Managing my financial journey

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Introduction

The dramatic events of the financial crisis in the late 2000s transformed the UK financial services industry. Long established institutions went out of business, others were forced into takeovers and only the intervention of governments worldwide - courtesy of eye-watering financial recovery packages - prevented the banking industry from implosion. Now, nearly 10 years on from the crisis, it’s time to take stock and examine how the industry looks today. Most importantly, how is the industry now working for the consumer? What are the products? How competitive is the industry? Is regulation working effectively to protect consumers in the financial marketplace? Where can consumers go to get help and guidance in a changing financial environment?

This four-week course will guide you through the UK financial marketplace, starting with a rapid review of the history of the industry leading up to the financial crisis that transformed it. You will:

- examine the institutions that comprise the industry and the issues they are currently grappling with
- walk down the aisles of the financial supermarket to see what is changing with the products on offer
- look at how the industry is now regulated
- find out how this regulation, and the guidance provided by various agencies, can help you make the right, informed choices when transacting in the financial workplace.

At the end of the course you will have gained a full insight into how the financial services industry operates and how you can transact business with knowledge and confidence.

This course is presented on OpenLearn with the kind support of True Potential LLP. If you want to know more about the work of the True Potential Centre for the Public Understanding of Finance (PUFin) and its mission to improve personal financial capability, check out the centre’s website. The centre, generously funded by True Potential LLP, has a mission to develop teaching and undertake research to help improve public financial capability.
Learning Outcomes

After studying this course, you should be able to:

- understand the development of the financial services industry up to the 2007/08 global financial crisis
- appreciate how the financial services industry and the way it is regulated have changed since the financial crisis
- understand recent developments to financial and other investment products
- understand how the regulation of financial firms is conducted
- understand how sales of financial products are regulated and how this regulation aims to protect consumers.

Week 1: The origins and development of financial services

Week 1 Introduction

Welcome to Managing my financial journey – a four-week course that looks at the UK financial services industry today, its origins and its contemporary challenges. The course also explores the way that financial firms are regulated and looks at how the rights and interests of consumers are protected.

Video content is not available in this format.

Introduction
In this first week you will trace the evolution of financial services all the way from the sixteenth century right up to the modern day. There is a particular focus on developments in the last 30 years – including the 2007/08 global financial crisis, which saw parts of the industry in meltdown. Certainly the crisis has affected the structure and operations of the industry today – particularly in terms of how financial firms are now regulated.

Before you start, The Open University would really appreciate a few minutes of your time to tell us about yourself and your expectations of the course. Your input will help to further improve the online learning experience. If you’d like to help, and if you haven’t done so already, please fill in this optional survey.

You will begin by tracing financial services back to their roots.

**Note: ‘firms’ and ‘companies’**

Throughout this course ‘firm’ is used as the collective term for all non-governmental institutions including companies (owned by shareholders), mutual organisations (owned by customers), partnerships and sole traders. This aligns with the use of the term by regulators in the UK. The specific terms ‘company’ or ‘mutual’, etc. are only used when the content relates to such types of firms or when the terms are used within the name of a type of financial product (e.g. company pension, company bond).

This course is presented with the kind support of True Potential LLP.

*The True Potential Centre for the Public Understanding of Finance* (True Potential PUFin) is a pioneering Centre of Excellence for research in the development of personal financial capabilities. The establishment and activities of True Potential PUFin have been made possible thanks to the generous support of True Potential LLP, which has committed to a five-year programme of financial support for the Centre totalling £1.4 million.
1.1 The origins of banking

Figure 1

The origins of financial services pre-date the industrial and agricultural revolutions and even the emergence of developed patterns of international trade. If we take the activity of money-lending as being a precursor to the banking industry, then we can find references to the early years of financial services in the Bible.

In the book of Exodus, we learn that the laws of Moses forbade money-lending, whereas in the book of Nehemiah there are references to the condemnation of usurers (money-lenders) who ‘upon lending money to their poorer kinsfolk, exacted pledges of vineyards and even children, and demanded interest’ (cited in Harvey, 1976). Within England during the Middle Ages, the Usury Laws, based on the doctrines of the Bible’s Old Testament, made it illegal to require interest to be charged on lent money. These laws were eventually repealed in 1545. For some religious groups, however, usury is still forbidden with the result that alternative arrangements, like Islamic finance, have to be used to facilitate borrowing and lending activities.

The transition of the ill-regarded activity of money-lending into the respectable profession of banking was linked to the development of trade and also the needs of government. A key development in England occurred in the later Middle Ages when merchants from Italy settled in London. Many were goldsmiths who dealt in gold and silver, but augmented this business by undertaking money-lending against the provision (pledge) of an asset (such as gold plate) as security. Prior to their abolition, the Usury Laws were sidestepped by charging the borrowers a fee either for the custody of the pledge or for its redemption on repayment of the borrowed money.
The seventeenth century saw the growth in affluence of the merchant classes (those engaged in domestic and international trade), who deposited their stocks of bullion with the goldsmiths for safe-keeping. Receipts were issued by the goldsmiths for the valuables deposited, and these receipts later became known as bank notes. Merchants found that they could exchange these notes to settle their financial obligations – in effect, starting the use of paper currency in the economy. Recognising that withdrawals of bullion by their owners only normally constituted a small proportion of that held in safe custody – a pattern reinforced by the practice of merchants using bank notes to settle debts, rather than drawing on their deposited bullion – the goldsmiths found that they could extend their lending business. They did this by issuing bank notes totalling in excess of the value of bullion held on deposit – so leading to the process of credit creation that is an integral feature of current banking practice. With the issuance of bank notes to support money-lending, the goldsmiths became the first banks.

1.1.1 Banking and the union of England and Scotland

The origins of banking in the UK had their roots as much in Scotland as they did in England.

In Scotland, the formation of the banking industry started with the formation of the Bank of Scotland in 1695, which retained monopoly powers in the country until the early eighteenth century. In its early years, the Bank of Scotland had to face the financial challenge arising from the collapse of the Darien Scheme which, without the support eventually given by England, threatened to bankrupt the Scottish economy.

The Darien Scheme was an attempt by Scotland to develop its colonial activities to rival those of England.

The scheme was masterminded by William Paterson and involved the establishment of a colony in the Isthmus of Panama, with the aim of benefiting from trade with the Far East. In a sense, the rationale of the plan was in line with that which eventually saw the construction of the Panama Canal.

The scheme got underway in 1696. The colony was initially based at the Bay of Darien. Organised by the Company of Scotland, which had been recently established to support Scotland’s colonial ambitions, the scheme attracted substantial investment from Scottish firms and individuals totalling around £40 million in today’s (2016) money.

Hit by disease, attacked by the Spanish (because Spain had a claim to the same territory) and undermined by England’s refusal to support the scheme (partly because it did not want to alienate Spain), the Darien Scheme quickly collapsed in 1700. Most of the colonists died and the investors lost their money.

The Darien Scheme has been cited as a major factor behind the Acts of Union 1707 between England and Scotland. It has been argued that the failure of the scheme led to a belief in Scotland that if it was to benefit from colonialism and international trade, it had to unite with England.

However, William Paterson had more success with another project on which he took the lead: the establishment of the Bank of England which you look at later this week.

Scottish banking after the union

In 1727, the Royal Bank of Scotland was formed. One early problem was that with both the Bank of Scotland and the Royal Bank of Scotland being Edinburgh-based, and Edinburgh-biased in their lending, businesses operating elsewhere (including Glasgow) often found it difficult to get credit. The upshot was that merchants in other cities set up
their own private banks – something which merchants in England were not legally empowered to do.

The British Linen Bank became the leading competitor to the two Edinburgh-based banks in the first half of the eighteenth century and set up offices in several Scottish towns. In doing so, it became the first of the Scottish banks successfully to start a branch network. During the industrial revolution in the early nineteenth century, the structure of Scottish banking changed quickly. The growth of trade and commerce meant that many of the smaller provincial banks were too small to provide the scale of banking support required by their customers. The result was the establishment of new, larger banks, formed in part through the merger of certain of the provincial banks. This period saw the establishment of the Union Bank of Scotland in 1830 and the Clydesdale Bank in 1838.

One clear feature of the development of the banking industries in England and Scotland was the limited nature of cross-border activities. The banks very largely kept within the borders of their own country – although the Scottish banks did open offices in London in the 1860s and the Clydesdale Bank caused controversy in 1874 when it opened three branches in the north of England. Both of these developments prompted considerable opposition from the English banks, and subsequently the Scottish banks gave up plans to establish branch networks in England. Some observers believe that this was to the disadvantage of the Scottish banks; these arguably had greater financial strength than their English counterparts in the nineteenth century. If cross-border activities had occurred, they would probably have included the acquisition of many of the English banks by those based north of the border.

The next century witnessed a period of consolidation in the Scottish banking industry. By the 1970s, the number of commercial banks had been reduced to three – the Bank of Scotland, the Royal Bank of Scotland and the Clydesdale Bank. The following decade also saw the consolidation of the small savings banks in Scotland into one institution – the Trustees Savings Bank Scotland (TSB Scotland).
1.1.2 The Bank of England and the growth of banking

In 1694, the Bank of England was established. This resulted from the need of the government of King William III to raise funds to finance the war with France. With no single goldsmith prepared to shoulder the risk, a group of partners agreed to share the business between them, lending the King £1.2 million at an interest rate of 8 per cent per annum. Additionally, the group of goldsmiths extracted the right, via a charter, to form a company to carry on banking operations in London under the name of ‘The Governor and Company of the Bank of England’. In subsequent years, the government borrowed additional sums from the bank, and when its charter was renewed in 1708 an Act of Parliament was passed prohibiting any other bank with more than six partners from issuing bank notes. This effectively gave the Bank of England the monopoly in note-issuing among the large banks in England.

The eighteenth century witnessed the development of country banks to provide banking services outside London, and the establishment of specialist, private banks in London. There were 68 banks in London at the end of the eighteenth century and around 400 in the provinces – and with most having no more than six partners, a high proportion of these were able to issue their own bank notes!

However, the years from 1775 to 1825 did turn out to be calamitous for the embryonic banking industry as it struggled during a prolonged period of weakness in the economy, with certain assets (particularly land) falling in value. The Bank of England itself came under pressure, with its cash reserves being depleted, largely due to the extensive borrowing by the government to finance the war with France. There was a succession of bank failures, with events culminating in 1825 with the collapse of 63 country banks.
These failures emphasised that the main weakness in the banking system was that the restriction on the right to issue notes if there were more than six partners meant that most banks were, inevitably, small. Consequently, many were always going to be vulnerable at times of weakness in the economy, and especially during localised weaknesses – with the result that many were unable to meet their obligations to their depositors.

Figure 3

The nineteenth century consequently saw a period of reform in the banking industry. In 1826, permission was granted to banks with more than six partners to issue notes, provided they had no branches within 65 miles of London. The additional power this gave to the provincial banks was counterbalanced by the Act also granting the Bank of England the right to set up branches in the provinces – a right it understandably took advantage of.

The year 1833 saw the right of the provincial banks to open branches in London, albeit without note-issuing rights. The first to do so was the London and Westminster Bank in 1834. The emergence of these new banks in London, operating without note-issuing rights, was effectively the birth of the banking system we are familiar with today.

The 1844 Bank Charter Act further constrained the right to issue notes by preventing any additional banks, from that point, from acquiring note-issuing rights. Furthermore, banks with the prior note-issuing rights that changed their corporate status (i.e. their ownership structure) or merged with another bank would lose their right to continue issuing notes. In effect, the 1844 Act paved the way for the Bank of England to become the sole issuer of bank notes in England.

You will recall that it was the power to issue notes (for those banks with no more than six partners) that provided the capacity to create credit through the issuance of notes with a value in excess of the value of the deposits of bullion held. Now, with the capacity to create credit through note-issuing denied to them, the banks had to turn to a new means
of supporting their lending activities. This led to the emergence of the cheque system, and with it the evolution of the modern banking industry.

1.1.3 Cheques and the emergence of modern banking

As early as the late seventeenth century, some bank customers were settling debts by writing letters to their banks requesting them to pay money to the person stated in the letter (the payee), with this being financed by funds being debited from the account of the person making the payment (the drawer). This means of settling debts was convenient not only for the customers (because it reduced the need for them to carry money around), but also for the banks. If both payee and drawer were their customers, the likelihood was that no actual funds would be withdrawn and that all that would be needed was for one account to be credited and the other debited. Given these advantages, those banks without note-issuing rights encouraged the use of cheques by their customers and began issuing cheque books.

Clearly the situation was more complicated if the two customers used different banks: funds would then have to pass from one bank to another, which was a cumbersome and often dangerous activity. To get around this problem, bank clerks started to meet at various venues, such as coffee houses, to set off the required cash movements relating to each cheque against each other, with only the balance having to be paid in actual funds from one bank to another.

These meeting places for bank clerks were the precursors of the clearing houses. In 1773, such a clearing house was set up in Lombard Street in London. In time, the member banks of the clearing house – that is, the clearing banks – kept their accounts at the Bank of England. This made the making of daily settlements between the clearing banks a simple process of book adjustments to each bank’s account. The consequence of the development of the cheque system was a vast reduction in the volume of cash required to settle debts. With greater capacity to hold cash as a reserve to meet unexpected demands from their customers, banks now had the capacity to create credit by granting loans to customers simply by crediting the customers’ accounts, as opposed to the old process of issuing and distributing their own bank notes. With the account credited, the customer could draw on the loan by writing cheques in favour of third parties to be drawn against their bank account.

The cheque system developed quickly in the nineteenth century, particularly as many banks lost their note-issuing rights through mergers and changes to their corporate status. The pattern of banking with which we are now familiar was thus established by the mid-nineteenth century. The subsequent century saw mergers and takeovers further reduce the number of banks in England and elsewhere in the UK, with the industry becoming centralised in London and Edinburgh. In England, by the second half of the twentieth century the banking sector was dominated by Lloyds, Barclays, Midland, Westminster and National banks – the original ‘big five’. The merger of the National and Westminster banks in 1968, to form the National Westminster Bank (in due course known as the NatWest) reduced the ‘big five’ to the ‘big four’.
Further material developments in the UK banking sector late in the twentieth century and early in the twenty-first included:

- Midland Bank being acquired by HSBC in 1992
- Lloyds Bank merging with the Trustees Savings Bank (TSB) in 1995 to become Lloyds TSB
- NatWest being acquired by the Royal Bank of Scotland (RBS) in 2000
- the Bank of Scotland merging with Halifax Bank (which had previously been a building society; see the next section) to become Halifax Bank of Scotland (HBOS) in 2001.
- Santander, the Spanish banking group, acquired the Abbey National Bank in 2004 and created Santander UK. Abbey National had previously been a building society but had converted to being a bank in 1989. We look at building societies in the next section.

So in the first years of the twenty-first century, the new ‘big six’ UK banks comprised Barclays, Lloyds TSB, HBOS, HSBC, RBS and Santander UK.

As regards the UK’s central bank, the position of the Bank of England as the central bank and the government’s banker was confirmed by its nationalisation in 1946 by the Labour government. The Bank still acts as banker to the banks, as the lender of the last resort and as the government’s banker.
1.1.4 Building Societies

Around the time that the banking industry was starting to take its contemporary shape, another facet of modern-day financial services was emerging. Building societies were formed in huge numbers during the nineteenth century, particularly in the north of England, as a means for those on modest incomes to be able to buy their own house. They were formed as ‘mutual’ organisations with each of the building societies being owned by its mortgage and savings customers – its ‘members’. This ownership status compares with that of companies, which are owned by their shareholders, with those who are just customers having no ownership rights.

In the following video Martin talks about the origins and evolution of the building societies sector in the UK.

Video content is not available in this format.

Martin Upton

1.1.5 The emergence of the insurance industry

The history of insurance can be traced back as far as Roman times and the existence of Roman collegia – groups of priests, artisans or neighbours held together by religion and common aims. One of the latter was ‘providing a fitting burial for the members’ (Jack, 1912). In return, the members would, from time to time, make a payment or donation to the collegia (or guilds, as they later became). This need arose from a desire to protect one’s family in the event of an early or untimely death, and as society moved away from a tribal to a family structure, the desire and perceived need for insurance grew.

Near the end of the seventeenth century, Daniel Defoe wrote ‘insuring of life I cannot admire, I shall nothing to it but that in Italy, where stabbing and poisoning is so much in vogue, something may be said for it’ (Defoe, 1969 [1697]). Despite Defoe’s misgivings, it
was the countries with the lowest early death rates, such as England, where insurance grew up and became popular earliest. So whereas forms of insurance have their roots in Roman times, insurance only started to become widespread from the late eighteenth century onwards (Cockerell and Green, 1994).

The insurance business in the UK has developed from these early beginnings to be the largest insurance industry in Europe and the second largest in the world, employing over 320,000 people in the UK alone (ABI, 2013).

**Figure 5** Insurance companies used to provide fire brigades for their insured properties. Owners were provided with a plate ('fire mark') to affix to their properties as proof of insurance cover.

The development of the business has been complex and interwoven with social changes and historical events and, because of the diverse nature of insurance, has developed in different ways depending on the ‘line’ (type) of insurance. For example, the history of motor insurance is much more recent than that of other types of insurance because the car was not invented until the late nineteenth century. To show this, you will explore the development of three different lines of insurance:

- marine insurance
- fire insurance
- life assurance (in the UK, the insurance of a life is known as life assurance).

Before this, however, you will briefly explore the purpose of insurance and distinguish between the two main groupings of insurance: long-term and general (also known as annual) insurance.
The purposes of long-term and general insurance

Insurance grew out of the need to provide some financial protection for individuals and businesses if a certain event happened. In return for this protection, the insured would pay to the insurance firm a premium to provide that protection.

Early life assurance policies were commonly taken out by a husband in order to protect his wife and children, should he die at an early age. Life assurance is an example of long-term insurance because, once started, the insurance continues over the long term – provided that the insured continues to pay their premium. It also usually means that, once the policy has begun, the level of premium stays the same. Long-term insurance is most commonly associated with insuring either someone’s life or their health.

In contrast, general insurance provides cover typically only for a year, at which point the firm has the right either to refuse continuing the insurance of the individual or firm, or to change the premium level. This business is usually associated with the need to provide financial protection in the event of destruction or damage to property (e.g. a car, house or building) and is usually known by the collective term of general insurance.

Now that you’ve examined the purposes of long-term and general insurance, it’s time to look at how some specific types of insurance have emerged since the seventeenth century.

Marine insurance and Lloyd’s

Much of the early insurance was underwritten by Lloyd’s underwriters. In the early days of Edward Lloyd’s coffee house in the late seventeenth century – where such insurance business was conducted (thus christening the name of the eventual institution) – these underwriters were individuals. Subsequently, these individuals underwrote for others, thereby creating ‘syndicates’. These individuals (and, subsequently, syndicates) initially just underwrote marine insurance – the insurance of ships and their cargo against loss or damage at sea.

By the mid-eighteenth century, the reputation of the coffee house was under threat from gamblers, and therefore in 1769 the foremost marine underwriters left the coffee house to form New Lloyd’s and to publish the New Lloyd’s List (a list of commercial and shipping information). New Lloyd’s subsequently became known as Lloyd’s, which then became the centre for marine insurance and the basis for good underwriting practice – and has remained so up to the present day.
Lloyd’s is now made up of a number of syndicates (96 as at September 2015) but these no longer consist of individual members or ‘names’. Until 1994 ‘names’ with unlimited liability were the only source of capital. However, following the huge losses incurred during the years of account from 1988 to 1992 (largely resulting from claims relating to asbestos and pollution), most ‘names’ were either unwilling or unable to continue to provide capital. Access to corporate capital was therefore permitted. Unlimited liability ‘names’ now only account for a tiny proportion of Lloyd’s capital and no further members are allowed to join on this basis. All capital providers are now known as ‘members’.

Until 1980 insurance brokers were allowed to own the managing agencies that managed the syndicates. This meant that it was perceived that brokers could bring undue influence to bear on underwriters under the same ownership to accept business from them or place reinsurance through them. This was one of the issues dealt with by the Lloyd’s Act 1982, which enforced divestment of managing agencies and brokers.

Marine insurance, as with many other types of general insurance, regains some of the losses it makes through the salvage of the goods that have been destroyed or damaged, and a significant salvage industry has arisen from this. Sometimes, however, this salvage can take many years to recover, as in the case of the SS Central America which sank in 1857 with 3 tons of gold on board. This cargo was not recovered until 1992, at which point the original insurers successfully claimed that it belonged to them.

Fire insurance

At around the same time that Lloyd’s was becoming established, other types of insurance were starting to become more popular. Although not the oldest class of insurance, fire insurance – insuring buildings against the risk of fire – was the first to achieve corporate status, with the creation in 1667 of the Insurance Office (which became the Phoenix
Insurance Company in 1710 and subsequently became part of the Royal & Sun Alliance Company, which exists today). Some of the first fire insurance policies were issued on properties rebuilt after the Great Fire of London in 1666. Although the earliest fire insurance policies were on private houses and contents, this market gradually expanded to cover fire risk to commercial buildings. Because of the larger risks being borne, insurance firms tended to spread the risk between numbers of them. Nevertheless, the Tooley Street fire of 1861 resulted in overall claims of £1 million (a considerable amount at the time) and led to the insurance firms backing the creation of the London Fire Service, to which they made contributions. Fire insurance continued to develop throughout the nineteenth century, eventually becoming part of a package of insurance cover which is commonly offered under buildings insurance policies today.

![Tooley Street fire](image)

**Figure 7 The Tooley Street fire**

**Life assurance**

Life assurance has been available in one form or another in the UK since the late sixteenth century. The first policies were typically only issued for a period of 12 months or for the term of an overseas voyage. By the early eighteenth century, life assurance schemes were starting to emerge, the first of these being the Amicable Society for a Perpetual Assurance Office in 1706. Each member paid a regular subscription and, when they died, their nominees were entitled to receive a lump sum from the society. One problem with life assurance was that initially it proved to be very unprofitable, with the pay-outs to nominees exceeding the premiums collected ahead of the deaths of the insured. That all changed with the introduction of mortality tables, which predicted the statistical likelihood of an individual dying within the lifetime of a particular policy. The first firm to adopt this ‘actuarial’ approach to life insurance was the forerunner of Equitable Life, and
subsequently life assurance quickly became much more widespread as a consequence of the skills provided by actuaries.

Another change fundamental to the development of all types of insurance, including life assurance, arose from the Gambling Act 1774 and certain earlier Acts relating to marine insurance. These brought in a requirement that in order to insure something you had to have an interest in it being unharmed – so that is why, for example, you almost certainly have an insurable interest in your own house but not so in your neighbours' houses. The legislation was required to stop unscrupulous individuals 'gambling' on the death of some unknown individual. In one notorious case, a group of men insured an old man who they believed was about to die. Unfortunately for them, he was more robust than they had thought and continued to live. Frustrated by the high premiums they were paying to insure him, they decided to murder him instead and collect the insurance – an act for which they were hanged (Spalding, 2008).

As assurance developed, so did the ability of assurance firms to better assess the risks each person brought to the insurance firm. It was common practice to increase premiums with age, but firms started to decline business or rate it (i.e. apply higher premiums) where the insured had some form of medical condition or brought – through their occupation or pastimes – a higher-than-average risk.

### 1.2 The London Stock Exchange

In the following video Martin examines the events leading to the creation of the London Stock Exchange and its development up to the twentieth century. In the video he also refers to the South Sea Bubble fiasco. Details of this famous historical episode are provided in the glossary.

| Video content is not available in this format. |
| Martin Upton |
1.2.1 The growth of the Stock Exchange

The table below shows the substantial growth and the changing composition of activity in the Stock Exchange in the 60 years leading up to the First World War. Note that most of the securities comprised what are known as debentures – bonds secured on the assets of the issuing companies – rather than ordinary shares, which are commonly used by companies these days to raise finance via the Stock Exchange.
The development of the Stock Exchange in the first half of the twentieth century was dominated by the financial effects of the two world wars and by the worldwide economic depression in the 1930s. One major consequence was the rapid growth in the need for finance by the UK government, with the level of national debt consequently rising substantially. A second consequence was the reduction in finance available for overseas investment as a result of the impact the wars had had in reducing the volume of funds for such activities. Additionally, the introduction, on the outbreak of the Second World War, of constraints on the amounts of foreign currency that could be acquired by both individuals and firms – known as foreign exchange controls – reduced the scope for investment abroad. These controls were to remain in place for 40 years.

One key development in the immediate aftermath of the Second World War was the nationalisation by the Labour government of the key utilities industries – including the railways, the energy companies (including the coal mining companies) and the steel industry. This resulted in the removal from the Stock Exchange of certain of the companies that had been nationalised, materially reducing the aggregate value of companies listed.

As the UK economy started to recover after the Second World War, the appetite for finance by companies increased. Instead of using debentures to raise funds, companies increasingly looked to the issue of shares to raise capital. This switch was in part the result of the growing importance in investment markets of the pension funds, which had a demand for long-term investments such as shares. Notwithstanding the changing fortunes of the UK economy during the 30 years after the Second World War, the role of the Stock Exchange as a centre for raising finance both for governments and for companies was maintained. Indeed, its position as the largest stock exchange in the world (until it was overtaken in size by the New York Stock Exchange) provided a keen incentive to companies to list their shares there.
to overseas companies to use it to issue shares. The position of the London Stock Exchange was also strengthened by its merger after the Second World War with the much smaller, provincial stock exchanges that had been established in other major UK cities. Foreign exchange controls – including those limits on how much foreign currency could be acquired by UK citizens and firms – were finally abolished by the incoming Conservative government in 1979. This both opened up the UK for inward investment from overseas and provided virtually unlimited scope for individuals and firms to invest overseas.

As you will see later, this change to the environment within which the Stock Exchange operated was matched by fundamental changes to the financial services industry as a whole.

Activity 1.1 Financing the industrial revolutions
Why did the development of the railway and mining industries in the nineteenth century prompt a major increase in the need for finance by firms involved in these two sectors?

Discussion
Railway and mining require a huge amount of money for investments in infrastructure before any income can be earned through the sale of rail services and mined products. The need for substantial finance – and for this finance to be available over a long-term period before it was repaid – required the use of the Stock Exchange to access funds of those who were prepared to invest over the long term, but who also wanted to be able to sell their investments to other investors at any time if they needed to recoup their money.

1.2.2 The rise of the investment funds
In the following video Martin talks to Professor Janette Rutterford about the emergence and development of investment funds.
Institutional investment funds

One of the most striking developments in the financial services industry in recent decades has been the rise of the institutional investment funds. These include the pension funds, unit trusts, open-ended investment companies (OEICs), investment trusts and the funds held by insurance companies.

