



UK Financial Regulations Made Easy Revision Notes

Written by
Adetomi Omidiora
MBA, CeMAP

Tel: 020 8443 2888 | www.cemap123.co.uk | www.cefa1234.co.uk

Futuretrend

UNIT 1:

Introduction to Financial Services Environment and Products

Intermediation

Intermediaries act as middlemen by borrowing from the surplus sector of the economy and lending it to the deficit sector of the economy. They will make a profit margin between the two rates.

Financial intermediaries are middlemen such as banks and building societies. They create liquidity, pool risks and minimize the costs of borrowing by locating and monitoring borrowers.

The process of intermediation has made life much easier for the consumer, in four different ways.

Geographical Location – Physical location of individual borrowers differ, an access to a high street bank solves the problem.

Aggregation – Retail deposits are relatively small while loans are typically larger (mortgages); intermediaries overcome this size mismatch by aggregating small deposits.

Maturity Transformation – A borrower may need funds for longer than a lender is willing to lend, intermediaries are able to bridge this gap because they borrow from a large number of people who deposit funds and draw them at different times. (Different maturity dates).

Risk Transformation – The bank does not go down because one borrower defaults.

Disinter mediation – It is very possible for a lender and a borrower to come together without a middleman e.g a company can float shares directly to the public.

Risk Management - It is a way of mitigating risks by individuals contributing to a pooled fund, to cover the burden of the few who may suffer the losses in the particular instance covered e.g car insurance.

Product sales Intermediaries – They involve financial advisors, mortgage advisors and insurance brokers.

Retail and Wholesale Banking

Retail banking – Building societies, high street banks who deal with individual transactions on a day- to- day basis in small to medium size.

Wholesale Banking - Involves financial institutions, Government and large companies dealing in huge sums of money, amongst each other. It is sometimes referred to as the Inter bank market. London inter bank offered rate (LIBOR), which is used are quoted daily.

- Both are forms of intermediation.
- Several institutions such as banks will operate in both markets

- The LIBOR will serve as an indication for most lending, which is usually quoted at a premium over LIBOR.

Clearing

- Clearing arises from the movements of funds such as ATM's, cheques, direct debits, standing orders, electronic transfers and credit card services.
- At the end of each business day there is a settlement between clearing banks. The net settlement involves all monies owed and all monies received by the individual banks.
- The net amount owed or payable is settled through the Bank of England (BOE)
- Few banks act as clearing banks to handle the net transfers at the end of each day.
- The Association for Payment and Clearing services (APACS) manages the clearing system through 3 operational services.
 1. Cheque and Credit Clearing Company- oversees the clearing of cheques and paper credits on a 3 daily basis.
 2. Voca Link Ltd - operates the electronic clearing such as direct debits. It was previously called BACS (bankers automated clearing services Ltd).
 3. CHAPS - (Clearing House Automated payment System) provides electronic same day inter bank transfer system for high value Payments.

Influences on Interest Rates

Level of Government Borrowing
 Level of Individual Borrowing
 Fiscal Policy
 Foreign Exchange rates

What is Inflation

- A sustained increase in the price of goods and services.
- A sustained decrease in the purchasing power of money.
- Where there is too much money in circulation.
- Inflation was previously measured by the Retail Price Index (RPI) but is now measured by the Consumer Price Index (CPI).
- The Harmonised Index of Consumer Prices (HCIP) is used to measure inflation within the European Economic area (EEA).
- The HCIP and CPI are derived in the same manner.
- The Government's target is to keep inflation at an annual rate between 1-3%.
- Deflation is a general fall in the price of goods and services, which may be experienced during a recession.
- Disinflation means that prices of goods and services are increasing but at a decreasing rate.

Government's Long-term Objectives

- Satisfactory Economic Growth
- The Unemployment Rate
- The Inflation Rate
- Balance of Payment Equilibrium
- Objectives are referred to as macroeconomic issues, which involve the whole economy.
- Microeconomics refers to the parts of the economy e.g families

2 Types of Policies to achieve Long Term Objectives

Monetary Policy

Government controls the money supply through the credit creation carried out by banks by manipulating the interest rates, which is set by the monetary policy committee (MPC) Monthly.

