

---

# The UK financial system

Theory and practice

second edition

---

Mike Buckle and John Thompson

Manchester University Press

Manchester and New York

distributed exclusively in the USA and Canada by St Martin's Press

# Contents

	Preface to the second edition	ix
	Preface to the first edition	x
<b>1</b>	<b>Introduction to the financial system</b>	<b>1</b>
1.1	Introduction	1
1.2	The role of the financial system	1
1.3	Financial claims	4
1.4	Sectoral analysis of the financial system	12
1.5	National wealth	12
1.6	Sector balance sheets	14
1.7	Sector financial transactions	18
1.8	Financial accounts for the UK economy	22
1.9	Conclusion	27
<b>2</b>	<b>Financial intermediation</b>	<b>28</b>
2.1	Introduction	28
2.2	Financial intermediation	28
2.3	Implications of financial intermediation	32
2.4	Rationale for the existence of financial intermediaries	39
2.5	Evolution of financial systems	43
2.6	Recent developments in the UK financial system	45
2.7	Market structure and financial innovation	52
2.8	Conclusion	56
<b>3</b>	<b>Retail banking</b>	<b>57</b>
3.1	Introduction	57
3.2	Nature of retail banking in the UK	57
3.3	Payments services	60
3.4	Risks in retail banking	62
3.5	The role of the Bank of England	66
3.6	Conclusion	72

<b>4</b>	<b>Wholesale and international banking</b>	<b>73</b>
4.1	Introduction	73
4.2	Nature of wholesale banking	73
4.3	Off-balance-sheet business	80
4.4	International banking	86
4.5	Sovereign lending crisis	94
4.6	Conclusion	101
<b>5</b>	<b>Other deposit-taking institutions</b>	<b>102</b>
5.1	Introduction	102
5.2	History of the building society movement	103
5.3	Competitive pressures on building societies	105
5.4	Consequences of the competitive pressures	111
5.5	After the Act	114
5.6	The balance sheet of building societies	116
5.7	The finance houses	118
5.8	Conclusion	119
<b>6</b>	<b>Investment institutions</b>	<b>121</b>
6.1	Introduction	121
6.2	Types of investment institution	121
6.3	General insurance	122
6.4	Nature of the liabilities of pension funds and life assurance companies	124
6.5	Portfolio investment of pension funds and life assurance companies	128
6.6	Unit trusts and investment trusts	133
6.7	The performance of institutional investors	137
6.8	Conclusion	139
	Appendix 1: Lloyd's of London	139
	Appendix 2: Hedge or leveraged funds	146
<b>7</b>	<b>Financial markets: introduction</b>	<b>148</b>
7.1	Introduction	148
7.2	London as an international financial centre	148
7.3	The nature of markets	152
7.4	Hedging, speculation and arbitrage	154
7.5	The efficient markets hypothesis	155
<b>8</b>	<b>The market for equities</b>	<b>158</b>
8.1	Introduction	158
8.2	The primary market	158
8.3	The secondary market for private securities	165

8.4	The Stock Exchange and the efficient markets hypothesis	176
8.5	Conclusion	178
<b>9</b>	<b>Interest rates and the bond market</b>	<b>180</b>
9.1	Introduction	180
9.2	The level of interest rates	182
9.3	The market for gilt-edged securities: new issues	184
9.4	The market for gilt-edged securities: the secondary market	187
9.5	The corporate bond market and credit ratings	189
9.6	The expectations theory of the term structure	191
9.7	The preferred market habitat theory of the term structure	196
9.8	Market segmentation theory of the term structure	197
9.9	Empirical evidence	197
<b>10</b>	<b>The sterling money markets</b>	<b>200</b>
10.1	Introduction	200
10.2	The traditional discount market	202
10.3	The parallel sterling money markets	208
10.4	Short-term interest rates and inflation	212
<b>11</b>	<b>The foreign exchange market</b>	<b>214</b>
11.1	Introduction	214
11.2	Nature of the forex	218
11.3	Nature of business	220
11.4	The efficiency of the foreign exchange market	221
<b>12</b>	<b>Euro-securities markets</b>	<b>226</b>
12.1	Introduction	226
12.2	Eurobonds	226
12.3	Euronotes	233
12.4	Euro-equities	236
12.5	Use of swaps in euro-securities markets	237
12.6	Securitisation	238
12.7	Conclusion	241
<b>13</b>	<b>Financial derivatives</b>	<b>242</b>
13.1	Introduction	242
13.2	The organisation of LIFFE	244
13.3	The nature of financial futures	248
13.4	The nature of options	254
13.5	Swaps	260
13.6	Forward rate agreements	263
13.7	The efficiency of derivatives markets	265
13.8	Conclusion	267

<b>14</b>	<b>Managing risk via the financial markets</b>	<b>268</b>
14.1	Introduction	268
14.2	Nature of risk	271
14.3	Managing exchange rate risk: internal methods	273
14.4	Managing exchange rate risk: external methods	275
14.5	Managing interest rate risk	286
14.6	Conclusion	289
<b>15</b>	<b>The single European market in financial services</b>	<b>291</b>
15.1	Introduction	291
15.2	A single European market in financial services	292
15.3	Likely effects of the liberalisation of EU financial services	295
15.4	European economic and monetary union	297
15.5	Conclusion	300
<b>16</b>	<b>The efficiency of the UK financial system</b>	<b>301</b>
16.1	Introduction	301
16.2	Efficiency of the financial system	302
16.3	Short termism	308
16.4	An alternative explanation of short termism	311
16.5	Remedies for short termism	312
16.6	Conclusion	313
<b>17</b>	<b>Regulation of the financial system</b>	<b>315</b>
17.1	Introduction	315
17.2	History of bank failures	315
17.3	Reasons for the prudential control of banks	320
17.4	The UK system of prudential control of banks	324
17.5	Control of investment business	333
17.6	Conclusion	335
<b>18</b>	<b>Conclusions</b>	<b>336</b>
18.1	Nature of the UK financial system	336
18.2	The financial system and monetary policy	337
	Glossary	340
	References	348
	Index	354