The aggregate institutional holding of UK shares doubled (from 35 per cent to 70 per cent of total share holdings) between the 1960s and the 2000s. Similarly, holdings of UK government securities (also known as gilts) by institutional investors increased from 25 per cent of the total to 66 per cent over the same time period (Rutterford and Davison, 2007, Table 10.1). By contrast, the same period saw an equally marked fall in the direct holding of such investments by individuals.

Table 1 Institutional investment funds

<table>
<thead>
<tr>
<th></th>
<th>1963</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rest of the world</td>
<td>7.0%</td>
<td>53.8%</td>
</tr>
<tr>
<td>Individuals</td>
<td>54.0%</td>
<td>11.9%</td>
</tr>
<tr>
<td>Unit trusts</td>
<td>1.3%</td>
<td>9.0%</td>
</tr>
<tr>
<td>Other financial institutions</td>
<td>11.3%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>10.0%</td>
<td>5.9%</td>
</tr>
<tr>
<td>Pension funds</td>
<td>6.4%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Public sector</td>
<td>1.5%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Private non-financial companies</td>
<td>5.1%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Investment trusts</td>
<td>*</td>
<td>1.8%</td>
</tr>
<tr>
<td>Banks</td>
<td>1.3%</td>
<td>1.4%</td>
</tr>
</tbody>
</table>
Charities, Church etc. 2.1% 1.2%

* The 1963 data for investment trusts are included in the ‘Other financial institutions’ data.

Source: Adapted from National Statistics Online and Office for National Statistics (2015a)

Although the privatisation of nationalised industries and the conversion of many building societies into banks in the 1980s and 1990s markedly increased the number of shareholders in the UK – from 3 million in 1979 to 15 million by 1997 (falling back to around 11 million by 2009) – most individual investors only have very small holdings of shares. Consequently, as mentioned above, these developments did not change the sharply downward trend line in the percentage of shares directly held by individuals. The main reason for this is that, during recent decades, individual investors have moved from investing directly in shares and securities to investing indirectly via third parties. One reason for this has been the growth of company pension schemes during this period, with individuals paying into pension funds that, in turn, invest in shares and other investments – in effect, on behalf of the individual contributors.

Another major reason for the shift of investment activity away from direct investments has been tax policy, with certain institutionally organised investments offering a better post-tax return. The tax relief applied to premiums paid to those investing in life assurance policies until March 1984, combined with a relaxed regulatory environment for selling these products, established an environment where sales of policies boomed. Additionally, life assurance products that paid lump sums to the policy-holders on the maturity of the policy (i.e. paid out a return even though the investor had not died) provided a means to enhance retirement funds – particularly for those with inadequate pension arrangements.

Use a fund manager or go it alone?
The growth of investment funds reflected a desire by investors to pass responsibility for their investments to fund managers.

Activity 1.2
What are the attractions in using fund managers as an alternative to looking after one’s own investments?

Discussion
The individual investor may be seeking to gain the fund manager’s expertise (with this being reflected in the returns from the investments). If nothing else, passing the responsibility also means that the individual does not need to spend time arranging and managing their investments. However, by passing responsibility, subject to the fund invested in and the mandate given to the fund manager, there is a loss of control by the individual over the management of their investments. Additionally, even the most experienced of fund managers sometimes achieve poor returns on the funds they are managing. Passing responsibility will also result in fund management charges being levied on the individual investor.

1.2.3 The liberalisation of the financial services
The financial services industry prior to the 1980s was an environment of demarcation. Banks provided cheque accounts, overdrafts and loans. Building societies provided
mortgages for home buyers and savings accounts for savers. Insurance firms provided insurance products. Although there were some modest overlaps in product offerings, the pattern prevailed of (informal) demarcation and clarity – in terms of where you went for a particular product.

A further feature was the nature of the relationships between the institutions and the public. These relationships were typically long-term and conflicted with the contemporary pattern where individuals move from one provider to another much more regularly in order to secure the best deal. If you were seeking to obtain a mortgage from a building society prior to the 1980s, the normal expectation was for you to have been a saver with the same building society for a period of time – thus paying at least lip-service to the original mutual concept of building societies. Even when a mortgage was approved, it was possible that you would have to effectively queue up for it rather than have the funds made immediately available to you. All of this is a far cry from the fluidity that now exists in the relationships between providers and product buyers. What changed this financial environment?

The overarching change was the liberalisation of the financial services industry that resulted from the Financial Services Act 1986, the Building Societies Act 1986 and the Banking Act 1987. These pieces of legislation provided greater freedom to banks and building societies to diversify their activities and to seek finance from the wholesale markets to support their lending. Subsequent years saw many of the larger building societies offer cheque accounts to customers, while banks moved more actively into the mortgage, savings account and insurance markets. This move into the insurance business gave rise to the term 'bancassurance', summarising the extended operations of these diversifying banks.

The enlarged scope to raise funds provided by wholesale funding meant that mortgage lenders could respond to the growth in mortgage demand that was stimulated by the expansion in home ownership. Additionally, subject to checks on the creditworthiness of customers, mortgages could be provided on demand. The requirement to be a saver with a building society before you could borrow from it quietly disappeared.

At the same time, changes occurred to the pricing of products. Previously, mortgage rates had been tacitly agreed by a cartel of the largest building societies, with the result that there was little to choose between the mortgage lenders in terms of price. The liberalisation of the industry saw the end of the cartel and the emergence of a more competitive market for mortgage offerings, to the benefit of customers. The liberalisation also saw new providers enter the market, with overseas financial firms such as MBNA entering the UK credit card market and supermarkets such as Marks & Spencer, Tesco and Sainsbury’s commencing financial services business in partnerships with banks.
By the 1990s, the preconditions for a boom in financial services – including a boom in the various forms of lending to individuals – had been created. Affluence and the demand for home ownership pushed at an open door of product availability that had been harnessed by the concurrent liberalisation of financial services.

Subsequently, most of the larger building societies converted to banking status – starting with the Abbey National Building Society in 1989, and then in the 1990s Halifax, Northern Rock, the Woolwich, Bradford & Bingley and Alliance & Leicester. Others, including the Leeds Permanent, National & Provincial and Bristol & West, were acquired by these ‘converters’ or other banks, with the result that the size of the building society sector shrank dramatically.

Various reasons were proffered by the converting societies to justify the change in their status – including increasing access to finance, greater recognition in the international environment, greater scope to diversify product offerings and even greater capacity to attract and retain top-calibre staff. The executives of the building societies may also have been influenced by the prospect of the higher remuneration likely to arise through conversion to banking status. Membership approval had to be sought for the changed corporate status – although the offer of ‘free’ shares in the new companies to members (who, after all, owned the building societies) provided an incentive to forgo mutual status.

In tandem with (and subsequent to) these conversions, the financial services industry witnessed a marked consolidation, with the Royal Bank of Scotland taking over NatWest;
Lloyds Bank taking over TSB; the Bank of Scotland amalgamating with the Halifax to become HBOS; and the international HSBC bank acquiring Midland Bank.

In the 2000s the Spanish bank Santander became a major player in the UK via the acquisition of Abbey National (in 2004), Alliance & Leicester bank (in 2008) and the deposit-taking part of Bradford & Bingley bank (also in 2008). The consequences of the 2007–08 financial crisis led to the takeover of HBOS by Lloyds TSB to form the Lloyds Banking Group, which as a result, became a colossus in the UK financial services industry.

1.2.4 Big Bang and the rise of the investment banks

The second major development that radically altered the operation of the financial services industry in recent decades was the so-called ‘Big Bang’ in October 1986. The phrase relates to the major changes to firms engaged in the markets that underpin the financial services business – including the stock market, the government securities market and the corporate bond markets. Prior to Big Bang, those firms engaged in market-making in these investment products, the so-called jobbers, had to be separate from the broking firms, the stockbrokers that marketed the products to investors. So the trade in shares and securities involved two separate groups of firms working together. During this time, there was also a clear demarcation between the activities of the Stock Exchange and the rest of the financial services industry – particularly the banks.

In the 1980s, the Conservative government reformed the practice of charging agreed minimum commission rates for transactions in securities. This abolition of minimum commission rates took place in 1986. The Stock Exchange firms, however, sought a quid pro quo (a trade-off) for the loss of these minimum commissions.

In response to this pressure – and to concerns in the government about how the opening up of the financial markets to overseas competition might adversely affect the Stock Exchange – the government introduced a wide-ranging series of changes to the financial services industry that became known as Big Bang.

Big Bang permitted the dealing (jobbing) and broking elements of financial services business to be conducted within the same firm. Thus firms could act in a dual capacity both as agents to investors and as dealers on their own account. This was provided that safeguards – known as Chinese walls – were put in place within the firms. These defined the constraints on the information that could pass from brokers to dealers within the same firm. These walls were in place to ensure that the broking arms of the firms acted in the best interests of their customers when conducting business, rather than conspiring with their market-making colleagues – and against their customers’ interests.

Big Bang also changed the ownership rules of member firms of the Stock Exchange. These had previously been unlimited partnerships of either brokers or jobbers. Now ownership was opened up to external limited-liability companies.
Figure 10

Big Bang not only changed the organisation of business in the City of London, having knock-on effects on the way financial services business was conducted with the public, but also transformed the nature of City institutions. Within a few years, virtually all the exchange’s jobbing and broking firms together with most of the City’s merchant banks had been acquired by financial firms – predominantly US and other overseas banks. So Big Bang resulted in a huge wave of investment in the City of London by overseas financial firms – a development which saw much of the City become dominated by overseas owners (mainly the US investment banks). The consequences of Big Bang therefore were influential in furthering the trend to globalisation in the industry.

1.2.5 Technological change

The third major development was the impact of technological change on the conduct of business within the industry. The arrival of the internet has radically changed the way in which people shop for financial products, and the scope this provides for making efficient choices and for dealing directly with financial services providers.

But even ahead of the now very widespread use of the internet by households in the UK, electronic communication was changing the way that the institutions in the industry undertook their business. For example, until Big Bang, transactions in the Stock Exchange were conducted on a face-to-face basis on the trading floor. The manner by which business was conducted gave rise to a number of phrases – for example those working in the Stock Exchange would describe their job as working on – rather than in – the Stock Exchange because business was executed on the trading floor of the exchange through a process known as open outcry. Another phrase associated with the Stock Exchange then was ‘my word is my bond’, where trust between parties to transactions on
the floor was underpinned by the acceptance of the professional integrity of the
participants. Technology changed this pattern of doing business and, in the view of many
who remember the old days of the Stock Exchange, made business less colourful and
more sterile in nature. Business in the Stock Exchange and elsewhere in the City of
London became conducted via computers and telephones from separate dealing rooms.

Figure 11

The simultaneous development of dealing information systems – such as the services
provided by Reuters, Telerate and Bloomberg – also ensured that traders and investors
had greater immediacy and transparency about market information (e.g. the prevailing
prices of securities and the market rates of interest) and about factors that would influence
such market prices (e.g. changes in the rates of price inflation).

Further technological developments have improved the speed and efficiency with which
transactions are settled between parties – i.e. the payment of cash from one party to
another in exchange for securities acquired. They have also reduced the cost of
transactions. The year 1997 saw the introduction of the Stock Exchange Trading System
(SETS) for trading, initially in the top 100 share issues. This was subsequently extended
to the top 250 shares, with less commonly transacted shares being traded on the
alternative SETSmm system.

Electronic multilateral trading facilities (MTFs) have now emerged. These are electronic
exchanges run by investment firms that provide alternatives to traditional exchanges,
such as the London Stock Exchange, to buy and sell securities. The development of
MTFs has been facilitated by the European Union’s ‘Markets in Financial Instruments
Directive’ (MiFID). This directive allows investment firms to provide services across the European Union and also harmonises the protection provided to personal investors. So technology has changed the very nature by which business is undertaken both between firms and between customers and firms in the financial services industry. However, this move is not without its potential for unfortunate glitches and human errors that result in financial calamities.

In one example, clumsy typing cost a Japanese bank at least £128 million and staff their Christmas bonuses after a trader sold 600,000 more shares than he should have. A trader at Mizuho Securities fell foul of what is known in financial circles as ‘fat-fingered syndrome’, where a dealer types incorrect details into his computer. He wanted to sell one share in a new telecoms company called J Com for ¥600,000 (about £3,000). Unfortunately, the order went through as a sale of 600,000 shares at ¥1 each. The result was a huge financial loss for his firm. As if the trader was not unpopular enough, the firm cancelled its end-of-year party (The Times Online, 2005).

1.2.6 The impact of the growth of home ownership

The following video looks at the historical trends in home ownership and house building in the UK and at the related changes to house prices and household debt.

Video content is not available in this format.

Home ownership

During the period of growth in real incomes and living standards in recent decades, certain specific developments have triggered greater demand for financial products. One
material development has been the rise in home ownership, with the percentage of households owning their own home in England rising from 51 per cent in 1979 to 70 per cent in 2006 (The Times Online, 2007). This period witnessed a continuation of the upward trend in home ownership in the UK seen since the start of the twentieth century, although in the last few years the percentage of homeowners has fallen slightly to 65 per cent.

A step-change to the proportion of homeowners in the UK occurred in the 1980s following the introduction of legislation by the Conservative government allowing council tenants to buy the properties they were renting. This was encouraged by offering the tenants often significant discounts off the market value, subject to how long the tenants had lived in the council property. Between 1980 and 1990, over 1 million properties transferred from public to private ownership under the right-to-buy (RTB) legislation.

The impact on the financial services industry of this growth in home ownership has been huge. With home ownership comes demand for mortgage products to facilitate the property purchase, investment policies to finance the repayment of certain types of mortgage products, possible bank loans to renovate the property and buy consumer goods, and the need for property insurance cover. It is therefore no surprise that the expansion of the financial services industry in recent decades can be related to the growth in home ownership.

1.2.7 The impact of an ageing and prosperous population

Growing living standards, increasing longevity and an ageing population have also impacted on the market for financial products – particularly pensions. The knock-on effects of this development – for example, on the expansion of the asset management business – mark it out as the most material source of change in the financial services business in recent decades.

Although a proportion of the population are still solely reliant on state pension provision, a significant proportion have company pensions, which normally both employer and employee contribute towards. Company pensions themselves represent a financial product – albeit one which is typically not well understood by the ‘buyer’ of the pension product (i.e. the employee).

The growth in the importance of the pension funds can be traced to the Social Security Pensions Act 1975, which obliged firms either to contract into the State Earnings Related Pension Scheme (SERPS) or to provide their own scheme on at least equally good terms for their employees. The pension schemes are either run as funds, separately from the company sponsors, or managed on behalf of the employee contributors and their company by a financial firm.

The Social Security Act 1986 gave a further boost to the pensions industry by allowing individuals to take out personal pension plans – with this move being encouraged by financial incentives to switch out of SERPS into these private schemes. This initiative has also provided a boost to the insurance firms as they are the main providers of personal pension schemes. With contributions into pension funds being income-tax-deductible, and with the returns from a pension fund not being liable to taxation, pension schemes offer individuals a very tax-efficient means of making investments.
A further development that impacted on pension provision in the UK came in 1985 when the Conservative government enacted legislation (taking effect in 1988) which enabled individuals to opt out of company pension schemes and seek their own pension products instead. In line with many of the government initiatives at this time, the move was intended to give people freedom to make their own choices when selecting a pension product. With many opting to buy their own products, the pattern of pension provision altered in the UK. However, the initiative was disastrous. As a result of poor advice, many made poor choices of products and ended up with pension provisions materially worse than if they had stayed in their company schemes.

Becoming a member of a pension scheme results in becoming, albeit indirectly, an owner of shares since most schemes invest in these. The impact of growing affluence on the direct acquisition of shares – as opposed to those acquisitions made indirectly via pension schemes – has, however, been less marked. In fact, the percentage of UK shares directly owned by individuals as opposed to institutions has fallen sharply in recent decades, from over 50 per cent in the 1960s to around 12 per cent (in 2014) – although this has been more than offset by ownership arising from holdings in collective investment schemes.

One development during the 1980s and 1990s cut against this trend: the offer of shares to the public arising from the privatisation of nationalised industries, including the water, gas and electricity industries. This strategy was based on a desire by the Conservative government to reduce state involvement in the economy and bolster public finance from the receipts from the share issues – which totalled some £70 billion between 1980 and 1997.

The successive privatisations were also marketed as a way for the public to 'buy in' to the share market and, by implication, to the principle of private ownership of businesses. The buying-in of the public to share ownership was certainly encouraged by the prices at
which most of the privatisation share issues were marketed to the public prior to their launch. In most cases, these share prices rose sharply immediately on the launch dates and, consequently, many members of the public quickly sold their holdings at a profit. Despite its high-profile impact in the 1980s and 1990s, privatisation has not materially impacted on the long-term (and marked) trend in the shift of share ownership from the public to institutional investors.

Following the publication of the Turner Report on pensions in 2005, the UK government has encouraged greater pension savings and has set out a phased increase in the State Pension Age (SPA). From 2010, the SPA for women started to be raised to 65 to bring it in line with the SPA for men. Between 2018 and 2020, the SPA will rise to 66, then to 67 between 2026 and 2028 and 68 between 2044 and 2046. The State Pension Age will be reviewed every 5 years with revisions to it likely to be linked to changes in life expectancy. This current plan remains broadly in line with the recommendation in the Turner Report to raise the SPA to between 67 and 69 by 2050. These developments reflect the financial burden that growing longevity is placing on the government’s finances. Social and economic changes in recent decades have had a marked impact on the demand for pension products and other financial services. It is therefore perhaps unsurprising that the industry itself simultaneously went through a period of transformation at the same time.

1.3 Regulation and regulatory failures pre-FSA

Perhaps inevitably, the changing structure of the industry resulted in changes to the regulatory arrangements. Prior to 2001, the industry had a number of different regulators for the various sectors – banks, building societies and insurance firms – with additional regulatory arrangements for other financial firms such as the broking firms. These regulators sought to ensure the proper running of business by firms in their sector and oversee the financial solidity of those conducting business in the financial services markets.

The liberalisation of financial services and the reality of financial services firms diversifying their activities made it increasingly difficult to maintain separate regulatory regimes. Increasingly, the largest firms could not be pigeon-holed into a particular sector. Consolidation of regulation under one authority therefore made sense.

The first change that occurred during this revolution in regulation came with the Financial Services Act 1986, which brought the hitherto largely independent and self-governing Stock Exchange into a broad regulatory framework. Legislation defined the basic regulatory framework, with the detailed rules being determined and administered by a number of practitioner-led (i.e. industry-based) associations, each of which was a specialist in a specific financial services sector.

The 1986 Act was also prompted by a series of high-profile scams in the 1980s that left personal investors out of pocket. Indeed, the need for public protection from financial scams continued to be highlighted by episodes even after the introduction of the 1986 Act.
Of all the financial scams in the 1980s that pointed to the inadequacies of financial services regulation in the UK, the Barlow Clowes episode was arguably the ‘lowlight’. This financial firm offered investors the chance to make good returns through investments in low-risk UK government securities (gilts). The inconsistency between high returns and low risk seemed lost on investors who piled money into the firm – but also, seemingly, on the government’s Department of Trade and Industry (DTI), which regulated Barlow Clowes and other such firms at that time. Unsurprisingly, when the firm was belatedly closed down in 1988, it became clear that its investors had been subjected to fraud, with the discovery of a financial ‘black hole’ of some £110 million. Barlow Clowes had used misleading statements to attract investors’ money. Peter Clowes was jailed for 10 years, having spent more than £100 million of investors’ money on an exotic lifestyle of private jets, homes, cars and a luxury yacht.

(Note: The co-founder of Barlow Clowes, Elizabeth Barlow, had no involvement in the scam, having left the firm many years earlier.)

Specifically, it was the collapse of the investment firm Norton Warburg in 1980 that had led to the Conservative government commissioning a report on investor protection, led by Professor Gower. The Gower Report of 1984 paved the way for the establishment of the Securities and Investment Board (SIB), which then had the responsibility for the regulation of investment services. The SIB was also given the power to regulate the sale of long-term insurance products. In October 1997, the SIB’s name was changed to the Financial Services Authority (FSA).
1.3.1 The rise and fall of the FSA

The experience gained through the operation of the 1986 Act, together with the break-up of the traditional boundaries between different financial services firms and the perceived need to reinforce investor protection, then paved the way for the replacement of the multiple regulatory bodies by a single statutory body.

The unification of the regulation of financial services in the UK under the FSA came in stages after 1997. In 1998, the responsibility for the supervision of the banking sector was transferred to the FSA from the Bank of England. In 2000 the FSA then took over responsibility for the UK Listing Authority (UKLA) – the body responsible for supervising and regulating the issue of listed securities by firms – from the Stock Exchange.

The final piece in the new regulatory jigsaw came with the enactment of the Financial Services and Markets Act 2000 (FSMA 2000). FSMA 2000 led to the completion of the consolidation of regulation of financial services under the FSA from 2001. The range of the FSA’s responsibilities, which were taken on from pre-FSA regulatory bodies, is set out in Table 2.

**Table 2 The FSA’s responsibilities**

<table>
<thead>
<tr>
<th>Pre-FSA regulatory body</th>
<th>Responsibilities of the body</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building Societies Commission (BSC)</td>
<td>Building societies</td>
</tr>
<tr>
<td>Friendly Societies Commission (FSC)</td>
<td>Friendly societies</td>
</tr>
<tr>
<td>Insurance Directorate (ID) of the Department of Trade and Industry (DTI)</td>
<td>Insurance</td>
</tr>
<tr>
<td>Investment Management Regulatory Organisation (IMRO)</td>
<td>Investment management</td>
</tr>
<tr>
<td>Personal Investment Authority (PIA)</td>
<td>Retail investment business</td>
</tr>
<tr>
<td>Registry of Friendly Societies (RFS)</td>
<td>Credit unions’ and other mutual societies’ supervision</td>
</tr>
<tr>
<td>Securities and Futures Authority (SFA)</td>
<td>Securities and derivatives business</td>
</tr>
<tr>
<td>Securities and Investments Board (SIB)</td>
<td>Investment business (including supervision of exchanges and clearing houses)</td>
</tr>
<tr>
<td>Supervision and Surveillance Division (S&amp;S) of the Bank of England</td>
<td>Banking supervision (including the wholesale financial markets)</td>
</tr>
</tbody>
</table>

Subsequently, in 2004, the FSA took on responsibility for the regulation of mortgages, and in 2005 the regulation of general insurance business was added to its responsibilities.

A further development that took place during this period was the decision of the incoming Labour government in 1997 to pass responsibility for monetary policy – and, specifically, the setting of the UK’s official interest rates – to the Bank of England. Previously, such decisions had sat with the government, with the Chancellor of the Exchequer normally taking lead responsibility. The move brought the UK into line with the eurozone and the USA (and most other major economies), where monetary policy is conducted away from the world of politics by the central banks. With the Bank of England in charge of setting interest rates, it arguably could not also perform the role of banking supervisor, given the possibility of conflicts of interest between the management of the economy (particularly inflation) and the best interests of the banking industry. This provided the rationale, at that time, to move banking supervision to the FSA.
The establishment of the FSA therefore resulted in a move away from the self-regulation of financial services, where certain sectors within the financial services industry regulated themselves, as opposed to being regulated by a separate and wholly independent body. Regulation by the FSA, therefore, alleviated the conflicts of interest that can potentially arise when sectors of the financial services regulate themselves.

More recently, following the 2007/08 global financial crisis (which you will cover in the next sections), plans were introduced by the coalition government in 2010 to abolish the FSA and redistribute its responsibilities to other, new, regulatory bodies. The two new bodies – the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – formally took over the FSA’s responsibilities from April 2013. The responsibilities and activities of the PRA and the FCA are examined in Week 2 and Week 4.

Figure 14

1.3.2 The build-up to the global financial crisis

No event in recent decades has had a more cataclysmic impact on the financial services industry than the 2007/08 global financial crisis. At the height of the crisis there was a material risk that the banking system would implode with banks refusing to lend to each other. Since confidence underpins banking and financial services generally, the collective collapse of confidence in these years posed a threat to the industry and the wider economy.

From the early 1990s through until the mid-2000s financial services experienced a boom – supported by factors like the housing market that you looked at earlier. Lending expanded rapidly and financial institutions saw growing balance sheets and profits. The underlying trend of falling interest rates helped to underpin the growth of lending business.
It is generally accepted that the immediate trigger for the problems was the collapse of the so-called sub-prime mortgage market in the USA.

What exactly is a sub-prime mortgage?

In simple terms, it is a loan for property purchase that is offered to a sub-prime borrower: one who is deemed to have a relatively poor level of creditworthiness. This of course begs the question of why anybody would want to lend money to someone who has a high chance of not being able to repay it. The rationale for undertaking such business is that the loans are made on terms which build in an expectation that a proportion of borrowers will default.

In 2007, the neat business model of sub-prime mortgage lending started to unravel, with global consequences. US interest rates, having fallen in the early years of the 2000s, rose sharply during the period 2004–2006. Inevitably, the sub-prime market suffered particularly badly, given the relatively poor credit standing – and, by inference, income levels – of the borrowers. Many experienced difficulties in meeting the resultant higher interest charges on their mortgages. Default rates – the proportion of mortgage holders unable to meet their repayments – rose sharply to levels much higher than anticipated by those firms that had originally made investments in the mortgage-backed securities that had been used to finance the sub-prime lending business.

As US homeowners defaulted, the investments that comprised the loans that had been made to them fell in value. The banks and the other investors that were exposed to these losses suddenly found themselves in difficulty. Several of these were banks in the UK. A US sub-prime problem had therefore hit the UK financial services industry.

The financial crisis that was about to befall the UK was also to extend beyond those firms directly exposed to the US market. The impact of the collapse of the sub-prime market meant that banks and other financial firms became reluctant to lend funds to each other in what are known as the wholesale money markets. This was because they had become concerned that they might be lending to those who had been caught up in the collapse of the sub-prime market and might therefore themselves face difficulties repaying borrowed money. The first UK casualty was Northern Rock bank, which had to be rescued in September 2007 and subsequently nationalised when it found itself unable to raise funds from the wholesale markets.
All around the world, a paralysis started to develop in the financial markets, as banks curtailed their lending activities and became more cautious about whom they would lend to. The availability of credit to financial and non-financial firms and households began to dry up. The ‘credit crunch’, as it quickly became known in the media, was taking hold of the global economy.

1.3.3 Collapse! The global financial crisis

In the following video, the build-up to the financial crisis is explored. It contains the observations of Sir Vince Cable, the UK coalition government’s Secretary of State for Business, Innovation and Skills between 2010 and 2015, on the near meltdown of the banking system in autumn 2008.

Video content is not available in this format.

Banks
The years 2007 and 2008 turned out to be close to catastrophic for the global banking system as the slowdown in activity in economies around the world, combined with the collapse of asset prices (particularly for property and for financial assets such as mortgage-backed securities), resulted in huge financial losses for many financial firms. Those who had been the most ambitious in their lending activities during the years of economic expansion in the 1990s and early 2000s now stood most exposed as economic activity contracted.