Bank base rates are standard variable rates as they follow the BOE base rate even though in recent times the banks have found it difficult to pass on rate reductions as times have been quite challenging.

Fiscal Policy (Budgetary Policy)

Government manipulates the finances of the Public sector spending, Taxation (revenue), borrowing and saving to influence the overall level of money supply and economic activity.

The Chancellor of Exchequer outlines the Fiscal Policy in the annual budget statement in March.

- The Government (Public sector) provides services such as health care, social security, education etc.
- The process is funded by collecting funds from the private sector, in the form of direct and indirect taxes. This is the main form of Government revenue.
- The Revenue is what is put into the economy to fund the services provided, and changes on either side of the equation will affect the economy as a whole.
- There are three possible outcomes: A balanced budget, budget deficit or budget surplus.
- A *Balanced Budget* is where Taxation is equals to Public Spending.
- A *Budget Surplus* is where Taxation is more than public spending.
- A *Budget Deficit* is where Taxation is less than Government Spending.
- A Government in Deficit can borrow.

The Deficit is Expressed in 2 Identities

a) Public Sector Net Borrowing ((PSNB)

- Current Public Spending plus Net Public Investment less Total Public Revenues

- b) Public Sector Net Cash Requirement (PSNCR)
- PSNCR is made up of PSNB and the financing requirements arising from financial transactions.

The Golden Rule

The Government will borrow only to invest and not to fund current government spending. This rule is golden and has been very difficult to follow lately.

The Sustainable Rule

The Public Sector Net Debt as a proportion of Gross Domestic Product (GDP) will be stable and prudent over the economic cycle.

Gross Domestic Product

Total goods and services produced in an economy in a fiscal year.

Money

Money serves as a common denominator against which the value of all goods and services produced could be measured.

Functions of Money

- Medium of exchange – Therefore it must be divisible, portable, generally acceptable and sufficient in quantity.
- Unit of exchange – Against which value good and services can be measured.
- Store of value – Money can be put away in the bank or under the bed, but the original amount stays the same.

The Bank of England (BOE)

The BOE is the central bank, which serves as the bank to the Government and is responsible for the printing of currency. The Government must back the printing of currency.

Other functions include:

- a) Controlling the money supply by setting interest rates through the monetary policy committee (MPC).
- b) Banker to all the other banks.
- c) Controls and manages the country's official reserves (gold and foreign currency).
- d) Lender of last resort, this becomes evident where a bank runs out of funds and has to borrow from the BOE.
- e) Government advisor.

Banks and Building Societies

- Both are different in the way they are regulated and in their legal constitution.
- Building societies are highly regulated by law.
- A building society is only allowed to raise a maximum of 50% of its liabilities as funds from the wholesale market.
- Banks are proprietary organisations (limited liability companies), owned by shareholders.
- Building societies are not companies they are mutual organisations owned by their members who are depositors and borrowers.
- Friendly societies are also mutual organisations.
- Certain life assurance firms are also mutual organisations.
- A building society is able to demutualise, that is change its legal status, to become a bank.
- Carpet bagging refers to the process of opening an account in a building society hoping it will become a bank so as to receive free shares.

Credit Unions

- Authorised and regulated by the FSA and protected by the Financial Services Compensation Scheme (FSCS).
- A credit union is a mutual organisation, run as financial cooperatives to assist their members who are linked by similar attributes, which may be cultural, social or economical.
- Originally for the poor, the scope has widened and improved the image by funding initiatives by Government, to include a wider scope of clients.
- Every member must purchase shares worth at least £1, but have the same rights irrespective of their share holding.
- Each share will pay dividends of 2-3% (usually) to 8% (maximum permitted) yearly.
- Interest rate on the loan is 1% of the reducing balance monthly; the maximum interest rate permitted is 2% of the reducing capital.
- Services offered will sometimes extend to mortgages, insurance services and bank accounts usually on a partnership basis.

Savings Gateway

- A two-year cash savings incentive for people on low incomes, with contributions of 50 pence on every £1 saved.
- The individual must be in receipt of a qualifying benefit such as income support or incapacity benefit and tax credits.

