis of local knowledge of customers; and that of the merchant banker, generally more internationally minded, mobilizing financial resources of others rather than lending his own and relying on entrepreneurial skills and flair to exploit new developments and opportunities.

The evolution of the banking system described above continued substantially undisturbed into the 1960s. The concentration of the clearing banks continued through amalgamations and mergers until there were four main groupings by 1968, while the 1950s were an active time for the merchant banks to incorporate from their traditional partnerships, with a number of them merging and becoming public companies.

It is important to remember that during the whole of the postwar period until 1979 financial institutions in the United Kingdom were subject to exchange control. This had the effect of drawing a ring fence around their domestic sterling activities, but leaving them, including the foreign-owned institutions established or setting up in London, free to conduct business in foreign currencies. This led to the paradoxical situation that the Eurodollar market that came into

being in the 1960s became established in London, despite a very strict exchange control regime. The London merchant banks were early participants in, and developers of, the Eurocurrency markets, and it was to London that the major U.S. investment and commercial banks came, in many cases following their U.S. clients forced to utilize the Euromarkets because of the OFDI regulations introduced in the United States in 1968. With them, they brought the issuing techniques of the U.S. capital markets as well as innovative ideas in banking to challenge the prevalent conservative banking orthodoxy. The corollary of the establishment and growth of the Eurocurrency markets in London was the explosive growth of the number of foreign institutions established there, which increased from around 80 in 1965 to around 340 today.

It would be true to say that the clearing banks were rather slow to join the bandwagon, partly for cultural reasons and partly because their domestic development had not involved them in capital issues or securities underwriting or trading to any large extent. That situation did not last long, as they themselves established or acquired merchant banking subsidiaries and as the advent of syndicated bank credits in the Eurocurrency markets, which enormously outpaced the growth of the Eurobond markets in the 1970s as inflation took hold, brought them to center stage with their ability to deploy far greater resources than those of the merchant banks.

In many ways the inflationary experience of the 1970s was one of the most potent stimulants of structural change, alongside the gradual internationalization of financial markets, for it broke down the traditional distinction between long-term capital market finance and banking finance for working capital needs. For some time, and in a number of countries where it had not traditionally been the case, banks became the main providers of long-term funds to companies. The wheel may now have come full circle, with syndicated credits out of fashion and increasingly replaced on banks' balance sheets by floating rate notes and other forms of securitized lending. But the point is that the clearing and commercial bankers have increasingly learned the investment bankers' trade and techniques in the process. Separation of functions has broken down, and the gap between the two cultures referred to above, although still visible in a number of ways, has become much less significant.

Simultaneous with these changes on the international side of the

British banks' business, major changes were **taking** place on the domestic side, of which one of the most significant was the rise of the building societies as takers of deposits compared with the clearing banks. In 1964, the London clearing banks accounted for nearly **33** percent of the total domestic sterling deposit market, while the building societies, broadly equivalent to U.S. savings and loan institutions, had some 18.4 percent. By 1970, the percentage shares were almost identical, at around 29 percent each, and by 1978 the building societies had pulled steadily ahead to nearly 38 percent while the London clearers had fallen to below 27 percent. Changes in the statistical reporting system make subsequent comparisons difficult, but the building societies' share seems to have been fairly steady throughout the 1980s at just over 40 percent, with the clearers' share some 10 percent less. Foreign banks have raised their share from under 1 percent in 1964 to just over 5 percent in 1986.

The reason for the rapid rise of the building societies is not hard to discern. They have traditionally been the main source of finance for house purchases, and in the period 1964 to 1985 the percentage of owner-occupied dwellings had increased from 45 percent to 61.5 percent. Furthermore, preference in lending was given to those who deposited their savings with the societies, and this natural magnet for attracting householders' savings was enhanced by better marketing, more customer-oriented opening hours, simplified tax treatment for interest earned, and more recently the addition of **checking** facilities. The challenge of the building societies to commercial banks in a number of areas has, in fact, been facilitated by new legislation that extends the range of activities they may undertake. (See below.)

