THE EVOLUTION OF BANK-BASED FINANCIAL SYSTEM IN THE UNITED KINGDOM

Sheilla Nyasha*, NM Odhiambo**

Abstract

This paper gives an overview of the banking sector in the U.K.; it highlights the reforms since the second half of the 20th Century; it tracks the growth of the banking sector in response to the reforms implemented over the past seven decades; and finally, it highlights the challenges facing the banking sector in the U.K. The country's banking sector consists of more than 340 commercial banks, with the Bank of England, which is the economy's central bank, at the apex. Since the 1970s, the U.K. government has implemented a number of banking sector reforms – in order to safeguard and improve the banking sector. The response to these reforms, by the banking sector, has been varied. As a result of these reforms, there has been an increase in the activity of foreign banks as the financial sector was regulated. There has also been an improvement in the Central Bank's oversight of the financial institutions, and an enforcement of the banks' capital-adequacy requirements. By any standard, the U.K. currently has one of the most developed banking systems in world. The country has enjoyed a substantial bank-based financial sector development over the years, and its institutional framework has also grown stronger. However, like any other financial system, the U.K. banking system still faces wide-ranging challenges, such as less than adequate disclosure standards, contagion risk from the euro zone, squeezed interest margin and uncertainties caused by changes in regulatory regimes.

Keywords: United Kingdom; Bank of England; banking sector; reforms

JEL Codes: G20, G21, G28

*Department of Economics, University of South Africa, P.O Box 392, UNISA, 0003, Pretoria, South Africa
Email: smagombeyi@yahoo.com
**Department of Economics, University of South Africa, P.O Box 392, UNISA, 0003, Pretoria, South Africa
Email: odhianm@unisa.ac.za / nmbaya99@yahoo.com

1 Introduction

The role of banks in economic development is widely acknowledged in the literature. In particular, Schumpeter (1911) put the role of financial intermediation at the centre of economic development. He argued that financial intermediation, through the banking system, plays a pivotal role in the economic development; and it does this by affecting the allocation of savings, thereby improving productivity, technical change and the rate of economic growth. Further, banks play a central role in the development of every economy by mobilising resources for productive investments, and by being the conduit for the implementation of monetary policy (Sanusi, 2011). In support of the importance of banks in the economic growth of a country, Boyd and Prescott (1986) model the critical role that banks play in easing information frictions and therefore in improving resource allocation, while Stiglitz (1985) and Bhide (1993) stress that stock markets will not produce the same improvement in resource allocation and corporate governance as banks. In a separate study, King and Levine (1993) show that bank development helps to explain economic growth in a sample of more than 80 countries. Levine (1999) and Levine, Loayza, and Beck (2000) confirm this finding.

The endogenous growth literature also supports the argument that financial development has a positive impact on growth (Bencivenga and Smith 1991). Well-functioning bank-based financial systems are able to mobilise household savings, to allocate resources efficiently, to enhance the flow of liquidity, to reduce information asymmetry and transaction costs, and to provide an alternative to raising funds through individual savings (Bencivenga and Smith, 1991). In the light of these functions, it may confidently be stated that banks have a positive impact on growth.

In the U.K., most companies and individuals raise their capital through the stock market more, than they do through the banking sector. This led the U.K. to be labeled as a market-based economy. The market based financial segment of the U.K. financial sector has been overshadowing the bank-based financial sector segment, even in research circles. Despite the important role banks play in the economic development of the U.K. economy, the U.K. banking sector has not received adequate coverage in terms of research. The documentation of the U.K. bank-based segment of the financial sector is very scanty (Staikouras and Koutsomanoli-Fillipaki, 2006; Goddard et al., 2009; Freixas, 2010; Pisani-Ferry and Sapir, 2010). This paper aims to put the U.K. banking sector in the limelight – by providing an overview of the country's banking sector, its reforms, its growth and challenges – since the second half of the 19th Century – and through to 2011.

The rest of this paper is organised as follows: Section 2 gives an overview of the bank-based financial system in the U.K. Section 3 outlines the reforms implemented to revitalise the banking sector. Section 4 tracks the growth of the banking sector in the U.K., in response to the reforms. Section 5 highlights the challenges facing the development of the bank-based financial sector in the U.K. This is followed by the concluding section.

2 An Overview of Bank-Based Financial System in the United Kingdom

The Bank of England (BoE/the Bank) is the central bank of the United Kingdom. Sometimes known as the 'Old Lady' of Threadneedle Street, the Bank was founded in 1694, nationalised on 1 March 1946; and it gained independence in 1997. According to the Bank of England (2012a), the Bank is committed to promoting and maintaining monetary and financial stability as its contribution to a healthy economy. The Bank of England was founded in 1694 to act as the Government's banker and debt-manager. Since then its role has developed and evolved, centred on the management of the nation's currency and its position at the centre of the U.K.'s financial system (Bank of England, 2012a).

