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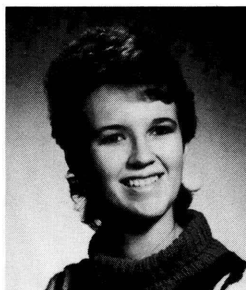
THE EFFECTS OF DEREGULATION ON LONDON'S FINANCIAL MARKETPLACE

Gail N. Eskuchen



Introduction

The old-fashioned, quiet, and reserved City of London (the financial district within London) is now only a part of history. The deregulatory changes made in response to the worldwide trend towards international competition among securities markets have drastically updated the City. In fact, the changes have been referred to by many as "the incipient Americanization of the City of London" (Campbell, p. 57).

The City, along with New York and Tokyo, has historically been regarded as one of the top three financial marketplaces in the world. However, a sweeping global movement towards an international marketplace during the 1970s and the 1980s has raised concerns that the City would fail to keep pace with other financial centers. Therefore, changes in the way the City did its business were considered necessary so that it could maintain its worldwide status.

During the period from 1979 to 1986, dramatic deregulatory changes took place in the City in an effort to maintain its competitiveness in the global marketplace. It appears that the deregulatory measures taken will indeed be effective in enabling the City to maintain its position as one of the world's most important international financial marketplaces.

This article discusses in detail the reasons why deregulatory changes were necessary in the City. It also examines the deregulatory measures that were instituted, and analyzes the effects of these deregulatory changes.

Background

The City's Position Before Deregulation

During the nineteenth century, the City was the world's center for financial transactions, backed as it was by Britain's empire and its stable monetary system. After World War I, however, the U.S. emerged in far healthier condition than any of the War's European par-

ticipants. Although the City maintained its stature as a marketplace for Eurocurrencies, Eurobonds, and gold bullion dealing, its influence in other securities markets dwindled (Mason, p. 179).

However, over the last several decades, the City regained its strength and again became recognized as a sound, competitive marketplace. Its size, in terms of domestic market turnover, became exceeded only by New York and Tokyo (Mason, p. 161). Unlike these two cities, however, the City of London boasted a greater degree of dealing sophistication, one that evolved through centuries of tradition. For example, London was the undisputed center of worldwide bank lending because bankers from other countries found that its skills, location, and facilities made it a better place to conduct business than their own countries. Through its years of experience in international trade, London became highly skilled in handling international currencies. Furthermore, the City's location midway between New York and Tokyo in terms of international time zones enabled it to form a link between the two other financial centers. Finally, the expansive resource facilities which have developed in London over the years, as well as the highly-esteemed Euroanalysts (researchers who analyze foreign companies) employed there, helped the City become regarded as an invaluable center for international financial information.

London has remained the dominant marketplace for international transactions in gold bullion, Eurocurrencies and Eurobonds. Furthermore, the City's regulatory structure was to become favored by financial institutions, because the structure restricted entry and controlled competition.

However, during the 1970s, a period of financial global deregulation emerged. This worldwide movement, which came to threaten London's competitiveness as an international financial marketplace, is discussed in the following sections.

Global Deregulation

The deregulatory movement of the 1970s was stimulated by three factors: 1) inflationary pressures, 2) the loosening of international exchange controls, and 3) the impact of increased computerization. These factors will now be examined.

The Role of Inflation

In the 1970s, growing inflation in most industrialized nations stimulated the development of financial investment alternatives. In some countries, new investment alternatives were developed which skirted government regulation, enabling customers to earn higher returns. In other countries, governments created more financial instruments to raise funds and reduce their international debt. However, these new alternatives caused more problems, as they diverted funds from banking systems, causing shortages of funds and disintermediation crises. These problems, in turn, prompted deregulation within each country, thereby creating a period of deregulation throughout the world.

The phenomenon can best be understood by examining the changes that took place in Japan, since this country provides a clear example of the pattern of events described above. Therefore, a brief digression to examine Japan's deregulatory changes is in order.

Early in the 1970s, Japan's highly-regulated financial structure allowed very few financial instruments to be traded. However, following the first oil shock of 1973, inflation accelerated and, in turn, government deficits grew. As a result, the government required a number of banks and securities firms to accept newly issued government debt instruments at below-market rates, to hold them for a specified period, and then to resell them. Thus, a secondary market for long-term government bonds developed. Since trading in the secondary markets was highly restricted, the government was forced to begin a progressive easing of restrictions imposed on their secondary sales. As Japan's secondary market developed and the demand by individuals for higher returns on investments grew, Japanese banks experienced disintermediation. The government was consequently forced to deregulate; it began to allow banks to issue negotiable certificates of deposit. Additionally, interest rate ceilings were eliminated on these deposits.