### **The role of the authorities**

It is appropriate at this stage, however, to comment on the role of the authorities in the process of change just described, and in this context, the authorities essentially means the Bank of England. Their role has been basically noninterventionist. In general, the market has been allowed to develop in its own way and to serve its customers as it sees best, with rules being relaxed when competitive pressures made their continuance either an obstruction or an irrelevance. Until 1971, there was in theory a cartel among the clearing banks governing

the rates paid on deposits and their terms, although in practice the banks had devised ways of bypassing the cartel through establishing a range of subsidiaries to offer better terms on deposits or other specialist services. The cartel was, nevertheless, tacitly supported by the authorities in those days, not least because it was seen to provide a means through which monetary policy and credit control could be applied to the U.K. domestic economy.

It became clear, however, in the late 1960s that the leakages in credit control were such that the subsidiaries of the clearing banks and all the other banks in the United Kingdom—domestic merchant banks and foreign banks—would have to be brought into a common system. Therefore in 1971, arrangements were introduced to abandon the cartel and to bring all banks onto the same footing in respect of the administration of monetary policy. The arrangements were known as "Competition and Credit Control", the title of an explanatory paper produced by the Bank of England, and their effect was to abolish direct controls on lending and to rely instead on the price mechanism.

Notwithstanding the Banking Acts of 1979 and 1987, there is still no legal definition of a bank in the United Kingdom. Prior to the 1979 act, several separate different authorizations from different authorities were available to banking companies, in particular in relation to taxation arrangements, the presentation of company accounts, and the administration of exchange control. But there was no statutory definition or description of a bank or of banking. In practice, the Bank of England chose those institutions that it wanted to classify as banks for credit control and national account purposes, who joined the so-called "authorized bank" category. In fact, the authorization related to engaging in foreign exchange transactions under the Exchange Control Act. Such banks were supervised by the Bank of England; others were not.

In the absence of formal authorization of deposit-taking businesses in this period, there had developed a number of "secondary banks," whose main objective had been to take advantage of the freedom from the panoply of official control for credit and monetary policy purposes to which authorized banks were subject. Following a sharp rise in U.K. interest rates in 1973, which led to problems in property financing, a number of these secondary banks found themselves in difficulties. The illiquid banks were sorted out from the insolvent,

and under the auspices of the Bank of England liquidity support was provided by the commercial **deposit-taking** institutions and the Bank of England through what was commonly known as "The Lifeboat".

The Bank of England had at that stage no legal or even moral duty to protect depositors in these secondary banks. But the secondary banking crisis, and the European Community requirement to have a statutory-based system of authorization of companies taking deposits from the public introduced in 1977, led to the first formal legislation for the authorization of all deposit-taking institutions in the United Kingdom, the 1979 Banking Act, which also introduced a deposit protection scheme.

The focus of this legislation is the taking of deposits from the public. Following the U.K. experience with secondary banks, a distinction was made in the 1979 act between licensed deposit-takers (companies offering only a limited range of **banking** services) and recognized banks (offering a broader range). In practice, most of the existing commercial banks and investment banks were classified as "recognized banks" under this legislation, with the result that the size and scale of operations of deposit-taking institutions became a major element as to which side of the dividing line they fell. A further banking act has recently been enacted which builds on the experience of implementation of the 1979 act, and under this new legislation this distinction has been abolished (See below.)

## **Banks and other financial activities**

Unlike in some other European countries, the activities that a bank may undertake are still not defined by statute in the United Kingdom. British banks are; at least in theory, free to undertake any activities, although of course the banking supervisors do have some opinions on this subject and, particularly under the 1987 Banking Act, some powers to enforce these opinions. It is, nevertheless, worth noting that some affiliated companies of the British clearing banks (mainly subsidiaries of finance **house/installment** credit subsidiaries) have been involved in automobile distribution and repair, television rental, and even the manufacture of railway freight cars. They have been relatively small operations in relation to their main banking business.

From the supervisory point of view the most important aspect in

such cases has been to ensure that the management of a bank fully understands the nature of any commitment it takes on, that the activity is run by people with the appropriate experience, and that the business, unless germane to banking and capable of being supervised on a consolidated basis, should be run at an arms length, *i.e.*, there should not develop a banking relationship between the parent bank and its subsidiary. The reason for this is primarily that **banking** groups are highly dependent upon market confidence and normally stand or fall together. In other words, the slightest hint that something is amiss in one part of a banking conglomerate usually puts other parts at risk of a liquidity crisis. A secondary concern has been the need to ensure that undue influence is not brought to bear by one part of a group on the normal commercial judgments of another.

