

## CHANGING CONTEXT OF THE UK FINANCIAL MARKETS

This document aims to present the main characteristics of the UK financial markets, with reference to recent changes in the latest decade as well as future trends.

Following the supply chain of capital from investors to companies, the institutions described are:

- Institutional investors, particularly:
  - pension funds
  - insurance companies
- Individual investors (particularly high-net worth individuals)
- Investment consultants
- Fund managers
- Investment banks and
- Public listed companies.

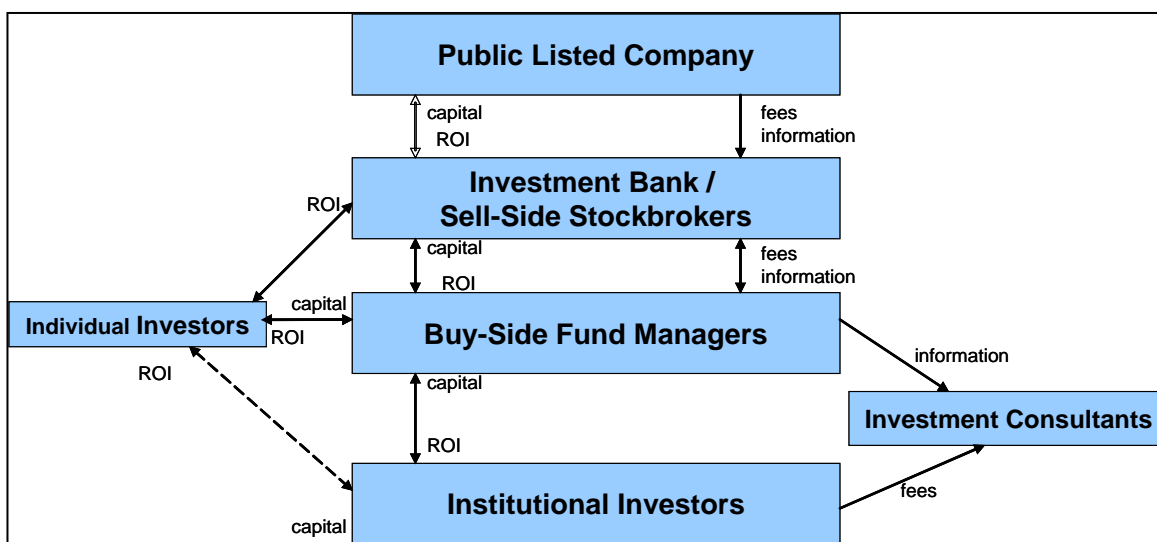


Figure 1 (adapted from Waygood 2006)