A sector that was particularly exposed was the investment banking sector in the USA. As such, many of the investment banks were very active in the aforementioned mortgage-backed securities business. Such banks normally have very limited dealings with individuals in the retail markets. Indeed, restrictions were placed on their ability to take deposits from the public.

As 2008 progressed, it became clear that one of the firms most exposed to the crisis unfolding in the financial markets and the wider economy was Lehman Brothers (commonly known as Lehman’s). The Federal Reserve (the US central bank that performs a similar function to that of the Bank of England in the UK) tried to organise a rescue for Lehman’s, but it quickly became clear that there were no takers for the bank. The Federal Reserve refused a state bailout, with the result that the bank collapsed. Perhaps the decision might have been different if Lehman’s had had a clear interface with retail customers – certainly many individuals were hit by the collapse of Lehman’s, particularly if they had been holding shares in the bank, but there was no large retail customer base that was directly exposed to the demise of the bank.

The collapse of Lehman’s sent shock waves around the global financial services industry because of the widely held (and ultimately false) assumption that it was too big a firm to be allowed to go bust. Shares in banks fell very sharply, and in the UK attention focused on those banks deemed to be most vulnerable to the impaired financial markets and the weakening economy. The two perceived to be most at risk were Halifax Bank of Scotland (HBOS) and Royal Bank of Scotland (RBS). Their plight forced the Bank of England, with the support of the Treasury and the FSA, to intervene on a massive scale. £61.6 billion of emergency loans were provided by the Bank of England to RBS and HBOS at the height...
of the financial crisis – although this only became public knowledge in November 2009 when the Bank of England reported these details to Parliament's Treasury Committee.

As the financial crisis deepened, the UK government, together with the FSA and the Bank of England, quickly sought the takeover of HBOS by Lloyds TSB Bank – the latter being perceived as relatively less exposed to the crisis in the financial markets. The resultant merged institution was named Lloyds Banking Group. With a 28 per cent share of the UK mortgage market and a 25 per cent share of the UK personal banking market, such a takeover would not have been allowed by the then Competition Commission (now called the Competition and Markets Authority) during normal financial times. Given the crisis, however, the government allowed the merger to proceed without reference to the commission.

Additionally, the government was forced to provide additional capital for both Lloyds Banking Group (initially taking a 43 per cent share of the new bank and subsequently raising this to 65 per cent) and RBS (taking a 70 per cent share of the bank that was subsequently raised to 84 per cent) in order to prevent any risk of their collapse. These injections of financial support were required because a huge volume of these banks’ assets had fallen substantially in value – these were the so-called ‘toxic assets’. In the case of Lloyds Banking Group, the support was needed to deal with the problems inherited via the takeover of HBOS rather than those of Lloyds TSB itself. The latter had been a very conservatively run bank with relatively little exposure to toxic assets.

The scale of the investment by the government in the country’s financial firms was estimated at £37 billion in October 2008 (HM Treasury, 2008). This was in addition to the provision of short-term loans to financial firms. Additionally, it has had to insure the banks against losses on several billions of pounds of toxic assets in an attempt to salvage the UK banking system and to get the banks into a position where they can start prudent lending again to businesses and individuals.

1.3.4 Rescuing the banks and the subsequent post-mortems

Following the rescue of the Royal Bank of Scotland in 2008 the FSA published two reports into the running of the bank and the causes of its near collapse.

The first short report in 2010 found evidence of mistakes but no wrongdoing by the bank’s executives and board. The report was widely ridiculed and the FSA was pressurised by the Parliamentary Treasury Committee to produce a fuller account of RBS’s business activities and management. As a consequence, a detailed and lengthy second report was published in 2011. This report was highly critical of failings at RBS, including its strategy of rapid growth in the years prior to its near collapse. The chief failing, though, was the disastrous takeover of the Dutch bank ABN Amro in 2007, since this significantly increased the exposure of RBS to US sub-prime assets and other bad loans that had been made to firms. The report noted that the takeover had been preceded by only limited ‘due diligence’ work on the quality of ABN Amro’s assets. But the FSA's report was also highly self-critical since they had approved the takeover of ABN Amro and had not sought to contain or moderate the fast-growth strategy of RBS in the years before its rescue in 2008.
While HBOS and RBS dominated the coverage of the financial crisis in the UK, other financial institutional failings went relatively unreported. At the same time as rescuing HBOS and RBS, the government had to bail out the mortgages business of Bradford & Bingley, simultaneously selling its savings business to Santander UK, the subsidiary of Banco Santander. This Spanish bank had previously bought Abbey National in 2004 and Alliance & Leicester in 2008 before transferring them to Santander UK. At the time of their acquisition, both Bradford & Bingley and Abbey National were banks, having previously converted from building societies to banks – as had Northern Rock.

Within a few weeks in 2008, the UK financial services sector was transformed, with household names disappearing, other firms merging and the government being forced to take a major share of three key banks (in addition to its ownership of the fully nationalised Northern Rock).

But the UK government has not been alone in having to support its fragile banking system. Elsewhere around the world, similar action has been taken by other governments, significantly augmenting the additional financial support raised by the banks from the private sector (see the table below). Indeed, the size of the intervention in the UK was dwarfed by the rescue package of capital injections in excess of US$300 billion approved by the US Congress to prop up the ailing US banking system.
The post-mortems that followed the crisis identified specific and systemic failures of regulation in the UK which were deemed to have contributed to the weaknesses of several large banks and some building societies. That these failings were emerging at the same time as an array of episodes of product mis-selling (for example payment protection insurance (PPI)) dealt a mortal blow to the FSA, since its core duties were the regulation of financial firms and the regulation of business conduct (including product sales). An overhaul of regulation was an inevitable consequence of the crisis.

**Activity 1.3 Banks are rescued while other firms are not**

At the same time that banks in the UK were being bailed out by the government, Woolworths Group, a well-known multi-product high-street chain store company, was availed no such support to prevent them going out of business in 2008. More recently we have seen steel-making firms in the UK closing with no bail-out on offer from the government.

Is this unequal treatment of non-banking firms justified?

**Discussion**

Bank failures undermine the financial system and have wide-ranging economic consequences. A loss of confidence in banks and the banking system would impact hugely on the way transactions are undertaken in the economy and on the level of economic activity. Woolworths Group was a company with a failing business model. Has the high street really missed it – particularly in the post-Woolworths era of multi-product discount stores, like Poundland?

The issue of the steel firms is more complex. Steel is viewed as a strategic industry and the price of steel over the years has been quite volatile, reflecting swings in the...
level of business activity globally and the impact of newer entrants into the industry in emerging economies. The case for government support is arguably more cogent than the case for support of Woolworths.

1.4 Week 1 quiz

This quiz allows you to test and apply your knowledge of the material in Week 1.

To view this content please access the complete course on OpenLearn
Open the quiz in a new window or tab then come back here when you're done.

1.5 Week 1 round-up

During this week you have explored the origins of banking and other financial services in the UK, tracked their development up to the modern day and examined the key turning points that have shaped the industry and how it operates.

You looked closely at the financial crisis of 2007/08, as this has radically affected the financial services industry, the way it is regulated and the public's perception of financial institutions and those who run them. The crisis has also affected the relationship between the sector and the government, which finds itself, for the time being at least, to be a major shareholder in banks.
In Week 2 you will look at the financial services industry today, the challenges it faces and the latest changes to the ways business in the sector is conducted.

You can now go to Week 2: Post-crisis: new players, new issues, new rules.

Week 2: Post-crisis: new players, new issues, new rules

Week 2 Introduction

The focus in Week 2 is looking at component parts of the financial services industry as it is today, at how the global financial crisis has changed the way business is undertaken and how it is regulated. The reforms and restructuring of the sector are examined as well as controversial issues like bankers' bonuses, attempts to introduce greater competition and the ring-fencing of retail banking from the speculative activities of investment banking.
You will look at payday lenders, hedge funds and the impact on the insurance industry of genetic testing.

You will look at how the way we shop in the financial services industry is changing too – for example, does the internet make it easier to find the right products or does it cause more complications for us?

**Figure 1** The UK financial services industry
This course is presented with the kind support of True Potential LLP. The True Potential Centre for the Public Understanding of Finance (True Potential PUFin) is a pioneering Centre of Excellence for research in the development of personal financial capabilities. The establishment and activities of True Potential PUFin have been made possible thanks to the generous support of True Potential LLP, which has committed to a five-year programme of financial support for the Centre totalling £1.4 million.

2.1 Banking: competition and the ‘challenger’ banks

Figure 2
The commercial banks provide financial services to both personal and corporate customers. Their activities are not limited to what may be viewed as conventional banking services – providing current account services, commonly online, and offering loans and overdrafts to their customers. Additionally, banks provide credit cards, offer mortgages to home buyers and provide insurance services too.

Table 1 shows the largest of the commercial banks operating in the UK and their asset sizes, as at September 2015. There are several other banks operating in the UK – for example, Sainsbury's Bank and Tesco Bank – but these are much smaller in size than those listed.

Table 1 Commercial banks

<table>
<thead>
<tr>
<th>Bank</th>
<th>Market capitalisation September 2015</th>
<th>Asset size December 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays</td>
<td>£43bn</td>
<td>£1358bn</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>£22bn</td>
<td>£1051bn</td>
</tr>
<tr>
<td>Lloyds Banking Group</td>
<td>£54bn</td>
<td>£855bn</td>
</tr>
</tbody>
</table>
HSBC | £99bn | £797bn
---|---|---
Standard Chartered Bank | £18bn | £465bn
Santander | £52bn | £276bn
Co-operative Bank | n/a | £38bn
Banco Sabadell (TSB) | £7bn | £27bn
Virgin Money | n/a | £27bn

Note: Market capitalisation is the price of the banks’ shares multiplied by the number of shares that have been issued. Asset size means the aggregate value of the assets on the banks’ balance sheets at 31 December 2014. Bn = billion. The UK asset size of Banco Sabadell is based on that of TSB bank. Co-operative Bank and Virgin Money are not listed on the Stock Exchange and, therefore, market capitalisation data are not available for them.

Sources: Adapted from *Sunday Times Business*, 13 September 2015, *Financial Times*, 15 September 2015, and the websites of each firm mentioned.

In considering how the banks conduct their business, it is important to remember their ownership status: they are, in most cases, public limited companies (plc’s) and are owned by their shareholders. A key objective for any plc is to aim to maximise value for its shareholders. The higher the level of profits, the greater the capacity to pay dividends to the shareholders – and/or for the share price of the bank to rise to reflect the growth in the value of the business.

The market for core financial services – such as banking, mortgage and savings products – is viewed as being less competitive than it was in the last century. A small number of banks have very large shares of the banking markets and hence have considerable ability to manage the profit margins at the expense of consumers. In the years after the 2007/08 financial crisis, HSBC, Barclays, Lloyds and RBS accounted for around 75 per cent of the personal current account market in the UK and close to 85 per cent of the small business market.

Recently, though, there have been new entrants into the UK banking sector. In 2009 Sir Richard Branson announced plans to extend the Virgin Money UK business to banking status, either by obtaining its banking licence from the FSA or by acquiring an existing bank (*The Times*, 2009a). In January 2010, this plan crystallised with the announcement of Virgin Money UK’s acquisition of the small bank Church House Trust. This move into banking by Virgin Money UK was extended in January 2012 with the acquisition of Northern Rock bank from the government for £747m. Virgin Money UK wasted no time in disposing of the tarnished Northern Rock brand.

Metro Bank has been a further new entrant becoming, in July 2009, the first new bank with a high-street network in the UK for more than 100 years. Recent years have also seen the emergence of Aldermore Bank in May 2009 and Shawbrook Bank in October 2011 – although neither has a branch network. Further new entrants are expected in the coming years to join these new so-called ‘challenger’ banks.

To generate further competition in the industry, the government announced a series of measures in 2009 – prompted by pressure from the European Commission – to scale back the market power of Lloyds Banking Group and the Royal Bank of Scotland (RBS). Under these plans, Lloyds and RBS were required to create one new bank each from their existing operations, which then have to be sold to create more competition in the UK banking market. Additionally, RBS was also required to sell off its insurance operations in addition to certain retail and investment banking operations.
In July 2012, a sale of 631 Lloyds Banking Group branches to the Co-operative Group was announced. However this deal was aborted in April 2013 when the Co-operative Group found that its banking arm (Co-operative Bank) had a ‘black hole’ in its finances, arising from the loan losses on the portfolio of assets it had acquired when it merged with the Britannia Building Society in 2009. Subsequently the Co-operative Bank has had to embark on a plan to cede 70 per cent of the ownership – and, by implication, control – of its business to its bondholders. These include the US fund management companies Aurelius Capital Management and Silver Point Capital.

Subsequently, Lloyds met the requirement to reduce its branch network by splitting itself into two banks – Lloyds and TSB – in September. For the time being, TSB remained part of Lloyds Banking Group until it was fully disposed of through a share offering in May 2014 that saw it separately listed on the London Stock Exchange. Then, in 2015, TSB was acquired by the Spanish challenger banking group Sabadell.

By 2013, Lloyds Banking Group had made a strong recovery from the financial crisis and, with the consequent rise in its share price, the Government was able to sell a 6 per cent shareholding in the bank for £3.2 billion, generating a profit of £61 million in the process. A further reduction in the government’s shareholdings occurred in 2014 and 2015, with the result that by August 2015 its stake in Lloyds was down to 13 per cent. In October 2015 the government announced plans to sell off its residual stake in early 2016.

RBS is meeting its requirement to create a new bank by 2017 by re-establishing Williams & Glyn bank. This spin-off challenger bank is rekindling the name of the bank that was absorbed into RBS back in 1985.

To facilitate greater competition the Independent Commission on Banking (ICB) also called for the charges and costs of current accounts to be made entirely clear and for the switching of accounts to be made easier and quicker. The commission also called for the new financial services watchdog – the Financial Conduct Authority (FCA) – to have a clear brief to promote effective competition in the UK banking industry. The Competition and Markets Agency (CMA) is currently investigating the competitiveness of the banking industry in the UK – specifically the competitiveness of services for retail customers. The CMA’s final report on this issue is scheduled for publication by August 2016.

2.1.1 Taxing banks and incentivising lending

The government brought two new pieces of banking legislation onto the statute book during 2008 and 2009 to address issues related to the management and operation of the UK banking system exposed by the financial crisis.

The Banking (Special Provisions) Act 2008 gave the Treasury the power to nationalise banks or force their takeover by another institution if they were deemed to be in material financial difficulty.

The Banking Act 2009 builds upon and revises certain parts of the 2008 Act by defining the processes for bank and building society takeovers, the administration of those parts of a bank or building society that remain unsold after a takeover has been agreed and the determination of compensation to those investors that lose money as a result of a takeover.

Arguably, lessons about how to nationalise or arrange such takeovers were very much learnt ‘on the hoof’ as a result of dealing with, in particular, Northern Rock and Bradford & Bingley in 2007 and 2008. The new legislation, however, has established clear principles about how to deal with banks that are in financial trouble in the future.
Taxing the banks

Following the 2010 general election, the coalition government announced that a new tax was to be imposed on banks. The so-called bank levy was unveiled by the then Chancellor of the Exchequer, George Osborne, in his first budget statement in June 2010. The levy was first applied in 2011, with smaller banks and building societies exempt. The rate for the levy is based on the size of the banks’ balance sheets. In 2015 the levy was 0.21 per cent of short-term liabilities and 0.105 per cent of long-term equity and liabilities. The current plan is to reduce this levy to 0.1 per cent (on short-term liabilities) by 2021, with it only being applied to UK banks. However the government has introduced, from 2016, an 8 per cent surcharge on bank profits.

Figure 3

The case for such a bank tax, to provide funds for future possible bail-outs of financial institutions, is also being advocated by the International Monetary Fund and President Obama’s administration in the United States. This development was quickly followed by the announcement by the EU internal market commissioner, Michel Barnier, advocating that all EU member states introduce a bank levy. This would provide member states with funds to ensure that the costs of managing future banking failures would not have to be met by taxpayers. Certain EU member states have also called for the establishment of a tax on financial transactions – also known as a ‘Tobin tax’ after the economist who advocated this. This is currently being firmly resisted by the UK.
Incentivising lending

The period after the financial crisis saw various initiatives by the government to encourage more lending to households and businesses. The rationale was that this lending would help the UK economy to recover from the economic downturn that the crisis had helped to instigate.

Project Merlin was an early initiative which was linked to the deal done with banks on bonus regulations. This committed the banks to lend circa £190 billion to UK businesses in 2011, including £76 billion to small firms. Project Merlin was not a huge success – partly because even if banks were willing to lend, many businesses did not want to borrow given the uncertain economic climate.

This initiative on bank lending was followed in 2012 by the Funding for Lending Scheme (FLS), which was launched by the Bank of England with the government’s support. This scheme has offered banks and other lenders the opportunity to borrow funds from the Bank of England at very low interest rates (0.25 per cent), provided the funds are used to support increased – and cheap – lending to businesses and households.

After a slow start in 2012, the volume of borrowing from the Bank of England under this scheme grew sharply. By June 2015 48 institutions had collectively borrowed £61 billion in total under the scheme and, with its growing success, the government announced its extension to 2016 (Bank of England, 2015). The latest news is that the scheme will run until January 2018, with the focus on lending to small and medium sized enterprises (SMEs). Since 2014, the scheme has entirely focused on lending to businesses and is no longer applied to lending to households. This decision reflected the improving credit conditions for those seeking mortgages to buy homes, particularly as a result of the Help to Buy scheme. The scheme has particularly helped first-time buyers get onto the housing ladder.

FLS has not been without its adverse side effects: with ready access to cheap funds, the banks and building societies have become less dependent on personal savings, with the result that rates offered to savers have fallen to very low levels (well below 2 per cent per annum in most cases). Clearly the overarching objective of getting the economy moving has been to the benefit of borrowers – but to the clear disadvantage of savers.

2.1.2 Investment banks after the financial crisis

The investment banks should be seen as distinct from the commercial banks because their activities are almost entirely focused on institutional (wholesale) business rather than personal (retail) financial services – i.e. they do business with other firms rather than with individuals.

However, these banks do play a key role in the industry because they are players in the markets where core financial products like shares and securities are traded. Indeed, as we saw in Week 1, they incorporate the majority of the old member firms of the London Stock Exchange. They have also incorporated – largely through acquisition after Big Bang – the so-called merchant banks that specialised in organising trade finance for firms.

Merchant banks

The merchant banks thrived on international trade, providing credit to importers and exporters as well as financing ships to fetch tea, coffee, precious metals, silks and spices. They had agents in the US, South America and the Far East, and helped foreign states to
raise money on the Stock Exchange. After the First World War, they adopted a more UK-focused approach and were involved in raising debt finance and equity finance for British industry. From the early 1970s, they became involved in early foreign currency loans and the Eurobond market. Starting in the 1950s and 1960s, the merchant banks also made a name for themselves by acting for corporate clients in takeovers and mergers. They also had investment departments which managed money for institutions and wealthy private clients, as well as offering pooled investment funds for less-well-off individuals. The major difference from the investment banks was that the merchant banks were much smaller, with less capital, preferring to make money on commission and advice rather than risking their own funds. After Big Bang, which liberalised the UK financial services industry, the merchant banks had to compete with the US investment banks that started to arrive in London.

The following years were eventful for the merchant banking sector. Barings became insolvent as a result of the losses amassed by the rogue trader Nick Leeson in Singapore, and was sold to ING for £1; Warburgs was bought by the Swiss Bank Corporation, and Morgan Grenfell by Deutsche Bank. A few merchant banks remain in the UK including N. M. Rothschild & Sons Ltd, Close Brothers and Lazard, whose London office merged with other Lazard firms across the world. A once great group of banks has, however, almost disappeared.

Figure 4

The investment bank sector

Because the investment banks also take the lead role in arranging finance for the firms in the ‘front line’ of financial services provision (the commercial banks, building societies and insurance firms), they clearly perform a critical role within the superstructure of the
industry. Indeed, many of the leading commercial banks do have investment banking arms – Barclays Investment Bank (formerly Barclays Capital), for example, is the investment banking division of Barclays plc.

The table below provides details of the main investment banks that are active in the UK. One interesting point to note is how many are overseas-owned (US ownership, in particular, is prevalent), emphasising the truly international nature of this sector of the industry.

**Table 2 Overseas-owned banks**

<table>
<thead>
<tr>
<th>Bank Name</th>
<th>Market capitalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>J.P. Morgan Chase</td>
<td>$231bn</td>
</tr>
<tr>
<td>Bank of America (owners of Merrill Lynch)</td>
<td>$167bn</td>
</tr>
<tr>
<td>Citigroup</td>
<td>$153bn</td>
</tr>
<tr>
<td>HSBC</td>
<td>$151bn</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>$80bn</td>
</tr>
<tr>
<td>Royal Bank of Canada</td>
<td>$79bn</td>
</tr>
<tr>
<td>United Bank of Switzerland (UBS)</td>
<td>$78bn</td>
</tr>
<tr>
<td>BNP Paribas</td>
<td>$77bn</td>
</tr>
<tr>
<td>Barclays</td>
<td>$66bn</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>$66bn</td>
</tr>
<tr>
<td>Credit Suisse (owners of Credit Suisse First Boston, CSFB)</td>
<td>$43bn</td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>$40bn</td>
</tr>
<tr>
<td>Société Générale</td>
<td>$38bn</td>
</tr>
</tbody>
</table>

Note: Market capitalisation is the price of the company’s shares multiplied by the number of shares that have been issued by them.

Source: Adapted from Financial Times, 15 September 2015.

The 2007/08 financial crisis had a materially damaging impact on the investment banks, with the greatest casualty being Lehman Brothers, which collapsed in September 2008. Other investment banks, including Bear Stearns and Merrill Lynch, were taken over (by J. P. Morgan and Bank of America respectively), and some others had to seek governmental support. The investment banking sector is therefore very different now from what it was prior to 2007. Note that some of the banks listed in the table also undertake commercial banking activities in addition to the services provided by their investment banking arms.

### 2.1.3 Tackling the bonus culture and ring-fencing banks

A highly controversial issue that the regulatory authorities had to address in the wake of the financial crisis was how much blame should be placed on the high salaries paid to those making investments and undertaking other financial transactions – and specifically the bonus culture within the major banks and other financial firms.
Tackling the bonus and high salary culture

The observation widely made in the aftermath of the financial crisis was that the bonus system – with the investment banks historically being at the forefront in terms of the size of bonuses – encouraged excessive risk-taking. If the gambles made by the dealers in their investments came off, they got high bonuses. If the gambles failed, then the resultant losses had to be absorbed by the banks – or, more specifically, the banks’ shareholders. There seemed to be a clear message: curb the bonus culture and you prevent excessive risk-taking and avoid the risk of a repetition of the financial crisis.

The return of several of the major financial firms to profitability in 2009 and the subsequent triggering of bonuses for their staff prompted a robust response from the Labour government. In the pre-budget statement in December 2009, the then Chancellor of the Exchequer introduced a 50 per cent tax to be paid by the banks on bankers’ bonuses in excess of £25,000.

In 2009, the FSA produced a code of practice on remuneration for employees of financial firms. The code banned guaranteed bonuses for periods of beyond 1 year, stated that it expected two-thirds of bonuses for senior staff to be spread over 3 years and required financial firms to submit their remuneration policies for review by the FSA. The expectation was that such policies should be consistent with effective risk management practices at the institutions.

The code was criticised for being weak. However, the then chief executive of the FSA, Hector Sants, pointed out at the time that the FSA did not have the powers to determine how much employees of financial firms got paid.

In July 2010 the FSA announced plans to update its remuneration code to accommodate remuneration rules required by the EU’s Capital Requirements Directive (CRD3) and the Financial Services Act 2010. The new rules took effect from 2011 and require at least 40 per cent of bonuses to be deferred over a period of at least 3 years, rising to 60 per cent for bonuses above £500,000. In addition, at least 50 per cent of performance-linked remuneration must be in shares or in other non-cash form. In respect of guaranteed bonuses, these may not be for periods of more than 1 year and may only be given in exceptional circumstances to those newly hired by firms.

When, in February 2011, the then Chancellor, George Osborne, unfolded the Project Merlin agreement with the banks, it included stipulations on pay and bonuses. The agreement included a requirement for the UK’s top four banks (Barclays, HSBC, Lloyds and RBS) to publish the pay of their five highest-paid staff below board level.

From 2012 all large UK banks – including overseas banks with UK operations – have had to publish the pay of their board members plus that of the eight highest-paid staff below board level.

Some banks continue to insist that material bonuses need to be offered to ensure that they can attract and retain the best banking staff – and that high-quality staff are needed to ensure profitability. Indeed, the investment bank J.P. Morgan was reported in December 2009 as considering abandoning its plans to build a headquarters in London as a result of concerns about the 50 per cent tax on bonuses and the tightening regulatory environment in the UK (The Times, 2009b).
Ring-fencing banks

One immediate decision of the new coalition government was to announce that the Independent Commission on Banking (ICB) – chaired by Sir John Vickers – would investigate the structure of banking in the UK, including the case for the separation of retail (commercial) and investment banking. The argument is that the risky activities of the investment banking sector should not be set in a business environment where they could undermine the conventional banking activities, for personal and business customers.

The final report of the ICB, published in September 2011, made a number of recommendations on the issue of the financial stability of the UK banking system.

First, there should be a ring-fence between high-street or retail banking (considered to be low-risk) and investment banking activities (viewed as being high-risk). This should be reinforced by each part of a bank that combines retail and investment banking operations having its own board and being operationally segregated. The commission did not, however, recommend the complete separation of investment banking from retail banking.

Second, the ring-fenced banks (RFBs) should be required to hold more capital. This is the money banks and other financial institutions have to hold to cover for losses arising from their business, for example when borrowers fail to repay loans. The commission called for the RFBs to hold capital totalling up to 20 per cent of total liabilities, with equity capital (raised through the issue of shares) amounting to at least 10 per cent of total liabilities. The largest RFBs should hold at least 17 per cent of their liabilities in the form of equity capital to reflect the risks they are taking in their business.
In December 2011, the government announced that it would accept these proposals, which found their way onto the statute book through the Financial Services (Banking Reform) Act 2013. Compliance with the legislation by the RFBs is required by the start of 2019. The then Chancellor George Osborne stated that the UK’s big banks would be broken up (i.e. formally split into retail and investment banks) if they did not effectively comply with the ring-fencing requirements.