There have been, however, some areas of financial business that the authorities have positively discouraged banks from entering, albeit without any statutory backing for such action. The most significant of these has been insurance, where the authorities have generally sought to restrict links between banks and insurance companies, particularly those involved in general insurance. The banking and insurance supervisors' main concern has been the possibility of conflicts of interest between depositors and policyholders in the event of a problem occurring in either company and the risk of cross infection between the two activities. Both banks and insurance companies are highly geared compared with the generality of companies. Both are dependent upon public confidence for their continued existence and are at risk to liquidity and solvency problems. There is the risk that a liquidity or solvency crisis in one company would almost certainly require intervention by the other, resulting in the possible collapse of both. The discouragement has not, however, been absolute, and there are a number of comparatively large insurance companies with interests in small deposit-taking companies, and conversely, some of the large commercial banks own comparatively small insurance subsidiaries. What we want to avoid is insurance companies and banks of similar size forming links, but that would not necessarily preclude the building up of one within the other by organic growth, and in a few specific cases permission has been given for a significant minority stake in one to be held by the other.

Although direct acquisition of insurance companies has been restricted, this has not prevented the commercial **banks** from offering



insurance services to their customers, and all the major banks have insurance brokering subsidiaries that advise and arrange business through the retail branch network.

## **Banks and building societies**

As discussed earlier, the main competition that commercial banks have faced in recent years in the domestic market has been from the building societies. These mutual companies, many of which are still regionally based, take funds mainly through their retail branch network and specialize in domestic mortgage finance. Indeed, the legislation governing building societies has hitherto been particularly restrictive. The range of assets in which they could invest has been narrow and their lending had been confined to secured lending against residential mortgages.

New legislation in 1986, however, has allowed the building societies to widen the scope of their activities. In particular, they are allowed to compete with banks for unsecured personal lending and to have limited access to the wholesale interbank market for funding.

The banks responded to the competition from the building societies in a number of ways. Six-day opening, which had been abandoned in 1968, was reintroduced in major shopping center sites. There was a marked effort to improve the image of the banks with the public. Branches were refitted, interviewing areas were opened up in the public areas of banking halls, and a general effort was made to make banks seem more approachable and friendlier places to do business. Banks also began to compete with building societies in the mortgage market itself. Their motives were partly to stem the switch of retail business from the commercial banks to the building societies, but more importantly because it was seen as a way of improving the asset quality of the banks. In the United Kingdom, and other countries in Europe, residential mortgages have thus far proved to be very high-quality assets with extremely low default rates. Transition by the clearing banks into this market was not entirely smooth. The funds initially allocated were insufficient and customer demand exceeded supply. The banks were criticized for being half-hearted in their commitment to providing mortgage finance. These initial problems have now been resolved, with the mortgage market generally moving onto

a competitive market-clearing basis. Pressure on capital ratios, however, has now led both the banks and building societies to look at ways of "securitizing" mortgage-backed assets by transferring them off balance sheet to specially established finance vehicles.

One of the clearing banks (Lloyds Bank) has also bought into a series of estate agencies, to produce a nationwide chain. Thus, it is able to offer a complete service to customers—finding the right house, financing its purchase, insuring the house, and if necessary, arranging life insurance for the borrower. The domestic property market has also been seen by others as a route into the retail market and, in particular, a way of marketing other financial services to high net worth individuals. Both a major insurance company (Prudential) and a merchant banking group (**Hambros**) have bought up individual estate agents to develop an extensive network marketing their services under the corporate name.

### **The U.K. securities market**

Until the events known as Big Bang, specialization of functions had also been a characteristic of the United Kingdom domestic securities market. Stock exchanges developed in this country largely in response to the need of joint stock companies to share the load of raising capital for new enterprise in the 19th century. There were local stock exchanges all over the country, each with its flavor of local industry. All the stock exchanges of Great Britain and Northern Ireland were amalgamated into a single stock exchange in 1973, enabling the stock exchange authorities to impose common standards of regulation, enforcement, and discipline. The London Stock Exchange naturally dominated all these developments because it was to London that savings gravitated, London was the location of government, that great consumer of private savings, and London was the center through which investment was channelled overseas.