In the view of the Bank of England (2012b), public finances were weak when King William and Queen Mary came to the throne in 1688; the system of money and credit was in disarray; and a national bank was needed to mobilise the nation's resources. This need prompted William Paterson to propose a loan of £1,200,000 to the Government. In return the subscribers would be incorporated as the Governor and Company of the Bank of England. The money was raised in a few weeks and the Royal Charter was sealed on 27 July 1694, marking the start of the Bank's life as the Government's banker and debt-manager. In 1734, the Bank moved to Thread-needle Street, gradually acquiring land and premises to create the site seen today (Bank of England, 2012b).

The Bank managed the Government's accounts and made loans to finance spending at times of peace and war. It became a commercial bank too; it took deposits and issued notes. During the 18th Century, the Government borrowed more money. These outstanding loans were called the National Debt. Reliance on the Bank of England was such that when its charter was renewed in 1781, it was described as ' the public exchequer'. By then, the Bank was acting as the bankers' bank too. According to the Bank of England (2012c), it was liable to fail if all its depositors decided to withdraw their money at the same time. However, the Bank made sure it kept enough gold to pay its notes on demand (Bank of England, 2012c).

By 1797, war with France had drained the gold reserves. As a result, the Government prohibited the Bank from paying its notes in gold, a period known as the 'restriction period'. In the 19th Century, the Bank took on the role of lender of last resort, providing stability during several financial crises. During the First World War (1914-18), the National Debt soared to £7 billion (Bank of England, 2012c). The Bank helped manage Government borrowing and resist inflationary pressures. In 1931 the United Kingdom left the gold standard; its gold and foreign exchange reserves were transferred to the Treasury. But their management was still handled by the Bank and this remains the case today (Bank of England, 2012c).

In 1946, the Bank was nationalised. However, it remained the Treasury's adviser, agent and debt manager. During the 1970s, the Bank played a key role during several banking crises. The Bank was at the fore when monetary policy again became a central part of Government policy in the 1980s (Bank of England, 2012a). In May 1997, the Bank gained operational independence. The Government gave the Bank responsibility for setting interest rates to meet the Government's stated inflation target. This was enshrined in the 1998 Bank of England Act.

From the Bank of England's (2012a) perspective, the origin and history of the Bank is naturally one of interest, but also of continuing relevance to the Bank today; events and circumstances over the past three hundred or so years have shaped and influenced the role and responsibilities of the Bank; and these events have moulded the culture and traditions, as well as the expertise, of the Bank, which are relevant to its reputation and effectiveness as a central bank in the early years of the 21st Century.

In pursuing its goal of maintaining a stable and efficient monetary and financial framework as its contribution to a healthy economy, the Bank has two core purposes, which are monetary stability and financial stability (Bank of England, 2012a).

The U.K. banking sector is governed by, among other pieces of legislation, the Bank of England Act 1694; the Charter of the Bank of England 1694; the Bank Charter Act 1844; the Bank of England Act 1946; the Charter of the Bank of England 1998; the Bank of England Act 1998; the Banking Act 2009; and various Orders (Bank of England, 2012d).

In Accenture's (2012) view, the banking sector in the United Kingdom is unique in its size, breadth and diversity. The UK, and not just London, is home to a large domestic banking industry and a large international industry. The domestic sector is predominantly centred on personal and corporate lending whereas the international sector helps to enable the functioning of global capital markets and provides investment management services from the UK to corporations, governments and individuals around the world (Accenture, 2012).

According to the Bank of England (2010), services offered by banks increased during the 18th Century. Clearing facilities, security investments and overdraft protections were introduced. An Act of Parliament, in 1708, restricted banks with more than six partners from issuing bank notes. This had the effect of keeping private banks as small partnerships. Joint stock investment companies were already well established, but joint stock banks did not become well established until the century that followed (Bank of England 2010).

In the 19th Century, a new joint stock bank was formed. This was quickly followed by formation of other financial institutions. In 1844, the government introduced the Bank Charter Act to regulate the issuing of bank notes (Bank of England 2012c). Two banking institutions collapsed - one in 1866 and another in 1878 - causing significant reputation damage. However, as a consequence, record keeping and accounting improved. In 1896, twenty smaller private banks formed a new joint-stock bank (Bank of England 2012c).

With the outbreak of war in the 20th Century, banking flourished and a series of takeovers and mergers commenced (Bank of England 2010, p. 323). Introduction of computing, credit cards and many new services continued to drive the expansion of banks and as deregulation was introduced, competitiveness increased. Banks improved services, refurbished antiquated premises and brought in further technology such as ATMs. Currently, banks in the United Kingdom have refined their services with most offering very similar services - being distinguished only by offering different interest rates.

