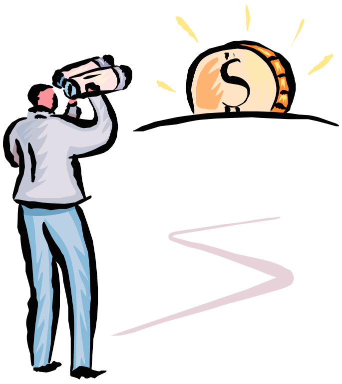
Topic 2: Understand who is who in the financial world

After completing this topic, you will be able to:

- define and explain the difference between banks and building societies;
- identify and briefly explain other providers, including:
  - insurance companies;
  - mutual insurance companies;
  - credit unions; and
  - other providers;
- explain the role of the Financial Conduct Authority (FCA); and
- explain ethics within the financial services industry.

Financial intermediaries

In the financial world, there will always be people who have spare cash that they want to put somewhere safe, and there will always be others who do not have enough money and need to borrow some more.



Imagine if there were no such thing as banks or building societies: the people with surplus cash might be prepared to lend it to those who do not have enough – but how would these two groups of people find each other?

Even if they were able to find each other, what if the person with cash to spare were to have only £10,000, but the person wanting to borrow some money were to need £15,000? The borrower would have to find someone else to lend them the other £5,000.

And even if the borrower were to manage to solve this problem by locating someone else with £5,000, what if the person with the surplus cash were willing to part with their money for only one year, but the borrower were to need it for five years?

This is where banks come in: they act as 'middlemen' – that is, they provide a place into which all of the savers can put their surplus cash, and a place from which all of the borrowers can obtain loans and other forms of credit. By charging their borrowers more interest than they pay to the savers, the banks make profit.

Banks are therefore known as 'financial intermediaries' – because they bring these two groups of people together.

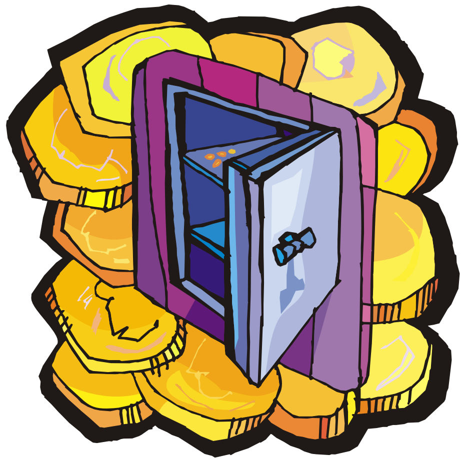
Building societies and credit unions are also financial intermediaries, for the same reasons.

An insurance company that is providing pensions and life assurance is also a financial intermediary. It collects premiums and pension contributions from its customers. It then invests these funds in (that is, lends to) other people and the insurance company makes a profit, part of which is shared with the customer.

Insurance companies that provide cover for risks, such as fire or theft, collect premiums from their hundreds of customers and pay out to the few who need to make a claim. This is another way in which they are financial intermediaries.

What are banks?

The first bankers were goldsmiths. People held their wealth in gold, but if they did not want to spend it and did not want to lose it or risk it getting stolen, they took it to a goldsmith. The goldsmith would give them a receipt and keep the gold in their safe.



People could then either take their receipt back to the goldsmith and get their gold back, or use the receipt as a type of currency. In other words, if they were to want to buy something, they could pay for it with their gold receipt – as good as paying in gold, because whoever held the gold receipts could go to the goldsmith and get the gold that it represented.

These receipts became the first banknotes.

When the goldsmiths realised that only a small amount of the gold deposited with them was wanted each day, they began to lend out the rest to creditworthy people.

These were the first bank loans.

Goldsmith-bankers provided monarchs and merchants with the money to fund their travels around the world.

The banks of today do not hold gold in their safes anymore; neither are they only a place to go for savings or a loan. The services offered by banks these days are vast, including:

- current accounts;
- savings accounts;
- investments for larger sums;
- loans;
- credit cards;
- overdrafts;
- mortgages;
- life assurance;

- pensions (that is, long-term savings for retirement);
- general insurance (such as house insurance, car insurance, medical insurance, etc);
- foreign currency exchange;
- share dealing (that is, buying and selling shares on behalf of their customers); and
- offering help and advice for businesses.

How many banks are there?

In the UK, there are over 150 banks – some of which you will never have heard of because they do not all have branch offices on the high street. Some of them specialise in one particular aspect of banking, such as investments for really wealthy people, or banking for businesses. Some of them are really small, while others have offices in almost every town centre. The names, logos and TV adverts of these types of bank are recognised by almost everyone.

