UK Financial Regulations

Made Easy

Towards the LIBF Syllabus
2024-2025

Revision Guide

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The UK Financial Regulations Made Easy Revision guide is to be used in addition to the main accredited Textbook and will never replace the detail contained there.

It was written as a breakdown of the syllabus with an intention to support the reader's understanding of the main aspects of the text and will serve as an appropriate revision guide to help pass the CeMAP 1 Exam.

The UK Financial Regulations Made Easy Revision guide published in June 2024 provides information for the LIBF 2024/25 UK Financial Regulations Syllabus. While the team has used all their efforts in preparing this book to the highest standards, there are no promises or warranties in respect of the accuracy or completeness of the content of this book with updated changes from the appropriate financial bodies.

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ABOUT OUR MADE EASY GUIDES

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ICONS USED IN THIS BOOK

Look for these icons throughout our Made Easy Books for visual clues to help your studies.

CALCULATIONS
This icon appears areas where calculations and formulas are explained

KEY POINTS
Based on LIBF syllabus and mock papers these are Key Areas to acknowledged.

PLEASE NOTE
These sections are notes, summaries and areas that need to be noted based on changes or amendments.

EXTERNAL LINKS
As in the LIBF Syllabus some areas are too large and cannot be broken down to be placed in the manuals or may change throughout the financial year. Here you can find links to the relevant resources.

CONTENTS

UNIT 1

FINANCIAL SERVICES ENVIRONMENT AND PRODUCTS

TOPIC 1 INTRODUCTION TO THE FINANCIAL SERVICES INDUSTRY

By the end of this topic you should have an understanding of:

- intermediation and its role in the financial services industry.
- the role of the Bank of England.
- mutual and proprietary organisations.
- credit unions.
- the difference between retail and wholesale banking.

1.1 Why do we need money?

Money acts like a special key that unlocks the doors of trade. But for it to work well, it needs to have some key qualities:

- Enough to go around: We need the right amount of money so that everyone can easily use it to buy and sell things.
- Universally accepted: Money has to be something that everyone agrees to use. It's like having a common language for transactions.
- Easy to split: Money can be divided into smaller parts, so you can buy things of different values without any hassle.
- Portable and convenient: You can carry money with you wherever you go, making it easy to buy things even in different places.

But money isn't just about buying and selling. It's also like a time capsule that preserves its value over time. For example, if you have £100 in cash today, it'll still be worth £100 a year from now. However, remember that inflation can impact how much you can buy with that money later on.

1.2 What is intermediation?

Intermediation:
Intermediation is like a helpful role played by banks. Imagine there are two parties - one with extra money (surplus party) and another in need of money (deficit party). The bank acts as the middleman, borrowing money from the surplus party at a low interest rate and lending it to the deficit party at a higher interest rate. The bank's profit comes from the difference between these interest rates.

Disintermediation:
Disintermediation is when lenders and borrowers directly interact, without involving a middleman like a bank. For instance, a company looking to raise funds for a new project can create a crowdfunding website. On this platform, the company promotes its project to potential investors who are willing to lend money in exchange for rewards or benefits.

The four elements of intermediation

There are four main reasons why both individuals and companies need the service of intermediaries and these relate to following factors.

Geographic location – Physical location problem where lenders and borrowers would have to locate each other and may be restricted to own area or circle of contacts and not aware of others outside of that, but they may have easy access to branch of a high street bank.	**Aggregation** – Not every potential borrower may have enough money available to satisfy the borrower's requirements. Intermediaries can overcome this size difference by aggregating small deposits.
Maturity transformation – Borrower may need funds for a longer period of time than the lender is prepared to agree too. Intermediaries are able to overcome this mismatch by offering a wide range of deposit accounts to a wide range of depositors.	**Risk transformation** – Due to risk of default or fraud, individual depositors are generally reluctant to lend all their savings to another individual or company. Intermediaries enable lenders to spread their risk over a variety of borrowers, so if there is a failure to pay the intermediary can absorb the loss.

Risk Management

Another way of risk transformation is through insurance in which an individual contributes to a fund through insurance premiums. This pool of funds helps to spread and minimize the financial losses that may occur due to unexpected events.

'Product sales' intermediaries

They act as a bridge between the companies selling financial products and the potential customers. These intermediaries include Financial Advisors (FA's), insurance brokers, and mortgage advisers. They help match customers with the right products and guide them through the process.

1.3 Financial institutions

This is an introduction into some of the types of financial institutions that make up the financial services industry in the UK. This will be covered more in Unit 2.

The Bank of England

The Bank of England is the UK's central bank and acts as banker to the government in supervising the economy and regulating the supply of money.

KEY POINT

Its mission is "to promote the good of the people in the United Kingdom by maintaining monetary and financial stability". In doing this it performs several important roles, its mains functions being:

Issuer of Banknotes – Ensures that an adequate supply of notes is in circulation.

Banker to the government – The Bank of England holds the government's own account and provides financial cover of any deficit by making automatic loans to the government, or if a surplus then the bank may lend out as part of general debt management.

Banker to the banks – All major banks have an account with the Bank of England for depositing or obtaining cash and other transactions. This gives the Bank of England considerable influence by being able to change the rate of interest it charges to any banks that borrow affecting the money market.