According to Silicon Valley Bank (2008), to date, the U.K. has a mature, competitive and efficient banking market comprised of domestic and foreign banks, building societies and credit unions. There are four major domestic banks that provide a full range of banking services to corporate clients. The major U.K. banks are direct participants in the clearing systems and have a nationwide branch network. This allows companies to hold one account and make deposit and withdrawals from any branch. Being direct participants in all the clearings, the major U.K. banks have a dominant share in processing payments by cash, checks and electronic payments. It is common for foreign banks to engage the clearing services of U.K. banks to offer domestic cash management services to their clients (Silicon Valley Bank, 2008).

According to IMF (2011), the U.K. financial sector is large, with bank balance sheets amounting to approximately five times GDP. Leading U.K. banks are among the most complex internationally in the world and London is a premier financial centre. Some major banks have more of a focus on retail and business banking, while others have material wholesale and capital markets businesses on a global scale. In addition to the six main banks and building societies, there are important foreign banks (both commercial and investment banks) and some 180 smaller banks and building societies (IMF, 2011).

The late 2000s financial crisis has materially affected the structure of the U.K. banking sector. In IMF's (2011) view, the U.K. banks faced losses from structured products and off-balance sheet vehicles to a degree, but also from asset quality problems in mortgages and business lending, as a result of previous high growth coupled with over-reliance, in some cases, on short-term wholesale funding. The IMF further highlighted that certain banks and building societies had strategic concentrations that led to asset quality problems, such as concentrations in commercial real estate. Mergers of banks were already occurring prior to the crisis, and subsequent mergers occurred as part of resolution of specific problems. Concentration in the banking sector has, therefore, increased. The five largest banks, the largest building society, and the largest foreign bank together account for close to 90% of retail deposits (IMF, 2011).

A number of medium-sized banks and building societies 'failed' during the crisis, and two large banks required material injections of public money. The authorities have conducted major stress tests of a range of banks as part of the response to the crisis and to determine recapitalisation needs. The United Kingdom has participated in European stress tests (IMF, 2011).

The British Bankers' Association (BBA) is part of the U.K. banking sector landscape. It is the leading trade association for the U.K. banking and financial services sector. The objective of BBA is to influence decision making through the promotion of a legislative and regulatory system for banking and financial services - in the U.K., Europe and internationally - which takes account of the association's members' needs and concerns and provides an effective and competitive market place in which their businesses can prosper. The BBA also promotes and defends the industry by engaging with government, devolved administrations and Europe as well as the media and other key stakeholders, to ensure the industry's voice is heard and to highlight the strength and importance of U.K. banking (British Bankers' Association, 2012).

3 Bank-Based Financial Reforms in the United Kingdom

Banking crises often result in new regulations. In the United Kingdom, a banking crisis in 1824–25 resulted in an important legislative change. Banks were no longer required to be small private partnerships sponsored by no more than six partners, but rather could be incorporated as joint-stock companies. These new banks, able to raise capital from shareholders, quickly took over older private partnership-based lenders (Bank of England, 2010). The number of joint-stock banks declined equally quickly, starting around 1875, as banks sought scale through acquisition. Over the same period, the volume of deposits grew rapidly, with banks gaining broader national reach by opening new branches. This meant that by 1900 much more banking was being done, but by far fewer institutions (Bank of England, 2010).

According to the Bank of England (2010), several key regulatory events in the second half of the 20th Century were then instrumental in even more fundamentally altering the structure of the U.K. financial system. These included, most notably, Competition and Credit Control in 1971 and the Big Bang in 1986. In 1971, Competition and Credit Control was introduced by the Bank of England, with the aim of promoting competition, both within the banking sector and between banks and the non-bank financial sector.

The 1971 reforms sought to end collusion on interest rates and began the process of widening the scope of banks' activities, breaking down old barriers between different types of intermediary. Among the measures introduced, deposit banks were allowed to participate freely in the wholesale market; previously they had only been able to do this through their finance house subsidiaries. The reforms also extended the scope of special deposits, whereby clearing banks were required to hold a percentage of their total deposits with the Bank of England. At the same time, liquidity requirements were relaxed. Before 1971, the clearing banks had been required to hold liquid assets equivalent to 28% of deposits - from 1951, the clearing banks held liquid assets equivalent to 28%–32% of total deposits. From 1963, this was formalised into a minimum liquidity requirement of 28%. From 1971, this was relaxed and extended, requiring all banks to hold reserve assets equivalent to 12.5% of eligible liabilities (Bank of England, 2010).