### 1 - Institutional investors

#### a) Pension funds

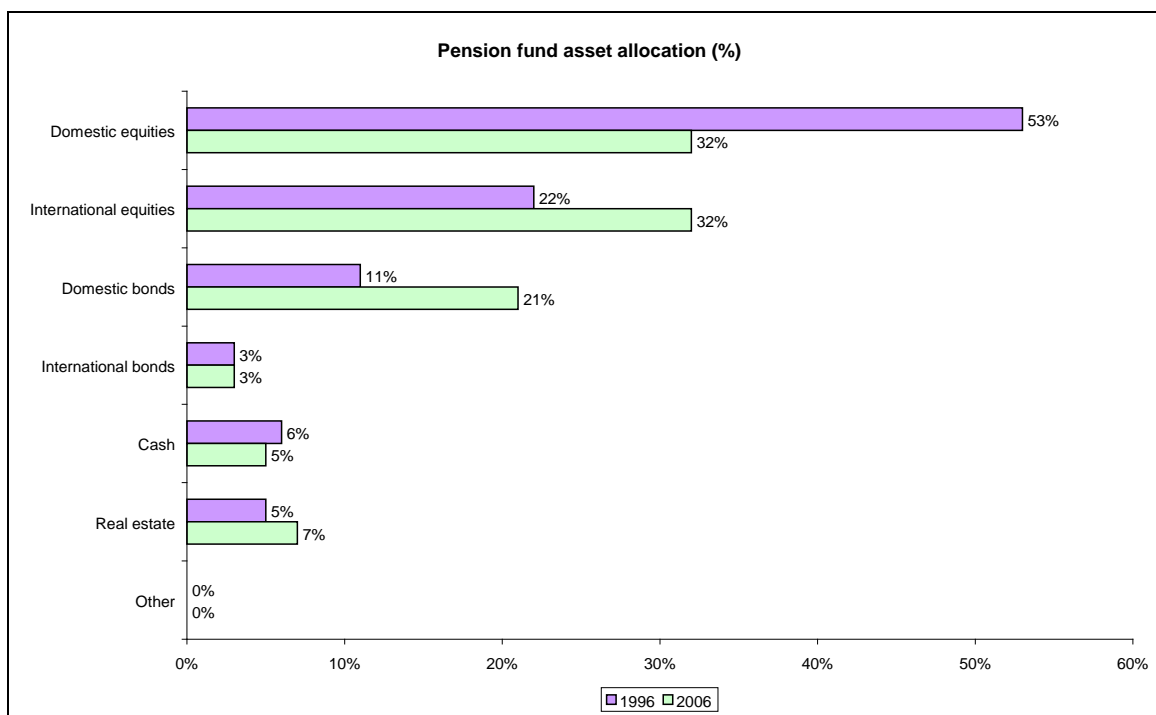
The UK pension fund industry is highly concentrated, representing the most significant group of institutional investors in the country (Valdez 2007) and \$2.9 trillion in assets (IFSL 2008a). The largest pension funds are the Scottish Public Pensions Agency NHS & Scottish Teachers Superannuation Schemes (£40.65 billion), BT Pension Scheme (£39.8 billion) and USS (£30.1 billion) (NAPPF 2008).



| Rank | 2003                            | 2008  |
|------|---------------------------------|---|
| 1    | British Telecom                 | Scottish Public Pensions Agency<br>NHS & Scottish Teachers Superannuation Schemes |
| 2    | Coal Pension Trustees Services  | BT Pension Scheme   |
| 3    | Electricity Pensions Services   | USS   |
| 4    | USS                             | Royal Mail  |
| 5    | Consignia                       | Electricity Supply  |
| 6    | Railways Pensions Management    | Royal Bank of Scotland  |
| 7    | BP                              | Railways Pension Scheme   |
| 8    | Lattice Group                   | BP plc Pension Fund   |
| 9    | Scottish Public Pensions Agency | Coal Pension Trustees   |
| 10   | Lloyds TSB Group                | National Grid   |

**Table 1 (adapted from IFSL 2003 in Waygood 2006; NAPF 2008)**

In terms of asset allocation, pension funds invest most of their assets in equities. However, this has been declining. From 1996 to 2006, the share of equities fell from 75% to 64%, and domestic equities dropped from 53% in 1996 to 32% in 2006. In the same period, the allocation of domestic bonds rose from 11% to 21%. Alternative asset classes are also attracting institutional investors (IMA 2008). Different reasons can be attributed to this trend. Firstly, pension funds are reducing investments in equities in an attempt to increase portfolio diversification as well as to reduce vulnerability to the stock market (National Statistics 2007). Secondly, following a dominant theme of discussion, pension schemes are looking to matching assets and future liabilities (liability-driven investment). IMA survey shows that 8% of the investigated pension funds are adopting liability-driven investment as their investment objectives, from 0.9% in 2005 and 6.1% in 2006 (IMA 2006; IMA 2007; IMA 2008). In addition, there was a growth in the issue of government bonds caused by higher borrowing (IFSL 2008a).



**Graph 1 - UK Pension fund asset allocation (adapted from IFSL 2008a)**

In relation to the share of occupational pension plans, there is a shift from Defined Benefit<sup>1</sup> (DB) plans to Defined Contribution<sup>2</sup> (DC) schemes. While DC plans represented only 3% in 1995, in 2006, they accounted for 20% of pension schemes, when DB plans represented 80% (IFSL 2008a). Figures from the Association of Consulting Actuaries (ACA) in 2007 contend that only one in five private sector DB pension schemes were still open to new employees (Hawthorne 2008). The 2007 NAPF Annual Survey shows that DB plans are entering a period of slightly more stability, as 62% of the pension schemes that still welcomed new members were expected to remain open under the current or a modified form over the next five years (IFSL 2008a).