The decision of the government to implement the findings of the ICB – albeit with some modest dilution of the commission’s proposals – has, though, attracted both concern and criticism from within the banking sector and elsewhere. With some forecasts indicating that the cost of the ring-fencing arrangements and the higher capital requirements could cost the industry anything between £4 billion and £12 billion, some banks have started to consider whether they should relocate to other jurisdictions (Nicolson, 2011). This would be at the cost of both jobs and tax revenues in the UK. There has also been speculation that banks will seek to recoup these costs by ending free current account banking for retail customers.

2.1.4 Building societies – their numbers decline further

In September 2015 there were 44 building societies in the UK. The table below shows the top five building societies in terms of total size of the assets on their balance sheet. The figures show how the industry is dominated by Nationwide, with an asset size that exceeds the combined size of all the other building societies (£130 billion).

<table>
<thead>
<tr>
<th>Total group assets*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nationwide</td>
</tr>
<tr>
<td>Yorkshire</td>
</tr>
<tr>
<td>Coventry</td>
</tr>
<tr>
<td>Skipton</td>
</tr>
<tr>
<td>Leeds</td>
</tr>
</tbody>
</table>

*Source: Adapted from Building Societies Association (2015).

Figure 6

The financial well-being of the building societies is very strongly related to the UK housing market, given that the majority of their assets are mortgages that are secured against residential properties. The UK housing market went into decline from autumn 2007 with
average house prices falling by 20 per cent by spring 2009 (Nationwide, 2015). This was, to a major degree, a further consequence of the ‘credit crunch’ that affected the financial markets in the wake of the collapse of the US sub-prime mortgage sector. In this environment, mortgage lenders found it difficult to raise funds in the wholesale markets to support their lending business. Additionally, they became more cautious about those to whom they would lend money for home purchase. These factors, in turn, reduced the demand for property, thereby resulting in downward pressure on house prices. Since spring 2009, average house prices have recovered steadily. In August 2015, the average house price in the UK was £195,279, 5 per cent higher than in October 2007, at the start of the financial crisis (Nationwide, 2015).

The economic environment that followed the financial crisis took its toll on the sector – particularly the smaller ones – resulted in a number of takeovers of weaker building societies by those in a stronger financial position. The Derbyshire and Cheshire building societies were taken over by Nationwide, and the Scarborough Building Society was taken over by Skipton Building Society. Additionally, the branch network, the good-quality loans and the retail and wholesale deposits of Dunfermline Building Society were acquired by Nationwide in 2009. The rest of the Dunfermline’s assets – the loans of weaker quality – were either taken on by the Treasury or placed into a special fund to be managed by the accounting and advisory firm, KPMG.

In December 2009, a merger was announced between Yorkshire Building Society and Chelsea Building Society, the latter having previously incurred material financial losses as a result of poor lending decisions and mortgage fraud. The merger was completed in April 2010. These and other mergers and takeovers further reduced the total number of building societies and reinforced Nationwide’s domination of the sector.

Is the core business of building societies really any different to the banks – particularly those banks that have previously converted from building society to banking status? One difference the building societies would point to is their mutual status and how this status affects their business model. Building societies, as mutuals, are owned by their members – including both savers and the mortgagors. In the ‘plc’ sense of the term, building societies do not have shareholders. So, with no need to run the business in the best interests of the shareholders, building societies are free to maximise member value – i.e. operate in the best interests of their customers.

Until the mid-1990s, there was arguably not much to distinguish between the banks and the building societies in terms of the treatment of their customers. However, in response to the rush to conversion in the 1990s, certain of the leading societies – including Nationwide and Britannia – sought to demonstrate their mutual approach to business by providing overt benefits to their members. Nationwide did this through changing its product pricing – cutting its mortgage rate and raising savings rates. Britannia, prior to its merger with Co-operative Financial Services, used to pay a form of dividend to its members. Other building societies adopted similar schemes to demonstrate the value that mutuality brought to members – although the evidence from market data indicated that the schemes were also useful in boosting the building societies’ share of the mortgage and savings markets, at the expense of the banks.
Activity 2.1

The vast majority of the lending business undertaken by building societies is in the form of mortgages on residential property.

What are the strengths and weaknesses of this part of the business model of a building society?

Discussion

The key strength is that the lending is secured against property. If a borrower defaults, their property can be repossessed by the building society and sold to recoup the original mortgage sum that had been lent. Until autumn 2007, rising property prices meant that the average value of the mortgage debt as a proportion of average property prices was falling – reinforcing the security that building societies had against the mortgages advanced.

The key weakness is that the financial health of building societies is largely tied to one sector only: the UK housing market. Societies’ asset portfolios are less well diversified than those of the banks. This makes them vulnerable to poor financial performance in periods of weakness in the housing market – for example, between 1990 and 1993 and from 2007 until 2009.
2.1.5 Credit unions to take on the payday lenders?

In the following video, Hugh Stickland, chief economist of Citizens Advice, talks about trends in enquiries seen from those who have got into difficulty with payday loans and whether the new rules of the Financial Conduct Authority (FCA) are helping consumers.

Video content is not available in this format.

Citizens Advice

Payday lenders are an alternative source of credit that have emerged in recent years. Lately, their business practices have come under fire and attracted great interest in the media and with regulators.

They are criticised for charging extortionate rates of interest on short-term loans and for dubious lending practices. The lenders have had to field calls for tighter regulation, including better tests of affordability when assessing applications for loans.

The Archbishop of Canterbury, Justin Welby, has gone on record as wanting to help credit unions take on payday lenders and force them out of business. There are over 350 credit unions in the UK who collectively lend around £700 million – these are mutual organisations often linked to places of work or particular localities that lend money from pooled savings.

In 2013, the Office of Fair Trading (OFT), which was then the regulator of the payday lenders, contacted 50 of them to review their practices and to form a view about their suitability to remain in business. Subsequently many lenders have ceased, or are ceasing, operations and others have had their lending licences revoked.

Concerns remained, though, about:

- whether the lenders are conducting proper affordability checks on borrowers
- the misuse of ‘continuous payment authorities’ that give payday lenders access to the bank accounts of borrowers to recover money lent
- the excessive rollovers of loans, with the consequent build-up of interest charges and the growing likelihood that the debts will become unmanageable
- aggressive debt collection methods.

Responsibility for the regulation of consumer credit, like payday loans, passed from the OFT to the Financial Conduct Authority (FCA) in April 2014.

Having taken over regulation of the payday lenders the FCA wasted no time in tightening up the rules applying to their lending. This included tighter rules on affordability and the application of a 0.8 per cent per day cap on interest charged from January 2015. Additionally, no one now has to pay back more than twice the sum borrowed (i.e. the aggregate interest charge is capped at 100 per cent of the loan).

The roll-out of the new affordability checks was followed, in October 2014, by Wonga – one of the largest payday lenders – announcing that it was writing off £220 million of debt relating to 330,000 customers following the application of the new criteria. Another 45,000 of Wonga’s customers who are in arrears will not have to pay interest on their loans.

So should payday lenders be forced out of business? Should their business be redirected to the credit unions?

While credit unions represent a lower-cost alternative to borrowing, the scale of the funds they have available is insufficient to replace the lending being done by the payday lenders (over £2 billion). Additionally, credit unions generally take a little longer to approve loans and this may be prohibitive for customers needing immediate cash. The harsh reality is that without payday lenders, many of their would-be customers could fall into the hands of the ‘loan sharks’ – something the FCA recognises.

While certain of the practices of the payday lenders may be condemned, their very existence and proliferation in recent years highlight both the current problem of falling living standards for many families, and the underlying issue of financial exclusion from mainstream financial services for thousands of households in the UK.

### 2.2 Insurance firms – addressing gender issues

In Week 1 we saw how insurance business is split between general (annual) insurance and long-term insurance. Most of the large UK insurance firms are ‘composites’ – active in both types of insurance business. However, some firms do specialise in just one of the two areas of insurance business. If active in both areas, firms must manage and report on the two business areas separately to demonstrate that there is no cross-funding of the two very different types of business.

Table 3 shows the largest UK insurance firms on the basis of their market capitalisation. The table only shows those firms whose core business is insurance, and so excludes the UK banks who own insurance subsidiaries.

<table>
<thead>
<tr>
<th>Table 3 Insurance firms and their market capitalisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market capitalisation</td>
</tr>
<tr>
<td>Prudential</td>
</tr>
<tr>
<td>Aviva</td>
</tr>
</tbody>
</table>
Note: Market capitalisation is the price of the company’s shares multiplied by the number of shares that have been issued by them.

Source: Adapted from *Sunday Times Business*, 13 September 2015.

In addition to conducting insurance business, many insurance firms have taken on a role as investment intermediaries – i.e. investment business not linked to insurance. This diversification has sprung from their life assurance business, where policies either pay out to the beneficiaries of policyholders in the event of death, or on maturity pay out to the policyholder.

The insurance sector, as with the building society sector, has seen the conversion of mutuals to plcs in recent years – with Standard Life and Norwich Union (now Aviva) being two major recent converters. The industry is now dominated by plc providers, with only a few mutuals remaining.

### Activity 2.2

A decision by the European Court of Justice meant that from December 2012 insurance firms in Europe could no longer take gender into account when pricing their insurance products. This move has had a major impact on the insurance industry.

Who do you think have been the gender winners and losers from this decision? In particular, think about car insurance and life insurance.

### Discussion

Women are losers when it comes to both car and life insurance – in both respects they are a lower risk than men and this should, with risk-based pricing, make insurance cheaper for women. By contrast men are losing out through the removal of the gender differential on annuities. Men used to get higher annuities due to lower average life-span – women got lower annuities due to longer average life-span. The differential has now been removed – although in recent years the average life-span gap between men and women has been narrowing.
2.2.1 Genetics and insurance

The life assurance industry is currently engaged in a debate surrounding the issue of genetic testing. This debate has intensified as scientists have made progress in our ability to detect the likely predisposition to certain conditions. To some extent, this capability has existed for many years – take the example of Huntington’s disease below.

Huntington’s disease is caused by a faulty gene, which leads to damage of the nerve cells in areas of the brain. This leads to gradual physical, mental and emotional changes. A parent who has Huntington's disease has a 50 per cent chance of passing the faulty gene on to their child. Anyone who inherits the faulty gene will, given time, develop the disease. A genetic test is available which will usually be able to show whether someone has inherited the faulty gene, but it will not indicate the age at which they will develop the disease. The symptoms of Huntington’s disease usually develop when people are between 30 and 50 years old, although they can start much earlier or much later. In the later stages of the disease, full nursing care will be needed. Secondary illnesses, such as pneumonia, are often the actual cause of death (Huntington Disease Association, 2008).

The genetic test for Huntington’s disease has existed for some time, but more recently other genetic tests have emerged which are slightly different in nature. In the case of Huntington’s disease, the test results provide a clear result one way or the other. Many tests for other types of disease only predict an increased likelihood of developing a certain condition – there is still a chance that this development will not happen. For example, in a small number of cases there is an inherited predisposition among women for contracting breast cancer. If you have the genetic predisposition identified by at least two close family members having contracted the disease, it increases the likelihood you will contract the disease.
disease but it does not make it a certainty (unlike the certainty of the genetic test for Huntington’s disease).

Nevertheless, there is an attraction to insurance firms of knowing someone’s predisposition to certain conditions, even if the tests involved do not provide a clear result. This is because the principle of insurance is that each individual should pay a premium according to the level of risk they bring. However, if genetic screening meant that certain people were excluded from life assurance, there would be implications for a whole range of areas, such as individuals not being able to purchase life assurance for mortgages. This would have a wide-reaching impact upon society (Cunningham, 2003).

Figure 9

Because of the concerns raised by genetic testing, life assurance firms have come under increasing pressure to be regulated in this area. As a result, the Association of British Insurers agreed to a voluntary code of practice for all their members. This code came into force in 1997 and runs until at least 2017.

The following are the key features of the code that all insurers must follow:

- customers will not be asked, nor will they be put under pressure, to take a predictive genetic test to obtain insurance cover
- customers who have taken a predictive test before the date of the code will be treated in the same way as customers taking tests under the terms of the code
- customers will not be required to disclose any of the following:
  - a predictive genetic test result from a test taken after the insurance cover has started, for as long as that cover is in force
  - the predictive test result of another person, such as a blood relative
  - a predictive or diagnostic test result acquired as part of clinical research.
Note, though, that those who have taken a genetics test for Huntington's Disease must disclose the test results if they are seeking life insurance cover of more than £500,000, critical illness cover of more than £300,000 or income protection cover of more than £30,000 per annum.

Like many other issues involving insurance, changes in society have the potential to have an impact upon the insurance industry, and vice versa. Time will tell how this issue develops, although it is likely to be a hotly debated area for some years (Cook, 1999).

Activity 2.3
What impact could genetic testing have on the pricing of life assurance products?

Discussion
The possibility is that insurers could apply what is known as 'price discrimination' in respect of the insurance premiums they charge customers. The premiums would be reflective of the risks the insurers are taking in the light of the information provided by genetic testing about the risks of customers contracting certain medical conditions. Customers deemed to be at high risk of contracting life-threatening medical conditions would be required to pay higher premiums than those with no genetic predisposition to such conditions.

2.2.2 The London Stock Exchange – evolving to compete

In Week 1 you looked at the development of the London Stock Exchange and at the changes to its operation and regulation that followed Big Bang. So what does the Stock Exchange currently do and what is now traded on the exchange?
Figure 10

The activities of the exchange can be divided first into transactions in shares and those in fixed-interest securities. The latter, often referred to as bonds, are issued by the government and by firms to raise finance, normally for defined maturity periods. The Stock Exchange’s trading activities currently take place in four markets:

- Main Market (UK and international)
- Alternative Investment Market (AIM)
- Professional Securities Market (PSM)
- Specialist Fund Market (SFM).

The Main Market – sometimes referred to as the Official List – comprises shares issued by firms that have their main share listing on the Stock Exchange and which satisfy its criteria relating to size, profitability and ownership. Some UK-listed firms do also list their shares on other exchanges (e.g. the New York Stock Exchange), particularly if they have extensive international activities. The Stock Exchange’s Main Market is the most tightly regulated of its share markets.

The Main Market includes both UK and international firms. The latter are overseas firms that have a listing in their own country, but who believe that an additional listing on the Stock Exchange enhances the visibility and marketability of their shares. There is also a subdivision of the Main Market called techMARK, which is a grouping of technology firms. TechMARK was originally launched in 1999 at the time of the boom in ‘dot-com’ firms, whose business activities are linked to, or transacted via, the internet.

The AIM was established in 1995 and is less tightly regulated than the Main Market. The AIM is aimed at smaller, often newly established firms, including overseas firms with an
insufficient financial track record to join the Official List. As with the Main Market, AIM includes UK and international firms.

The PSM, opened in 2005, is used by firms to raise finance through the issuance of specialist bonds, including debt and depositary receipts that are sold to professional investors such as financial firms and investment funds.

The SFM, launched in 2007, is the Stock Exchange's market for specialist investment funds. The market targets institutional, professional and other investors deemed to be ‘highly knowledgeable’.

The table below show the trends in the numbers of firms using the Stock Exchange to raise capital over the past five decades. The clear trend is for fewer firms to use the Main Market – although this may be ascribed, in part, to merger activity in recent decades reducing the number listing on the Main Market. A second clear trend is the growing popularity of AIM.

<table>
<thead>
<tr>
<th>Year</th>
<th>Main Market: Great Britain (GB)</th>
<th>Main Market: International</th>
<th>techMARK</th>
<th>AIM</th>
<th>PSM</th>
<th>SFM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1968</td>
<td>3,673</td>
<td>420</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1978</td>
<td>2,930</td>
<td>374</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1988</td>
<td>2,054</td>
<td>526</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>2,087</td>
<td>522</td>
<td></td>
<td>312</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>853</td>
<td>415</td>
<td>40</td>
<td>1,091</td>
<td>36</td>
<td>26</td>
</tr>
</tbody>
</table>

**Figure 11** Source: Adapted from London Stock Exchange (2015).

The two main types of bond issuance in the Stock Exchange's markets are UK government securities and Eurobonds.

Government securities, also known as ‘gilt-edged stock’ or just ‘gilts’, are issued in accordance with the borrowing requirement of the UK government, which in turn is dictated by the government’s fiscal policy (its policy on taxation and public spending) and by economic conditions. Normally, the need to borrow through the issue of gilts rises as economic growth slows, as a result of the consequent adverse impact on tax receipts. If tax receipts fall – as they normally do during an economic downturn – the government is more likely to have a shortfall on income relative to its expenditure and is thereby forced to borrow more to close the difference between the two. The responsibilities for arranging the issue of gilts lie with the UK’s Debt Management Office.
Eurobonds are bonds issued by the larger firms – particularly financial firms who use the proceeds from bond issues to finance their lending activities.

In October 2007, the Stock Exchange merged with the Italian exchange, Borsa Italiana, creating Europe’s leading diversified exchange group.

Then, in February 2016, it was announced that the London Stock Exchange was in merger talks with Germany’s stock exchange Deutsche Bourse. This merger was agreed by the London Stock Exchange in March 2016. So, further major developments in the history of the London Stock Exchange are currently unfolding.

2.2.3 Fund managers – central to the way we invest

Investment firms play a central role in the financial services industry. The firms include:

- investment trusts
- unit trusts
- open-ended investment companies (OEICs).

There are clear legal and operational differences between these, although ultimately their investment objectives – to maximise returns to investors, subject to the constraints that are applied to their holdings of assets – are the same.

An investment trust is a limited-liability company that raises funds for investment by issuing shares on the Stock Exchange. Once an investment trust has been launched, it takes in no new funds unless it issues new shares in the form of a rights issue. Consequently, investment trusts are also referred to as ‘closed-end funds’. Shareholders of the trust can only extract the funds they invested by selling the shares issued to them on the Stock Exchange. However, some investment trusts do have pre-set dates at which they will be wound up. At this point, after creditors have been paid, the investors will recover the remaining value left in the trust.

Unit trusts are not companies; rather, they are trusts that raise funds by issuing investment units to investors. These units are not quoted on the stock exchange. Instead they can be directly bought from and sold to the managers of the trusts. Issuance is made on demand, as are repayments of existing units, albeit at the prevailing market price of the units, which in turn is dictated by the prices of the underlying assets that the unit trust’s funds are invested in. Because unit trusts are continually open to new funds from investors and can create or cancel the number of units in issue to meet supply and demand, they are referred to as ‘open-ended funds’.

In 1997, legislation was passed in the UK allowing open-ended investment funds to be formed into limited companies. Unlike normal companies, these OEICs have the power to issue and buy back their shares on an ongoing basis. This gives them the same operational flexibility as traditional unit trusts. Most new unit-based investment funds are OEICs, and some existing unit trusts have converted to OEIC status – incentivised by the economies in running costs that can be achieved because several funds can be run within one OEIC structure.

Table 4 shows the assets under management in UK investment trusts and unit trusts in 1995 and in 2013.

Table 4 Asset managements

<table>
<thead>
<tr>
<th>Assets</th>
<th>1995</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment Type</td>
<td>Value 2009 (£bn)</td>
<td>Value 2015 (£bn)</td>
</tr>
<tr>
<td>------------------------------------</td>
<td>------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>UK gilts</td>
<td>£3.1bn (2.0%)</td>
<td>£38.3bn (4.1%)</td>
</tr>
<tr>
<td>UK shares</td>
<td>£78.5bn (50.7%)</td>
<td>£255.1bn (27.4%)</td>
</tr>
<tr>
<td>Non-UK shares</td>
<td>£55.6bn (35.9%)</td>
<td>£297.1bn (31.9%)</td>
</tr>
<tr>
<td>Total shares</td>
<td>£134.1bn (86.6%)</td>
<td>£552.2bn (59.3%)</td>
</tr>
<tr>
<td>Other UK securities$^a$</td>
<td>£4.2bn (2.7%)</td>
<td>£61.3bn (6.6%)</td>
</tr>
<tr>
<td>Other non-UK securities</td>
<td>£4.3bn (2.8%)</td>
<td>£89.0bn (9.6%)</td>
</tr>
<tr>
<td>Total other securities</td>
<td>£8.5bn (5.5%)</td>
<td>£150.3bn (16.2%)</td>
</tr>
<tr>
<td>Property and land</td>
<td>£1.9bn (1.2%)</td>
<td>£13.7bn (1.5%)</td>
</tr>
<tr>
<td>Other assets including short-term liquid assets</td>
<td>£7.1bn (4.6%)</td>
<td>£176.2bn (18.9%)</td>
</tr>
<tr>
<td>Total</td>
<td>£154.7bn (100%)</td>
<td>£930.2bn (100%)</td>
</tr>
</tbody>
</table>

$^a$ These are mostly bonds issued by firms and non-UK governments.

Source: Adapted from Office for National Statistics (2009b, 2015b).

From the viewpoint of the investor, there are two general attractions of investments in trusts. The first perceived advantage is that the collectivisation of investment provides an efficient means of investing sometimes small amounts of money across a range of assets. Such diversification of holdings could not be achieved so efficiently – indeed, it might not be practical at all – if the investor acted alone. The second perceived advantage is that, by placing funds within a trust, investment decisions are passed (at least in part) to a professional team of investors, with the expectation that higher returns will be achieved than if the investor acts alone. However, data on investment performance by trusts – and generally by professional investment managers within the industry – does cast considerable doubt on the view that the ‘professionals’ consistently outperform the average returns from the markets they are active in.
2.2.4 Hedge funds – are they market manipulators?

Hedge funds have attracted considerable attention and, on occasion, criticism in recent years – but what are they, and how are they different from other types of investment funds? The term relates to an array of funds with a variety of structures and investment strategies. However, there are some common features:

- some are targeted at wealthy individuals (those of ‘high net worth’) who may be prepared to take greater risks with their investments than ‘ordinary’ investors
- the managers of hedge funds charge high fees for their services, often linked to the performance of their funds
- the funds tend to adopt riskier investment strategies than ‘ordinary’ investment funds, often building up their positions by borrowing money from the wholesale markets to finance their investments.

The main criticism levied at the hedge funds is that there is evidence that they target firms they perceive to be in difficulties and engage in strategies to profit from a fall in their share prices. They do this by ‘short-selling’ – entering into agreements to sell shares they do not possess for settlement at a future date. The intention is that between the transaction date and the settlement date, the market price of the shares in question will fall, enabling the hedge fund to buy them at the lower market prices to deliver them as required under the terms of the original transaction. The profits arise from having originally sold the shares at a higher price than the one at which they were ultimately acquired for delivery to the customer. If this strategy pays off, it is often to the disadvantage of the affected firms, who...
may find that their share price has been driven downwards – or, at worst, that the fall in the price has provoked panic selling by other investors, thereby jeopardising the firm’s existence. Hedge funds were widely criticised for their role in pushing down bank share prices during the 2007/08 financial crisis.

Figure 13
Ironically, the term ‘hedge’ is widely used in the financial markets to describe a method for reducing risk. Hedge funds, by contrast, are widely viewed as seeking to increase risk in the search for higher investment returns.

However, to be fair, there is a huge variation of styles and risk profiles within the hedge fund sector. Consequently, recent years have seen the rise of the ‘fund of hedge funds’ (FOHF): investors buy into a FOHF and leave the manager of the FOHF to use their skill and judgement to decide which hedge funds to buy into. This can provide greater investment diversification and thus help to reduce the overall risk to the investor.

2.2.5 Advisers and fees
Two key decisions involved in making financial decisions are whether professional advice should be sought and, if so, where do I find it? Taking advice is different to using a broker – a broker simply executes the transaction you have decided to make at the best possible price. An adviser provides direction on which transactions should be undertaken.

In terms of whether advice should be sought the key factors are:

- How well informed are you about the product in question and all its associated risks?
- How experienced are you in respect of the product (for example, what experience do you have in different types of investments)?
Are you able to access the market for the relevant product effectively (for example, do you know the best providers and their current product offerings)?

The use of financial advisers varies from product to product. For some basic products, like a savings account, they are not really needed. For more complex investment, pension and borrowing products that have material risks associated with them, seeking advice is prudent and, in certain cases, essential.

A poll of investors by the online investment platform, Interactive Investor, found that one in five now prefer to make their own investment decisions having previously relied on an adviser to assist them *(Sunday Times*, 2014).

Since 31 December 2012, financial advisers have been required to be fully transparent about their costs and need to set these out ahead of the completion of transactions on behalf of customers.

Financial advisers should also specify their extent of the market for the financial products that they cover. There are two main categories:

- independent/unrestricted: such advisers cover the whole of the market
- restricted: advice is provided on only a limited number of products or advice about the range of products provided by a certain financial firm.

There is also a further category for much more limited advisory services:
- simplified: advice is given only on very straightforward products like stakeholder pensions. The assessment of suitability is questionnaire-based and is typically provided online or by telephone and is defined as 'an automated advice process' *(Mindful Money*, 2014). With simplified advice, no assessment is made on a customer’s existing products.

The fees charged by advisers vary according to the category of service they provide.

If you need the services of a financial adviser, then both the [Unbiased Financial Advice](https://www.unbiased.co.uk) and the [Money Advice Service (MAS)](https://www.moneysavingexpert.com) sites will help you.

Financial advice is distinct from services provided by brokers or platforms in undertaking (or ‘executing’) the orders given by a customer. In these circumstances, no advice is given about the suitability of decisions being made by the customer. ‘Execution-only’ services involve no financial advice.
2.2.6 Advisers in the contemporary financial marketplace

In the following video David Harrison of True Potential LLP provides his thoughts on what to look for when choosing a financial adviser, and on the regulatory developments that are changing the way that advisers operate.

Chris Woolard, director of strategy and competition at the Financial Conduct Authority (FCA), talks about the review of the Financial Advice Market Review (FAMR) that was initiated in 2015 and on the changing expectations the regulator has about the provision of financial advice.

Video content is not available in this format.
Financial Conduct Authority
2.3 The Bank of England – a bigger role in regulation

In the next video, Andy Haldane, chief economist at the Bank of England, talks about the Bank's responsibility for monetary policy and the range of factors its Monetary Policy Committee takes into account when setting the level of the 'official interest rate' (or 'Bank Rate').

Video content is not available in this format.
Bank of England
Following the financial crisis, the role of the Bank of England in the oversight of the financial services sector has been enlarged.

Since 1997 the Bank of England has managed monetary policy in the UK through its Monetary Policy Committee (MPC). The MPC sets the level of the ‘official’ rate of interest (also known as Bank Rate). By setting the official rate of interest, the Bank of England is able to influence the general rates of interest applied by financial institutions. The MPC determines what official interest rate to set by reference to the aim of ensuring that economic activity in the UK is maintained at a level consistent with the achievement of the medium-term target for price inflation, as established by the government.

The prevailing medium-term target (in 2016) is an inflation rate of 2 per cent per annum as measured by the UK’s Consumer Prices Index (CPI). This focus on controlling price inflation altered to a degree in 2013 when the Canadian, Mark Carney, took over the role of the governor of the Bank of England from Sir Mervyn King. The new governor indicated that monetary policy would focus more on helping to contain and reduce unemployment. This approach was subsequently revised to a focus on the more general indicator of ‘spare capacity’ in the economy.