These changes in financial structure sparked the beginning of a wealth of further deregulation in Japan. Although the financial system still remains in a web of bureaucracy to a certain extent, deregulation has allowed Tokyo to establish itself as an internationally respected financial center.

Granted, the impact of inflation in other countries did not produce effects as dramatic as those in Japan. Nonetheless, inflationary pressures in other countries (such as the United States and France) stimulated similar patterns of events, thus producing an era of global deregulation which opened the world's financial markets for international trade.

The Impact of Exchange Controls

In addition to the deregulation prompted by inflation within most industrialized countries, the elimination or relaxation of exchange controls by 1980 facilitated the development of an integrated world financial market. Exchange controls were initially imposed by many countries to control excessive capital flows into strong deutsche marks and yen from 1973–1978. However, in anticipation of a strengthened dollar in 1979, the exchange controls were lifted, allowing U.S. currency to flow freely on a global basis. Therefore, the deregulation of these controls fostered the mobility of international capital and the resulting integration of the world's markets.

The Role of Technology

The third factor that hastened the development of a global marketplace was the impact of computer technology. Computers have substantially improved transaction processing, and have given institutions the ability to handle a tremendous number of transactions more inexpensively and rapidly than ever before. Additionally, computers have provided for the rapid and economical dissemination of information both within and between marketplaces. Fax machines and telex telephone systems are only two examples of computerized communication systems which have greatly speeded communication between the world's financial markets.

Some observers estimate that the costs of international information transmission have been lowered by 98% over the last two decades (Goodhart, p. 7). Without these technological advances, the development of a world capital marketplace would have proceeded much more slowly than it did.

Deregulation in London

As a result of the factors discussed above, global deregulation had brought sweeping changes to the world's financial marketplaces by 1980. London, however, was only a minor participant in this deregulatory movement. Granted, a deregulatory inroad was made in 1979 when exchange controls were abolished, allowing non-U.K. residents to freely enter London's currency market and repatriate previously invested funds without restriction (Mason, p. 180). However, many other competitive restrictions and procedural inefficiencies remained, which limited the City's potential as an international marketplace. Exchange membership was restricted, fixed minimum commissions persisted, and methods of conducting transactions were inefficient. All three of these areas needed to be improved if London was to remain globally competitive.

To remedy London's persisting problems, many deregulatory changes were instituted between 1983 and 1986. First, a 1983 settlement concerning the Restrictive Practices Act eliminated the Stock Exchange's rule book and provided for the elimination of fixed commissions on securities transactions by 1986. Second, in 1984 minimum commissions on "gilts" (London's term for government securities) were reduced, and commissions involving overseas securities were made negotiable. Third, banks and building societies (similar to U.S. savings-and-loan institutions) were put on equal footing with respect to tax treatment and government regulation in 1985, and the British government initiated a movement towards a new corporate debt market. Finally, a complex collection of deregulatory changes dubbed the "Big Bang" was instituted in 1986. Each of these deregulatory measures are discussed in the following sections.

The Abolition of the Restrictive Practices Act

In 1983, a landmark out-of-court settlement was struck between Sir Nicholas Goodison, the Chairman of the Stock Exchange, and Cecil Parkinson, the Secretary of the State for Trade and Industry. The case was initiated in 1978, when Roy Hattersley, then the Labor Industry Minister, decided to challenge the Stock Exchange's rule book. According to Riley, since the rule book controlled the types of business that could be transacted and the rates of commission that could be charged, it perpetuated the pattern of relatively small, weakly-capitalized firms to the exclusion of outsiders and significant international links.

After five years of litigation, a settlement was reached that exempted the Stock Exchange from the Restrictive Practices Act, the act enforcing the Stock Exchange's rule book. Therefore, by eliminating this restrictive rule book, the groundwork was laid for allowing the market to become more competitive.

