The Consequences of Financial Deregulation: the London “Big Bang”

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12 January 2018
Financial Deregulation

• Reduce barriers to entry to increase competition
• Reduce barriers to access to financial services
• Increase efficiency
• Controversial: systemic importance of sector, information asymmetries, pricing of risk, mobility of market
• Strong supervisory structures
• Strong governance
• London Stock Exchange – a self regulating organization (transparent price setting through market, fees/rules, collective insurance against fraud)
• Eurobond market – unregulated, foreign
Big Bang 27 October 1986

End of fixed commission on brokerage

- End of separation of Brokers (dealers for customers) and Jobbing (market makers for brokers)
  *Single Capacity*

- Considered a protection to customers that dealers not trading on own account

- Gilt Market reforms: increase competition for tenders, liquidity of market
  - 2 jobbers control 70-80% of gilt market

- Open membership of Stock Exchange

- New Curbs on self-regulation (Financial Services Act, Securities Investment Board)

- New IT system
‘Without [Big Bang], it is doubtful if London would have retained its place as Europe’s pre-eminent financial centre, and certain that it would not have become the foremost truly international financial centre of the modern globalised economy that it is today, to the great benefit of the British economy as a whole’

Nigel Lawson (2006)
Total Value of Stocks Traded (current US$ million)

Source: World Bank
Road to Big Bang (UK)

• UK Competition and Credit Control 1971
  • Interest rate competition, wholesale market open to banks, lower liquidity requirements
  • Fringe Banking Crisis 1974

• ISRO: International Securities Regulatory Organisation
  • Eurobond OTC market dominated by US firms
  • Reuters discussing support price disclosure
  • LSE threatened in London
Road to Big Bang (UK)

• Fair Trading Act 1973 (extended to services); Restrictive Practices Court Act 1976

• **End of exchange controls 1979: relocation, capital flows to NY out of London**

• Stock Exchange Rule Book referred by Director-General of Fair Trading 1979:
  • Thatcher refuses to exempt LSE, scheduled for Jan. 1984 (share-owning democracy)
  • Michie (2001) RPC delays reform

• 1983 deal: voluntarily end fixed commissions by 27 October 1986

• 1986 Financial Services Act: bureaucratic, controversial
Road to Big Bang (USA)

- Relaxation of reporting/disclosure terms for foreign issuers in NY 1979/81
- Depository Institution Deregulation and Monetary Control Act 1980: banks and thrifts freer to compete with nonbank financial firms
- 1982 and 1984 relaxation in obstacles to Mergers: lower concentration index, efficiencies included in deciding whether to allow mergers
- Computer IT changes operations, barriers to entry
US ‘May Day’ 1975

- End of fixed-rate commissions: off board trading
- Competition: discount brokers
- Size matters: capital, scale required
- Mergers and Acquisitions
  - Horizontal to build capital, efficiencies, sales force
  - Vertical to build into new markets and products
  - Banks’ participation limited by Glass-Steagall
- Commissions **fall** for institutional investors (25c to 8c per share) and **rise** for retail investors (30c to 40c)
- Trading volume rises but returns fall (commissions fall from 50% to 25% of revenues by 1984)
- Diversification into other fee generating business: corporate finance, research
- Trading on own account (conflict of interest with customers)
Muriel Siebert: first woman Member of NYSE
Discount retail brokering
Also offering institutional services at discount
Don’t need research or advice
Impact of Big Bang

- Stock Exchange Membership rises (187 ISRO)
  - Gilt jobbers increase from 8 to 27
- Commissions rise for small trades, fall for large trades
- ISRO members and foreign firms allowed to acquire existing member firms or become members themselves (distinct from May Day)
- Diversification/Cross-Border Conglomeration: financial conglomerates and universal banking
Mergers and Acquisitions