Deposit Based Investments

- They are usually available at banks, building society or the post office (NS&I products).
- They are referred to as emergency funds (accessible) or rainy day funds (new car, next year holiday, or emergencies).

- An investor is prudent to have some of the investment portfolio in readily accessible funds.
- Although the capital element on the investment remains fixed, the income from the investment may vary.
- The advantages are that they are secure and accessible but inflation reduces value of capital in real terms.
- In the medium to long term they are unattractive when compared to asset backed investments.
- Tiered interest rates are also available on bank and building society accounts. The larger the investment, the higher the rate paid. If the investment falls into a lower tier, the rate will be reduced.

Interest Bearing Current Account

- Has evolved in recent years due to increased competition among the banks.
- Although the interest rates are relatively low, instant access is allowed without loss of interest.
- Where the individual seeks higher interest, it is possible to consider Internet accounts, accounts processed through call centres or be prepared to maintain a higher minimum balance (£1,000 to £10,000).
- Accounts with a higher minimum balance are also free from charges.

Money Market Deposits Accounts

- It is convenient where a person has a lot of funds to place in the short term.
- There are 2 types, fixed and notice accounts.
 - a) Fixed Accounts – Term deposits accounts with fixed interest rates. The term will range from overnight deposits to 5 years.
 - b) Notice Accounts – Some notice must be given to access the funds otherwise a penalty is charged. Notice that must be given can range from 7days to 12 months.

Offshore Deposits (Tax Havens)

- A tax haven based outside the UK in countries such as Luxembourg, Cayman Islands and Channel Islands.
- Although the interest is paid gross a UK resident is liable for tax and must declare the funds on the tax return.
- If the interest has been taxed overseas tax relief could be given under the double taxation regime.
- It is a brilliant arrangement for people who want money available outside the UK, or want to retire abroad.
- Disadvantages are that they at risk to currency movements and are not usually covered by investor protection schemes.

National Saving and Investments (NS&I)

- Available at the post office on behalf of Government – Low Risk

Easy Access Savings

- New card and Pin.
- Individual must be over 11
- The minimum Balance £100

Investment Account

- Individual must be 7 years and over.
- Tiered interest rates at 7 levels (£50-£50,000 and beyond).
- Interest paid gross but liable to income tax.

Income Bonds

- Interest rate is variable and tiered.
- No term is required.
- The capital can be withdrawn at any time and interest will be paid up to but not including the day it is withdrawn.
- Interest is paid gross but liable to income tax at investor's rate (10%, 20% and 40%).

Guaranteed Income Bonds

- The person must be age 16 or over to take out the bond
- Lump sum investment for a fixed term.
- Pays out a guaranteed interest rate for chosen term with the interest paid monthly.
- Interest is taxed at 20% at source, HRT pay an additional 20%.

Guaranteed Growth Bonds

- Individual must be at least age 16 to take out the bond.
- Lump sum investment for a 1,3 or 5 year term.
- Interest is calculated on a yearly basis and added to bond at end of term.
- Interest is taxed at 20% at source, HRT are liable for an additional 20%

Guaranteed Equity Bonds

- Individual must be at least age 18 to take out the Bond.
- Lump sum investment for a fixed term.
- Performance of the bond is linked to FTSE 100 index.
- Investment is secure, as the capital invested will certainly be returned.
- Interest payable depends on growth of underlying asset
- Interest is paid gross but is liable to income tax.

Savings Certificate

- They are either fixed or Index linked (value increases with inflation).
- The term ranges from 2 to 5 years.
- Certificates are available from £100 to £15,000.
- There is no CGT or income tax liability.
- As such, they are very attractive to higher rate taxpayers.

Premium Bonds

- Bonds can be bought at £100 up to a maximum amount of £30,000.
- Tax- free prizes are drawn monthly and it is possible to win as much as £1m.
- Capital is secure, but 8 days notice must be given to cash the bond.

Children Bonus Bond

- A single Premium investment that can be retained for 5 years or more.
- Individual must be aged 16 to buy for anyone under the age of 16.
- Interest is payable until the 21st Birthday.