An additional provision to this agreement was the abolition of fixed commissions on securities transactions by 1986. This provision was prompted by the 1979 lifting of exchange controls previously discussed. When the controls were lifted, U.K. investors gained the experience of transacting in markets much more competitive than London's. Furthermore, the type of investors who used the market changed dramatically, as small, private investors gradually gave way to large institutions, whose professional fund managers had a much-less-generous idea of how much they ought to be paying in commissions.

Faced with this provision concerning the abolition of fixed commissions in the out-of-court discussions, the Stock Exchange decided that it would be better to decontrol commissions rather than face the alternative of an enforced court order. The Exchange knew that the enforcement provisions of its regulatory bodies were not effective, since the enforcement procedures were usually based on the use of persuasion rather than court proceedings. Realizing that some brokers were already giving discounts to their major institutional customers in spite of the existing restrictions, the Stock Exchange accepted the provision. To avoid any legal confrontation concerning its regulatory system, the Exchange thus preferred to devise positive measures to deal with the new situation.

The fixed commissions had made it possible for many small undercapitalized firms to survive. The prospective reduction in income which would result from the elimination of fixed commissions meant now that these firms would have to have established reputations, proven expertise in broker's market-making and order-execution abilities, and high quality research capabilities. In essence, elimination of fixed commissions increased competition to such a degree that only strong, efficient firms would be able to survive in the marketplace.

The Deregulatory Measures of 1984 and 1985

On April 9, 1984, two additional changes were instituted. First, reductions were made in the level of minimum commissions on dealings in gilt edged stocks or "gilts." This change brought about a substantial decline in commissions, as much as 20% for large institutional investors. The reduction in gilt commissions had much the same effect as the elimination of securities commissions in 1986: a much more competitive and efficient marketplace.

Also on this date it became permissible to negotiate commissions on transactions involving overseas securities — a change which would make the market much more competitive internationally. This was so because investors already conducting U.K. securities transactions with London brokers would now be more likely to also conduct overseas securities business with them, instead of taking their transactions to less expensive brokers overseas.

Two major changes affecting banking and corporate debt were also instituted in 1985. First, regulatory revisions were made allowing all banks and building societies to compete in an environment of equal tax treatment and legal restrictions. Before 1979, the banking system in Britain was subdivided into two entities, banks and building societies. Building

societies possessed a substantial advantage over banks in competing for retail savings deposits in that the interest paid on consumers' deposits in building societies had certain tax advantages. Additionally, building societies dominated the mortgage lending market because of various legal restrictions. Therefore, banks tended to lend only to their prime customers.

However, regulations were lifted in 1979 and 1980, thus enabling banks to circumvent the restrictions and enter the mortgage market. Finally, in 1985, the authorities harmonized the tax treatment of banks and building societies, thereby eliminating the advantages which the building societies enjoyed. The resulting equal treatment of banks and building societies has fostered more competition, which has in turn improved service to customers.

Also in 1985, the British Government allowed the issuance of one-to-five-year sterling corporate debt issues (corporate bonds). This action is seen as a precursor to the development of an extensive commercial paper market in London. Allowing the development of new financial instruments and possibly an entire new market in London enhances the attractiveness of investment in the City to overseas investors by giving them more financial investment alternatives. Therefore, the development of the corporate debt issues will make the City even more competitive internationally.

Deregulation in 1986

The majority of the deregulatory measures in London occurred in 1986. Besides the elimination of fixed minimum commissions brought about by the 1983 out-of-court settlement, the following measures were instituted to increase market competitiveness:

1. the distinctions between brokers and jobbers were eliminated;
2. regulations governing membership of the Stock Exchange were relaxed;
3. a computerized trading system was set up;
4. limits concerning shareholders' rights were relaxed;
5. the number of firms dealing in gilts was greatly increased; and
6. the regulatory structure of the marketplace was reformed.

Each of these changes will now be discussed.

Broker-Jobber Distinctions

On October 27, 1986, the "Big Bang" took place in London. The effects of the Big Bang were to eliminate all fixed commissions on securities, as previously discussed, and to eliminate all of the regulations which differentiated "brokers" and "jobbers."

Unlike the U.S., the London Stock Exchange had a system of "single capacity." This meant that a broker could act as an agent for a client only by taking orders, but could not trade for his own account. A broker had to pass his orders on to a jobber, whose role was much like that of a floor specialist in the U.S.—i.e., "making a market" and quoting two prices, a "bid" and an "ask." In essence, a broker could not "make a market" in a security, while a jobber could not deal with the public; in this respect, each functioned in a "single capacity."