- **Advisor to the government** – Since 1997 the bank's Monetary Policy Committee (MPC) has had responsibility for setting interest rates. They meet 8 times a year with a mandate in setting the base rate to ensure government inflation target is met.
- **Foreign exchange market** – Manages the UK's reserve of gold and foreign currencies on behalf of the Treasury.
- **Lender of the last resort** – Makes funds available when the banking system is short of liquidity to maintain confidence in the system.
- **Maintaining economic stability** – The Bank of England's Financial Policy Committee (FPC) is responsible for identifying and monitoring risk that could affect the economy.

Previously The Bank of England was responsible for managing new issues of gilt-edged securities before this was transferred to HM Treasury's Debt Management Office to avoid conflict of interest with the Banks responsibility for setting interest rates.

Gilt-Edged Securities
More commonly known as Gilts and are loans to the government and are available in a wide range in issue offering loans at different rates of interests over different periods. (Covered in more detail in Topic 6).

The Bank of England's Role as a Regulator
The Financial Service Act 2012 that took effect from 1st April 2013 divided responsibility for the financial stability between the Treasury, the Bank of England and the two new regulators in the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

This Act was then modified to the Financial Service Act 2016 and provided more powers to the Bank by bringing the PRA within it establishing a new Prudential Regulation Committee (PRC). (Regulated bodies covered more in Topic 17)

Proprietary and mutual organisations

Proprietary Organisations
This accounts for most of the large financial institutions and are limited companies that are owned by shareholders with the right to share the distribution of company profits in form of dividends. They can also contribute to decisions about how company is run by voting at shareholder's meetings.

Mutual Organisations
Not constituted as a company so does not answer to shareholders, and in effect is owned by its members (those who deposit, borrow or are policy holders) who can determine how company is managed through general meetings.

Most common types of mutual organisations are building societies, friendly societies and credit unions.

Demutualisation
Demutualization is a process where a building society transforms itself into a bank and changes its status to become a public limited company. This change requires approval from the society's members, as governed by the Building Societies Act of 1986.

During demutualization, members often receive a windfall or financial gain due to the conversion. To prevent opportunistic behaviour known as "carpet bagging," where people open new accounts just to profit from subsequent share allocations, building societies may restrict the opening of new accounts during this process to protect their existing members.

What is a credit union?

A credit union is a mutual organisation generally operating as an alternative to 'loan sharks', providing savings and reasonably priced short to medium term loans for the benefit of their members and supported by the government through a number of initiatives and enacted legislation to help widen the scope. They are authorised and regulated by the FCA and savers are protected through the Financial Services Compensation scheme.

In order to join, a credit union member must meet the membership requirements, pay any required entrance fee, buy at least one £1 share in the union. Credit Unions can choose whether to offer ordinary shares which are paid up bringing all the benefits of a normal credit union membership or as deferred shares, which are only payable in special circumstances. In either case all members are equal regardless of the size of their shareholding.

Credit unions are owned by its members and controlled through a voluntary board of directors, elected from current credit union members at the annual general meeting (AGM), though day to day running is usually carried out by employed staff.

<u>What products and services does a credit union offer?</u>

Credit unions offer the following products and services to their members:

- Savings Facilities: Members can deposit their money into savings accounts, where they may receive either a fixed rate of interest or a yearly dividend payout based on the profits made by the credit union in that year. Credit unions paying interest must have proper systems and controls in place and maintain a reserve of at least £50,000 or 5% of total assets (whichever is greater).
- Loan Facilities: Members' savings create a pool of money that can be lent to other members. Credit unions typically offer loans with an interest rate of about 1% of the reducing balance each month, with a legal maximum of 3% of the reducing balance.
- Additional Services: Many credit unions also provide extra services such as basic bank accounts, insurance offerings, and mortgages to stay competitive in today's financial marketplace.

Retail and wholesale banking

The main difference between retail and wholesale transactions is that of size with wholesale being generally the larger.

<u>Retail Banking</u>

These are banks that provide more general services to customers such as deposits, loans and payment systems. Acting as intermediaries between those that wish to borrow money and those that are prepared to deposit. The price for borrowing and reward for investing is the interest paid.

<u>Wholesale Banking</u>

This refers to the process banks providing funding for other financial institutions (pension funds, government agencies) or larger corporate clients (mortgage lenders, real estate developers).
For example, if a bank spots an opportunity to make a substantial profitable loan but does not have adequate deposits, it can raise money very quickly on the interbank market.

Building societies are also permitted to raise funds on the wholesale markets but unlike banks they have a restriction of 50% of their liabilities with remainder coming from deposits.

What are Libor and Sonia?

London interbank offered rate (Libor) was the benchmark rate of interest charged in the inter market acting as a reference rate for most corporate lending. Rates were fixed daily and can vary in maturity from overnight to up to a year.

Libor was calculated using information submitted by major London banks on the interest rates they are paying to borrow from other banks to assess the health of the financial system.

> **<u>LIBOR Scandal</u>**
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> In 2012, it was found that banks were lying about their interest rates to make more money or seem more reliable. A review suggested that banks should use actual interbank deposit transactions for Libor rates and keep records of these transactions. It also said the rates should be published. The Financial Services Act 2012 made it a criminal offence to knowingly make false or misleading statements in relation to Libor.

As a result of the Libor scandal, a shift has been made to Sonia (sterling overnight index average) in 1997 and administered by the Bank of England since 2016 with calculation and publication responsibilities also passing to the Bank following a reform of Sonia in 2018 (Bank of England, 2021). It is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight from other financial institutions and other institutional investors.

Financial institutions use Sonia to value around £30tn of assets yearly.