Access to the stock exchanges was restricted to members who formed themselves into partnerships. Incorporation was not **permitted** until 1969 and then only 10 percent of a firm's capital could be owned by a single nonmember. This was increased to 29.9 percent in 1982, but it was not until the changes associated with Big Bang that 100 percent outside ownership by a single nonmember was permitted.

Under the impact of heavy personal taxation that prevailed from the end of World War II until the burden began to be lifted from 1979 onwards, stock exchange firms became increasingly undercapitalized. This tendency was fostered by what was known as "single capacity", the rule that members of the exchange must either be brokers, acting as agents for their customers but taking no position as principals, or jobbers, making markets in stock but only able to deal with brokers. This system was undoubtedly good for investor protection, but it made it hard for U.K. stock exchange firms to compete with much better capitalized foreign securities houses as the securities markets became more international, or for them to satisfy the demands of the institutional investors that came increasingly to dominate the market.

Two further features of the stock exchange **rulebook** hindered its growth and development: minimum commissions set by the stock exchange itself, which were thought to be essential for the maintenance of single capacity, and limitations on membership which excluded foreign and corporate membership. The stock exchange was long able to satisfy the requirements of British industry and British investors, and its rules ensured that it was honest and ethical. But they left it ill-adapted to cope with internationalization of capital markets: the development of the Eurobond market in London almost completely bypassed the London Stock Exchange. No doubt this insularity was to an important extent encouraged by the existence of exchange control, which limited the horizon of U.K. investors. Certainly the large savings surplus associated with North Sea oil and the related abolition of exchange control in 1979 **brutally** exposed the limitations of the stock exchange, as the business arising from the portfolio diversification that ensued in large part went to overseas intermediaries in the country of investment rather than being routed through London brokers. This was chiefly because British stockbrokers had concentrated on the secure domestic market and had not sought or achieved analytic or dealing skills in overseas securities. And at least in comparison with U.S. markets, the London Stock Exchange was technologically backward.

It was the submission of the stock exchange **rulebook** to the Office of Fair Trading under the Restrictive Trade Practices legislation that was the catalyst for the changes that have transformed the face of the domestic securities markets. In order to avoid the delays and the inhibition to change involved in fighting a case before the

Restrictive Trade Practices Court, the stock exchange authorities agreed with the government to abolish fixed minimum commissions and to include lay members in their council. In the event, the changes went considerably further. Single capacity gave way to dual capacity so that the **broker/jobber** distinction disappeared, 100 percent outside ownership of member firms by other **financial** institutions was permitted, and a new market structure was introduced using screens for dissemination of market makers' quotes.

The consequences have been far-reaching, both in institutional terms and as regards trading structures. Nearly 20 percent of current member firms of the stock exchange are now foreign owned and the proportion of large firms that are foreign owned is much higher. U.K. **banks**, both clearers and merchant banks, have established powerful groupings combining stock exchange membership and market making. In sum, there has been a substantial increase in capital employed in position-taking and brokerage. The method of trading has also been radically transformed with the system being broadly comparable with that of the NASD in the United States (NASDAQ). Traditionally, the London Stock Exchange had enjoyed floor trading among competing market makers for domestic purposes. The Eurosecurities market that developed in London during the 1960s and 1970s was largely outside the stock exchange and was a telephone and screen market among competing dealers. With the new technology introduced into the stock exchange in the context of Big Bang, it was expected that the trading floor would decline in importance and that a considerable amount of business would be conducted from dealing rooms through telephones and screens. It was not expected that within a few weeks of Big Bang two-thirds of the equities transactions would be conducted away from the exchange floor and that now, nine months on, the floor would be virtually deserted.

As foreseen, the market for equities in London has become more efficient and competitive. The value of transactions has more than doubled since Big Bang—in response to lower transaction costs and increased information available to investors, which enables them to arbitrage more effectively. The enhanced liquidity of the market has mainly involved the most actively traded shares, but shares in smaller firms have benefited also. Spreads between best bid and offer prices have narrowed, and the transactions costs paid by institutional investors have fallen on major stocks from around 2.5 percent to 1.5

percent, in part because of a cut in stamp duty from 1 percent to 0.5 percent. In addition, an ability to deal on a net basis with **principals**—over 50 percent of deals are now conducted on this basis—thereby avoiding brokers' commission altogether, can reduce the transaction costs even further—to under 1 percent in some instances. The increase in turnover in equities has also been affected by the coincidence of another government policy, privatization.