According to Cameron (1998), these reforms improved the relative competitiveness of clearing banks and were expected to trigger a gradual process of re-intermediation away from the fringe banking sector. However, fringe banks continued to expand after the introduction of Competition and Credit Control, in part reflecting economic expansion during the 1971–73 period and a relaxation of controls on property development (Capie, 2010).

This combination of regulatory and economic factors coincided with one of the most rapid periods of credit growth in the 20th Century. It also contributed to an on-going decline in banks' liquidity holdings, ultimately to below 5% of total assets by the end of the 1970s (Bank of England, 2010).

From 1939, only authorised U.K. banks had been permitted to deal in foreign exchange, to keep accounts in foreign currency for non-residents, and to carry out certain exchange-control functions. In the light of changes in the international monetary system over the course of the 1970s, these arrangements were deemed no longer appropriate, and in 1979, exchange controls were lifted.

At the same time, the 1979 Banking Act was passed. This Act, the first to establish a regime of banking supervision, created a two-tier system of banks and licensed deposit-takers. Although this distinction created some barriers to entry, Matthews *et al*., (2007) viewed the combined effect of these changes as increasing competition for U.K. banks from both foreign banks and non-bank institutions.

According to the Bank of England (2010), the differential between domestic sterling and euro sterling interest rates disappeared following the removal of controls, and international capital flows accelerated. With exchange controls also lifted in several other countries - the United States lifted some exchange controls in 1974, Japan in 1980, Australia in 1983, and France and other European countries in 1986 - gross capital outflows as a percentage of world GDP grew from an average of 2.8% during 1980–89, to 4.5% during 1990–99, and further to 8.7% during 2000–09.

The Bank of England (2010) further stressed that the abolition of exchange controls made subsequent financial liberalisation more likely, because businesses had an option to relocate to less tightly regulated jurisdictions. Such deregulation occurred over the course of the 1980s, particularly in 1986. As such, from the 1980s onwards, U.K. banks became increasingly global. Many established a presence overseas (either organically or through acquisition) and other cross-border business also expanded. By the peak in 2008, U.K. financial institutions' external assets were approaching six times GDP.

In 2000, deposit insurance was formed in the U.K., under the name: Financial Services Compensation Scheme (FSCS). The FSCS is the U.K.'s statutory fund of last resort for customers of financial services firms. This means that FSCS can pay compensation to consumers if a financial services firm is unable, or likely to be unable, to pay claims against it. The FSCS is an independent body, set up under the Financial Services & Markets Act 2000 (FSMA). The FSCS compensates 100% of the first £85,000 per person per firm (for claims against firms declared in default from 31 December 2010) (Financial Services Compensation Scheme, 2012).

In IMF's (2011) view, the global financial crisis of the late 2000s triggered further bank based financial sector reforms. The U.K. framework for crisis management and safety nets has evolved rapidly since the start of the crisis. The failure of some of its significant banks exposed significant gaps in the legal framework for bank resolution, prompting an emergency response in the form of the Banking (Special Provisions) Act of 2008. Consequently, the U.K authorities had to take decisive policy actions to support the stability of the financial system (IMF, 2011).

Following the Bank of England act as a lender of last resort to one of its failing bank in September 2007, the parliament passed emergency legislation in the form of the Banking (Special Provisions) Act in February 2008. It provided resolution tools - that were later enacted permanently in the 2009 Banking Act - to facilitate the resolution of failing banks. In April of the same year, the Bank of England, in coordination with HM Treasury and the Debt Management Office, launched the Special Liquidity Scheme (SLS), which allowed banks and building societies to swap their high-quality, mortgage-backed, and other securities for the U.K. Treasury Bills for up to three years (IMF, 2011).

In October 2008, at the height of the crisis, the U.K. authorities took several measures, which included: i) raising the guarantee on bank deposits from £35,000 to £50,000; ii) launching the Government Recapitalisation Scheme; and iii) launching the Credit Guarantee Scheme (Financial Services Compensation Scheme, 2012).

In January 2009, the U.K. Government introduced two other facilities. The first was an Asset-Protection Scheme to insure/guarantee participating banks' toxic assets. The second was an Asset Purchase Facility in which the Bank of England would buy high-quality assets, financed by the issue of Treasury Bills and the Debt Management Office's cash-management operations. In March 2009, the Monetary Policy Committee began a program of asset purchases for monetary policy purposes (quantitative easing) under the Asset Purchase Facility (IMF, 2011).

In February 2009, the Banking Act 2009 was passed. The Act established a permanent regime for the resolution of distressed banks and building societies. The Act also modified the arrangements for the liquidation and administration of insolvent banks and building societies. Also noteworthy are the provisions of Part 5 of the Act, which enhanced Bank of England's role in payment system oversight. The resolution regime was used successfully in the resolution of a moderate sized building society in 2009 (Bank of England, 2012d).