However, on October 27 these differences were eliminated. Brokers and jobbers were now allowed to perform both sales and trading functions in a "dual capacity." It was inevitable that the system of single capacity would be abolished when fixed commissions were eliminated. The reason is that if broker commissions were reduced, brokers would be forced to augment their incomes by trading on their own accounts. Also, because of the increasing internationalization of global marketplaces, it was necessary to expand the capacity of major brokers for them to compete globally.

Relaxation of Exchange Membership Regulations

Several of the Stock Exchange's membership regulations were relaxed in 1986. Under the new provisions, both foreign and domestic corporations, as well as domestic banks, were allowed to become members of the Stock Exchange. Furthermore, foreign firms were also allowed to acquire 100% of a Stock Exchange member firm. The previous limit was 29.9% (Mason, p. 180).

Joining the Exchange offers several advantages. First of all, membership gives companies access to otherwise unattainable flows of information. Second, trades by recognized brokers are exempt from certain taxes. Third, membership is desirable because only Exchange members can deal in gilts. Finally, only members of the Stock Exchange have voting rights.

The new membership privileges have allowed an array of global financial giants, including American Express, Barclays Bank PLC, and Union Bank of Switzerland, to take full ownership of exchange firms in which they already hold minority stakes (Putka, Truell, and Winkler, p. 1). The fact that commercial banks in the U.S. or Japan are not permitted to facilitate securities transactions was expected to further increase London's International influence.

The Effects of Computerized Trading

Before the Big Bang, trading in the London securities market consisted of traditional face-to-face dealing in a central marketplace, much like that in the New York Stock Exchange. However, on October 27, a computerized market-maker system called the Stock Exchange Automated Quotation System (SEAQ) was instituted, eliminating traditional trading in the City.

The new system was designed to function like the National Association of Securities Dealers Automated Quotations system (NASDAQ) in the U.S. The information presented on computer screens is updated continuously and transactions occur instantaneously (with the exception of extraordinarily large transactions). The SEAQ is equipped to handle 60,000 transactions per day, a substantial increase from the pre-Big Bang average of 27,000 per day (Putka, Truell, and Winkler, p. 11). The system has proven to be reliable, since the trading systems "coped remarkably well" during the week of the October 1987 market crash (*Wall Street Journal,* February 11, 1988). As a result of the institution of SEAQ, trading is now handled in firms' electronic dealing rooms, with price quotations displayed on computer screens and trades struck by telephone.

The computerized system has proven to be advantageous to brokers, because it helps them to cope with the increase in transaction volume that resulted from the elimination of fixed commissions. The system also provides more information to brokers, since the screens give stock buyers the advantage of seeing all the prices offered on a certain company's shares by competing market makers.

Changes in Shareholders' Rights

Two important changes regarding shareholders' rights were instituted in 1986. First, limits on the number of shares in a particular company that another firm can hold were eliminated. This means that large institutions are now able to purchase more financial instruments in the City, instead of having their purchasing power limited.

Also, rules governing shareholders' rights to first refusal of new issuances were relaxed. Initially, the rules were similar to the United States' preemptive-right provisions included in the by-laws of a corporation. These provisions, which are optional for each U.S. corporation, allow shareholders the right of first refusal so that they may maintain their relative interest in the company. In the City, these provisions were not optional for each corporation, but were required by law. The relaxation of these laws implies that higher demand for new issues of stock will increase competition in this area.

Increased Membership in the Gilts Market

Before the Big Bang, only a dozen specialist stockbrokers had conducted institutional business in gilts. This system was known for discouraging competition and encouraging "cozily high" commissions (Smith, p. 13). In its place, an almost exact copy of the American government securities market was introduced, creating positions for an additional twenty-eight primary dealers. This allowance for increased participation was expected to reduce commission rates by 25% to 35% and to result in increased volume.

Restructuring of the Regulatory System

Prior to the Big Bang, an inefficient regulatory structure plagued the City's marketplaces. This structure was developed during the early years of this century, when the authorities (primarily the Bank of England) sought to allay concerns about investor protection and the stability of the financial system. The Bank proceeded to formalize the separation of various financial services into distinct compartments, and encouraged the creation of self-regulating organizations within each compartment. The function of these organizations, which became known as "clubs," was to oversee the behavior of the firms participating in the market and to provide a channel of communication between the firms and the authorities.