Big Bang was not only designed to improve the market in U.K. stocks and shares. It was also aimed at capturing for London a significant share of the trading in equities that are internationally traded, which has been one of the most recent developments in the general internationalization of capital markets and has followed logically from the success of the international bond market. There are, of course, important differences between equity shares and bonds that are likely to prevent the development of an offshore equity market like that in international bonds. Investors need more protection regarding equities because the return is dependent upon the performance of the company and disclosure requirements are more crucial. There is also scope for insider trading. However, a domestic market can provide the right environment for trading of foreign equities. Shares in foreign companies have long been listed and traded in the United Kingdom—the shares of nearly 500 foreign companies from **38** countries are listed on the stock exchange. Changes in technology in the London market for international equities predate those in the domestic market. The London Stock Exchange developed a screen-based market in international equities some 18 months before Big Bang. This new market has been very successful, with at present **43** market makers, dealing in leading equities from about a dozen countries.

Another important area of the securities market that has undergone total transformation is the U.K. government bond or gilt-edged market, which is of particular concern to the Bank of England. In order to accommodate the move to dual capacity it became necessary to restructure this market rather on the lines of the U.S. Treasuries market. There are now **26** gilt-edged market makers (equivalent to primary dealers in the United States) and six **interdealer** brokers providing pricing information and anonymity in dealing between the market makers. Because of this market's importance to the authorities, the Bank of England acts as the supervisor of the prudential standing of the market makers and the interdealer brokers but the basis

for all the changes in this market is nonstatutory. Here too, post-Big Bang experience has been encouraging. An already liquid market has become more liquid, with turnover now three to four times as large as before Big Bang. Dealing costs and price spreads have clearly fallen. Furthermore, the authorities have been able to embark on an experimental series of auctions to cover part of the government's funding requirements, supplementing the conventional **tender/tap** arrangements. Such an innovation is only possible because of the existence of a number of well-capitalized market makers in place of a few slimly-capitalized jobbers previously.

The restructuring of the securities markets has not all been plain sailing. There have been difficulties arising from the increase in the volume of trading in the U.K. equities markets. In so far as this related to some initial teething troubles with the new **screen** quotation system, matters were relatively easily rectified. The persistent difficulties firms' back offices and company registrars are having in keeping pace with the volume of business generated in a bull market in the new environment, with the added problem of coping with massive privatization issues, is more worrying. The stock exchange is addressing the problem with urgency, but experience in New York in the late 1960s and early 1970s and the difficulties being experienced in other European centers adapting to higher business volume shows that these problems are not easy to overcome. With the development of international trading in equities, settlement difficulties carry the risk of contagion between firms in different centers where there are delays in the transfer of securities that have been traded and, hence, of possible financial failure, quite apart from the risks inherent within a single center with settlement problems. They are also likely, unless cleared up fairly soon, to restrain the development of the international equity market.

In response to these settlement constraints, dealing costs to small investors, which had fallen less than those to institutional investors since Big Bang, have now risen back to the pre-Big Bang level and a number of firms are taking no new clients—at least temporarily. This is certainly an unwelcome development. By and large, however, the verdict must be that so far the main aims of Big Bang have been successfully achieved, although it is to be remembered that the systems **have** not yet been tested in a bear market.

## Regulation of securities markets

The reverse side of the coin from the reorganization in the securities industry described above has been the construction of a new regulatory framework within which that industry should operate. The financial services industry in the United Kingdom had for many years been regulated by a limited and rather outdated statute, The Prevention of Fraud (Investments) Act 1958. This had been bolstered by varying degrees of self-regulation of some markets. This system is being replaced with a comprehensive regulatory system for investment business under the Financial Services Act. There has been some considerable misconception about the nature of regulation under this new legislation. The categories of statutory regulation and self-regulation and the well-rehearsed arguments for and against each style cannot be sensibly applied in the U.K. context. The new structure makes use of regulation by practitioners, but within a statutory-based system, although in one rather high profile area that is not subject to the Financial Services Act—the regulation of takeover and mergers activity—the Panel on Takeovers and Mergers does still operate on a wholly **nonstatutory** basis, subject, of course to the possibility of judicial review.