The following are a few of the better-known banks:

- Santander;
- Bank of Scotland;
- Barclays Bank;
- Co-operative Bank;
- HSBC;
- Lloyds Bank;
- NatWest;
- Royal Bank of Scotland;
- Sainsbury's Bank; and
- Tesco.

Who owns banks?

Modern banks are very large companies. They have the letters 'plc' as part of their name, which means 'public limited company' – that is, a company that is owned by shareholders. The shareholders can buy and sell their shares in the company on the stock exchange.

All businesses, small or large, operate to make a profit and a bank is no different. Any plc, not only a bank, is expected to make a profit for its shareholders. Banks do this in two ways:

- they charge more interest to their borrowers than they pay to their depositors (savers) and the difference is their profit; and
- they have fees and charges for a number of the services that they provide.

After all of the bank's expenses have been paid (such as salaries for the staff, rent for premises, electricity costs, and the costs of computers and stationery, etc), what is left is the bank's profit. Some of this profit is paid out to the shareholders. This payment is called a 'dividend'.

A bank is a 'proprietary' organisation, which means that it has shareholders.

Did you know?

Following the problems in the banking industry in 2008, the main shareholder of Lloyds Bank and RBS Group is the UK government.

- The government owns 81 per cent of RBS Group (although their voting rights are limited to 75% to comply with Stock exchange rules).
- The government owns 32.7 per cent of Lloyds Bank.

This means that much of the profit that these banks make is paid to the government.

What are building societies?

Building societies do not have shareholders; rather, they are owned by their members. The 'members' are the people who hold savings accounts or mortgages with the building society. Building societies also operate with the aim of making a profit – but that profit is then used for the benefit of the members, such as by offering better interest rates for its savers and borrowers.

In other words, when a building society pays interest to its saver members, the interest that they receive includes a share of the profits. Mortgage members, meanwhile, will have a better interest rate because the profit share reduces the interest rate that they have to pay on their mortgage.

Because there are no shareholders to pay, building society interest rates are more competitive than those of banks.

A building society makes its profits in the same way as do banks – that is:

- it charges more interest to its borrowers than it pays to its depositors (savers) and the difference is its profit; and
- it has fees and charges for a number of the services that it provides.

The types of account and lending offered by a building society are restricted by law. The money provided by its savers has to be protected and so the law does not allow the societies to engage in risky lending. The safest form of lending is mortgage loans, because the money lent is secured on the property purchased. This means that if the borrower defaults (that is, stops making repayments), the building society can take the property (that is, repossess it) and sell it to recover its money.

A building society is a mutual organisation – that is, it is owned by, and run for the benefit of, its members.

Which are the building societies?

The biggest and best-known building society is the Nationwide. The following are some of the other 45 British building societies:

- the Cambridge Building Society;
- the Manchester Building Society;
- the Skipton Building Society;
- the Swansea Building Society; and
- the Yorkshire Building Society.

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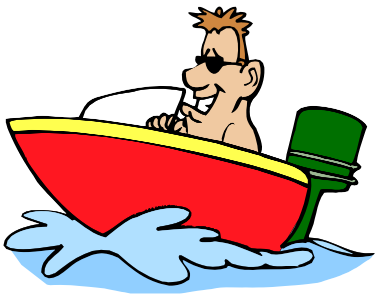
What do you notice about the names of the building societies?

Insurance companies

Insurance companies are also financial intermediaries.

Some of them offer life assurance; some of them offer general insurance (that is, house insurance, car insurance, travel insurance, pet insurance, etc). Some of them offer both, through different departments.

Some insurance companies offer a wide range of different insurances; others specialise in one type of insurance, such as car insurance or travel insurance. There are even some insurance companies that insure only boats.



Those that offer life assurance, as opposed to general insurance, tend to offer a variety of associated products, such as pensions, investments, long-term sickness insurance, endowments and whole-of-life policies.

Who owns insurance companies?

Most insurance companies are plcs. They have shareholders, and their shares can be bought and sold on the stock exchange, just like the shares of a bank. Some insurance companies are actually owned by banks and their services are offered through the bank's branch network.

Did you know?

Examples of plc insurance companies include Aviva plc and Prudential Insurance plc.

Examples of banks that own insurance companies include:

- RBS plc, which owns Churchill; and
- Lloyds Banking Group, which owns Scottish Widows.

Mutual insurance companies

Some insurance companies are 'mutual'. Just like building societies, this means that they do not have shareholders that expect to be paid some of the profits. Instead, 'mutual insurance companies' are run for the benefit of their members – in this case, their policyholders.

The profits that they make are used to boost the value of the endowments and pensions of their members.

Did you know?