In June 2010, the Independent Commission on Banking, "the Vickers Commission," was established in the United Kingdom, to consider structural and related non-structural reforms to the U.K. banking sector, to promote financial stability and competition. It was established in the wake of the global financial crisis, which began in 2007. The Commission made its recommendations to the U.K. Government on 12 September 2011. Its headline recommendation was that British banks should 'ring-fence' their retail banking divisions from their investment banking arms to safeguard against riskier banking activities. The Commission also made a number of other recommendations on bank capital requirements and competition in retail banking. The government announced the same day that it would introduce legislation into Parliament aimed at implementing the recommendations (HM Treasury, 2012).

On 26 January 2012, the Financial Services Bill was introduced to Parliament. The Bill would implement the Government's commitment to strengthen the financial regulatory structure in the U.K. The legislation would fundamentally reform the current regulatory system, which divides responsibility for financial stability between the Treasury, the Bank of England and the FSA (HM Treasury, 2012).

The new system would give the Bank of England macro-prudential responsibility for oversight of the financial system and, through a new, operationally independent subsidiary, for day-to-day prudential supervision of financial services firms managing significant balance-sheet risks. The FSA would cease to exist in its current form. A proactive new conduct of business regulator will also be created to protect consumers, promote competition and ensure integrity in markets (HM Treasury, 2012). The legislation aims to implement these reforms by: i) establishing a macro-prudential authority, the Financial Policy Committee (FPC) within the Bank of England, to monitor and respond to systemic risks; ii) clarifying responsibilities between the Treasury and the Bank of England - in the event of a financial crisis - by giving the Chancellor of the Exchequer powers to direct the Bank of England where public funds are at risk and where there is a serious threat to financial stability; iii) transferring responsibility for significant prudential regulation to a focused new regulator: the Prudential Regulation Authority (PRA) established as a subsidiary of the Bank of England; and iv) creating a focused new conduct of business regulator – the Financial Conduct Authority (FCA) – which would supervise all firms to ensure that business across financial services and markets is conducted in a way that advances the interests of all users and participants (HM Treasury, 2012). Subject to the parliamentary timetable, the Government's aim was for the Bill to gain Royal Assent, and for the new system to be operational by 2013 (HM Treasury, 2012).

On 12 October 2012, the Government published the draft Financial Services (Banking Reform) Bill, to implement the recommendations of the Independent Commission on Banking (September 2011 recommendation by the Vickers Commission). According to the HM Treasury (2012), the draft Bill was the first step in the legislative process towards a more resilient, stable and competitive banking sector. HM Treasury (2012) further laments that the Government would remain on track to have all legislation enacted by the end of this Parliament (2015) and reforms will be in place by 2019.

According to the U.K. Parliament (2012), the Financial Services (Banking Reform) Bill would amend the Bank of England Act 1998, the Financial Services and Markets Act 2000 and the Banking Act

2009; to make other provision about financial services and markets; to make provision about the exercise of certain statutory functions relating to building societies, friendly societies and other mutual societies; to amend section 785 of the Companies Act 2006; to make provision enabling the Director of Savings to provide services to other public bodies; and for connected purposes.

4 Banking Sector Growth in the United Kingdom

At the end of the 1950s, around 100 banks provided information to the Radcliffe Committee, which had been established to review the workings of the U.K. monetary system (Bank of England, 2010). Of these, the 16 London and Scottish clearing banks held around £8.3 billion in assets, amounting to 85% of total U.K. banking assets and more than 30% of U.K. GDP. According to the Bank of England (2010), the clearing banks were relatively narrowly focused on the provision of payment services, deposit-taking activities and short-term corporate lending. They were almost entirely funded by customer deposits, 60% of which were held in current accounts (Bank of England, 2010). A further 35% of deposits were held in interest-bearing time deposit accounts. Customer loans constituted just 30% of the London clearing banks' assets. Other financial institutions were important lenders to households. That included the building society sector, which in 1960 held £2.6 billion of predominantly mortgage assets - around a third of the value of clearing bank assets (Bank of England, 2010, p.322). Banks' and building societies' sterling assets grew steadily over the next two decades, together increasing from around 50% of GDP to 65% between 1962 and 1979.

During the 1960s and 1970s, foreign-owned banks began to expand their presence in the United Kingdom (Davies, 2002). This contributed to a sharp increase in holdings of foreign currency assets by both domestically and foreign-owned banks operating in the United Kingdom. By 1979, the U.K. monetary and financial institutions held £172 billion of foreign currency assets – more than half of their total assets. Foreign-owned banks were also predominantly engaged in wholesale activity, in part reflecting the rise of the Eurocurrency market (Bank of England, 2010).