The Financial Services Act requires anyone engaging in investment business in the United Kingdom to have specific authorization to do so. The definition of investment business is drawn very wide, ranging from primary and secondary market activities in equities and debt instruments, the giving of investment advice on all investment instruments, the marketing and management of investment trusts and unit trusts, to the retail marketing of life insurance. The act gives powers to the Secretary of State for Trade and Industry, which he will delegate to the authority designated to regulate investment business in the United Kingdom, the Securities and Investments Board (SIB). The SIB will be financed entirely from the **private** sector by fees levied on those regulated. Firms will either have to be directly authorized by the SIB or will have to be a member of a Self-Regulatory Organization (SRO) recognized by the SIB. In order for the SIB to delegate its regulatory powers to an SRO, it must be satisfied that the regulatory scheme proposed is at least equivalent to that of the SIB. There are two main aspects to the regulatory schemes encapsulated in the **SROs'** rulebooks. The first concerns the financial **sound-**

ness of the companies involved, including capital requirements for securities business. The second relates to the rules for conduct of business, covering such items as best execution of deals, conflicts of interest, etc.

The SIB received its authority from the Secretary of State for Trade and Industry last month and the five SRO's (the Association of Futures Brokers and Dealers; the Financial Intermediaries, Managers and Brokers Regulatory Association; the Investment Management Regulatory Organization; the Life Assurance and Unit Trust Regulatory Organization; and the Securities Association) are in the early stages of seeking recognition from the SIB. The SRO that will seem most familiar is that brought into existence by the merger of The Stock Exchange with the International Securities Regulatory Organization to form The Securities Association, which will cover most securities activities, including the Eurobond market in London. The intention is that the **whole** structure will be in place in the first half of 1988.

This regulatory scheme is somewhat unusual in having market participation as a fundamental precept. This is based on the principle that those closest to the market are better able to regulate the markets than a somewhat distant government department. It is recognized, however, that such a system could be open to abuse and it is for this reason that the SIB (which, while being practitioner based, is not self-regulatory) is, as it were, set in charge of independently overseeing the work of the **SRO's**. In this way, it is hoped to preserve the fine balance that there is in regulation not only between short-term market forces and the need for long-term stability and confidence but also between the political need to protect the small investor and at the same time meet the needs of the professional participants that bring the vigor and innovation on which markets thrive.

The new financial services legislation was triggered by concerns about small investors and, therefore, has relatively detailed rules aimed at protecting the small investor. It is in the wholesale money markets in sterling, foreign exchange, and bullion that the investor protection elements of the Financial Services Act seem, likely to be least appropriate. To recognize this fact, the government has provided an exemption for firms that come onto a list to be published by the Bank of England. Supervision of these firms' wholesale market activities will be on a nonstatutory basis, with their conduct being governed by codes of best market practice published by the bank. No firm will



be compelled to come onto this list, but the bank considers it likely that most market makers and brokers will want to do so.

In admitting firms to its list, the Bank of England will take account of certain factors—in particular that the firm is adequately capitalized, has the relevant expertise to carry out its market making or broker function, and is of good reputation. Although there are some differences between the details of the capital adequacy tests proposed by the bank and those of the SIB, these are not expected to be significant in practice for most firms. More important, both the SIB and the Bank consider that their requirements will be broadly equivalent to those of the Securities and Exchange Commission in the United States, and intend to work towards the creation of a level playing field internationally.

### **Regulation of the banking sector**

Turning to the regulation of the banking sector, the main changes took place with the initiation of a statutory based regime in the 1979 Banking Act. The 1987 Banking Act, which comes into force in October, mainly incorporates a number of amendments to the earlier regime that experience in the intervening eight years has suggested to be desirable and that were set out in the White Paper on Banking Supervision published in December 1985. The most significant changes are that, as mentioned above, the two-tier system of recognized banks and licensed deposit-takers is abolished and replaced by a single category of authorized institutions. The use of the name "bank" in a title is restricted for **U.K.-incorporated** authorized institutions to those with paid-up capital and/or reserves of more than five million pounds. Institutions are required by the statute to report to the Bank of England individual large loans and other exposures that are over 10 percent of their capital base and give prior notification of any proposed transaction which would exceed 25 percent of their capital base. The Bank of England's powers to obtain information from authorized institutions are enhanced, particularly as regards those that were recognized banks under the 1979 act. A discretionary power is given to Her Majesty's Treasury to direct the Bank of England to object to proposed controllers in **U.K.-incorporated** authorized institutions if the persons are connected with countries

that do not give reciprocal access to U.K. entities in the fields of banking, insurance, and investment business. Authorized institutions are required to maintain adequate control systems and adequate accounting and other records, and auditors of authorized institutions are enabled to pass **confidential** information to the Bank of England, notwithstanding their general duty of confidentiality to their clients.

