cc B/UP

PRIME MINISTER 11 April 1986

BIG BANG: A PROGRESS REPORT

Big Bang takes place on 27 October. Then, the Stock Exchange abandons its two major restrictive practices:

(i) fixed commissions - the cartel agreement on charges for trading securities; and

(ii) single capacity - the rigid division between brokers (trading for customers on an agency basis) and jobbers (trading as principals on their own account).

The other main restriction - preventing banks and foreign institutions from being members of the Exchange - was abandoned on 1 March.

The Big Bang will produce major structural changes in the UK securities industry, involving the way markets work, the players in the markets, the amount of risk they are prepared to take, and the regulatory framework of the industry.

Changes in the City as a result of Big Bang

Negotiated Commissions: The charges for buying and selling securities will be freely negotiated between the parties involved, and not fixed by the SE. The fixed commission cartel was the foundation of the old City arrangements. When

Cecil Parkinson removed it, all the other changes had to follow.

<u>Dual Capacity</u>: Individual security firms will be able to trade both on their own behalf and on behalf of their customers. This is a consequence of commissions being driven so low that firms will need a further source of income. Stockmarket firms will instead make their profits on the gap between the prices at which they buy and sell stock (their turn).

<u>Ownership</u>: Dual capacity in turn means more risk for stockbrokers, because firms may be holding large amounts of stock and hence exposed to big price changes. So they need more capital from outside. In the run-up to Big Bang, banks, financial conglomerates and foreign banks and security firms have bought up stockholders to join the SE. Already over two-thirds of SE turnover is in the hands of firms owned by banks (British banks account for about one-third).

<u>Unbundling of Services</u>: Fixed commissions subsidised certain services (research, price information, comment) for which there were no direct charges. Competition will force firms to unbundle their services and charge each item separately to reflect full cost. This gives investors greater choice, and will improve efficiency.

<u>Statutory Regulation</u>: The Financial Services Bill proposes a statutory framework for all investment business. But we are trying to keep some of the traditional British approach - the

lawyers will not take over completely. Instead, the Securities Investment Board and the six Self-Regulatory Organisations will be private bodies staffed by practitioners, though with statutory duties delegated to them.

The Issues

The key questions are:

- Will changes in commissions deter the small investor?
- What are the effects on the City's ability to raise funds for industry and Government?
- Will we see boom and then bust?
- Will there be more embarrassing fraud cases?
- Have we got the regulatory régime right?
- Will the technology be ready?

Commissions and the Small Man

At the moment, commissions are fixed as a percentage of the value of a transaction, though with some tapering. Excluding VAT and Stamp Duty, the commission on a straightforward share transaction is something like this:

Value of Transaction	Commission (approx)
£1,000	£15
£10,000	£150
£10m	£21,000

But there is hardly any difference in the cost to a City firm of buying £10 million of ICI shares for the Pru or £1,000 of ICI shares for a popular capitalist. If anything, the small transaction is more expensive, as several such transactions often have to be added together before approaching a jobber. So there is a hidden subsidy to the small man which will be competed away. Brokerage costs for the big investor will fall enormously, but for small transactions they might rise in the short term to about £30.

This looks rather odd for a Government trying to encourage popular capitalism. But we can expect the situation to right itself in two ways:

i. Some of the organisations buying into the SE have big retail networks (the clearers, for example). They will want to offer direct share-dealing services at their high street branches at a modest price.

ii. Electronic broking will cut costs.

We can expect a cheaper, no frills service aimed at the small investor to develop.

Funds for Industry and Government

The City's job is to make it easier for the rest of us to raise funds. Increased turnover means increased liquidity for those stocks traded more actively. Investors benefit. But this - together with reduced fees charged by the institutions - should also help companies and government raise capital on better terms.

Twenty eight firms have been admitted by the Bank of England as primary dealers in the gilts market: this gives them privileges (eg a direct dealing relationship with the Bank, borrowing facilities, etc) as well as responsibilities (to make a continuous and effective market under all conditions). This is an enormous number - we must expect a shake-out. We may well find more turbulence in gilts prices than we experienced before.

Boom and Bust?

The last major deregulation in the City was in banking - Competition and Credit Controls in 1971. It was followed by the property boom of 1972-73, the market collapse of 1974, and then the fringe bank crisis of 1974-75. Might not something similar happen following the deregulation of the securities industry?

1986 is different from 1971 for two major reasons:

i. In 1971 there was not an adequate framework of banking supervision. We have learnt from our mistakes. In a sense, Johnson Matthey came at just the right time. It gave a jolt to our bank supervision arrangements shortly before Big Bang. The Financial Services Bill also fills a gap.

ii. Monetary conditions are much tighter.