Individual Saving Account (ISAS, 6/4/1999)

Cash ISAS

- They are tax efficient personal savings certificates for all UK residents.
- They can be held at a bank, building society or post office (NS&I).
- Anyone above the age of 16 can have cash ISA.
- Cash ISAS are deposit based accounts.
- A maximum amount of £3,600 can currently be held in cash ISA.
- This amount increases to £5,100 in April 2010.
- For persons aged 50 or over the amount increases to £5,100 from 6th October 2009.

Equity ISAS

- They are also called stock and shares ISAS.
- Equity ISAs can be opened by anyone who is 18 or over.
- Shares within the ISA fund can be held in unit trusts, OEICS and investment trusts in the UK (pooled/collective investments).
- Shares and stocks (fixed interest securities) could also be held in corporate bonds issued by firms listed on the stock exchange worldwide and gilts and other fixed interest securities issued within the EEA.
- A maximum of £7,200 can be held in shares/stocks yearly. Where the cash amount of £3,600 is utilized, only £3,600 over the cash amount can be held in shares/stocks (£7,200 - £3,600).

- Withdrawals can be made from the ISA, without affecting the tax-free status, however the withdrawals made, cannot be replenished within the same tax year.
- The overall limit for an ISA increases to £10,200 in April 2010 or from 6/10/2009 for those aged 50 or above.

Gilt Edged Securities

- Gilts are Government issued securities, which represent Government borrowing.
- The management of new issue gilt stocks, is undertaken by the debt management office of the treasury department.
- The redemption date of the stock is the date that the government buys back the gilt.
- The coupon represents the interest payable over the term at par value.
- The price of the gilt is usually quoted par value at a nominal of £100.
- Gilts are actively traded on the stock market this is because they cannot be redeemed before maturity but can be sold to other investors.
- The coupon on the gilt is paid half yearly.
- The interest on gilts are paid gross, but taxed at the individual highest rate (10%, 20% or 40%)
- Gilts are CGT free.
- Cum –dividend indicates that the purchaser will acquire the gilt and entitlement to next interest payment.
- Ex- dividend indicates that the purchaser will acquire the gilt but the next interest payment is made to the previous owner of stock.
- The level of market rates, nearness to redemption date and supply and demand will affect the price of gilt.

- Gilts are classified by the Government as follows:

Short dated Gilts – less than 5 years to run before redemption.

Medium dated Gilts – 5 to 15 years to run before redemption.

Long dated gilts – over 15 years to run before redemption

- The UK Debt Management office's classifies Gilts as follows:

Short Dated Gilts – 0-7 years

Medium Dated Gilts – 7-15 years

Long Dated Gilts – Over 15 years

Index linked Gilts – Interest payments and capital value move in line with inflation, therefore purchasing power of capital and interest remains constant.

Undated gilts – undated gilt is redeemable only at the Government's discretion, which is under no obligation to redeem them. However, they can be sold to other investors in the secondary market.

Local Authority Stocks

- The bonds represent local authority borrowing and are secured on local authority assets.
- Interest is guaranteed, as the local authority is unlikely to go bankrupt, and is paid half yearly.
- Interest is taxed at source, 20% net, HRT pay an additional 20%.

Permanent Interest Bearing Shares (PIBS)

- The bonds represent borrowing by building societies to raise capital.
- They are irredeemable shares, as the building society is under no obligation to recall them.
- An investor who wants to sell can do so on the stock market, as shares are actively traded on the stock market.
- If a building society becomes insolvent, PIBS rank below ordinary shares for payment.
- Interest is paid gross, half yearly, but the investor is tax liable (10%, 20% or 40%).

Corporate Bonds

- The bonds represent a company borrowing to raise capital.
- They are very risky, as a company is more likely to go into liquidation than a Government, local authority or building society.
- Issued with fixed interest and maturity dates.
- Interest is taxed at source, 20% net, HRT pay an additional 20%.

Partnership

In a partnership, the partners jointly own the assets and liabilities of company, and are jointly responsible for profits and losses.

Partners pay income tax and not corporation tax.