Another important evolution in the field of banking supervision, not confined to the United Kingdom, is the proposals on primary capital and capital adequacy assessment agreed between the **U.S.** federal banking supervisory authorities and the Bank of England and set out in a joint paper issued in January 1987. It is very much to be hoped that by the end of this year these proposals, amended as necessary, may have been generally agreed among all supervisory authorities of the **G10** and European Community countries, thus establishing for the first time commonly accepted standards in this vital area. The evolution of international banking in a highly competitive environment has made harmonization and agreement between supervisory authorities on the fundamental supervisory concept of capital adequacy a high priority. Without it, there is a risk that a competitive rat race could be encouraged, which would not be conducive to the security of the international banking system.

### **Some regulatory problems**

The patient reader will have observed that the separate evolutions of the banking system and securities industry in the United Kingdom described above have tended to bring them closer together and for the functions performed by institutions in each increasingly to merge. This has culminated in the creation at the time of Big Bang of significant financial conglomerates, combining under the same overall management a wide variety of financial operations (albeit often in different subsidiary companies) that had earlier been carried out in separately owned and managed entities. This functional evolution has followed the evolution of markets themselves, which have become more international, more integrated, and very much faster moving.

On the regulatory side, however, the functional basis of supervision has been deliberately maintained, notwithstanding the real possibility of supervisory overlap between regulatory agencies. This

is potentially unsatisfactory and routes are having to be found to overcome these problems while still allowing individual regulatory agencies to fulfill their statutory responsibilities. Not only are there potential overlaps between one supervisory regime and another—for example between the Banking Act and the Financial Services Act—but also within regimes, such as between one SRO and another within the Financial Services Act. The most critical area of overlap is perhaps between banking and securities supervision when these activities are transacted within the same company. Both supervisors have statutory responsibility for the financial soundness of the company as a whole, and yet the rules being applied to determine that soundness may be different from one agency to another. In the case of banking and securities regulation there is a marked difference. Banking supervisors have a strict definition of capital, but a more flexible approach as to what counts as "adequate", in that they can tolerate short-term fluctuations from the target capital ratio set for an individual bank. Securities supervisors, on the other hand, have a strict capital requirement for a given portfolio of securities but a different definition of what constitutes capital from that of the banking supervisor. This, no doubt, reflects to some extent concern for the liquidity position of the securities houses, the volatility of a securities trading book compared with a banking book, and the greater precision with which position risks on portfolios of securities can be estimated from historical data.

The details of how supervisors will share their responsibilities are still being worked out. In principle, it has been decided that most banking companies caught within the Financial Services Act net will be subject to lead monitoring by the banking supervisors. The latter will confirm to the securities supervisors that the capital is adequate after taking into account the securities positions of the bank and will pass over to the securities supervisors any returns received that relate to securities business. It is also proposed that the banking supervisors notify the securities supervisors if the bank fails at any stage to meet its target ratios or if they decide to amend the target ratio, although the details of the revised ratio would not necessarily be discussed. The securities supervisor would have sole responsibility for compliance with the conduct of business rules. In principle, it is also possible that the banking supervisors may delegate lead monitoring of banks whose business is almost exclusively securities trading to the securities

supervisor.

As far as complex financial groups are concerned, the United Kingdom has developed the concept of a "college" of supervisors. While individual subsidiaries would be subject to separate supervision by the appropriate regulator, it is seen as essential that supervisors should have the opportunity to discuss the activities of the group as a whole and to air any concerns with other supervisors. A group including banking and insurance supervisors, as well as the SIB, has been studying financial conglomerates and allocating them to a lead regulator who would chair the discussion of a particular financial group. At present, it has been relatively easy to determine which financial groups should come under the wing of which lead regulator. In other words, it is relatively easy to determine which groups are predominantly banks and which are predominantly securities traders. In the case of insurance companies, the policy of the banking and insurance supervisors, referred to above, has kept insurance companies and banks from combining with companies of similar size in each others' area. As with lead monitoring of individual companies, while outline arrangements for "colleges" have been agreed, the operational details have still to be resolved, but the Bank of England remains confident that with good will from all concerned, solutions to these complex problems can be found.