To date, more than 300 banks and building societies are licensed to accept deposits in the United Kingdom. However, the provision of retail banking services is highly concentrated. Of the 16 clearing banks present in 1960, 15 are now owned by the four big U.K. banking groups – through mergers and acquisitions. These banks, along with other two U.K. banks, together account for almost 80% of the stock of U.K. customer lending and deposits. Collectively, however, the four largest groups account for a smaller share of the market for these services than the banks from which they originated (Bank of England, 2010). Table 1 shows the growth of banks in the U.K. during the period 2001 – 2012.

Table 1. Number of banks in the United Kingdom (2001 – 2012)

Year	Banks incorporated in the United Kingdom	Banks incorporated outside the EEA authorised to accept deposits through a branch in the UK	Banks incorporated in the EEA entitled to accept deposits through a branch in the UK	Banks authorised in the EEA entitled to establish branches in the UK but not to accept deposits in the UK	Total
2001	185	104	94	20	403
2002	184	104	91	16	395
2003	171	93	90	22	376
2004	173	89	88	25	375
2005	157	75	91	25	348
2006	160	81	95	24	360
2007	159	83	99	21	362
2008	155	83	88	21	347
2009	154	81	96	21	352
2010	154	80	79	22	335
2011	155	79	82	30	346
2012	156	80	81	30	347

Source: Financial Services Authority (2012)

The building society sector, having continued to expand during the 1980s and 1990s, saw a sharp contraction in the mid-to-late 1990s, as many building societies demutualised and became banks. Over the past 50 years, the number of building societies has declined from over 700 in 1960 to just 52 in 2010 (Bank of England, 2010). Thus, major trends in the U.K. banking sector, over the last years, include the conversion of building societies into banks, the consolidation of the U.K. banking industry and the entrance of non-financial firms into the financial services market. Following the Building Societies Act 1986, a number of building societies converted into banks, especially between 1994 and 1997. In addition, the remaining building societies witnessed an increase in their commercial freedom in 1997 - with the Building Societies Act 1997. These changes enhanced the scope for increased competition and wider choices for consumers. Furthermore, according to McCauley and White (1997) and White (1998), the U.K. experienced more merger and acquisition activity in its banking sector between 1991 and 1996 than did any other European country.

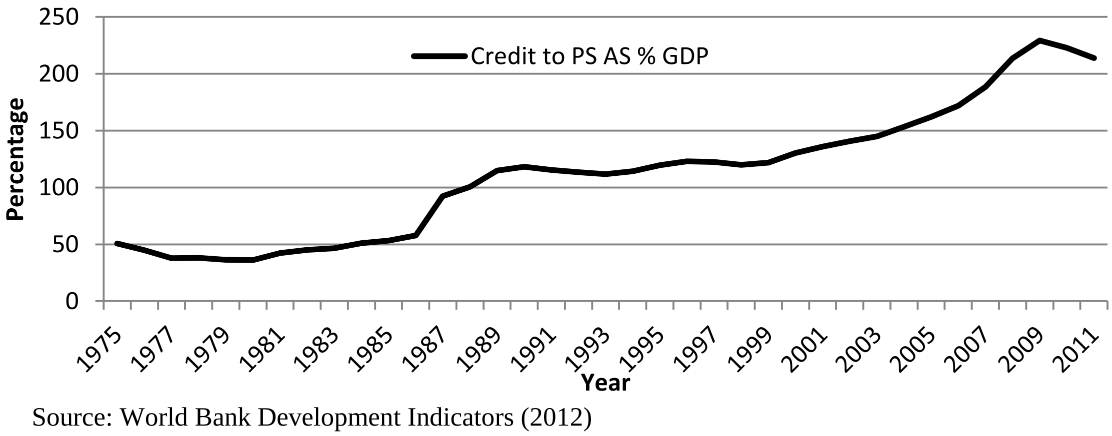
As the clearing banks have grown and consolidated over recent decades, they have also taken on a broader range of functions. According to the Bank of England (2010, p.324), the largest banks have become truly 'universal' banks, their activities encompassing securities underwriting and trading, fund management, derivatives trading and general insurance. Bank of England further highlights that the U.K. banks have established themselves as major global players in these markets. For instance, recent market surveys place three U.K. banks among the top ten worldwide in several markets, including bond underwriting, foreign exchange trading and interest rate swops (Bank of England, 2010).

The evolution to universal banking is reflected in an increase in the contribution of non-interest income to banks' earnings. Today, non-interest income accounts for more than 60% of banks' earnings, having been a minor share three decades ago (Bank of England, 2010). Bank of England further highlights that collectively, the U.K. banks' balance sheets are now more than 500% of annual U.K. GDP, with much of this growth having occurred over the past decade. Three of the four largest banks, individually have assets in excess of the annual U.K. GDP. Relative to the size of the national economy, the U.K. banking system is second only to Switzerland among G20 economies, and is an order of magnitude larger than the U.S. system (Bank of England, 2010). In the view of the Bank of England (2010), the expansion of the U.K. banking sector, particularly since the late 1990s, far exceeds that in other financial sectors. The size and the importance of the U.K. banking sector is reiterated by Accenture (2012, p.2).