As you saw in Week 1, in April 2013 the Bank also took on responsibility from the FSA – via its new subsidiary, the Prudential Regulation Authority (PRA) – for the regulation of the banks and other deposit-taking institutions, investment firms and insurers.

Additionally, the Financial Policy Committee (FPC) was established to monitor the economy and to identify macro-economic and financial issues that could threaten stability. The committee, chaired by the governor of the Bank of England, addresses these potential threats to financial stability by instructing the PRA or the Financial Conduct Authority (FCA) to take regulatory action with respect to the financial firms involved. To assist in this process the PRA and the FCA produce annual Risk Outlooks that set out an assessment of the economic and financial trends in the UK as a context for regulatory decision making and the supervision of financial firms.
2.3.1 The regulators

The aftermath of the financial crisis saw a major overhaul of the regulation of financial services – both in terms of the institutions charged with regulatory responsibilities and in terms of how regulation is applied to business in the sector.

With effect from April 2013 the regulation of the financial services industry was formally passed to the Prudential Regulation Authority (PRA) – a subsidiary of the Bank of England – and the Financial Conduct Authority (FCA).

The PRA

The PRA's statutory objective is to promote the safety and soundness of PRA-authorised firms. It aims to achieve this by 'seeking to avoid adverse effects on financial stability, and in particular seeking to minimise adverse effects resulting from disruption to the continuity of financial services that can be caused by the way firms run their business or upon their failure' (Bank of England and FSA, 2012, p. 5).

This, however, does not mean ensuring that no financial firm goes out of business: ‘firm failures will happen, but the PRA will seek to ensure that they do not result in significant disruption to the supply of critical financial services, including depositors’ ability to make payments’ (Bank of England and FSA, 2012, p. 5).

While the PRA has inherited the FSA’s detailed prudential policy framework, it is developing this to ensure that it can achieve its core statutory objective.

The FCA

The FCA has the strategic objective of ensuring that the relevant markets function well. To support this, it has three operational objectives (FCA, 2013):

- to secure an appropriate degree of protection for consumers (the consumer protection objective)
- to protect and enhance the integrity of the UK financial system (the integrity objective)
- to promote effective competition in the interests of consumers (the competition objective).

As with the PRA, the FCA has inherited and is reshaping many aspects of the FSA's regulatory framework. It is particularly focused on the senior management and board-level involvement in decisions made by financial firms about their products and how these are marketed to their customers – an area of regulation referred to as 'conduct risk'.
The PRA and FCA

Liaison between the PRA and FCA

Clearly the PRA and FCA cooperate closely. The fact that the FCA is the conduct regulator for PRA-authorised firms and the conduct and prudential regulator for many other smaller UK firms is suggestive of potential overlaps – and perhaps conflicts – between the regulatory activities of the two organisations. To address these potential operational problems, a Memorandum of Understanding between the two authorities has been drawn up. This addresses the need for, and the process of, coordination between the PRA and FCA while recognising their separate, independent mandates and statutory objectives.

Regulation of pensions

The PRA and FCA’s responsibilities do not extend to the regulation of work-based pension schemes. The responsibility for these was passed from the Occupational Pensions Regulatory Authority to the Pensions Regulator in 2005 following the enactment of the Pensions Act 2004.

The Pensions Regulator has three statutory objectives (Pensions Regulator, 2013):

- protecting the benefits of members of work-based pension schemes
- reducing the risk of situations arising that may lead to compensation being payable under the Pension Protection Fund
- promoting, and improving understanding of, the good administration of work-based pension schemes.

2.3.2 Regulatory changes since 2000

In the following video, Andy Haldane, chief economist at the Bank of England, talks about the changes to the regulation of financial services in recent years and the rationale for them. He particularly focuses on the role of two parts of the regulatory structure that are the responsibility of the Bank of England – the Prudential Regulation Authority (PRA) and the Financial Policy Committee (FPC).

First, Chris Woolard, director of strategy and competition at the Financial Conduct Authority (FCA), talks about the new regulatory structure and its aims from the viewpoint of this other key regulatory body.

Video content is not available in this format.

Chris Woolard

You will examine the activities of the regulators further in Week 4.

2.3.3 Financial services business – changing technology

In this video, David Harrison of True Potential LLP talks about the technological changes that are changing the way we are conducting financial services business. He also provides a very interesting insight into the absence of an age divide when it comes to the way the public are adjusting to these changes.
Since the mid-1990s, the financial services industry has been undergoing a large amount of change driven, in part, by the advent of the internet and other digital services that facilitate new ways of making financial transactions.

A 2015 survey on behalf of True Potential LLP showed that the use of digital services, including online, smartphone and wearable technology, is most popular for clients when it comes to managing savings and investments. The survey found that 'almost 55 per cent currently use digital services to manage their savings and investments, compared with only 34 per cent who use face to face services and just 11 per cent who now use telephone banking' (True Potential, 2015, p. 13).

New advances in technology are making the use of online and digital services easier and more accessible across all age groups. The survey data revealed that, looking ahead 5 years, 15 per cent believe that they will use either a smartphone or a wearable device as their primary way of managing savings and investing.

2.3.4 Comparison sites

Comparison sites are one of the main services to have emerged from this new technology. Comparison sites are a way for customers to compare the costs and benefits of one firm’s products against another. They provide a relatively quick way to gain quotations from a number of different organisations. Most now also offer a way of buying the product the customer chooses online or via the telephone. This can apply to a range of financial
services products (such as mortgages and ISAs) or insurance products (such as motor, household or pet insurance). In effect, comparison sites are a form of brokerage, with financial services firms paying the firm owning the comparison site each time one of their products is sold.

According to Which? the strongest brands currently are Confused, Go Compare and Money Supermarket. Note that the consumer advice organisation Which? also, itself, provides financial product comparisons on its website.

Despite this popularity, some firms are making a virtue of not being on the comparison sites by claiming that their products are cheaper as a result, such as Direct Line.

A few years ago concerns raised about these websites were raised by the FSA, which was concerned that customers were not getting the required level of clarity they need to make decisions about which products to buy.

Research by the FSA also highlighted a number of regulatory failings among a number of firms selling insurance policies through price comparison websites. These included breaches of compliance with the Conduct of Business regulations for the sale of insurance and firms not having the appropriate ‘permissions’ to conduct such business. This prompted the publication of new guidelines on internet selling by the FSA (FSA, 2011).

In 2014, however, a review completed by the Financial Conduct Authority (FCA) found that many comparison websites were failing to provide appropriate and clear information to enable consumers to make sound decisions about financial services products. Additionally the FCA found that the websites did not make clear both their role in the distribution service and the nature of the service they were providing. Some sites that were a part of a larger broking group or product provider were not disclosing this clear conflict of interest. The FCA also concluded that many comparison sites were not fully complying with the FSA’s 2011 guidelines (FCA, 2014).

However, despite these issues, comparison sites continue to be popular with customers, and it is likely that the service they provide will be a major factor in the financial services market for the foreseeable future (Booth, 2008).

Activity 2.4
What do you think might be the impact on the market for financial services products of these comparison sites?

Discussion
These websites make it easier for customers to shop around and therefore switch providers on a more regular basis. This makes the market more competitive. It also means that providers are likely to have a higher turnover of customers, leading to higher costs – since it is usually less expensive to keep a customer than gain a new one. This in turn has driven financial services providers to look at ways of driving down their operating costs – or, in some cases, at withdrawing from these comparison sites altogether.

Another impact is that some providers have altered the structure and terms of their products to make them appear cheaper on the comparison sites – for example by heavy discounting, but for only the first year of a debt or insurance product. In these cases, they hope that inertia will lead to a good proportion of customers not moving to new providers after the end of the ‘cheap’ first year.

So while the sites are convenient to use it is important that consumers remember to identify all the features and terms of competing products.
2.4 Week 2 quiz

This quiz allows you to test and apply your knowledge of the material in Week 2.

To view this content please access the complete course on OpenLearn
Open the quiz in a new window or tab then come back here when you're done.

2.5 Week 2 round-up

There is plenty of change currently unfolding in the financial services industry. New banks are challenging the existing incumbents. Pay and bonuses are more tightly regulated than before the financial crisis. Retail banks are in the process of becoming ring-fenced from the speculative activities of their associated investment banking arms. New rules are being applied to the ways financial advisers operate. The insurance industry is adjusting to new rules on discrimination and to medical advances. In addition we are increasingly doing our financial services business on phones, tablets and laptops as opposed to calling in at bank branches.

But while the structure, operation and regulation of financial services are changing, what about the current issues and developments in respect of the products on offer? This is what we turn to in Week 3.

You can now go to Week 3: What's on offer? The marketplace and current issues.
Week 3: What’s on offer? The marketplace and current issues

Week 3 Introduction

Last week it was about players in marketplace – the financial firms and the regulators – and the issues, challenges and changes they are currently experiencing.

This week you will focus on the financial products in the marketplace and at the developments taking place in these – like the growth of the equity release market and the pensions revolution in the UK. You will look at the financial firms to go to for the products and the risks associated with them. You will also look at the factors that you should apply to your decisions about financial products by using a four-stage decision-making model.

The marketplace is changing – let’s have a look at what is on offer.

Video content is not available in this format.

Marketplace
possible thanks to the generous support of True Potential LLP, which has committed to a five-year programme of financial support for the Centre totalling £1.4 million.

3.1 Banking services – the competition for current accounts

Twenty years ago, doing banking business involved regular trips to your branch to pay in cheques and organise other financial transactions. These days the use of cheques has diminished as people routinely use internet banking facilities to check their bank balance, move money between accounts and settle payments. The facilities offered extend to more than just current account operations, with the capability to open savings accounts and arrange loans online without the need to visit a bank branch.

The move to internet banking is clearly affecting the high street with hundreds of bank branches being closed and with some smaller communities being left without a single bank branch. In 2015, the commitment by banks never to close the last branch in town was abandoned and the prospect is that, with the popularity of online banking, hundreds more bank branches will close in the coming years.

Another contemporary feature in banking services is the fierce competition for current account business. Some banks are offering upfront cash payments to those signing up, and others are offering interest rates on current account balances that are materially higher than on conventional savings accounts. Some current account products offer deals on insurance products – for example, travel insurance. However, those offering such products have to do checks to ensure that the insurance product involved is suitable for the customer.

The financial rationale is simple: with current account business comes the greater likelihood that customers will opt for the institution’s other offerings like loans, mortgages and insurance products. The margins made on cross-selling business, combined with the lower rates offered on conventional savings products, subsidise the keen rates and other incentives paid to those new current account holders they attract. The ability to cross-sell is accentuated by the fact that access to current account activity alerts banks and building societies to behavioural patterns that help sell further products. Current account customers also visit branches more often than other customers, providing further opportunities to cross-sell.

This development has been helped by new regulations that require current account providers to be able to switch accounts within seven working days, with standing orders and direct debits being automatically transferred in the process. With only 9 per cent of account holders taking advantage of this new flexibility in the last 3 years, there is a large pool of potential customers for banks and building societies to target and to bombard with incentives.
In October 2015, the Competition and Markets Authority (CMA) released the findings of its inquiry into the UK current account market. The CMA concluded that customers could, on average, save £70 a year by switching their current account provider. The CMA found that 57 per cent of customers had stayed with the same current account provider for more than 10 years and 37 per cent had not moved accounts for more than 20 years (BBC, 2015).

To facilitate greater switching the CMA recommended that:

- banks should prompt customers to consider switching accounts at certain ‘trigger’ points – for example, if the bank increases its overdraft charges
- banks should set up a current account price comparison site for small business customers
- banks should fund an advertising campaign to encourage people to use the Current Account Switching Service.

Those seeking to switch accounts should check whether the deals on offer only apply if the monthly salary is paid into the new account. The interest structure for balances should also be checked carefully – in some cases the highest, ‘headline’, interest rate advertised only applies above a defined minimum balance that can be as high as £3000 or more.

### 3.1.1 Borrowing – the debt products on offer

One major area of financial services business is lending money to households and businesses. We borrow money for a variety of reasons including purchasing property or cars, to finance a holiday or to furnish and renovate our homes. Sometimes we need to borrow if there is a shortfall in income relative to our spending needs.
Borrowing can take many forms – here’s a rundown of the most common forms of borrowing.

**Overdrafts:** a flexible means of accessing debt on a bank current account, up to a limit approved by the lender. Unapproved overdrafts normally attract penalty fees and high interest charges.

**Credit cards (including store cards):** their credit limits are set by the lender and normally require a minimum amount to be repaid each month – typically between 2 per cent and 5 per cent of the balance of debt. They may offer a short period of interest-free credit until payment is due. Credit cards vary widely in the interest rate charged on the balance that is not paid off, and some have an annual fee attached, although many do not. Store cards are a form of credit card used for buying from specified outlets. They tend to have much higher interest rates than credit cards.

**Charge cards:** can be used like credit cards to make purchases and obtain approximately 2 months’ free credit between purchase and paying off the outstanding amount. Charge cards differ from a credit card in that a borrower is required to pay off the entire balance each month. The 2-month free credit period arises when the charge card bill is sent out monthly, with a further month in which to settle the bill. A fee may be payable for the card.

**Personal loans:** loans made to individuals, typically with terms of between 1 and 10 years. They may be either unsecured or secured against a property (such as a house) or other assets. Unsecured personal loans are not contractually linked to any assets the borrower buys. These are available from credit unions, banks, building societies, direct lenders and finance firms.

**Hire purchase (HP):** a form of secured debt where payments (interest and part repayment of the principal) are made over a period, normally of up to 10 years, to purchase specific goods. The legal ownership of the product only passes to the borrower when the final instalment has been paid.

**Mortgages:** loans to purchase property or land, which are secured against these assets. Debt terms for mortgages are normally up to 25 years. There are many types of mortgage and it’s possible to fund spending through equity withdrawal.

**Alternative credit:** these are the areas of sub-prime lending described earlier, and include buying on instalments through mail-order catalogues, doorstep lending and ‘payday lending’. Commonly, interest rates are high and there are heavy penalties for late payment.

**Peer-to-peer (Peer2Peer or P2P) lending:** this is an emergent form of lending in the UK and involves savers pooling funds for on-lending to individuals and businesses. This form of lending, arranged through intermediaries like Zopa and Financial Circle, circumvents banks and other conventional lenders. P2P lending, which is a debt product, is distinct from ‘crowdfunding’ where the funds raised are for a share of a business.

When making comparisons between debt products you should compare their Annual Percentage Rate (APR). This measure not only takes into account the interest rate on the product but also when and how often interest is paid each year plus any other compulsory fees or costs associated with the product – for example arrangement fees on mortgage products or annual fees on credit cards.
3.1.2 Have borrowers never had it so good?

In the following video, Andy Haldane, chief economist of the Bank of England, talks to Martin about the trends in borrowing in the UK during the current period of low interest rates and whether these trends are of concern to the Bank.

Video content is not available in this format.
Andy Haldane
Those borrowing money in recent years have benefited from the historically low rates of interest charged on debt products. Why have interest rates been so low since the end of the 2000s? To understand this, we need to explore how the ‘official’ rate of interest is set in the UK, since this provides the basis on which interest rates on financial services products are set.

As we saw in Week 2, responsibility for monetary policy was passed from the UK government to the Bank of England in 1997. This enables the Bank to set the level of the UK’s official interest rate without being subject to political influence. This matches the arrangement in the US and in the eurozone, where the official rates are set by the Federal Reserve Bank and the European Central Bank respectively.

The rate set by the Bank’s Monetary Policy Committee (MPC) – Bank Rate – is the rate at which the Bank of England will lend to the financial institutions. This, in turn, determines the level of bank ‘base rates’ – the minimum level at which the banks will normally lend money. Consequently, Bank Rate effectively sets the general level of interest rates for the economy as a whole. Bank Rate is therefore hugely influential in the determination of the rate that will be paid on savings and interest-bearing investment products.

The prime objective is for the MPC to set interest rates at a level consistent with inflation of 2 per cent per annum (p.a.). For example, if the MPC believes inflation will go above 2 per cent p.a., it might increase interest rates in order to discourage people from taking on debt – because if people spend less, it could reduce the upward pressure on prices. Conversely, if the MPC believes inflation will be much below 2 per cent p.a. it might lower interest rates (also known as ‘easing monetary policy’) – people might then borrow and spend more.

Given the weakness of the economy after the financial crisis, Bank Rate was cut to a historic low of 0.5 per cent in March 2009 to help stabilise the financial system and foster economic activity. The rate has remained at this level ever since and is still 0.5 per cent at the time of writing, in February 2016. With unemployment falling quickly after 2012 and with stronger economic activity generally, with faster economic growth, the governor of the Bank of England, Mark Carney, has regularly indicated that Bank Rate is likely to rise.
(gradually) in the not too distant future to prevent inflationary pressures building. However, the reality of a higher Bank Rate has not materialised to date. Despite falling unemployment, the absence of price inflation pressure and the weakness of world equity markets (which is impacting adversely on the level of economic growth) have provided a strong argument to hold off from tightening monetary policy by raising Bank Rate. This is continued good news for borrowers although, as Andy Haldane comments in the video, the growth in certain forms of personal borrowing – partly stimulated by the prevailing low interest rates – is a matter of concern.

![Figure 3](image.png)

**Figure 3** Nominal and real interest rates and inflation in the UK, 1980–2014 (HouseWeb, 2010; ONS, 2010).

Official rates of interest tend to be cyclical, rising to peaks and then falling to troughs. Since 1989, the trend in the UK has been for nominal interest rates to peak at successively lower levels. Nominal rates fell to 3.5 per cent in 2003. In 2009 they hit a record low of 0.5 per cent.

Note that real interest rates are nominal rates adjusted for the prevailing rate of price inflation. So, for example, if the nominal rate of interest is 2 per cent and price inflation is 2 per cent, the real interest rate would be 0 per cent (zero).

### 3.1.3 The mortgage market – rock-bottom rates

Buying a property, particularly your first property, usually involves taking out a mortgage – a loan secured against the home.

To guide you through what can seem like a maze of mortgages, here’s personal finance expert Jonquil Lowe to explain the six most common types. At the time of writing the rates on mortgage products are, like other forms of borrowing, at historically low rates. The
availability of such cheap finance is one reason why house prices have seen such strong growth since 2010.

- Fixed-rate mortgage
- Variable-rate mortgage
- Capped-rate mortgage
- Offset mortgage
- Flexible mortgage
- Shared-ownership mortgage

Video content is not available in this format.

Mortgage

3.1.4 Islamic finance – a growing market in the UK

When looking at ways that money can be borrowed, we also need to look at the concept of Islamic finance. Internationally this is now the fastest growing financial sector.

In the UK at the end of 2014 there were 22 firms that offered financial products that complied with Islamic Sharia Law. These included six fully fledged Islamic banks including the Bank of London and Gatehouse Bank. Collectively the firms held an estimated total of $19 billion of assets (Reuters, 2014).

To learn more about this growing market, first read the description below about how Islamic home finance works, then watch the video on the growing Islamic bond market.
Islamic home finance

Islamic home finance is based on the Islamic finance principles of *Ijara* (lease agreement) and Diminishing *Musharaka* (equity participation). You make two contracts with the bank. In this scheme, the bank and you jointly own the property, although the title deeds will be in the bank’s name. You will then buy back the bank’s share over a number of years. During that period, the bank will charge you rent for living in the property on the percentage of shares it has. With each payment, your share of the property increases, while the bank’s percentage decreases. At the end of the term, the bank will transfer the title deeds of the property into your name.

Video content is not available in this format.

Home finance

The figure below shows how the arrangement works.
Figure 4 The Islamic system of home finance.

Step 1 – You make an initial payment to the bank of at least 10 per cent of the property value. You sign two contracts, the Diminishing Musharaka contract and the Ijara contract. You promise to purchase the remaining 90 per cent of the property over an agreed period and you agree to pay rent to the bank.

Step 2 – The bank contributes up to 90 per cent of the property value and buys the property on your behalf.

Step 3 – The property is then transferred to you from the seller.

Step 4 – The property deeds are transferred to the bank.

Step 5 – When you have purchased the property completely, the property deeds are transferred to you.

3.1.5 Savings products – rock-bottom rates and government incentives

Here you start to explore the different savings choices for a household that has surplus income or has budgeted to create surplus income. You begin to learn to make some important distinctions between savings products:

- products that earn interest where the nominal value of the capital (the amount you put into the product) stays the same
- investment products, which you look at later, that can make capital gains and capital losses, where the investment you make can subsequently go up and down in value.

There are thousands of different savings products available, and such choice can be daunting. Yet it’s possible to make sense of the choice with reference to available interest
rates and, where applicable, the taxation of that interest. An understanding of these, as well as a clear idea about the reason for wanting to save, should provide enough background information to make a more informed decision about a product. The financial services industry is required to show interest rates on all savings products so that they can be easily compared. For savings products, this rate is called the Annual Equivalent Rate (AER).

The AER allows a comparison of savings products with different interest payment patterns. The AER is the annual interest rate that savers receive, taking into account when interest is actually paid (for instance, annually, quarterly or monthly).

The concept of real interest rates is important when looking at investment returns. These show the return after the impact of price inflation has been taken into account. Thinking in real terms can help to show what's happening to the value of savings over time. For example, the significance of a 5 per cent interest rate on savings is dependent on the rate of inflation, and is very different at either 1 per cent or 6 per cent.

In the latter case, the real interest rate is actually negative, that is, your savings could buy less in a year’s time, even after the receipt of interest. Theoretically, this could cause some people to decide to consume more now and save less. Conversely, when inflation has been high in the UK, it can make people want to save more to make sure the real value of their savings is not reduced.

In the UK, only National Savings & Investments periodically offers an inflation-proofed savings product in the form of index-linked certificates. For example, holders of the 48th issue 5-year certificates are guaranteed to get their original investment (their 'capital') back at the end of 5 years with interest equal to inflation over the period plus 0.5 per cent a year, in other words a real return of 0.5 per cent. Someone who invested £1000 in these 5-
year index-linked certificates on the first date of their issue in May 2011 would, on 14 October 2015, have found that they had a valuation of £1164.60, giving a return since the start of the investment of 3.5 per cent a year once inflation had been added to the real return.

At times of low inflation, the return on index-linked investments can seem unattractive, but they come into their own in periods when inflation is expected to be high. Most savings products do not offer inflation-proofed returns.

On 29 September 2015, the Bank of England published news that came as no surprise to the UK’s beleaguered savers. Rates on savings accounts were at a historic low. At 1.43 per cent, the interest on cash ISA accounts was the lowest since records began in 2011. It was no better for notice accounts, where the average rate for these products was the lowest since records began in 1999.

The reasons for this are well known. Bank Rate has been at a historic low since March 2009. With economic conditions weakening globally in recent months, in the wake of problems in China, no early increase to this key rate is expected. The Bank of England’s Funding for Lending Scheme (FLS) continues to give financial institutions access to cheap money for lending to businesses, thus reducing their need to attract funds from personal investors.

Better news for savers comes with the tax breaks available to them. Investors can place savings in cash Individual Savings Account (ISA) products – up to an annual limit set by the government – with the interest earned being free of income taxation. In 2016/17 the limit for such investments is £15,240 per person. In the March 2016 budget statement it was announced that a new ‘lifetime ISA’ would be available from April 2017 for those aged under 40 years. These new ISAs will allow tax-free savings of up to £4,000 per annum with the government topping up balances by £1 for every £4 saved. Lifetime ISAs, which can be built up until the age of 50 years, are intended to help people save for property purchase or to help provide income in retirement. To support this development, the overall ISA limit (for both ordinary and lifetime ISAs combined) will be £20,000 for the 2017/18 tax year.

In addition, and with effect from 2016/17, the first £1000 of interest earned from non-ISA savings accounts is also free from income tax for basic-rate taxpayers. For higher-rate taxpayers, the first £500 of interest is tax-free. Also for low earners, with an aggregate of income and interest earnings of up to £16,000, no income tax is payable on the first £5000 of interest.

A new savings scheme for those on low incomes was also unveiled in March 2016 with those on in-work benefits who save £50 per month for up to 4 years getting a 50% top up from the government (up to a maximum of £1200).

3.1.6 Bonds – currently offering low yields for investors

In personal finance, the terms ‘savings’ and ‘investments’ have different meanings. Savings accounts refer to any form of deposit account that pays interest on top of the amount deposited. The amount deposited is not at risk unless the institution defaults. Investments also allow interest or dividends to be paid but, crucially, the investment itself can fall or rise in value. Financial investments are those products with the warning in the small print that the value of your investment can go down as well as up.

Financial investments, which for simplicity we will call ‘investments’, include shares and bonds and investment funds that hold these types of assets. The amount invested – the ‘principal’ or ‘capital’ – is usually at risk, as well as the rate of return on the investment.
This means that it is not income alone that is relevant (as the rate of interest is on savings products) but the total return, which may be made up partly of income and partly of the change in the value of the capital. If the price of the investment goes up, a capital gain will be made, but if the price goes down, a capital loss is made. Newspapers often print cases of investors who have lost money on investment schemes.

With increased regulation of financial intermediaries and other financial firms, including the actual providers of savings and investment products and their salespeople, and the requirement to explain fully the characteristics of the financial products they sell, mis-selling of financial products should, in theory, be unlikely. But it still happens.

Figure 6

A bond generally represents a promise to pay a regular rate of interest over a fixed period, from 1 to 50 years, plus the promise to repay the nominal value (also known as the face value) of the bond (say, £100) on the maturity date. The interest rate is normally fixed, for instance, at 5 per cent or 10 per cent of the nominal value each year.

The nominal value is the amount on which the interest is calculated and can be divided into small amounts for sale, usually £1000 or less. For example, an investor could buy £100 nominal of a ‘5-year 5 per cent bond’. This will pay 5 per cent a year for 5 years on £100 nominal – that is, £5 a year. The interest may be paid quarterly, semi-annually or annually, depending on the type of bond bought. At the end of the 5-year period, an investor would receive £100 in repayment of nominal (or ‘face’) value.

Bonds tend to be less risky than shares because they have a promised interest rate and because company bonds rank in front of company shares in the event of a company being liquidated. Although less risky than shares, bonds are riskier than savings accounts. This is because with savings products typically the amount of capital you receive back is fixed – if you deposit £100, you get £100 back.
With a bond, the amount paid back on maturity is also fixed (but may be more or less than the amount paid for the bond). However, if the bond is sold before maturity, then more or less than the promised nominal amount may be paid. Whether it is more or less will depend on movements in the level of interest rates after the bond has been issued. If interest rates fall, the market value of an earlier issued fixed-rate bond will rise, since it offers investors an interest rate higher than that currently being offered on newly issued bonds. The reverse applies if interest rates rise.