Watson Wyatt's report states that, "in its current form, the expectation is that DC plans will deliver inadequate retirement income to large segments of the population" due to "poor contribution rates, poor investment strategy and poor investment choice" (Watson Wyatt 2008, p. 13). This is a negative prospect seeing that the UK system currently delivers only "37% of earnings compared with 70% in the Netherlands, 76% in Sweden and 71% in France" (Pensions Commissions 2004, p. 58).

Another change refers to the management style. There is increasing separation of alpha (value-added by active management) and beta (market return) and more specialisation of investment products (IMA 2008). There is also recent stability in the use of passive management, which represented 18% of assets under management (AUM) in 2003 and 32.1% of AUM in pension funds

<sup>1</sup> Retirement income is linked to a percentage of the employee's salary on leaving the scheme (Myners 2001)

<sup>2</sup> pension income is related to the pool of assets accumulated on the fund at retirement (Myners 2001)

and, and in 2007 around 20% of AUM and over 30% among pension funds (IMA 2008).

DB sponsors are considering transferring plan liabilities to insurance companies, but there are concerns that a substantial increase could lead to capacity issues, impacting price and popularity (IMA 2008).

The stability of the pension system is worsening due to increasing longevity of the population, falling birth rates, and rising dependency ratios<sup>3</sup>. In the UK, the ratio in 2005 was 24% (meaning one retired people for every four working people), but it is expected to be 40% in 2050, (IFSL 2008a). Moreover, it is likely that the operating environment will become tougher with the introduction of the 2012 pension reforms, which include the introduction of Personal Accounts and auto-enrolment (Hawthorne 2008).

Thus, the trend will be towards DC schemes, less equity holdings and more investment in fixed income and alternative assets (Towers Perrin 2008).

## **b) Insurance companies**

The UK insurance industry remains the largest in Europe and third largest in the world, consisting of insurance companies, the Lloyd's market, intermediaries and various specialist support professions and services (ISFL 2007b). Most of the business in the insurance industry concentrates on savings and investments rather than insurance products (Myners 2001).

While the largest companies in the long-term insurance business<sup>4</sup> are Standard Life (£11.136 billion), Aviva plc (£9.767 billion) and Legal & General (£7.361 billion), the largest companies in the general insurance business consist of Aviva (£5.9 billion), RBS Insurance (£4.4 billion) and AXA (£2.7 billion).

The long-term insurance market is highly concentrated, since the ten largest companies retain almost four-fifths of the market and the two largest ones (Standard Life and Aviva plc) retain one-fifth of the clients (ISFL 2007b). Life insurance products, with the exception of pooled pensions, are typically retail products (Myners 2001).

Also, the UK general insurance market is one of the most concentrated in Europe as a result of large-scale merger activity (IFSL 2007b).

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<sup>3</sup> Population aged over 65 as a percentage of working age population (15-64)

<sup>4</sup> includes permanent health insurance and pensions, basic life insurance, endowment policies and annuities.

| Rank | 1997  | 2002   | 2006                    |
|------|---|--|-------------------------|
| 1    | Prudential<br>(including Scottish Amicable) | Norwich Union<br>(Aviva)   | Standard Life           |
| 2    | Standard Life                               | Prudential<br>(including Scottish Amicable and M&G)                          | Aviva plc               |
| 3    | Commercial Union                            | Barclays   | Legal & General         |
| 4    | Norwich Union                               | Standard Life  | Prudential              |
| 5    | Equitable Life                              | Halifax (including Clerical Medical)   | Lloyds TSB Group        |
| 6    | AXA Sun Life                                | Scottish Widows  | Aegon                   |
| 7    | Legal & General                             | Legal & General  | ALICO                   |
| 8    | Royal & Sun Alliance                        | Zurich Financial Services (including Eagle Star, Allied Dunbar and Sterling) | HBOS Financial Services |
| 9    | General Accident                            | AXA (including PPP Lifetime)   | AXA                     |
| 10   | Scottish Equitable                          | ALICO  | Canada Life             |