In a Limited Liability Partnership (LLP), profits and losses are still shared among the partners.

Limited Liability Company

A Company is a separate entity, owned by shareholders whose liabilities are limited to the amounts they have invested.

Most common way in which company can raise money to expand its operations is to float ordinary shares, usually bought by private investors but more so by institutions and life pension funds.

Nature of the company, Power to borrow and Rights attaching to shares are set out in the *Memorandum and Articles of Association*.

Shares

- Shares are also called asset backed investments

- Although investment in shares can prove risky, in the long-term, share investment has generally outpaced inflation.
- Shares usually provide a higher return than deposit type investment in the medium to long term.

Share Indices

- They measure the overall performance of shares.

Financial Times 30-share index (FT 30) – 30 major industrial companies – $\frac{1}{4}$ of market value of UK equities.

FTSE100 (footsie) – 100 top companies in capitalisation terms. Weighted according to market value

FTSE All Share Index – About 900 shares split into sectors; yields, ratios, return of shares. Measures price movements, showing yields, financial ratios as well as return on share investment.

Two markets:

- 1) The Stock exchange (main market)
- 2) The Alternative market

Main Market

- Shares are traded if they are fully listed.
- To be fully listed, the firm must have been trading for 3 years, with 25% of the shares in public hands, and must have disclosed financial and other information subject to FSA requirements.
- The firm must act in accordance with the stringent rules set by the FSA, the UK listing authority (UKLA).

Alternative Market

- Market for smaller and newer firms who can also register with the stock exchange in an alternative market, but the shares are not fully listed.
- The rules set here are less stringent.
- The firm will be able to raise capital, enjoy public finance, and have easy exposure to investors who will have a sense of confidence dealing with them.
- This will enhance their potential for expansion.

Rights Issue – New Shares must first be offered to existing shareholders to avoid dilution of their holdings in proportion to total shareholding.

Script Issue – Bonus / Capitalisation issue. Increasing the number of shares to reduce share price at no cost to existing shareholders. Achieved by transferring reserves into a company's share account.

Types of Shares

Ordinary Shares – Share holders receive distributed profits (dividends) and have voting rights (participation)

Preference Shares - Dividends are paid from company's profits and may be fixed. *Cumulative preference shares* will accumulate dividends until such a time as they can be paid.

Preference shares rank above ordinary shares in priority of distribution if the firm were to go into liquidation, but after loan stocks. They do not carry voting rights but may acquire it if dividends have been delayed. *Convertible Preference* is a share that carries the right but not the obligation to be converted into ordinary shares.

Loan Stocks – Stocks carry a fixed rate of interest (not dividends). Interest would be paid if or not the firm makes a profit. The loan is not secured on company property. No voting rights. Loan Stocks can also be issued with convertible rights.

Debentures – Similar to loan stocks but are secured on company property/assets.

Order of Ranking if Firm becomes Insolvent

Debentures are paid first, then Loan Stocks, then Preference Shares, then Ordinary Shares.

Measures Used To Assess Shares

Dividend Cover

- It is a measure of how much of a company's profit has been paid out to share holders in dividend.
- A dividend cover of 2 or more is good.
- A dividend cover below 2 is unacceptable. It indicates that the firm may not be able to sustain dividends going forward, and that the firm may be paying some of the dividend from retained surpluses from previous years.
- A company, which pays out 25% of its profits in dividends, has a dividend cover of 4 that is $100/4$, which is acceptable.
- A company, which pays out 100% of its profits in dividends, has a dividend cover of 1, that is, $100/100$, this is unacceptable to the shareholders.

Earnings per Share (EPS)

- A company will not distribute the entire profits, as it will have to retain some for expansion.
- The EPS will indicate how much the share has actually earned.

- Calculation of the EPS is Net Profit/Number of shares

Price/ earnings ratio (P/E Ratio)

- An investor is interested in the growth prospect of a share.
- The P/E ratio will indicate the share's growth prospect.
- A ratio of 20 or more indicates that the share is doing good and is expected to grow.
- A ratio below 4 indicates that the share has poor growth prospects.
- P/E ratio is calculated as the Share Price/ Earnings per share.