An example of a mutual insurance company is Liverpool Victoria, which operates under the brand name 'LV'. This is the largest mutual insurance company in the UK.

Credit unions

Credit unions are financial co-operatives owned and controlled by their members. They offer savings and loans, and they are local, ethical and know what their members want.

There is a difference between a co-operative and a mutual. The members of a co-operative can take an active part in managing the business, unlike the members of a mutual. A credit union is also smaller and more local than most mutuals.

A common bond must link the members of a credit union – that is, the members must all have something in common. The common bond may be that the people all live or work in the same area, or that they all work for the same employer, or that they all belong to the same association, such as a church or trade union.

How do credit unions work?

Members of a credit union pool their money together and make loans of these funds to those members who need them. The rates of interest paid by those who borrow from their credit union are not very high, because credit unions are non-profit organisations and the rate of interest that they can charge is restricted by law.

Did you know?

Examples of credit unions include:

- the Bristol Credit Union;
- the Capital Credit Union;
- the North Yorkshire Credit Union; and
- the Reading Credit Union.

Activity 2a

Visit www.abcul.org – that is, the Association of British Credit Unions Ltd – and search for some more credit unions. See how many there are in your area.

Other providers

Even though there are many banks from which you can choose, you can also get financial services from lots of other places, such as:

- supermarkets – for example, Sainsbury's, Tesco and Harrods;
- high-street retailers – for example, Marks & Spencer and Debenhams;
- online retailers – for example, Amazon; and
- motoring organisations – for example, the AA and the RAC.

Why do you think these organisations offer financial services as well as their main business?

When customers buy financial products from retailers, they are often given special offers, vouchers, points and prizes. All of these encourage the customer not only to use the card more often, but also to visit the shop or website more often.

Then, once the customer has bought one financial product from the organisation and feels a sense of loyalty towards it, the customer might try it out for something else, such as home contents insurance or an individual savings account (ISA).

Some of these providers do not actually offer financial services themselves. Often, there will be a bank in the background with which your savings are actually invested, or from which your loan actually comes. The provider will tell you this in the small print on the leaflets. Tesco and Sainsbury's, however, do actually operate their own banks.

Financial Conduct Authority (FCA)

The Financial Conduct Authority (FCA) is the industry regulator, responsible for regulating the behaviour (conduct) of firms and individuals within the financial services industry. (You may also have heard of the Prudential Regulation Authority, or PRA, which works alongside the FCA and is responsible for maintaining the financial strength of banks and financial firms. The activities of the PRA are beyond the scope of this text.) The FCA's main objective is to protect and enhance confidence in the UK financial system, and its three operational objectives are:

- to secure an appropriate degree of protection for customers;
- to promote efficiency in the market for financial services; and
- to protect and enhance the integrity of the UK financial system.

Did you know?

This process is known as 'financial regulation'.

The FCA is known as the 'regulator'.

Before April 2013, the regulator was the Financial Services Authority (FSA).

Financial regulation is important because most financial products are quite complicated and the words used in the documentation are not easy to understand. The FCA makes sure that people understand what they are buying, that it is suitable for their needs and that they are not misled.

The FCA does this by setting standards that financial services firms have to meet and it will take action if the firms fail to adhere to these standards.

Protecting consumers

Every financial provider that we study in these topics is regulated by the FCA. This means that they have to follow all of the same rules.

Activity 2b

Try to think of all of the main rules that financial providers have to follow – for example:

- ***before giving financial advice to a customer, they must complete a factfind to gather information about the customer's personal and financial circumstances;***
- ***financial providers have to send regular statements to their customers to show them how their investment is performing, or how their loan balance is reducing; and***
- ***there are certain qualifications that people have to pass before they can give financial advice.***

How many more rules can you think of?

Think about the rules relating to the prevention of money laundering, or the rules relating to giving customers the opportunity to change their mind after buying a financial product.

The FCA promotes financial understanding through a range of publications, including a range of leaflets.

Activity 2c

Visit www.moneyadviceservice.org.uk and look at the range of free printed guides available under 'Tools and resources'.

a) ***Read the following guides:***

- **Your pension: it's time to choose*;***
- **You can afford your mortgage now, but what if...?*; and***
- **Problems paying your mortgage.**

Discuss in your groups the usefulness of the information contained in these guides. Do you think that they are easy to understand? Think about the types of person who would benefit from these guides. Why do you think the government produces them?

b) ***Still on the Money Advice Service website, put*** **'Dealing with debt'** ***into the search box. One of the suggestions is to 'prioritise your debts'. Discuss in your groups how you might do this – that is, how you might decide which debts take priority over others. Another suggestion is to 'talk to the people to whom you owe money'. How do you think this might help a person experiencing financial difficulties?***

Achieving the FCA's objectives

The FCA is responsible for requiring firms to put the well-being of their customers at the heart of how they run their businesses. This means that firms must focus on meeting customers' genuine needs and recommend only products and solutions that are suitable for them. If the FCA thinks that a particular financial product posts too much risk to a customer, it will stop firms from selling it.