In the ultra-low interest rate environment following the financial crisis, the yields on bonds have been at historical lows, whilst the market value of bonds issued before the crisis have soared as they offer higher interest rates than those on bonds issued in recent years.

An additional risk of bonds is if the issuer of a bond defaults. UK government bonds, known as gilts, are seen as safer than bank and building society accounts, as the government is even less likely than a bank or building society to default. Bonds can be bought through stockbrokers or, in the case of gilts, through a special purchase and sale service organised by the Debt Management Office, the government department responsible for issuing government debt. As gilts are safe to invest in, their returns are normally the lowest you can get on sterling-denominated bonds. In October 2015, the return for investing in a 45-year gilt was 2.47 per cent per annum.

One problem with bonds is that not everyone means the same thing when they talk of a ‘bond’. The kinds of bond we have described are company or government bonds with a fixed interest rate and a fixed repayment date. But the term ‘bond’ has sometimes been taken in vain. Financial intermediaries have sold bonds that were in effect shares by another name. Similarly, long-term savings products may not only be bank accounts promising interest, but also linked to company bonds or shares. There is no regulation in the UK on terminology, and consequently it is important to read the small print of any product.

Some National Savings & Investment products use the name ‘bond’ – for example, Premium Bonds and Income Bonds – but are types of deposit. A range of products, some that are deposits and others more risky investments, used to be called Guaranteed Equity Bonds. Although they have since been reclassified as ‘structured products’, they still individually go by names such as Capital Bond, Stockmarket Linked Bond and Double Asset Bond. Therefore, in reality, the term ‘bond’ is applied to products that are very different, and not just company or government bonds. To get round this confusion, you will also see true bonds referred to as ‘fixed-interest’ investments.

An important product that does not fit within the bonds category that we have described is the Premium Bond. Premium Bonds, owned by 22 million investors in the UK in 2013, are a lottery-based form of savings account backed by the UK government. A lottery is held every month and the equivalent of 1.35 per cent p.a. (in 2015) on all the Premium Bonds is paid out in tax-free prizes.

3.1.7 Shares – volatile but good long-term performers

Shares are sometimes called ‘equities’. They entitle the holder to a share or part ownership in a company. Depending on the type of share, this may entitle the shareholder to vote on how the company is run. Shares also usually entitle their owners to receive dividends, paid by the company out of the profit it makes. The receipt of these dividends is, for the shareholder, the income element of the return from their investment in the shares.
The price at which a particular share can be bought or sold will vary from minute to minute, depending on the balance of investors who want to buy them and existing holders who want to sell. If investors are able to sell shares at a higher price than they originally paid, they make a capital gain. If they sell for less, they make a capital loss.

Shares are bought through a broker. A broker can be found in high-street banks, on the internet or in a stockbroking firm. For online broking, there is typically a flat-rate charge for any transaction, say £12 for one-off trades, or £10 per trade for frequent traders, so it is not usually worth buying or selling shares in very small amounts. Conventional stockbrokers may also charge a percentage commission on the value of the transaction as well as a minimum commission.

Stamp Duty Reserve Tax (SDRT) of 0.5 per cent is paid when shares are bought electronically (which the vast majority are these days). SDRT is not paid when shares are sold. Share prices can be seen in most newspapers that report daily on share prices as well as on other information.

You have seen earlier the factors that can dictate the prevailing level of interest rates in the economy and, by inference, the returns on interest-bearing investments.

So what drives the levels of share prices?

The first important point is to distinguish between the factors that will generally affect the levels of share prices – typically measured by referring to stock market indices like the FTSE-100 – and those factors that specifically affect a particular, individual, share price.

**Figure 7** Share prices of selected UK high-street retailers, 12 January 2016 (*The Times*, 13 January 2016, p. 47)
3.1.8 Drivers of equity markets

The key drivers of equity markets are:

- the prevailing and expected level of economic activity, as measured by gross domestic product (GDP) growth, employment levels and movements in the real incomes of households
- the prevailing and expected level of price inflation
- the prevailing and expected level of interest rates
- the trends in and expectations of the financial performance – particularly profitability – of the firms whose shares comprise the equity markets.

In addition to these core drivers, other factors that impact on equity markets include:

- movements in exchange rates
- changes to taxation – particularly company profits and on dividends paid to shareholders
- changes to commodity prices – particularly oil and gas
- random non-financial events like wars and disease epidemics which are expected to impact on (global) economic activity.

These factors impact, to greater or lesser extents, on the financial performance and expected future performance of the companies whose shares comprise the equity indices that investments in shares are linked to. A slowdown in economic activity, perhaps reflected in a weakening in price inflation, can be expected to reduce sales and profits. Under these circumstances companies may be forced to reduce the dividends paid to shareholders or even pay no dividend at all. The attraction of holding shares, relative to other assets, is then reduced, exposing the risk of a fall in share prices. The reverse generally holds as well – growing economic activity and a pick-up (provided it is not excessive) in inflation are co-related to higher share prices as companies experience growing sales and profits.

The relationship between inflation and the performance of stock markets is complex and hotly debated by analysts. Modest inflation may be favourable to share prices but higher inflation rates raise the prospect that action will be taken to stem inflationary pressures by raising interest rates and depressing economic activity – a scenario which would not be good for share prices. The other factors listed above have a role too in driving share markets. Higher interest rates are bad news for equities as they presage a decline in economic activity – as do higher commodity prices. If exchange rates move adversely – particularly if the domestic currency strengthens against foreign currencies – then equities can be hit since export sales may be reduced.

In addition to these factors that generally influence share prices, investors should look at company-specific factors that affect individual share prices. These factors are linked to the financial performance of companies – their published and forecast sales and profits in particular. There may also be responses to issues that have caused reputational damage to a company.

In 2015, the UK equity market witnessed a fair degree of volatility, with share prices falling sharply in the third quarter of the year. This was largely a reaction to concerns about the prospects for economic growth given the slowdown being witnessed in the Chinese economy.
Activity 3.1
Who have been the financial winners and losers from the financial crisis – savers or borrowers? What factors have led to this outcome?

Discussion
Borrowers have clearly benefited from rock-bottom interest rates on loans and mortgages – although those holding balances on credit cards and store cards might disagree. Savers have lost out with returns low in nominal terms and, between 2012 and 2014, negative in real terms once price inflation is taken into account. This outcome seems unfair since excess debt was one of the background factors to the financial crisis of 2007/08, while savers are doing what governments regularly exhort them to do – saving money for the future and retirement. However, the harsh reality is that to facilitate a recovery from the financial crisis, both personal and corporate debts had to be made manageable to limit the risk of adverse knock-on effects on the economy. Making debts more manageable has meant ensuring they are cheap to service – hence the low interest rate policies seen in the UK and globally since 2008.

3.2 Investment funds
In the next video, Professor Janette Rutterford talks to Martin about the different types of investment funds, including hedge funds and the factors that investors should bear in mind when choosing funds to invest in.

Video content is not available in this format.
Investment
Buying shares in a single company or even holding shares in, say, three companies, is generally a risky form of investment. This is because the fortunes of a company, on which its dividends and share price depend, are subject to all sorts of risk. These risks can be broad economic risks, such as recession or an increase in the cost of oil, or risks specific to each company, such as the loss of a major contract or increased competition.

To spread these risks, investors typically invest in shares – and other assets, such as bonds – through investment funds. An investment fund pools the money of lots of investors and uses it to hold a wide range of shares, bonds and other assets. Even relatively small amounts of money placed into such funds can be spread across a wide variety of shares or other assets.

The investments in these investment funds may be selected by managers, based on their research, which aims to assess the prospects for shares and other bonds (called ‘actively managed’ funds). Investors pay fees for the services of the fund managers and are provided with periodic reports on their investments. Other funds (called ‘passively managed’ or ‘tracker’ funds) simply hold investments designed to move in line with a specified share index, and typically have lower charges.
Figure 8 With different compositions of investments the returns from different unit trusts vary substantially.

3.2.1 Types of investment fund

Investment funds – as you started to find out in Week 2 – come in many forms, including:

- **unit trusts**: this is an arrangement whereby trustees hold shares and/or other assets on behalf of investors and a management firm makes decisions about what and when to buy and sell. Investors hold units in the unit trust and the value of the units directly reflects the value of the underlying assets in the fund.

- **open-ended investment companies (OEICs)**: these are very similar to unit trusts, but are structured as companies rather than trusts. This structure is more familiar and acceptable to investors in other countries of the European Union and so enables managers to trade more easily across borders. Investors buy shares in the OEIC and the value of the shares directly reflects the value of the assets in the underlying fund.

- **investment trusts**: these are companies that are quoted and traded on the stock market. But, unlike trading companies, the purpose of an investment trust company is to run an investment fund. Investors buy shares in the company. The price of the shares partly reflect the value of the assets in the underlying fund (called the ‘net asset value’ or NAV). But the price is also affected by the balance between investors buying and selling the shares on the stock market. As a result, the shares could trade at less than the NAV (called trading at a discount) or at more than the NAV (trading at a premium). Like any other company, investment trusts can borrow money, which enables them to boost the amount they can invest. Borrowing to invest increases the inherent risk of the fund.
- **exchange-traded funds (ETFs):** these are also companies traded on the stock market but, in this case, the share price is directly linked to the value of the underlying investments. Traditionally, ETFs are tracker funds. This could be, for example, the FTSE-100 Index or a more unusual index tracking, say, the price of commodities or works of art. But, increasingly, new types of ETF are being developed that follow different investment strategies.

- **life insurance funds:** some types of life insurance can be used as investments. The investor pays in regular premiums or a single lump sum premium and the policy builds up a cash value that may be drawn out either as a lump sum or as a stream of income payments, depending on the particular type of policy. Often policies are unit-linked, which means that the premiums are invested in the policyholder’s choice of one or more funds, similar to unit trusts. The cash-in value of the policy depends on the performance of these funds.

- **pension funds:** in a similar way to life insurance, contributions to a pension scheme may be invested in one or more underlying funds. The value of the pension scheme depends on the performance of those funds.

Investment funds can be bought direct from fund managers, through stockbrokers or through websites (often called ‘platforms’).

An additional consideration for many people is a desire to invest their money in a socially responsible way. There are different aspects to what constitutes socially responsible investment, including both positive and negative criteria.

Positive criteria include investing in companies that treat workers fairly or are engaged in environmental protection. Examples of negative criteria include avoiding funds that invest in companies involved with animal experiments, arms, violating human rights or pornography.

One difficulty for an investor is that ethical or social responsibility is a relatively subjective term so you need to examine where the fund invests your money. One way of checking whether a fund that claims to be ethical or socially responsible shares your own views, is to check the main companies the fund invests in.

### 3.2.2 Tax-efficient savings

In the following video, David Harrison of True Potential LLP argues the case for using Individual Savings Accounts (ISAs) to build up a fund for retirement income. David explores why this may be a better route to building up pension savings than using conventional pension schemes. David also highlights the way that successive governments in the UK have changed the tax rules applying to pensions – a comment which is particularly apposite given the significant changes to tax relief on pension contributions and to the taxation of pension benefits that have taken place recently.

Video content is not available in this format.

**David Harrison**
Having reviewed the main types of financial investments – and prior to examining conventional pension schemes in the next few sections – we should look at how tax-efficient investments can be used to build up a savings pot to draw on in later life.

Rather than making contributions to occupational or personal pension schemes many people prefer to make their own investments. There is much scope to invest in tax-efficient schemes – particularly now that the annual limit on investing in ISAs has been raised so much in recent years. In 2016/17 the annual allowance for ISA investments is £15,240 per person. The income and capital gain on these investments are not subject to taxation and this helps the aggregate saved amount build up over the years.

When investing for the long term there is also scope to choose Stocks & Shares ISAs, rather than Cash ISAs, given the likelihood – based on historical evidence – that these will perform better over the longer term.

An attraction of going alone in building up savings for the future is that ISA products can be simpler and easier to understand than pension products.

Those aged under 18 years can start early by investing in Junior ISAs. In 2016/17 the annual allowance is £4,080 per child.

As you saw earlier this week, from 2017/18, lifetime ISAs will be available for those under the age of 40, with an annual investment limit of £4,000, designed to help with property purchase or income in retirement.

Other tax-efficient ways to save for the future include onshore and offshore bonds. These are investments that have the form of insurance policies and attract a favourable tax treatment for the investor.

With onshore bonds the tax planning benefit is that income and capital gains can be rolled into the investment over time and it is only subject to life fund tax (where the funds are taxed as though the investor had paid the basic rate of income tax on the gains made by the fund). Withdrawal of up to 5 per cent of the fund can also be made each year without immediate liability to tax. This annual limit can be carried forward if not used, though the aggregate carried forward cannot exceed 10 per cent. The major benefit arises from cashing in the bond, or accessing funds above the annual tax-deferral allowance of 5 per
cent of the investment, when you are no longer a taxpayer or have moved overseas and have become a non-UK resident for tax purposes. So onshore bonds allow the returns on the bonds to be rolled up to a point in time when drawing on the investment can be done with a limited or nil liability to tax.

With offshore bonds, which are held in overseas countries, there is the additional benefit of all the income and capital gains being allowed to roll up on a gross basis with no liability to life fund tax. This allows the funds invested in offshore bonds to roll up more quickly than those in onshore bonds. There may, though, be a liability to a typically small withholding tax levied by the overseas country's government which cannot be recovered even by non-taxpayers.

The bonds are more complex than ISA products and consequently advice should be sought before investing in them. Investments in certain of these bonds may also present ethical issues for investors. Additionally, offshore bonds are not normally covered by the UK's consumer protection rules. They can, though, form an effective way to save in a tax-efficient way for the future.

3.2.3 Pensions

With most occupational schemes and all personal pensions, money is paid into the scheme to create a pension pot – a pool of investments. These are called funded schemes. Employers pay into occupational schemes and usually require employees to contribute too. With other types of scheme, individuals often fund the whole scheme.

In most large, occupational defined benefit schemes, experts are appointed to manage the investments, and pensions are paid directly from the fund as they fall due. With defined contribution arrangements, an insurance firm often looks after the investments, and the pensions are typically paid by taking money out of the fund to buy annuities. The changes to pension rules we look at in the next two sections are, however, providing alternatives to buying annuities for those approaching retirement.

By contrast, state pensions are pay-as-you-go (PAYG) schemes. There is no pension pot. Instead, the pensions paid out today are financed from National Insurance and other tax revenues collected today. Sometimes this is referred to as a 'contract between the generations', with today's taxpayers paying for today's pensions on the understanding that when they retire, their pensions will be paid for by the taxpayers of the future.

Some public sector occupational schemes (covering, for example, civil servants, teachers, National Health Service (NHS) workers and the Armed Forces) are also financed on a PAYG basis, with employees' contributions and general tax revenues used to pay the pensions of many retired public service workers. In contrast, the schemes for local authority employees and university lecturers in some universities are funded schemes.

With defined benefit schemes, the entitlement to a pension is contractually set out and is typically a proportion of the final year's salary or of the average salary earned when a member of the scheme. The proportion is usually based on the number of years in the scheme.

With defined contribution schemes the annual pension (or 'annuity') is linked to the value of the pension pot built up ahead of retirement. The determination of the annuity takes into account prevailing investment returns – particularly long-term interest rates – and estimates of longevity (since this provides a forecast of the length of time the annuity will be paid). Consequently the annual pension you will get cannot be forecast in the same way that it can with defined benefit schemes. Pension reforms enacted in the UK in 2015
do, though, now give those with defined contribution schemes more options for using their pension pots than just drawing an annuity. We look at these reforms in the next two sections.

The year 2012 saw the start of a new government-led pensions initiative with auto-enrolment workplace pension schemes. Larger firms were required to offer a workplace pension scheme to their employees and contribute to the scheme as well. Employees aged 22 or over and earning more than £10,000 a year are automatically enrolled onto schemes unless they are already in a scheme or they make the decision to opt out. This move was designed to increase the numbers of people in pension schemes. Evidence to date shows only 8 per cent of employees electing to opt out of their workplace scheme – far less than had been forecast when auto-enrolment started (The Times, 2015). By 2018 all firms in the UK will have to offer auto-enrolment schemes to their staff and be making contributions into their scheme.

In the UK and elsewhere contributions to schemes attract income tax relief as governments are keen to encourage people to save for their retirement. In 2016/17 the annual limit on contributions that attract such tax relief is £40,000.

The government also applies a lifetime tax allowance on an individual’s pension fund. From April 2016, this lifetime allowance fell from £1.25 million to £1 million. Holdings beyond this limit will be taxed at 55 per cent when drawn down on retirement. This is the third cut in the lifetime allowance since 2011/12 when the allowance stood at £1.8 million and the move is aimed at curtailing the growth of tax relief on pension contributions.

<table>
<thead>
<tr>
<th>Pension scheme</th>
<th>Organised by</th>
<th>Basis on which pensions are provided</th>
<th>How pensions are financed</th>
<th>Who pays?</th>
</tr>
</thead>
<tbody>
<tr>
<td>State scheme: basic</td>
<td>State</td>
<td>Defned benefit</td>
<td>Pay as you go</td>
<td>State provision</td>
</tr>
<tr>
<td>State scheme: additional pension</td>
<td>State</td>
<td>Defned benefit</td>
<td>Pay as you go</td>
<td>State provision</td>
</tr>
<tr>
<td>Occupational scheme: final salary</td>
<td>Some public sector employers</td>
<td>Defned benefit</td>
<td>Pay as you go</td>
<td>State provision, usually employer too1</td>
</tr>
<tr>
<td></td>
<td>Private sector and some public sector schemes</td>
<td>Defned benefit</td>
<td>Funded scheme</td>
<td>Employer, usually employer too1</td>
</tr>
<tr>
<td>Occupational scheme and NEST2: defined contribution</td>
<td>Private sector employers</td>
<td>Defned contribution</td>
<td>Funded scheme</td>
<td>Employer, usually employer too1,3</td>
</tr>
<tr>
<td>Personal pension</td>
<td>Individual</td>
<td>Defned contribution</td>
<td>Funded scheme</td>
<td>Individual (employer occasionally)4</td>
</tr>
</tbody>
</table>

1 Tax relief on contributions and on the return from pension fund investments means the State also pays towards the cost of occupational and private pensions. However, some of this tax relief is clawed back once pensions start to be paid because pension income is taxable.

2 National Employment Savings Trust.

3 Employees must contribute to NEST.
3.2.4 Access to pension pots: the 2015 pensions revolution

In his 2014 Budget Statement the then Chancellor, George Osborne, unveiled proposals for pensions reform which are now changing the financial options for those approaching retirement. These proposals took effect from April 2015 and have led to tax restrictions on access to pension pots being eased.

These are the key features of the pensions revolution, introduced by the coalition government:

- The Taxation of Pensions Act 2015 provides greater freedom for those in defined contribution schemes to access personal pension funds (or ‘pots’). Funds can be accessed before retirement and used, say, to invest in a range of assets (like property) or to pay off a mortgage or other debts or simply to finance current consumption. For each lump sum accessed, 25 per cent is tax-free. Sums accessed in excess of 25 per cent are taxable as income and so could attract tax of up to 45 per cent (for taxable income above £150,000).

- Those retiring with defined contribution pensions now have increased alternatives to buying an annuity with their pension savings. At retirement, up to 25 per cent of the remaining pot can be taken as a tax-free lump sum (as previously applied prior to 2015). But, as an alternative to buying an annuity many are expected to leave at least 75 per cent of their pots invested and take income from the fund when needed.

- There was a proposal for freedom, from April 2016, for 5 million existing defined contribution pensioners to sell their annuities for a lump sum which could then be accessed in the same way as for those approaching retirement, as set out above. However, in October 2016 the government abandoned this plan as it had found out there was little appetite among financial firms to participate in a second annuities market.

- The government announced that the cap on the lifetime allowance for pension schemes of £1.25 million would be reduced to £1 million from 2017. Amounts held in pension funds in excess of the lifetime allowance are subject to tax when accessed, with a rate of 55 per cent applying to lump sums and 25 per cent (on top of normal tax) for taxable income drawn from the fund.

- There is greater flexibility to pass on a pension to dependants after death. For those dying prior to the age of 75, income from pension assets can be passed on to beneficiaries tax-free. This tax treatment previously only applied to lump sums from a pension ‘pot’. For those dying aged 75 or over, the tax rate applied to lump sums has fallen from 55 per cent in 2014/15 to normal income tax rates, with effect from April 2016). Normal tax rates apply to income passed to beneficiaries.

This last reform is forecast to cost the Exchequer some £150 million a year. Arguably, what it does do, though, is remove an unfair excess tax charge on pension pots to which the deceased have spent their lives contributing. An alternative view is that it will provide a way to avoid inheritance tax, with those in retirement drawing on savings and other investments while leaving their pension pots untouched. Doing this could leave up to £1.25 million in pension pots being exempt from inheritance tax.

While the greater flexibility that these reforms provide for pensioners should be welcomed, a few concerns cannot go unobserved.

First, one motivation for these greater freedoms seems, in part, to be the belief that annuities are poor value and, by inference, that other ways of investing pension funds may be better for pensioners. Yet while there have clearly been issues about how some
insurance firms have sold annuity products, it is unfair to say that all are poor value. The low annuity rates prevailing today simply reflect growing longevity and the currently prevailing low interest rates.

Second, there are concerns that many pensioners will spend large portions of their pension pot and not invest the funds to provide the income stream needed in retirement. The upshot is that within a few years, some pensioners will find themselves short of the income needed for a comfortable retirement.

Finally, there is the concern – particularly given the pace of the reforms – that the pensions industry is not adequately prepared to deal with the consequent advice that is required as a result of wider freedoms available to those pensioners and those moving towards retirement.

3.2.5 The UK pensions revolution

In this video, Martin Upton and Jonquil Lowe answer questions posed by learners on pension schemes and the reforms to pensions that have given those approaching retirement greater freedoms to access and use their pension ‘pots’. The video was recorded shortly before the reforms took effect in April 2015.

Video content is not available in this format.

Jonquil Lowe

Activity 3.2 Risks arising from the pensions revolution

What risks do you think are associated with the reforms to pensions introduced in 2015?

How might these risks be mitigated?
Discussion
A number of potential risks come to mind:

- pension pots may be spent quickly, leaving people short of income in retirement
- decisions may be made that are tax-inefficient (significant parts of the pension pots could be lost to income tax)
- the access to pension pots may result in some pensioners falling prey to investment scams
- the alternative assets that pension money is invested in (e.g. property or shares) may fall in value.

Risk mitigation can be achieved by seeking financial advice and from taking guidance from such resources as Pension wise, The Money Advice Service (MAS) and Age UK.

3.3 Property investment – a boom in buy-to-let investors

In this video Shaun Cummings explains how he got started in buy-to-let and shares tips with those thinking of this type of investment. He also looks at the pitfalls.

The UK has seen a boom in buy-to-let investments in recent years, partly as a result of the low interest rates which have made many people seek alternatives to savings products.
The boom has also been supported by the growth in demand for rental properties from those not in a position to buy their own home.

Buy-to-let mortgages normally have higher interest rates than mortgages for purchasing your own home. The deposits required from those borrowing to finance the purchase of buy-to-let properties tend to be higher too. This is because of the risks associated with such lending – particularly the fact that the ability to repay the mortgage is linked to receipt of rental payments by the tenants of the properties. If tenants default on rental payments or if the property is empty (‘void’) for periods of time, the buy-to-let landlord may struggle to keep up with their mortgage repayments.

This boom might be coming to an end though. In July 2015 the government announced that, from the 2017/18 financial year, the tax relief that landlords receive on mortgage payments will, in stages, be reduced to 20 per cent. Currently landlords can receive tax relief up to 45 per cent, the highest marginal rate of tax on incomes. This move may lead to some landlords quitting the market and selling their properties. One alternative, though, is that the additional mortgage cost arising from the reduced tax relief will be passed on to tenants in the form of higher rents. This, though, could result in some tenants opting to buy their own property instead of carrying on renting.

From April 2016, those buying property to let out have also become liable to a 3% surcharge on the Stamp Duty Land Tax (SDLT) paid on property purchases. This may also take some of the heat out of the buy-to-let market.

3.3.1 Equity release

In this video, Martin Upton and Jonquil Lowe discuss the growing market in equity release products. They examine the social and economic reasons for the growth in business and whether the products are a good way to raise funds for later life.

Video content is not available in this format.

Growing markets
There are essentially two types of equity release products.

Lifetime mortgages involve borrowing against the equity a homeowner holds on their property but without the need to make repayments. Interest on the borrowed funds is ‘rolled up’ with the original sum borrowed. On death, or the sale of the property, the lender recoups the initial sum borrowed and the rolled-up interest during the term of the loan. Lifetime mortgages can be taken out from the age of 55.

Home reversion plans involve the outright sale of a share in the property. So here the homeowner does not face interest being added on to the amount of money raised by the part-sale of their property. On the eventual disposal of the property, the lender takes the percentage share of the selling price agreed at the time that the home reversion plan was put in place. It is the share of the property value at the point of its sale that the lender recoups, rather than the sum paid for that share when the home reversion plan was put in place. Home reversion plans can only be taken out from the age of 65.

Equity release products are complex and have significant implications for families. No one should enter into such arrangements without seeking specialist financial advice and without discussing the matter with their families and other parties with an interest in the property involved.

Activity 3.3

In the light of the discussion between Martin and Jonquil in the previous section:

- Do you think equity release products are a good way of providing money in later life?
- Would you contemplate using such products yourself?
- What are the alternatives for households seeking additional resources in later life?

Discussion
Equity release products are not the cheapest nor the most attractive means of raising funds. The rolling-up (or compounding) of interest with lifetime mortgages can significantly erode the equity held in a property. The amounts paid for a given share of a property under home reversion plans can be considerably below the market value of that share when the plan is taken out.

The earlier an equity release product is taken out by a homeowner, the greater these financial disadvantages tend to be.

Downsizing, delaying retirement or even taking in lodgers (up to £7500 of room rent per year is currently tax-free) may represent better ways of raising additional money in later life. For those without such options, equity release may be the only way to raise additional money in later life – but even in these circumstances, financial advice must be sought and the family consulted on such a material financial decision.

3.3.2 Buying insurance

Insurance is a method whereby individuals or households (or organisations) can protect themselves against the unexpected. To do this, they pay a sum of money called a premium to an insurer in exchange for being indemnified (protected) against the losses that result from specific perils, under conditions specified in a contract. This contract is called an insurance policy. When you take out an insurance policy you’re transferring to the insurer the risk of the financial loss arising from the peril, and so you’re reducing the potential consequences to yourself.