This does not mean that there might not be individual financial failures as a result of bad commercial decisions; but we do not expect a systemic problem.

Fraud

Under the old system, the separation of brokers from jobbers was a method of investor protection: because the broker did not deal off his own account, the investor was always assured of the best price. Under the new system, firms will run their own book, act as brokers for clients, and manage funds in a fiduciary capacity: the result is an opportunity to dump losses on clients.

The Financial Services Bill deals with this problem in two ways: by disclosure of information to ensure the "best execution price"; and the duty, where there is a conflict of interest, to put their customers first. But in a bear market when profits are squeezed other firms will be under great pressure to pass losses on to the client.

City conglomerates are erecting Chinese Walls to divide up their businesses (though City cynics say that every Chinese Wall has a creeper trailing over it). The US attempts to deal with the problem through the Glass-Steagall Act, which separates the securities business from banking. Japan has a similar law. It must be open to question as to whether we shall some day, after a nasty scandal, be forced in the same direction.

Have we got the new Regulatory Bodies right?

Mr Nelson's amendment making the SIB the only body which can regulate the securities industry did little to change the Financial Services Bill. His other amendments, however, would have made the SIB a conventional government agency - with its budget, staffing and powers under full departmental control. This would have alienated the practitioners whose co-operation is vital if SIB is not to become an adversarial regulatory agency like the SEC. It would also bring all SIB's staff and expenditure within Treasury constraints - and we would probably lose the services of practitioners like Sir Martin Jacomb and Mr Mark Weinberg.

Resisting Mr Nelson's amendments does not mean a weaker regulatory system - on the contrary, it distances Ministers from the day-to-day surveillance of the financial markets, yet requires full accountability to Minister (and Parliament) that "an adequate level of protection" for investors is constantly maintained.

Big Bang is on 27 October 1986, but the Financial Services Act doesn't come into operation until various dates in 1987. The delay could create dangers. There will be a period when competition and risks increase, especially if there is a bear market because, say, Labour is ahead in the polls. DTI could, if pressed, bring forward the administrative arrangements - though it would be a rush, and mistakes might be made.

Will technology and systems be installed by 27 October?

Big Bang requires companies to install new electronic settlement systems which also provide information regarding their positions and margins. Some City firms are in trouble over their technological preparations. Either they will not be able to be active players immediately following Big Bang; or, if they are active, they might find profitability being eroded quickly without realising it. There is a risk literally of wires getting crossed and the system breaking down.

Conclusions

1. Big Bang extends competition to the securities industry. Competition will produce tangible benefits for borrowers and lenders.

2. But increased competition involves increased risks. These are likely to be greatest in the equity markets: in the gilts market, the Bank is monitoring risk-taking very carefully.

3. The regulatory bodies have as much potential power as the SEC - but remain practitioner-based rather than extensions of central government.

4. Because of the post-Big Bang delay in implementing regulation, the failure of some firms to install technology, and the inevitable risks of adapting to a new environment, the first 6-9 months look like being turbulent.

5. The outcome depends critically on the part the SIB choose to play - which in turn comes down to their staffing. It may be opportune to call for a report, including their plans for expansion, method, recruitment and funding.

Brian Griffiths
BRIAN GRIFFITHS

David Willetts
DAVID WILLETTS

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PRIME MINISTER

BIG BANG

You asked before Easter for a note setting out details of the changes which would happen with the Big Bang. A note from Brian Griffiths and David Willetts below explains the position.

You also thought it would be worth considering a seminar to be held either here or at the Bank which would be attended by people from the Government and the City to talk about the Big Bang.

I have discussed this with Bernard. We are both doubtful about it. The main lines of the regulatory framework have already been decided. The Financial Services Bill is going through the House, and it would be very undesirable for an impression to be given that you or other members of the Government had any doubts about its effectiveness. And unless the seminar produced new ideas or proposals for changes to the regulatory framework or other ideas to forestall problems after the Big Bang it could too easily give the appearance of concern without action, or as if you were simply wanting to inform yourself about what was likely to happen.

But there is equally a risk that departments now have their eyes firmly on the trees which have been planted, not on the shape of the wood they will produce. One possibility would be to commission a paper from the Treasury, Department of Trade and Industry and Bank of England which would be a situation report on how the Financial Services Bill is likely to come out, the state of preparation of the SIB and the other regulatory organisations, and how well the banks and brokers will themselves be prepared by 27 October (e.g. on technology). This could lead to a stock taking meeting with the Chancellor, the Governor and Mr. Channon.

Agree to commission a paper as the basis for a meeting?

Yes please MT

DRN

(DAVID NORGROVE)

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