Although these clubs offered many advantages, the arrangement soon became a high cost and inefficient one because resources were duplicated among the many self-regulating organizations. Furthermore, the clubs proved to be highly ineffective in new product development and in the introduction of new technologies. For this reason, many fringe institutions developed in efforts to circumvent the restrictions of the clubs. Since these fringe institutions began to offer certain services (such as reduced commissions and volume discounts on transactions) barred by the rules to club members, it became even more apparent that regulatory change was necessary.

In November, 1986, the Financial Services Act instituted a new regulatory structure concerning all facets of the U.K. investment business. This act set up general principles of investor protection, which are in turn interpreted by the Securities and Investments Board (SIB). The board oversees five different Self-Regulatory Organizations (SROs), which adapt and refine the rules of the Act to make them applicable to the market they are regulating. It is hoped that this new structure, while overcoming previous constraints and inefficiencies, will improve investment regulation in the City, thereby making investors feel more safe in conducting transactions there.

The Effects of Deregulation

It has been noted by Leigh Pemberton, the Governor of the Bank of England, that "business likely will gravitate towards the (financial) centers offering the lowest transactions costs, the most liquid markets, the widest range of financial instruments and services, and the surest settlement and communication systems" (Putka, et al., p. 11). It was hoped that the changes instituted in the City from 1983 to 1986 would make the City highly competitive in these respects.

The City has indeed become more competitive since the deregulatory changes were made. The measures instituted have created a new era of international competition within the City. For example, 40–50% of the U.K. securities industry is now under foreign control. All of the City's major brokers and most of the City's jobbers — formerly independent — are now under the control of either foreign or British companies. Sixty of the 220 Stock Exchange members have been acquired, so that the City's most prestigious names are now owned by foreign institutions.

American firms have become considerably more active in the London market, such as Citicorp, Merrill Lynch, Salomon Brothers, and Prudential-Bache, to name just a few. Many European banks have also become more involved, including Credit Suisse, Union Bank of Switzerland, and Credit Commercial de France. Japanese firms such as Nomura Securities and Daiwa Securities have also increased their presence in the market. Finally, many British banks have become active in the investment business. Most notable among these are National Westminster Bank, Barclays Bank, Midland Bank, and Lloyds of London.

With the increase in the number of market participants, London's trading in foreign shares has surged. For example, a 1987 estimate indicated that London is doing 50 percent more business in foreign stocks than the NYSE and the U.S. over-the-counter markets combined. Trading has moved to the City from Sweden, Germany and other European countries in order to avoid high transfer taxes and/or commissions in these countries. According to Phillip

Gray, international investment manager at G.T. Management in London, the trades are moving to London because it is increasingly seen as a better capitalized, more efficient market. Furthermore, according to David Head, the chief international trader at Shearson Lehman-Hutton (London), customers are going to London "because it is cheaper. It's as simple as that" (Putka, April 3, 1987).

The End Result

What will be the end result of the sweeping movement towards participation in securities transactions in the City? The primary underlying motivation of market participants at present is simple—survival. Each firm is working with a goal of strength through efficiency and capital, so that it will not need to merge—or, worse, be acquired—to be competitive.

To be able to survive, however, firms must ensure that the demands of their customers are met. What are the needs of the clients of financial services firms? Most cutomers are interested in four aspects of financial service. First of all, clients demand access to a variety of investment alternatives. Second, they want to be furnished with timely and accurate information and advice about investment alternatives, so they can make sound investment decisions. Third, customers wish to have their transactions processed quickly. Institutional investors especially realize that exercising transactions rapidly can mean the difference between gains or losses of millions of dollars. Finally, investors desire low fees. They want to pay as little as possible for the services provided to them by investment firms.

In the future, then, only those firms which can service their customers according to these requirements will survive. Many firms at present are becoming increasingly aware of this as they merge and acquire new firms. For example, foreign firms are merging with companies which already have expertise in dealing with clients in London. They are also acquiring small "market-niche" firms with expertise in specialized financial areas.

So when the pace of mergers and acquisitions slows, the result will be a small number of one-stop "financial supermarket" businesses which can conduct transactions effectively and efficiently in the City, while they provide customers with the diversity of services demanded. And as a result, the City, composed of an industry of financial giants, will remain one of the most competitive financial marketplaces in the world.

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