### Conclusion: The future

The restructuring of the British financial system centered around Big Bang is still very recent, and the new supervisory regime is not yet fully in place so it would be tempting providence to speculate too far about possible further development. The ardent wish of many of those involved must be for a pause for breath, during which the new structures of markets and supervision can bed down into some sort of new equilibrium, but a great surge of competitive energy having been unleashed, a period of consolidation seems relatively unlikely. Experience shows us, of course, that human structures never are in equilibrium—every apparently static state has within it the seeds of its own change. The best one can do at this stage, perhaps, is to try to identify the main characteristics of those seeds, without seeking to forecast which will prove dominant.

The influences tending to push developments further in the direction in which they are already moving, i.e., towards further competitive restructuring of functions and the creation of new and larger financial service conglomerates, are still enormously powerful. International competition shows no signs of abating, particularly if judged against the volume of complaints that the playing fields are unlevel, and is likely to be given added impetus to the extent that pressures in the United States and Japan to amend the Glass-Steagall Act and Article 65 of the Japanese Securities Act prevail. There is no sign either that the major corporate customers for the improved and cheaper financial services being provided under the new structure are showing any tendency to move away from supermarket shopping to boutique shopping. We frequently hear from banks that in order to gain or retain major international companies as clients it is necessary for them to be in a position to offer a full range of products and services. Finally, the decisions taken at the political level by the countries of the European Community to liberalize capital movements and establish a free "internal market" in goods and services within the European Community by 1992 suggests that the scope for the establishment of genuinely European financial conglomerates could be enhanced. The competitive strength and capitalization of U.S. and Japanese securities houses in foreign markets is in no small part based on the size of their respective domestic markets. The creation of a genuinely free internal European market in financial services has the potential to provide a comparably strong domestic market to underpin the international activities of those European **financial** institutions with the imagination and will to exploit it, although it would be foolish to underestimate the political obstacles to be overcome.

There are, however, influences moving in the other direction. The adequacy of structures can only be determined when they have been tested in adverse conditions. So far, the restructuring of the British financial system has taken place in a sustained bull market. There are already signs, however, that some participants have decided that there is not enough profitable business to be done in certain areas, even in a reasonably benign market climate, to sustain the number of players currently competing for it. A few market makers have already withdrawn from particular markets. And concern is widely felt and expressed at the level of overheads, particularly in terms of remuneration packages that will have to be covered before profits

will be seen. None of this is surprising in the context of the holistic changes that have taken place. By no means all firms wish to be all things to all men and by no means all who do are finding the going easy.

It is not only in new British financial conglomerates that the problems of control in large organizations have come to the fore, aggravated no doubt to some extent by the cultural differences to which reference has been made earlier. The measurement and control of risk is a difficult area for all firms operating in the current environment of financial innovation on an international scale, and there have been welcome signs in a number of areas recently that managements of financial institutions are **taking** this message to heart.

The danger of controls being inadequate in large organizations affects the attitude and conduct not only of management but also of supervisors. The larger and more varied the conglomerate, the more each functional supervisor must be concerned less a problem in one part of a conglomerate spreads by **contagion** to another. The instinct in such circumstances must be to err on the side of caution, which implies more supervision rather than less. There is a real danger that the costs of supervisory compliance may outweigh the potential gains of synergy from the formation of a conglomerate in the first place. Much will depend in the longer term on management systems to monitor and control risks being seen to be effectively implemented. The better the internal management controls are seen to be, the less intrusive need be supervisory requirements. We shall hope to achieve the necessary stringency combined with adaptability at reasonable cost, by maintaining a pragmatic approach that remains so far as possible practitioner-based. Indeed the apparent complexity of the Financial Services Act derives in no small part from the attempt it represents to incorporate practitioner-based supervision within a statutory framework. It is too early to say that the attempt will be successful.

Finally, it is hard to imagine any such success being lasting without the development of a harmonized approach to securities market regulation internationally. This has been the inevitable trend as regards banking supervision, slow and difficult as the process of harmonization has proved to be. It can hardly be otherwise **with** 'securities market regulation, and it is encouraging that the first steps are being taken in this direction.