• 1986: London merchant banks acquire stakes in 11 brokers and 3 jobbers
  :65 Foreign institutions acquire stakes in 90 brokers and 15 jobbers
• Shift from partnerships to public companies changes burden of risk from owners to shareholders
• But other Opportunities also drive conglomeration: Corporate IPO, privatization wave, interest rate volatility and surge in bond market trading, Single European Act Feb. 1986 (single market looming 1992)
• Barclays buys Zoete and Bevan (broker) and Wedd Durlacher (jobber)
• SG Warburg buys Akroyd & Smithers (jobber), Rowe & Pitman (broker) and Mullens & Co. (govt broker)
• Smith Brothers (equities jobber) merge with Scott Goff Layton (broker) to become Smith New Court
• Security Pacific Bank bought broker Hoare Govett and jobber Charles Pulley
• Citicorp buying Scrimgeour Kemp-Gee and Vickers da Costa
• Midland Bank buys Greenwell and Co
Number of M&As in the UK Financial Sector - By types of TARGET companies - 1981-1989

Number of M&As in the UK Financial Sector - By types of acquirer companies - 1981-1989

- Bank
- Jobber
- Broker
- Assurance
- Financial Group
- Investors
Nationalities of Acquirer Companies - 01.1981-12.1986

British: 50.00%
Europe: 8.96%
USA: 3.73%
Various (Investors): 16.42%
Other Countries: 20.90%


British: 57.55%
Europe: 6.12%
USA: 12.24%
Various (Investors): 17.14%
Other Countries: 6.94%

Morgan Grenfell

- Traditional, prestigious London Merchant Bank
- Build equity trading from scratch: September 1985 recruit John Holmes (UK) from Hoare Govett and Geoffrey Collier (NY) from Vickers da Costa + 300 staff
- November 1986: insider trading scandal Collier
- December 1986: take over CJ Lawrence in NYC
- January 1987: Guinness Scandal
- October 1987 crisis
- August 1988 onward, losing £13m in Sept-Nov (£1m per week)
- December 1988 close equities and gilts: layoff 450 staff (82% re-hired elsewhere in City)
- 1989 taken over by Deutsche Bank
Verdict on M&A

*Clemons and Weber* (1990): ‘mergers led to conflict in style and business culture and to large-scale defections. There appear to be serious difficulties when bankers move into securities broking’

*Bellringer and Michie* (2014): ‘What Big Bang had done was to expose the City of London’s brokers, dealers and investment bankers to external competition and, even when combined, they lacked the scale, culture and management required to survive’

• Wimbledon-isation

• Literature suggests impact of M&A for financial institutions is at best neutral for performance and do not yield safer firms or more resilient systems
Cross Border Claims of US and UK Banks by Nationality of Reporting Bank

[Graph showing the cross border claims of US and UK banks by nationality of reporting bank from 1983 to 2004.]
Registered Banks' Cross-Border Claims by Nationality of Bank as % of All Reporting Banks (BIS)
Operations Impact

• SEAQ: Stock Exchange Automatic Quotation System
  • 28 firms had trading pitches on Big Bang day compared with 19 previously
  • But in first week only one quarter to one third of trading was on the floor.
  • Floor crowd fell from 1800-2000 people to 200-300 a week later

• Banks build their own dealing floors ‘over 70% of banks who took space in the City in 1985 took in excess of 10,000 square feet’ (Lenon 1987)

Canary Wharf: new financial centre for London
FT (27/10/86) Development Co. Bankrupt in 1992
John Wilson, head of equities at James Capel: ‘The speed of transition to screen trading surprised me. I thought all the information you needed was on the floor: eye contact, sweat, movement. You could always tell from the eyes of the junior trader whether his boss was long or short, and how badly they wanted to get out of their position’

1989 survey of 69 people/firms – notes that 86% regret the move from the floor and 72% were surprised at the speed. Good for speed of information, bad for feel for market and interactions
Conclusions 1

- Not deregulation, not a ‘Bang’
- Big Bang needs to be viewed as one of a series of reforms in UK and USA and global securities markets
- Reaction to market evolution after end of exchange controls as much as creating a new framework
- Political drive to promote retail shareholding
- Impact due to open-ness of London to foreign capital, expertise: not UK firms
- Financial Services Act – onerous reporting requirements – SIB governance over SRO (not deregulation)
Conclusions 2

• Financial innovation and regulation encourage off-balance sheet activity
• Impetus for scale and cross border markets decreases transparency
• Governance of transnational financial conglomerates challenging
• Cross Report (1986) ‘how the central banks would respond to the collapse of a major international investment bank that posed a threat of contagion remains to be seen’