The FCA will also step in if it thinks that any of a firm's marketing literature or other promotional material is misleading for customers and is not portraying the true facts. For example, it may focus too much on the positive aspects of a product, including the negative aspects only in small print. The FCA makes sure that, whatever financial product a person is buying, whether a basic bank account or a complicated investment, there are no hidden charges.

The FCA is also responsible for promoting effective competition, which means that it will make sure that larger firms do not dominate the market and that, if new firms want to start selling financial products, there are no barriers to their doing so.

Did you know?

The FCA regulates 27,000 firms, ranging from global banks to very small businesses, and around 165,000 individuals. This industry contributes 6.8 per cent of UK gross domestic product (GDP) and employs 1.1 million people, providing products and services to millions of consumers.

Ethics

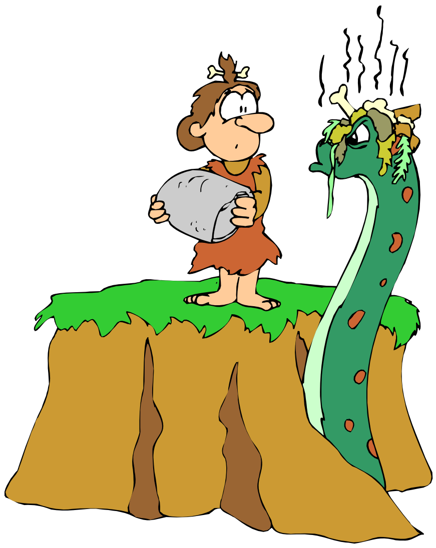
'Ethics' is about behaving correctly towards all groups interested in, or affected by, a business. In financial services, ethical behaviour can be shown in attitudes towards customers, the environment and the types of business to which a bank will lend.

The Co-operative Bank has gained a reputation for being ethical. It states its concern for:

- the local community;
- responsible retailing;
- protecting the environment;
- tackling global poverty
- responsible finance; and
- human rights..

(Source: www.co-operativebank.co.uk)

The Co-operative Bank will not lend to any firm that it thinks does not meet its ethical principles.



Other examples would include a bank that refuses to lend to a clothing company that has its clothes made by children in poor countries, or companies that pollute the environment.

Some ethical investment firms will consider buying shares only in companies that are making an effort to reduce their reliability on non-renewable energy, such as gas and oil.

Waste and use of paper is also a part of ethical behaviour. Many banks encourage customers to choose electronic bank statements as part of online banking.

Review questions

1. Summarise in your own words what a ‘bank’ is.

2. Summarise in your own words what a ‘building society’ is.

3. What is meant by ‘ethics’?

4. Can you think of any further examples of behaving ethically?

Learning activities

Internet

- Visit the websites of any of the banks or building societies, and look at their histories.
- Visit the Building Societies Association (BSA) at www.bsa.org.uk and look at the names of the 45 building societies listed. Use the links to look at the website of a building society near to you.
- Visit www.lv.com and explore the site – especially the company's heritage, which you will find under 'About us'.
- Visit the Association of British Credit Unions at www.abcul.org and see if you can find a local credit union. What is its common bond? Look at the section about setting up a credit union.
- Visit www.moneyadviceservice.org.uk. Search for 'Staying safe against scams', then read 'A beginner's guide to scams' and 'Protecting yourself from scams and theft'.
- Visit www.co-operativebank.co.uk and, at the bottom of the page, select 'Ethical policy'. Look at the examples given of ethical investments, and view the Youtube clip.

Group

Discuss the main differences between banks and building societies. Think about who owns them, how their profits are distributed, where they are located and the different products that they offer.

Individual

Visit www.which.co.uk/money/savings-and-investments/guides/ethical-investments/. Read the sections called 'Ethical investing explained' and 'How ethical are ethical funds?'. What is meant by 'positive and negative screening'?

Key points for Topic 2

You should now understand:

- how to define a 'bank';
- how to define a 'building society';
- the differences between a bank and building society;
- what is meant by 'mutuality';
- the business types of insurance companies and mutual insurers;
- how to define a 'credit union';
- some providers that are not mainly financial services providers;
- some reasons why these other providers offer financial services;
- how to define the 'Financial Conduct Authority (FCA)' and be able to state its objectives;
- how to define 'ethics' within financial services and be able to give examples of ethical behaviour.