Taxation of Dividends

- Dividends are taxed 10% at source (tax credit) and the 10% tax is not reclaimable by anyone.
- HRT is liable for an additional 22.5% bringing their total tax liability to 32.5%.

Real Estate: Three Types

- Residential property
- Commercial and Industrial Property
- Agricultural Property

Residential Property

- Purchase of one's home.
- Recent price falls in 2008 have indicated it can be a risky investment.

Buy to Let

- Traditionally they were viewed as commercial rather than residential mortgages, so interest rates were a lot higher.
- Moreover in those times, rental income was not taken into consideration, the mortgage was based on affordability.
- Property bonds have also made it more affordable for the small investor and for those who want to spread their risk. Instead of investing directly in one property the underlying fund is invested in a range of properties and shares in property firms.
- Letting Agents usually belong to the Association of Rental Letting Agents (ARLA)
- Gross rents are usually calculated at 125% - 150% of the monthly mortgage Payment.
- Rental income is treated as earned income and is subject to income tax but cost of insurance, agent fees can be offset against this.
- When the property is sold, the gains are also subject to CGT.

Commercial Property

- Covers all properties that are non –residential.
- Longer leases than residential property so they offer stability in terms of the lease, but equity will not grow as fast.

Commodities

- Silver, gold, foodstuffs, electricity, timber, music, artistic work etc.
- Gold is a major investment for Governments and private individuals.
- A popular gold coin the South African Krugerrands is sold by Government to small investors.
- Commodity trade is carried out through forward contracts (see derivatives).

Foreign Exchange

- Refers to currency exchange and transfer on behalf of a financial institution's clients or for own account.
- Foreign exchange needs will arise from trading in goods and services.
- Short and long term Investments will also give rise to foreign currency exchange needs.
- A currency speculator will purchase and sell currency because he predicts that the exchange rates will change. The spread will be a profit to his account.

Money Market Instruments

Money market instruments can be described as short-term debt instruments issued by the Government, Banks, Building societies and several organisations with no interest to the investor during the term.

3 Types

- Treasury Bills
- Certificates of Deposits
- Commercial Paper

Treasury Bills

- Low risk short-term securities issued by the Debt Management Office, and backed by the UK government.
- Usually the premise of the investor (main corporations or financial institutions), who want to invest large sums of money.
- The bills are highly liquid, as they can be converted easily to cash at minimal costs.
- There is no centralised market place; they are also traded on the secondary market by financial institutions.

- The term is 91 days and they have a zero coupon as no interest rate is payable during the term.

Certificates of Deposit (CD)

- CDs are issued by banks/building societies as a means of facilitating short lending.
- They are bearer instruments, which indicates that the holder of the certificate at the end of the term will be paid the funds.
- The term of the CD is usually between 3-6 months with a roll over option.
- They are usually in the range of £50,000 or more, and can be sold from one person to another.
- Building societies and Banks also trade in CDs to manage their liquidity position.

Commercial Paper (unsecured promissory notes)

- Involves a company borrowing for short-term purposes (working capital), with a term of between 5-45 days (average of 30-35 days).
- Offers a roll over facility, which is flexible and allows the ability to re-arrange the interest rate.
- It is beneficial to the firm with good credit rating as borrowing is cheap.
- A company without good credit ratings can have the borrowing backed by a Letter of Credit issued by a bank as a guarantor.
- The bank will charge a fee.

Child Trust Fund (CTF)

- Tax free, savings incentive, initiated by Government for children born on or after 1 September 2002.
- The initial payment is increased to £500 from £250, if the family is eligible for full tax credits.
- Parents and others can add a maximum of £1,200 per year to the account.
- At age 16, the child begins to run the account.
- The money becomes available on the child's 18th Birthday

3 types

- a) Deposit (savings) accounts
- b) Direct/indirect share investment accounts
- c) Stakeholder accounts – The stakeholder CTF account will invest in a variety of company shares. At the age of 13, the funds are moved to lower risk assets. If the parent does not opt for any CTF arrangement within 12 months of the voucher being issued, HMRC will open a stakeholder CTF on behalf of the child.