In the decade before the financial crisis, the U.K. financial services sector grew more than twice as fast as the U.K. economy as a whole. Measured output growth in the U.K. financial services sector averaged over 6% per year, compared with overall U.K. GDP growth of 3% per year. The sector's share of the economy also grew significantly, and by more than in most other major advanced economies (Bank of England, 2011).

The growth of the U.K. banking sector is also evidenced by growth in private sector credit. In 1975, credit provided by financial institution to the private sector was 50% of GDP. It, however, decreased slightly during the late 1970s and slightly increased during the early 1980s, leaving an impression of a shallow trough between 1975 and 1984. During the mid-1980s, credit to private sector improved remarkably, reaching 115.2% of GDP in 1991. Thereafter, the extension of credit to private sector continued to increase at a modest rate and reached a peak of 229.2% in 2009; only to decline to 222.6% in 2010 and further down to 213.8% in 2011. Although credit provided to private sector has declined in the past few years – due to the aftermath of the global financial crisis of the late 2000s - it remains very much higher than that of developing countries and other developed economies (World Bank, 2012). Figure 1 shows the trends in banking sector growth, as shown by credit extension to private sector in the U.K. during the period 1975-2011.

Figure 1. Trends in Banking Sector Growth in the United Kingdom (1975-2011)



Source: World Bank Development Indicators (2012)

The U.K.'s non-performing loans, though generally low, have been on the increase since 2008. Credit information is easily available to both consumers and banking institutions. Both consumers and institutions have strong legal rights. Table 2 shows some of the banking indicators showing the development of U.K.'s banking sector.

Table 2. Growth of Banking Sector in the United Kingdom (2000 – 2011)

	Bank Non-performing Loans to Total Gross Loans (%)	Credit Depth of Information Index (0=low to 6=high)	Strength of legal rights index (0=weak to 10=strong)
2000	2.5	-	-
2001	2.6	-	-
2002	2.6	-	-
2003	2.5	-	-
2004	1.9	6	10
2005	1	6	10
2006	0.9	6	10
2007	0.9	6	10
2008	1.6	6	10
2009	3.5	6	10
2010	4	6	10
2011	-	6	10

Source: World Bank Development Indicators (2012)

The growth of the U.K. banking sector can also be portrayed by the increasing number of Automated Teller Machines (ATMs). Technological innovations have transformed the U.K. financial sector landscape in the past decade, by helping to extend financial services to millions of people. At the end of 2000, around 34,000 ATMs were in service in the United Kingdom, double the number of machines at the end of 1991 (BIS, 2012). In 2010, there were close to 65 000 ATMs, of which slightly more than half were owned by banks and building societies, leaving the remainder under the ownership of independent deployers (Bank of England, 2010). Almost all of these are connected via the LINK interchange network, which allows customers of participating banks and building societies to access their accounts through the ATMs of any member institution.

In 2000, there were over 2 billion ATM withdrawals, with a total value of around GBP 113 billion. In addition to cash withdrawals, many ATMs enable their users to order new cheque books or statements and make balance enquires and deposits. More advanced ATMs allow customers to make bill payments, funds transfers, standing order enquiries, and to order mini account statements (BIS, 2012).

5 Challenges Facing Bank-Based Financial Development in the United Kingdom

Although on overall, the public infrastructure supporting effective banking supervision is well developed and business laws including contract, bankruptcy and property law are well developed and reliable, the U.K. banking sector still faces some challenges. These challenges include less-than-adequate disclosure standards, contagion risk from the Eurozone, in addition to squeezed interest margin and uncertainties caused by changes in regulatory regimes.

According to IMF (2011), the U.K. banking sector disclosure is less than disclosure in other markets. Regular financial statement disclosures related to market risk, liquidity risk and credit concentrations, for example, appear to be less than in some other major markets. The FSA does not itself publish extracts from regulatory returns, although this is recommended. The FSA publishes an annual Financial Risk Outlook (replaced starting in 2011 by a Prudential Risk Outlook and Conduct Risk Outlook) and the Bank of England publishes twice-yearly financial stability reports. IMF further laments that despite these publications, overall, disclosure is less than that in other leading markets and the authorities are encouraged to review the adequacy of disclosure.