You can see from the chart the actual uptake of various types of insurance in the UK. The chart also shows the average expenditure on each type of insurance policy by those households that buy them, although it doesn’t include insurance cover provided through employers, so it understates total insurance expenditure.
Actuaries provide statistics to insurers to help quantify the risks that insurers are taking on. Insurers need data on the probabilities of the perils for which they offer insurance – death, illness, disease, burglary, accidents and so forth – and data on people of different ages, genders, locations, postcodes and households, so that they can estimate their risks of paying out.

Actuarial data will give an approximation of the future claims that the insurer might face across the range of perils they insure. Insurers will then aim to set premiums so that, on average, total premium income will cover the cost of paying out for claims, building up reserves and making a profit.

Insurers spread their risk by insuring many individuals and households against various risks. By insuring a large number of risks, the average number of times that insurers have to pay out will be more predictable, and so will be the total amount that they have to pay out in any given year. In taking on the risks of many and aggregating them, the insurer faces a more predictable future than individual policyholders would if they had to face their risks themselves.

What are the different strategies for managing risk and uncertainty?

One approach is to ignore the risk. If the peril then materialises, there could be major negative financial ramifications, and so this would be a high-risk strategy.
Another approach is to try to eliminate or reduce risk. Strategies here could include fitting house alarms (to reduce the risk of burglary or fire), eating healthily (to reduce the risk of premature death) or not flying (to eliminate the risk of death in an air crash). These might be beneficial in themselves—although they may have costs attached too—but they cannot eliminate all of life’s risks and uncertainties.

A different strategy is risk assumption. This involves taking on the potential financial impact of the peril materialising. It implies a policy of self-insurance: establishing a fund using savings products to cover the costs of any potential financial loss. This can be a strategy adopted by choice by people who are risk takers or who have enough income or savings to cover possible losses. It can also be adopted by default when other types of insurance are not available or are too expensive. Yet where the financial impact of a peril is large and beyond the financial resources of most individuals, many people who can afford to do so pursue a policy of transferring the financial risk, by using insurance to pass it on.

3.3.3 A decision-making model for financial products

In the next video, Martin introduces the financial planning model, which provides a systematic process for making financial decisions, including those relating to financial services products.

Video content is not available in this format.
Financial Planning Model

Capability in making decisions about financial products involves being able to work out a financial plan for achieving a goal, given the constraints that you face. Constraints include things like income and existing savings, personal circumstances such as having to care for children or elderly relatives, and emotional factors such as how you feel about taking risks. For example, if your goal is to reduce debt worries, then financial capability involves...
better debt management. If you decide to consolidate debts into one package and then pay them all off systematically, some of these packages cost less than others (other things being equal). If there are debt problems, it’s better to seek advice from professional bodies like the government's Money Advice Service (MAS), or from Citizens Advice or StepChange, rather than going to a ‘loan shark’ who charges extremely high rates of interest. Alternatively, if you’re saving to buy a flat, some savings schemes offer a better return than others (other things being equal), and all of them are likely to be better than stuffing cash under the proverbial mattress.

Seeking out well-informed advice and choosing better products, given constraints and goals, would be evidence of greater financial capability.

In the next sections, you’ll apply this financial planning model to decisions about insurance products.

3.3.4 Insurance – applying the four-stage model (1)

Apply Stages 1 and 2 of the financial planning model to insurance

Let us look again at the financial planning model and apply it to insurance. Remember that, in practice, financial planning needs to be a flexible process, with movement back and forth between the stages.

For Stage 1, where you assess the situation, it’s worth stressing the significance of the perils that can be insured against, as related insurance policies vary according to individual circumstances. Life insurance, for example, is likely to be especially important in a family with children and one income earner, but may be regarded as irrelevant to a single person with no dependants.

An important factor to consider is what other protection is available. State benefits are part of this equation, as are any benefits available from an employer. With large employers, benefits may include sick pay above the statutory minimum, ‘death in service’ benefits and private medical insurance (PMI).

As part of your Stage 1 planning you need to find out what you are entitled to. Your entitlements may not completely replace the need for additional private insurance, but it’s important to know what they are.

The combination of what the state and an employer provide could eliminate the need for some types of private insurance, or reduce the amount of additional cover needed. The private insurance element can be seen as building on the insurance cover provided by the state and by employers.

A further factor to assess at Stage 1 is your attitude towards risk. Your aversion (or otherwise) to risk will be affected by a number of factors, including age, tastes and preferences. The more risk-averse you are, the more likely you are to consider additional insurances.
Figure 11 Effective financial planning means devising and employing a clear and straightforward model.

Stage 2 is when you decide which additional insurance policies are appropriate for yourself or your household. As a rule, the greater the potential financial impact of a peril, the more likely it is that you will consider insuring against it. The key determinant is whether you could bear the cost of a risk materialising – even if the risk is very low. The obvious example of this is insuring your home – rebuilding costs would be far beyond most people’s means, and so most owners decide that risk shifting makes sense (or have to do so as a condition of their mortgage).

But where the costs of the loss would be smaller, self-insurance may be considered a better alternative. To illustrate, paying the cost of domestic appliance repairs may make more sense than taking out an extended warranty.

Another factor in deciding on insurance is the cost of the insurance policy. Normally, the higher the premium, the less likely someone is to take out an insurance policy. It would be theoretically possible to calculate the expected benefit from an insurance policy, taking into account the financial impact of a peril and the probability of it occurring. However, such calculations are extremely hard to perform in practice.

Your decisions about whether to take out insurances will have a direct impact on your household budget as the more policies you take out, the more your expenditure increases. Conversely, by actively seeking ways to reduce the premiums you pay, for example by fitting window locks or a burglar alarm, your expenditure will decrease.

One way to think about the impact of insurance payments on your household budget is to realise that the current expense aims to protect you and your household from greater expense in the future.
3.3.5 Insurance – applying the four-stage model (2)

Apply Stages 3 and 4 of the financial planning model to insurance

Stage 3 is about acting to put the insurance plan into effect. This involves looking at the details of policies and shopping around for the best deal. There is quite a bit of going backwards and forwards during Stages 1–3. Some plans you try to put into action may not work, or the plans may turn out to be more expensive than you first thought, and so the plan will need to be remade.

As the UK’s insurance market is so developed, taking out most types of insurance is relatively easy. Insurance policies can be bought either directly from an insurance firm or through an intermediary (usually called a ‘broker’) who can select a policy from different firms. Insurance is also sold by third parties, such as shops that sell extended warranties on their goods and travel agents that sell holiday insurance.

Brokers, such as members of the British Insurance Brokers Association, deal with insurance such as home, motor and travel insurance as well as term life insurance (which is an insurance policy for a defined period). Increasingly, though, insurance is bought on the internet – particularly via the numerous price comparison websites.

Financial advisers are the intermediaries who can give advice on life insurance, complex health insurances, savings and investments and pensions.

In all cases, unless simply ‘executing’ a client’s instructions, the firm or intermediary is required to recommend a product that meets individual circumstances and needs. Generally, the more complicated the insurance, the more an intermediary can help you in assessing your situation and needs, recommending and explaining policies, and in assisting in the event of a claim.
Effective financial planning means devising and employing a clear and straightforward model.

Stage 4 is to ensure that you regularly review your financial planning decisions. This feeds into regularly assessing your need for insurance, and into the other stages too. You should always review your insurance needs when policies come up for renewal and when personal circumstances change (for example, when the composition of the household changes or when new assets are acquired).

A common failing in personal financial management is simply to renew with the same insurance provider rather than shop around for a new deal. Such inertia can cost you money, as the best deals are often offered only to new customers – not to existing ones. As with any plan, you need to check periodically how things have worked out in the light of experience. This gives you the chance to remove ‘double insuring’ – to check that the same risk is not insured twice (for instance, with a travel and a home insurance policy), which would be unnecessary expenditure.

It is also important to remember that the financial planning process takes place inside the social and economic context. One feature of this context is that insurance is heavily marketed, with adverts for various insurance policies on television and in many other media, and with promises of cheaper quotes, often through market comparison websites. This reinforces the need to approach decisions about insurance in a methodical manner, such as through the four-stage financial planning process you’ve been looking at.

**3.4 Week 3 quiz**

This quiz allows you to test and apply your knowledge of the material in Week 3.
3.5 Week 3 round-up

There is a lot going on the financial marketplace. New products are emerging and others are changing and all this has been against the backdrop of volatile financial markets – particularly the equity market.

The government is attempting to influence behaviour through pension reforms, together with tax changes intended to encourage savings and to take the heat out of the buoyant buy-to-let property market.

This week has aimed to get you up to date with the latest developments in the financial markets and provide you with systematic approaches to making decisions about financial products.

Figure 13

Next week, in the last week of Managing my financial journey, we turn the spotlight on regulation in the industry. How are financial firms regulated? How are consumers protected when being sold financial products? What recourse and protection has the public got if problems arise?

You can now go to Week 4: Regulation and consumer protection.
Further reading

MAS SAVINGS CALCULATOR If you want to explore savings accounts further, and the returns you receive on them, why not access the MAS savings calculator (in a new window or tab)?

Annuities offer ‘fair value’ Jonquil Lowe, Lecturer in Personal Finance at The Open University, queries the notion that annuities are poor value in a research paper.

Week 4: Regulation and consumer protection

Week 4 Introduction

The focus of this final week of Managing my financial journey is on how regulation works and how it is intended to protect the consumer – by ensuring the financial solidity of financial firms and by requiring firms to have procedures in place to ensure that product sales are conducted properly.

In the event that things still go wrong, the regulatory environment has additional safety nets, including a complaints system (Financial Ombudsman) and a compensation system (Financial Services Compensation Scheme).

You will also look at the work that advisory organisations, like the Money Advice Service (MAS) and Citizens Advice, undertake to help the public when it comes to financial management and guidance on financial products.

You will finish the week, and the course, with an extended test to assess your knowledge across each of the weeks of Managing my financial journey.

Video content is not available in this format.

Introduction
This course is presented with the kind support of True Potential LLP. The True Potential Centre for the Public Understanding of Finance (True Potential PUFin) is a pioneering Centre of Excellence for research in the development of personal financial capabilities. The establishment and activities of True Potential PUFin have been made possible thanks to the generous support of True Potential LLP, which has committed to a five-year programme of financial support for the Centre totalling £1.4 million.

4.1 The regulatory structure

In Weeks 1 and 2 you saw how the regulation of financial services in the UK was radically reformed after the financial crisis. In this animation, the current structure of the core components of financial regulation in the UK, and the relationship between them, are set out.

Video content is not available in this format.

Regulation
You can view and download the regulatory structure PDF from the animation.

4.1.1 Getting to know the PRA and FCA

As you saw in the previous section and earlier in the course, the core regulatory bodies for UK financial services are the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) – with the consequence that the new framework is known as the ‘twin peaks’ regulation.

Deposit-taking firms (including banks and building societies), the investment banks and insurance firms are regulated by the PRA whilst other financial firms are regulated by the FCA. However, the FCA’s brief extends to market conduct and consumer protection matters which relate to the activities of all financial firms. As a consequence, PRA-regulated firms are also regulated and supervised by the FCA.

How do both go about their business? Many, but certainly not all, of their regulatory processes have been inherited from the former regulator, the Financial Services Authority (FSA), which the PRA and FCA formally replaced in April 2013.

Once a firm is permitted to conduct business in regulated activities, it is assigned to a supervisory team (or teams, if the firm is dual-regulated by both the PRA and the FCA). These teams will typically comprise specialists in the firm’s financial sector (banking, building society, insurance, etc.). This supervision will include checking that the firm adheres to the terms of its ‘permissions’ (the authorisations it has to conduct different types of financial services business) and will seek to ensure that the firm is managing its business and financial risks effectively.

Underpinning the FCA’s regulatory framework and the rules detailed in it are their eleven Principles for Business. These are set out below.
Table 1 The FCA's eleven Principles for Business

<table>
<thead>
<tr>
<th>FCA Principle</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Integrity</td>
<td>A firm must conduct its business with integrity</td>
</tr>
<tr>
<td>2 Skill, care and diligence</td>
<td>A firm must conduct its business with due skill, care and diligence</td>
</tr>
<tr>
<td>3 Management and control</td>
<td>A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems</td>
</tr>
<tr>
<td>4 Financial prudence</td>
<td>A firm must retain adequate financial resources</td>
</tr>
<tr>
<td>5 Market conduct</td>
<td>A firm must observe proper standards of market conduct</td>
</tr>
<tr>
<td>6 Customers' interests</td>
<td>A firm must pay due regard to the interests of its customers and treat them fairly</td>
</tr>
<tr>
<td>7 Communications with clients</td>
<td>A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading</td>
</tr>
<tr>
<td>8 Conflicts of interest</td>
<td>A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client</td>
</tr>
<tr>
<td>9 Customers: relationships of trust</td>
<td>A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgement.</td>
</tr>
<tr>
<td>10 Clients' assets</td>
<td>A firm must arrange adequate protection for clients’ assets when it is responsible for them</td>
</tr>
<tr>
<td>11 Relationships with regulators</td>
<td>A firm must deal with its regulators in an open and co-operative way, and must disclose to the regulator(s) appropriately anything relating to the firm of which the regulator(s) would reasonably expect notice</td>
</tr>
</tbody>
</table>

Source: FCA (2013a, Section PRIN 2.1)

The PRA's equivalent of the FCA's 'Principles for Business' are known as its 'Fundamental Rules'. These are essentially equivalent to FCA principles 1–4 and 11, plus the rule that firms must be able to prepare for an orderly resolution of their business (in effect the transfer of their business or their takeover by another firm), if the need arises due to failures by them. So, the key difference between the FCA's 'principles' and the PRA's 'rules' is that the latter do not include those of the FCA that relate to market conduct and consumer protection, since the FCA supervises these areas for all firms.

4.1.2 Regulation moves from 'principles' to 'judgement' and 'forward-looking'

In the following video, Andy Haldane, chief economist at the Bank of England, talks about the changes to the way financial firms are regulated under the PRA and FCA.

Video content is not available in this format.

Chief Economist
Principles-based regulation

Under the previous FSA regime, regulation was described as being ‘principles-based’. Just prior to the financial crisis this was described as follows:

principles-based regulation means, where possible, moving away from detailed prescriptive rules and supervisory actions about how firms should operate their business. We want to give firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes we have specified.

(FSA, 2007, p. 4)

The inference is that financial firms were, to a degree, able to apply self-regulation to their business conduct.

Within this principles-based regulatory framework, the approach to the supervision was termed ‘risk-based’. This meant that the FSA focused its supervisory resources on monitoring and controlling the most material risks that arose from a firm’s business. The greater the perceived risks, the more intense the degree of supervision, and the greater the restrictions placed on the firm.

Principles-based regulation – sometimes referred to as ‘light-touch’ regulation – was deemed to have failed because the financial crisis revealed the inadequate management and business activities of several banks and other financial firms. Consequently it has been replaced by ‘judgement-based’ and ‘forward-looking’ regulation. What does this mean?

Judgement-based regulation

Under judgement-based regulation:
the nature and intensity of supervision will depend on the risks posed by each firm. Supervisory effort and resource will focus particularly on ‘big picture’ issues with potential systemic impact.

(HM Treasury, 2011, p. 11)

This approach is being adopted by the new regulators and it is ‘forward looking to take into account a wide range of possible risks to our objectives’ (Bank of England and FSA, 2012, p. 1).

Both the PRA and the FCA are reinforcing the ‘stress testing’ introduced by the FSA. Firms are now required to examine the impact of adverse developments affecting their business – whether specific to the firm or systemic. They then have to assess how they would respond in these circumstances and whether they have the capacity to continue with their business. This includes the requirement for firms to conduct what is known as ‘reverse stress testing’. This is where the firm considers the various circumstances that could, in theory at least, force them out of business and then work back (i.e. reverse) to the plans and safeguards they can put in place to minimise their future exposure to these risks. The circumstances that firms have to consider extend beyond adverse developments in their core businesses (e.g. a major recession reduces demand for their products) to a range of contingent, but possible, events like fraud, systems failures, adverse reputational developments and natural disasters.

Additionally, there is now a requirement for firms to establish planning processes to enable them to recover from major setbacks to their business. These requirements were set out in an FSA consultation paper, ‘Recovery and resolution plans 2011’ (FSA, 2011a). These recovery and resolution plans are aimed to help firms plan how they would try to recover from severely adverse conditions that could cause their failure. They set out in advance a firm’s ‘menu of options’ for dealing with a range of severe stress events.

4.1.3 Approving the firm and its senior managers

In the next video, Chris Woolard, director of strategy and competition at the FCA, talks about the new Senior Managers Regime that is used to assess the competence, and understand the responsibilities, of key post-holders in financial firms.

Video content is not available in this format.

Strategy
The process of defining a regulated activity involves the following two steps:

1. The activity has to involve certain defined financial services products. These are known as the ‘specified investments’.
2. The actual ‘activity’ being undertaken in respect of these ‘specified investments’ has to be defined (borrowing, lending, investing, insuring, etc.).

There are, however, some specific exemptions where firms undertaking regulated activities do not need authorisation as their activities are subject to supervision by other regulatory bodies.

Conducting business in regulated activities without authorisation or exemption, or without an exclusion applying, is a criminal offence under the Financial Services and Markets Act 2000. Offenders can receive unlimited fines and jail sentences of up to 2 years. Contracts previously agreed under these circumstances are unenforceable.

What do the regulators do ahead of granting permissions for firms to undertake regulated activities? First, there are five ‘threshold’ conditions that the applying firm must meet. These are designed to promote financial safety and soundness. They are:

1. A firm’s head office, and its ‘mind’ and management, must be in the UK if it is incorporated in the UK.
2. A firm’s business must maintain appropriate financial and non-financial resources.
3. The firm itself must be ‘fit and proper’ and be adequately staffed.
4. The firm and its group must be capable of being effectively supervised.
5. The firm’s business model must be suitable for the regulated activities it seeks to carry out.

(Adapted from Bank of England and FSA, 2012, p. 8 and CISI, 2015, p. 12)
‘Approved persons’ and the Senior Managers Regime

The ‘fit and proper’ test does not just apply to the firm as a whole, but is also applied to the specific employees within it that perform certain key controlled functions. Until March 2016 these controlled functions were divided between what were known as:

- significant influence functions (SIFs), where the activities of these individuals can materially impact upon their firm’s business affairs
- the consumer function, which relates to arranging transactions and managing investments where there is contact with customers (e.g. investment advisers and mortgage advisers).

To undertake these controlled functions, individuals had, until 2016, to be designated as ‘approved persons’. From March 2016, the ‘approved persons’ regime was superseded by the Senior Managers Regime (SMR). This requires that all those in a senior management function (SMF) are required to have their responsibilities and reporting lines mapped out, and are required first to be vetted via internal procedures by the firm before subsequently being approved by the regulators.

In applying this new ‘fit and proper’ test to those seeking ‘SMF’ status, the regulators check for evidence about their competence and experience – specifically in relation to the management responsibilities that they wish to fulfil. Second, the regulators assess the integrity, reputation and financial soundness of the individuals by checking, for example, if they have ever been made bankrupt.

Once the regulator has satisfied itself that the ‘fit and proper’ test has been passed by those who are to undertake the SMFs, and also satisfied itself that the five threshold conditions have been met by the firm, permissions to undertake the specified regulated activities can be given. The firm thus becomes authorised to conduct those areas of financial services business that fall within the scope of their permissions.

Activity 4.1

What views do you have on the potential for the new regulatory structure to be more effective than the FSA proved to be in regulating the financial services industry?

- Is judgement-based and forward-looking regulation better than principles-based regulation?
- Will splitting regulatory responsibilities between the FCA and the PRA – as opposed to having a single regulator – be a help or hindrance?
- Do the new arrangements place too much of a regulatory burden on financial firms?

Discussion

Time will tell if the new regulatory structure is too ‘engineered’. Certainly the splitting of responsibilities could lead to problems – although the FCA and PRA have set out plans about how they will communicate and work with each other in Memorandums of Understanding.

It does seem a little odd to have unified regulation under the FSA in 2001, only then to divide up regulation again 12 years later.

Concerns have been raised within firms about the regulatory overload and the associated cost of regulation, with some fearing that the need to focus on regulation diverts management from spending time on the core business activities.
However, experience of the new regulatory approach supports the view that it is much more forensic and robust than that applied by the FSA.

4.2 The regulation of sales – customer classification

You will now look at the way that the sales of products to customers are regulated. This is a key aspect of regulation given the plethora of episodes where products have been mis-sold to the disadvantage of the public.

The FSA set out key principles for the proper selling of financial products in their Treating Customers Fairly (TCF) code (FSA, 2006). Subsequently these principles and rules have been extended – particularly by its ‘Conduct Risk’ strategy and the Retail Distribution Review (RDR) which we will look at later this week. However, ‘TCF’ still underpins the way that the FCA expects sales to be conducted.

Treating Customers Fairly (TCF)

1 – **Culture** Consumers should be confident that they are dealing with firms where the fair treatment of customers is central to the corporate culture.

2 – **Customer needs** Products and services marketed and sold in the retail market should be designed to meet the needs of identified consumer groups and targeted accordingly.

3 – **Information** Consumers should be provided with clear information and are kept appropriately informed before, during and after the point of sale.

4 – **Advice** Where customers receive advice, the advice should be suitable and take account of customers’ circumstances.

5 – **Product performance** Consumers should be provided with products that perform as firms have led them to expect. Additionally the associated service should be both of an acceptable standard and as the customers have been led to expect.

6 – **Flexibility** Consumers should not face unreasonable post-sale barriers imposed by firms to change products, switch providers, submit claims or make complaints.

One of the key principles of a risk-based approach to regulating the sale of products is to categorise the customer – the rule here is that the less sophisticated the customer is deemed to be, the greater the protection that should be afforded when products are being marketed and sold to them.

The FCA defines three customer status categories:

1 Retail clients – the general public and any other customer not falling within the two other categories below.

2 Professional clients – largely firms and other entities that operate in the financial markets and have some expertise in financial matters.

3 Eligible counterparty – this category covers those entities that are deemed to be expert in the financial markets.

The classification process involves both qualitative tests – involving forming an assessment of the customer’s knowledge – and quantitative tests relating to size of the customer’s investment portfolio and the number of materially sized transactions they undertake on a regular basis.
The system of categorisation has certain safeguards built into it – the default being that, where there is doubt, higher (rather than lower) levels of customer protection should apply. Thus professional and eligible counterparties can seek the higher protection given to retail customers. Additionally, the firms selling the products may initiate a reclassification of their customers to enforce a higher level of protection on them, and to minimise the risk of selling products within a regulatory framework that is inappropriate, given their customers’ level of financial sophistication. So the clear principle here is that if either party to a business relationship is in doubt, then higher levels of protection should apply.

The firm also needs to supply details of the terms under which it will provide the service – usually in the form of a ‘key facts’ or equivalent statement.

4.2.1 Selling to customers – communications

Having determined their classification, financial firms must be mindful of this when communicating with their customers.

Communication ahead of a transaction may typically involve either selling the services of the firm itself or promoting particular products.

As may be anticipated, the definition of what is ‘clear, fair and not misleading’ (referred to in the FCA’s principle 7) must take into account who the recipient is and, therefore, what may reasonably be viewed as appropriate, given the level of their financial sophistication.

When promoting products, firms do have to be explicit about the potential financial risks involved and the financial prospects for the investment. The nature of the returns from the investment should also be specified – are these in the form of interest, capital gain or some other return? Additionally, customers should be advised of the actual producers or managers of the product. This information is important because it advises the customer of the financial firms to whom they would be exposed, and who would have management responsibilities, if they invested in the product.

For retail customers, where the level of protection is greatest, communications about financial products are required to be clear and explicit. This means that the description of potential benefits of the products must be balanced against details of risks and, hence, potential losses – and without these risks being ‘played down’. Furthermore, these details must be provided in a way that is intelligible to the general public. So, it is essential when marketing products that:

> the information [provided] should not seek to cajole an inexpert customer into purchasing an overly complex and overly risky product for the customer’s purposes by emphasising some information and suppressing other information.

(Hudson, 2009, p. 233)

In cases where the taxation treatment of the investment is referred to, it should be noted that this treatment depends on individual circumstances and could change if taxation rules are altered.
4.2.2 Selling to customers – suitability reports

The FCA lays down a series of requirements for the selling of products to customers in cases where the firm making the sale is recommending the product or where the firm is managing the investment themselves. The key aim is that due regard is taken to ensure that the product – and specifically the risk features associated with it – are suitable, given the needs and circumstances of the customer. Compliance with this requirement is through the completion of a ‘suitability report’ that is required for designated investment products.

In completing the suitability report, the firm needs to assess:

- the customer’s knowledge of, and experience in, the investment product
- the capacity the customer has to absorb the financial risks – i.e. the risk of losing money – that could arise through investing in the product
- the nature of the customer’s investment objectives.

Firms are entitled to base their assessment of the suitability of the product on the basis of the information supplied by the customer, unless there is clear evidence that the information is incorrect, out of date or incomplete.

Once the information has been assessed, the firm can advise its customer on whether or not the product is suitable.

Where the product is deemed suitable, the firm should, in its suitability report, explain to the customer exactly why the product is appropriate – but should still set out the potential disadvantages of, and risks inherent in, the product. This suitability report must be sent to the customer ahead of the completion of the sale of the product.
Where the product is deemed not to be suitable for the customer, the firm must report this to the customer, thus warning them that investing in the product is inappropriate. The customer must also be advised when insufficient information is supplied by them for the completion of the suitability assessment. If, despite these warnings, the customer decides to go ahead with the investment, then it is at the discretion of the firm as to whether they go ahead and conduct the business.

There are some circumstances in which the assessment of the suitability of a product is not required. These circumstances relate to transactions in which the firm is merely executing the customers' orders (i.e. the firm is neither advising on nor marketing the relevant product). Suitability analysis is also not required for transactions undertaken at the request of the customer in equities and a number of ‘vanilla’ (i.e. non-complex) securities. This is provided that there is information generally available about these investments to form a view of the risks involved. Investments in investment funds – including unit trusts – similarly do not require a suitability test to be completed.

The assessment of suitability provides a safeguard against retail customers ending up incurring financial losses on products that they do not really understand. Additionally, it provides an audit trail to protect firms from accusations of selling products to unwitting customers who were never warned of their inappropriateness to them as investments.

Firms also need to advise customers on their rights to cancel (and hence withdraw from) contracts. The objective here is to give customers a ‘cooling-off’ period, enabling them to reconsider the investments they have made following their initial commitment to them. These cooling-off periods are short – typically 14 days and no more than 30 days because, if they were any longer, the customer would in effect be given the flexibility to walk away from an investment that had moved adversely in value.

Firms must disclose the scope of the advice provided – meaning the range of the institutions whose products are compared by the firm, and from which the recommended products are selected. Additionally, the type of product must fall within the range that the firm sells in the course of its business. In respect of the disclosure of scope, the firm should be explicit about whether its product recommendations are based on the entire market for the product (independent and unrestricted) or a limited number of products or product providers (restricted) or whether only ‘simplified’ advice is given (see Week 2).