The Bank of England (2012e) views reduced interest margin as another challenge facing the U.K. bank based financial sector. Competition for retail deposits is very stiff, so that even though in normal terms, rates paid to savers are at historical lows, the gap between the Bank of England Base Rate and retail term rates is historically high (Bank of England, 2012e). On the other side of balance sheets, although loan rates are re-priced upwards, it has on average not been as rapid, and is dependent on contractual terms as to how much a loan can be re-priced in terms of the rate charged. Consequently, interest margins and income for banks are squeezed. Nonetheless, according to the Bank of England, (2012e, p.2), the U.K. financial authorities are on the whole, better placed seeing the cost come through in bank margins than in more re-possessed homes and the dislocation of households that goes with that.

It is also the view of the Bank of England (2012e) that a further factor weighing on U.K. banks is the risks from the euro area. U.K. banks have been advised to have a contingency plan in anticipation of deepening euro zone problems. That work has now been under way among banks for some time. According to the Bank of England (2012e), whatever happens in the euro area, there is a cost of adjustment, and that too will act as a drag on the returns earned by banks, and in the worst scenario presents a clear threat to financial stability. Thus, this is the biggest risk to stability that U.K. banks face today (Bank of England, 2012e, p.2).

As if the macroeconomic backdrop was not enough, the banking sector is in the midst of a major transition to a new and stronger regulatory regime for banks, in response to the recent financial crisis. This is also a challenge facing U.K banks according to the Bank of England (2012e) and IMF (2011). According to the Bank of England (2012e, p.3), capital and liquidity buffers were clearly inadequate in the past, exacerbated by the culture of loose regulation and arbitrage of regulation by banks in the run-up to the crisis. This is changing, and this transition is another drag on the banking system in terms of returns.

According to the IMF (2011, p.6), oversight of investment banking activities as well as of core market infrastructure, needs to be improved further in the new regulatory structure. The United Kingdom is a financial markets hub, and a major home and host country to bank and nonbank financial institutions. The oversight of investment banking and trading activities are a challenge, given the limitations to what the United Kingdom can do alone, particularly with respect to institutions that it hosts, such as branches of foreign bank entities. Without intensive supervision of investment bank risk taking, the IMF (2011) reckons that the domestic and global financial stability cannot be assured. It is critical that financial market infrastructure, including Central Counterparties, should also maintain robust prudential and risk-management standards, and that contingency plans are put in place to deal with potential failures (IMF, 2011).

The Bank of England (2012e) views another challenge facing retail banks as the very strong, and desirable, push to make all banks, including the largest, resolvable in the event of them approaching failure. The U.K. financial authorities are optimistic that they are beginning to see the making of solutions for the resolution of major banks, most likely with the bail-in of creditors as the way to end the dependence on public money. According to Bank of England (2012e), it is a reality - in transferring the responsibility from the public purse to private creditors - that the pricing of the risk of banks failing would be improved, which is one of the important transitional elements in the cost of banking.

Inadequate competition and disclosure and how to put it to an end by improving transparency in some bank products is also a challenge. Free in-credit banking in the U.K. is regarded as a dangerous myth by some financial authorities. According to the Bank of England (2012e), it is regarded as a myth on the basis that nothing in life is free; rather, it means that consumers pay for their banking services in ways that are hard to link to the costs of the products they receive. This could distort the supply of banking services. The dangers include the pricing of banking to consumers varying too much depending on the services they use. Although some authorities think that the reform of retail banking in the U.K. cannot move ahead unless the issue of free in-credit banking is tackled, and there is a much better sense of what customers are paying for and how they are paying; authorities, however, note that this is not something that will happen spontaneously. It is the Bank of England's (2012e) view that it is hard for a single bank to break out of the existing situation without appearing to raise the price of its service to customers (even though it may not actually be raising the price as a whole). According to the Bank of England (2012e), financial authorities also reckon that the U.K. will not have a retail banking industry that is properly serving the interests of the public until the dangerous myth of free in-credit banking is tackled.

6 Conclusion

This paper has given an overview of the banking sector in the U.K; it has highlighted its reforms since the second half of the 20^{th} Century; it has tracked the growth of the banking sector in response to the reforms implemented over the past seven decades; and it has highlighted the challenges facing the banking sector in the U.K. Since the 1970s, the U.K. government took over where it had left after the post 1824-25 banking crisis reforms. The government has implemented a number of reforms, in order to safeguard and improve the economy's banking sector. These reforms have focused on ending collusion on interest rates and began the process of widening the scope of banks' activities, breaking down old barriers between different types of intermediary. In addition, these reforms increased risk-management procedures and enhanced corporate governance, in order to strengthen and reposition the banking industry, to fostering healthy competition in banking operations, and to enable it to contribute effectively to the development of the real sector through its intermediation process. Although the banking sector responded positively to some of these reforms, it still faces a number of challenges. These challenges include less-than-adequate disclosure standards, contagion risk from the Eurozone, squeezed interest margins and uncertainties caused by changes in regulatory regimes.

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