From 2013 the FSA prohibited financial advisers and sales staff from receiving commissions from firms whose products they are selling. The move is to help prevent customers being sold products by advisers and sales staff who may be motivated by commissions paid by the product providers. This move may, of course, mean that customers have to pay higher fees for the products sold by advisers and firms, who can no longer recoup earnings from the product providers.

The procedures for selling products are extensive and bureaucratic, but their intention is to provide a framework that minimises the risk of the mis-selling of financial products.

4.2.3 The Retail Distribution Review (RDR)

In 2006, the FSA launched its Retail Distribution Review (RDR) to address the persistent problems that it had observed as a result of its regulation of the retail investment markets. The FSA had observed that there was evidence that consumers had insufficient trust in the products and services supplied in the retail investment markets.

Following research and discussions with industry practitioners, consumer organisations and other stakeholders, the FSA published a consultation paper in 2009 setting out its initial proposals for dealing with these issues.
These included:

- requiring firms to be clearer about the services they provide – this has now materialised in the four-category classification of adviser services (unrestricted, restricted, simplified and basic) we looked at in Week 2
- addressing the issue of how remuneration structures for advisers may lead to adverse outcomes for customers
- improving the professional standards of advisers.

(Adapted from FSA, 2009)

One of the first outcomes from the Retail Distribution Review came with the announcement by the FSA in March 2010 of new rules designed to prevent advice on investment products being biased by the commissions that advisers receive for selling products.

From the start of 2013, as we saw in the previous section, financial advisers have been prohibited from receiving commissions from firms whose products they are selling. Firms have to be explicit about how much they charge for their services and can no longer conceal the cost of their advice behind the overall cost of the investment product. Consequently, the cost of the advice on products is now agreed between the consumer and the adviser, not between the adviser and the product provider.

Figure 2

The ‘conduct risk’ review

A further related development has been the ‘conduct risk’ review that the FSA started to roll out in 2010 (FSA, 2011b, c). This is a development that has been built upon the FSA’s
Treating Customers Fairly (TCF) framework. TCF set out the key expectations for the way a firm that sells products goes about its business – including identification of a customer’s needs, provision of information about products – and, where needed, advice – plus the setting out of details of the performance history of the product being sold.

The Conduct Risk strategy, now being taken forward by the FCA, takes the principles of TCF further. It involves:

- intensive supervision to ensure that firms are treating customers fairly
- an increased focus on the identification and mitigation of risks before customers suffer adverse outcomes; this interventionist approach is aimed at anticipating detrimental outcomes for customers and to intervene before they occur, which is likely to include interventions such as banning products or prohibiting the sale of certain products to specific groups of customers
- the testing of product design and product governance arrangements

A particular feature of the new approach is the marked focus on product governance. This is aimed at ensuring that customer care is embedded into the decision making processes of financial firms right up to board level. This approach involves the scrutinising of the whole of the product life cycle from start to finish rather than just focusing on rules and procedures that apply at the point of sale. The FCA's view is that firms can do much more to protect consumers when designing products and that this would lead to an improvement in product distribution standards.

It is therefore clear that the FCA will take a tough line where it finds poor outcomes from its supervisory reviews of firms. Specific actions are likely to include product bans, price interventions, consumer warnings and further competence requirements for firms. Clearly there will be reputational and commercial impacts on those firms if such actions are invoked against them.

A further tightening-up of sales regulations came in 2013, with the introduction of the requirement for investment advisers to hold a Statement of Professional Standing (SPS). The statement is intended to provide customers with evidence that their advisers subscribe to a code of business ethics, are qualified and have kept their market knowledge up to date.

4.2.4 Viewpoints on the Retail Distribution Review

In the next video Chris Woolard, director of strategy and competition at the Financial Conduct Authority (FCA), sets out the purpose and objectives of the Retail Distribution Review (RDR).

David Harrison of True Potential LLP expresses his views on the review, and his reservations about the differences in the extent of regulation of different financial products.

Video content is not available in this format.

David Harrison
Activity 4.2
Having reviewed the process for selling financial products, and assuming that the financial adviser follows this process fully and correctly, do you think that there are any weaknesses in the safeguards against customers buying the wrong type of product? Think particularly about the compilation of the suitability report.

Discussion
The risk of buying the wrong product still arises through the customer’s disclosures, and the adviser’s interpretations of these disclosures when obtaining information for the completion of the suitability report.

Having some knowledge, as a customer, of financial products and their risks is not the same as being expert in both. Customers may not fully disclose the nature of their financial position – perhaps through inadvertently underestimating their prevailing liabilities, thus producing a mis-impression of their ability to bear the financial consequences that may arise from their investments. Customer understanding of different risk categories may also be superficial. Lack of clarity about the intended term of the investments – short-, medium- or long-term, also risks the wrong product being sold.

Additionally, even where customers accurately understand their current financial position and risk appetite, they may not be allowing for adverse contingencies like a household member losing their job. Additionally, the returns from investments will depend upon the customer’s tax circumstances (e.g. whether they are a basic-rate or a higher-rate tax payer and their liability for capital gains tax). Some customers may be insufficiently aware of their own, individual tax circumstances to know whether the product being sold is appropriate for them.
4.2.5 The Mortgage Market Review (MMR)

A further key recent development affecting the industry and the regulations for selling financial products has been the FSA’s ‘Mortgage Market Review’ (FSA, 2011d). This was initiated in 2009, and by 2012 the policy implications of this review began to be applied. This review has two broad aims:

1. for the UK to have a sustainable mortgage market, which means having a market where the mortgage lenders have sufficient capital and financial solidity to support their business and the market is competitive and innovative
2. for the UK to have a market that works better for consumer, which means a market where there are a range of products available to consumers, where they are aware of the costs and risks of both mortgage borrowing and property ownership and where the process of selling (or ‘distributing’) mortgage products is undertaken professionally and with the aim of achieving good outcomes for consumers.

The particular focus of the review has been on how mortgage products are structured and sold, with the FSA asserting that a ‘key problem [with mortgage selling] has been the lack of proper affordability assessments [and] irresponsible lending practices’ (FSA, 2009, p. 12).

The key policy implications are:

- the tightening-up of regulations about who can undertake advised sales of mortgage products, with all advisers being required to be professionally qualified in respect of such business
- the extension of the ‘approved persons’ regime to mortgage advisers and arrangers
- the requirement for improved recording, management and recovery of mortgage arrears
- the requirement for full disclosure to consumers of all information relating to the costs and risks of mortgage products, including adviser charging
- closer attention by mortgage lenders to the affordability of mortgages being sold to consumers – in respect of both the payment of interest and of the capital sum advanced; this includes the requirement for stress testing to assess if consumers can afford to meet payments on their mortgage at higher interest rates than those prevailing at the time of the mortgage sale
- the recording of whether sales of mortgage products are ‘advised’ or ‘non-advised’: the former are sales that follow the guidance supplied by mortgage advisers; the latter are mortgage sales where the customer makes their own choice.

The roll-out of the new regulatory rules under the Mortgage Market Review was completed in 2014. The subsequent – albeit temporary – dip in lending was ascribed to the impact of these new tighter rules on mortgage sales.
4.3 The protection safety nets

In this animation you will examine the various features of regulation that provide protection to consumers in the financial market place. The focus is on the protection afforded to consumers before, during and after the sale of financial products.

Video content is not available in this format.
Animation
4.3.1 Misleading statement regulations and whistle-blowing

Two aspects of regulation that are aimed at ensuring that consumers are not put at risk in the financial market place relate to the rules preventing misleading statements being placed in product promotions and to ‘whistle-blowing’, which can flush out improper practices within financial firms.

**Misleading statements**

A further form of protection for customers comes in the legal sanctions that apply to firms producing misleading statements about their products and services. Under Section 397 of the Financial Services and Markets Act 2000, it is a criminal offence to encourage customers to purchase investment products by the use of false or misleading statements. In fact, the law here extends to more than just statements which have been made that are untrue or deceptive. It also applies to the deliberate concealment of relevant facts that, if made public, would deter customers from acquiring the product. It also applies to forecasts or promises about the potential returns from the product which are manifestly unrealistic. The provisions of the legislation also apply to activities which falsify the market price of a product, with the intent of encouraging a customer to either buy or sell a product.

The deliberate misrepresentation of the facts about a product, the market it trades in and its prevailing market price is clearly a form of market abuse because retail customers, in particular, rely on the professional practices of firms to make considered and accurate judgements about their financial services dealings. Despite the existence of the legal protection, the risk of such misleading statements should encourage customers to get ‘clued up’ on the products they are thinking of investing in – rather than relying on the apparent expertise of those selling the product. At the very least, getting third-party advice...
about products that you have limited knowledge of, and familiarity with, makes good sense.

**Whistle-blowing**

Operating in a climate where those with concerns about aspects of their firm’s activities can speak out and report matters without suffering adverse consequences is an important facet of a strong regulatory environment. It provides an additional safeguard to customers because employees of financial services firms may spot a misdemeanour in their firm’s conduct that would otherwise go undetected.

Under the Public Interest Disclosure Act 1988, protection from retaliation by their employers is afforded to those who report matters of concern about their firm’s conduct – an activity commonly known as ‘whistle-blowing’. This Act provides the framework for employees to make protected disclosures (i.e. ‘blow the whistle’) where they believe a legal offence or miscarriage of justice has been committed, or where they believe that there is a deliberate attempt to conceal such acts.

The additional support that this provides for the regulation of financial services is shown by the way the regulators provide guidelines to the industry on how firms can apply procedures within their risk management frameworks to allow for whistle-blowing to take place.

*Figure 4*
4.3.2 Protecting customers’ assets

One inevitable feature of undertaking financial services transactions is that money will flow from customers to firms and back again as products are bought and sold. This creates the risk that a customer’s money or other assets can become mingled with the assets of the firm undertaking the business on the customer’s behalf – a risk that becomes very material if the firm gets into financial difficulties.

To avoid this improper treatment of customers’ money, the Client Assets Sourcebook (CASS) sets out regulations to safeguard customers’ money and to ensure that it is properly segregated from the firm’s assets. This ensures that if a firm gets into financial difficulties, customer money is not used to settle its debts. The rules apply both to money and to the financial assets (e.g. shares and securities) that are owned by customers.

The key measure to ensure compliance with CASS is that financial services firms should place customer funds into designated customer bank accounts. These have to be entirely separate from the firm’s own accounts and have to be treated as such by the firm’s bankers.

To ensure the effective management and segregation of customer funds, CASS also requires a regular reconciliation of customers’ money and assets. These should be performed regularly, and the reconciliation of the bank accounts and asset records should be carried out by those who were not involved in their original completion. This segregation of responsibility between the record maker and the record checker is an important financial control.

The reconciliation process will involve both internal and external checks. The internal ones are where the financial services firm checks its own records on customer money, albeit with the segregation arrangements outlined above. The external ones are where the firm’s own records are cross-referenced to those prepared by an external party – typically the bank that holds the customer’s money.

Any discrepancies in the records have to be investigated, and if a shortfall (or excess) in customer money or assets is proven, then the firm must rectify the position.

Failure to execute effective reconciliation procedures is viewed seriously and firms failing to comply with these procedures are required to inform their regulator. Proof of this came in June 2010 when the investment bank, J.P. Morgan, received a record fine from the FSA of £33.3 million for failing to segregate its clients’ money properly. The original fine was £47.6 million but was reduced by 30 per cent because J.P. Morgan worked constructively with the FSA once its regulatory failure – which went back over a period of 7 years – had been detected.

In 2010 the FSA reinforced the requirements of CASS through its Policy Statement – the Client Assets Sourcebook (Enhancements) Instrument (FSA, 2010). The measures were in response to issues relating to client assets that surfaced during the financial crisis – particularly those identified following the insolvency of Lehman Brothers. Amongst the measures are greater restrictions on the investment of client money, with institutions within the same banking group as that holding the client’s account. This is designed to diversify the investment of clients’ money thereby avoiding excessive credit exposure to one or a few financial firms. There is also a requirement for financial firms to establish a CASS controlling function.
4.3.4 Data protection

One inevitability of financial services business is that firms will gather a considerable amount of personal data about their customers – much of it relating to their financial status and to the location of their assets (e.g. their bank accounts). The risk is that this could fall into the wrong hands and be misused to the customer’s disadvantage.

The importance of data protection applies widely in economic and social life, and does not just relate to financial services activities – although the potential for financial loss through poor data protection is arguably greatest in the arena of financial services.

Regulatory protection for customers in the UK is provided here by the Data Protection Act 1998. This lays down the rules about how personal data must be managed in order to protect against its misuse.

Because financial services firms will maintain considerable personal data – remember, as we found out earlier this week, they have an obligation to ‘know their customer’ – they will automatically have a responsibility for compliance with the Data Protection Act. They will therefore have to be registered with the Information Commissioner’s Office (ICO), which oversees the implementation of the content of the Act. Indeed, the PRA and FCA themselves have to be compliant with the Act, given the personal data it holds as a result of its operation of the Senior Managers Regime.

Applying the Data Protection Act requires firms to comply with the following:

- data should only be obtained for ‘specified and lawful purposes’ – i.e. data should not be obtained unnecessarily or spuriously
• the amount of data gathered should only be that which is required for the business or transaction in question – i.e. excess data should not be gathered
• the data should be processed properly and lawfully
• the data should be checked to ensure accuracy at the time of receipt, and then be subsequently kept up to date
• the data should only be held for as long as is necessary for the business or transaction in question
• the use of the data must not be in breach of the rights of the customer providing it
• procedures must be employed to prevent misuse, loss or destruction of the data
• the data must be retained within the European Economic Area (EEA) and may only be transferred outside the EEA if the recipient country can prove that it has an effective personal data protection environment.

(Adapted from Turner, 2008, p. 93)

The Data Protection Act was amended in May 2008 to give the ICO the power to impose financial penalties for serious breaches of the Act. However, this power can only be brought into force when the relevant Statutory Instrument is passed.

The compliance regime in respect of data protection is onerous for both financial and non-financial firms. With fairly regular stories about data protection failures – by both private- and public-sector bodies – finding their way into the media, it is evident that the data protection regime in the UK is not flawless. Despite this, the protection the regime affords customers – when it is properly applied – is important in helping to ensure that financial services business can be executed both securely and discreetly.

Data security failings

**HSBC fined £3 million for data security failings**

In July 2009, the FSA announced fines for three HSBC entities, totalling £3 million, for failing to have adequate systems and controls in place to protect their customers’ confidential data.

The failings included the loss in the post of two unencrypted disks containing personal data, the failure to store data securely, and poor staff training in respect of the identification and management of information security risks.

The fine was at the time the highest that had been applied for data security failings in the UK, despite a 30 per cent discount applied in recognition of HSBC’s cooperation with the FSA on the matter.

(Adapted from Hunton and Williams, 2009)
Activity 4.3
Identify two developments in recent years that have made data protection more challenging for financial (and other) institutions.

Discussion
A number of developments spring to mind:

- The storage and transmission of data in electronic format, which means that it can be sent quickly and easily to a variety of destinations.
- The growth in the number of accounts that customers hold – particularly given the increase in the number of credit and store cards in use; each additional account provides another set of data to potentially be mislaid.
- The increased prevalence of ‘working from home’, with data being accessed and transmitted from locations away from the place of work and with data being held on computers in less than ideally secure environments; think about the number of stories about potential data protection breaches which relate to stolen or mislaid laptops.
- The volumes of data that can be held in electronic format; this means that if there is a data protection breach, it rarely relates to just a handful of customer accounts.

What other factors did you think of?
4.3.5 Complaints: the Financial Ombudsman Service (FOS)

A further inevitability of financial services dealings is that there will be some disputes between customers and the firms they deal with. During its existence the FSA laid down various requirements for the processes for dealing with disputes and these remain an integral part of the FCA's Treating Customers Fairly (TCF) regime.

To deal with disputes firms are required to have in place written procedures to deal with all complaints in whatever way they are made (i.e. written or oral), and regardless of whether or not the complaint appears to be justified.

Although disputes may first be dealt with by the firms themselves, complainants have the right, if they remain unsatisfied with the outcome, to go to the Financial Ombudsman Service (FOS), which can independently review the case.

The first part of the process of dealing with a dispute is to determine whether it arises from an eligible complainant. These comprise the following retail customers:

- consumers
- small businesses (‘micro-enterprises’), with fewer than 10 employees and with an annual turnover not exceeding the equivalent of €2 million
- the trustee of a trust, where the value of the trust is less than £1 million
- charities with an annual income of less than £1 million.

These are deemed to be less financially sophisticated and hence more vulnerable than other complainants. Disputes arising from these parties must be dealt with in accordance with the firm’s procedures. There is no obligation by the firm to apply these same procedures where disputes arise with those who are not eligible complainants.
The process and timings that apply to the internal investigation of disputes are subject to a number of requirements.

As regards the process, the complaint must be investigated by someone who both has the competence to make a judgement on the matter and who has not been involved in the business area from which the dispute has arisen. Additionally, the person who responds to the complainant, after the internal investigation has been completed, must be empowered to make any required settlement with the complainant and to arrange any required compensation.

As regards timings, a series of minimum time periods for processing a complaint are laid down. Originally, and until September 2011, it was a two-stage process. The complaint had to be initially acknowledged within 5 business days, and firms had up to 8 weeks within which to provide the complainant with their final response. From September 2011, however, this two-stage process was abolished. Delays in response beyond this 8-week period must be explained to the complainant.

Those eligible complainants who are dissatisfied with the way that the financial services firm has dealt with their dispute can escalate the matter to the FOS, the independent body established to resolve outstanding disputes relating to financial services business. The service of the Financial Ombudsman is free to complainants.

The business of the FOS splits into two separate jurisdictions. FOS’s compulsory jurisdiction relates to those unresolved disputes from eligible complainants that were not adequately resolved by the FCA-authorised firms. Additionally, the FOS has a voluntary jurisdiction which handles those disputes that do not fall within its compulsory jurisdiction. These can include disputes relating to firms not regulated by the FCA – for example, certain credit card business activities.

The important distinction between the compulsory and voluntary jurisdictions is that firms must accept the compulsory jurisdiction. There is no similar requirement for firms to accept voluntary jurisdictions – although customers still then have the option to take civil action in court.

If the FOS rules in favour of the complainant, it can require the culpable firm to provide financial compensation. The original maximum compensation payable was £100,000. Following an FSA review of the complaints system (FSA, 2011e), however, an increase of the limit to £150,000 took effect from 2012. However, if the FOS considers that an amount in excess of £150,000 is justified, it can recommend (but not insist) that the firm pays out the assessed higher sum.

The FSA review also set out further proposals for the procedures for FOS to follow when handling complaints. These took effect from September 2011 and included:

- the aforementioned abolition of the two-stage process for complaints handling
- the provision of detailed guidance on the procedures firms should have in place to take account of FOS’s decisions and other guidance when resolving complaints
- the restatement of the guidance on the requirement on firms to undertake root cause analysis of the complaints they receive and take action as appropriate
- the requirement for firms to nominate a senior individual to have responsibility for the complaints-handling function within the firm.

Two final facets of the complaints ‘safety net’ introduced in 2012 are super-complaints and mass-detriment references which may be made to the FCA.

Super-complaints can be made by consumer bodies in respect of competition and consumer issues which they deem to be widely, and significantly, damaging to the
interests of consumers. One recent super-complaint was made by the consumer body Which? in 2015, in respect of the pricing practices of supermarkets in the UK. Mass-detriment references may be made by the FOS – and also by financial firms – where they deem that the practices and regulatory failures of a firm have, or potentially have, been to the disadvantage of consumers.

4.3.6 The Financial Services Compensation Scheme (FSCS)

Figure 8
We now reach the last safety net for customers engaged in financial services business – the Financial Services Compensation Scheme (FSCS).

The scheme allows ‘eligible claimants’ to be paid financial compensation in the event of a default by a financial firm. As with the eligible complainants in respect of disputes procedures, the eligible claimants are those who are deemed to be the less financially sophisticated groups of customers of the defaulting entity – so, once again, we see how the regulatory framework is designed to help the most vulnerable participants in the business of financial services. The scheme does not, for example, afford protection to most other financial services firms, governments (both central and local), and large non-financial firms.

Note that the compensation being paid to customers here is in effect the same as an insurance pay-out and normally occurs when the relevant entity has become insolvent. So the ‘insurance’ claims under the FSCS typically (but not exclusively) relate to money placed in savings accounts offered by, and claims on insurance contracts provided by, the defaulting entity. Compensation is also provided in respect of certain protected investment business.
So, to have a legitimate claim for compensation, you must be both an eligible claimant and have a claim in respect of these specific ‘protected’ assets.

From the end of 2010, the maximum sum for protected (‘covered’) deposits under the scheme was raised from £50,000 to £85,000 per person per financial firm. Following the growth in value of the UK pound against the euro, this cover has been reduced to £75,000 from 2016 to align more closely with the €100,000 cover in the eurozone.

The maximum compensation for protected (‘covered’) investments is currently £50,000. An additional provision of cover up to £1 million is also available to those who temporarily hold large sums in their bank accounts as a result of, say, completion of the purchase or sale of their property. Clearly if a bank defaults at such a point, the outcome would be disastrous for the customer, if only £75,000 of compensation was available.

The compensation arrangements only apply to authorised financial firms, and not to individual brands that the authorised firm uses to conduct through. So if a banking group comprises a number of bank brands that are all covered by a single authorisation, the compensation limit applies against the aggregate of the investments held with the component brands of the banking group. The limit does not apply to each of the component bank brands.

Certainly, savers and investors should be clear not only about which institutions they have placed their money with, but also about whether institutions are part of the same banking group. Additionally, being aware of the particular guarantee scheme that applies to the investments is also essential.

One feature of the compensation scheme is that payments are funded from levies on firms in the same financial group as the defaulting entity. There are eight groups of firms: deposit takers including banks and building societies; life assurance and pension providers; general insurers; general insurance intermediators; life assurance and pensions intermediators; investment firms; investment intermediators; and home finance providers. The levies are proportionate to the size of the firm in each group.

So the compensation bills that arose following the break-up of the Bradford & Bingley bank and from the Icelandic banking crisis have had to be met by other deposit-taking institutions in the UK – including the building societies. If you have a building society account (or if you are a shareholder in a bank), you will be able to check out the costs arising by reviewing the summary financial statements that they send out to customers. Many of these institutions – particularly the building societies – have complained that they are paying the costs for the poor business models and risk management of those failing institutions. Since building societies are owned by their customers (or members) – see the section on building societies in Week 1 – and since banks are owned by their shareholders, the reality is, of course, that these costs are effectively met by these members and shareholders.

So if you are a customer (member) of a building society or a shareholder of a bank that came through the recent financial crisis unscathed, the reality is that you have not entirely avoided the resultant financial costs of the crisis.

**Nationwide’s criticism of the FSCS**

In May 2009, the Nationwide – comfortably the largest building society in the UK – announced a 69 per cent fall in pre-tax profits to £212 million for its 2008/09 financial year. The then chief executive, Graham Beale, laid a major part of the blame for the fall in profits at the door of the FSCS. The charges levied on other deposit takers, resulting from
the government rescue of the Bradford & Bingley in 2008, had hit Nationwide heavily, given that it had to pay into the compensation scheme proportionately to its share of the retail savings market. Nationwide’s large share of this market resulted in a charge by the FSCS of £241 million. The then chief executive said that the basis for the FSCS’s levies was flawed because it penalised conservative, low-risk firms such as Nationwide that used the retail savings market to fund its business more than the riskier wholesale markets.

4.3.7 Guidance and support – the Money Advice Service

One of the FSA’s original responsibilities was to promote public awareness about financial matters. The role here was educational, with the FSA promoting public understanding of the nature and risks of products, and of rights to (and the necessity of) access to information and advice about them.

In October 2010, this objective of ‘public awareness’ was transferred from the FSA to the new Consumer Financial Education Body (CFEB), subsequently renamed the Money Advice Service (MAS) in April 2011. This new body has now taken responsibility for helping consumers understand financial services and manage their finances effectively. The MAS provides free and unbiased advice to consumers. The MAS operates independently from the PRA and FCA, although the two regulatory bodies have a joint statutory oversight of its work.

In March 2016 it was announced that the MAS is to be abolished with its responsibilities passed to a new, smaller body. Additionally, two other advisory bodies, Pension Wise and The Pensions Advisory Service (TPAS) are to be merged to provide one source of advice for the public on pensions and retirement planning. Full details of the new advisory arrangements are expected later in 2016.

In this video Caroline Rookes, chief executive of the MAS, talks about the work of the organisation in helping the public with financial management.

Video content is not available in this format.

Caroline Rookes
4.3.8 Guidance and support – Citizens Advice

Citizens Advice is the UK charity that provides free guidance to the public through its bureau locations around the country and its web site. The charity’s work is largely undertaken by over 21,000 volunteers.

Perhaps predictably, much of the advice relates to household financial management particularly budgeting and debt management.

In this video Hugh Stickland, the charity’s chief economist, talks about the work of Citizens Advice and the range of issues that the public seeks help with. The trends in financial problem subjects are also explored.

Video content is not available in this format.

Hugh Stickland
4.3.9 True Potential LLP

This course along with Managing My Money and Managing My Investments has been made possible by the financial support provided to The Open University Business School by True Potential LLP.

As you move towards the end of Managing my financial journey, David Harrison, senior managing partner of True Potential LLP, talks about his reasons for supporting personal finance education and his hopes for what the courses will help to achieve.

Video content is not available in this format.
Potential
4.4 End-of-course quiz

You can now take the end-of-course quiz, which consolidates your understanding of all the topics you’ve studied.

To view this content please access the complete course on OpenLearn

Open the quiz in a new window or tab then come back here when you're done.

4.5 Week 4 and course round-up

Martin concludes the course by reviewing the subjects and issues covered.

The financial services industry will continue to change and evolve in coming decades as will the way it is regulated.

Consumers should expect to deal with trained and professional staff at the financial firms they do business with. They should also expect that financial firms are properly regulated and that product selling is subject to appropriate safeguards for their customers.

But the fact is that to make best use of the financial marketplace requires education to ensure that consumers make knowledgeable and effective decisions.

We do hope that Managing my financial journey has helped to put you in that position.

Video content is not available in this format.

Conclusion
Now you’ve completed the course we would again appreciate a few minutes of your time to tell us a bit about your experience of studying it and what you plan to do next. We will use this information to provide better online experiences for all our learners and to share our findings with others. If you’d like to help, please fill in this optional survey.

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**Week 1**


**Week 2**


References


The Times (2009a) ‘Virgin wants UK bank’, 29 December, p. 36.


Week 3


Week 4


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