**Table 2 - Life Insurance Business (adapted from BI 1999, IFSL 2004c; IFSL 2007b)**

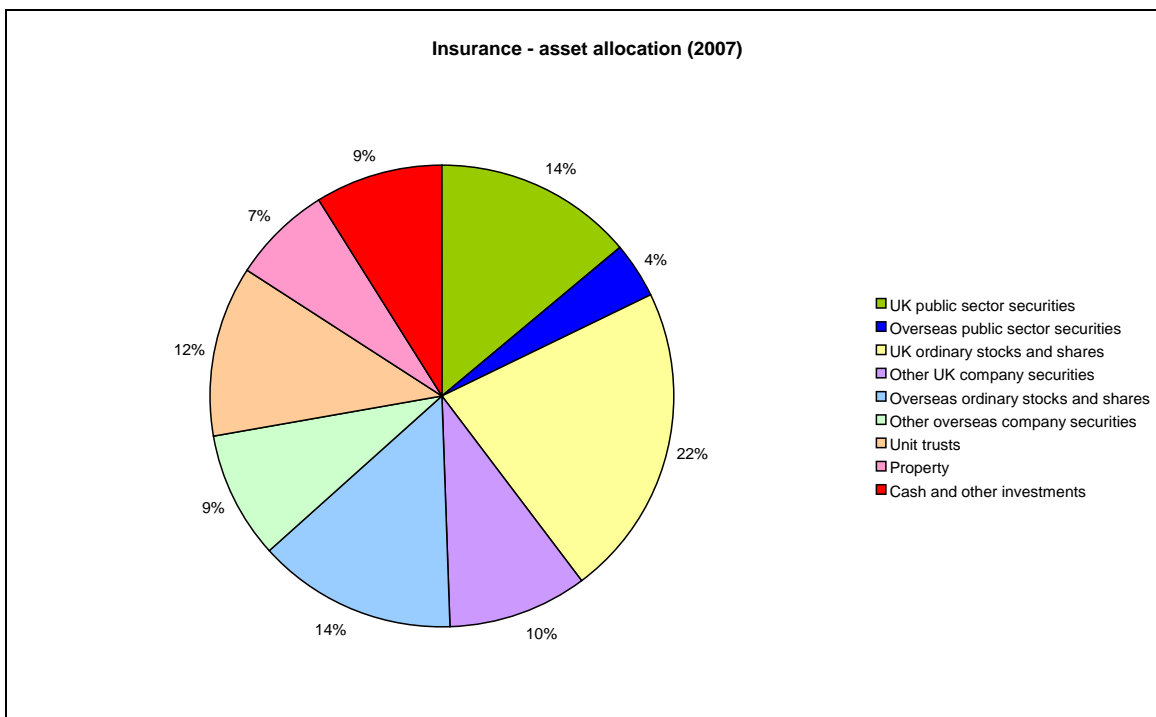
| Rank | 1997                        | 2002                           | 2006                     |
|------|-----------------------------|--------------------------------|--------------------------|
| 1    | Royal & Sun Alliance        | Norwich Union<br>(Aviva)       | Aviva                    |
| 2    | Commercial Union            | Royal & Sun Alliance           | RBS Insurance            |
| 3    | General Accident            | AXA Insurance                  | AXA                      |
| 4    | Guardian Royal Exchange     | Zurich Financial Services      | Royal & SunAlliance      |
| 5    | Eagle Star                  | Churchill Group                | Zurich FS                |
| 6    | Norwich Union               | Direct Line Group              | BUPA                     |
| 7    | BUPA                        | BUPA Insurance                 | Allianz                  |
| 8    | Cornhill Insurance          | Allianz Cornhill               | HBOS                     |
| 9    | ITT London & Edinburgh      | NFU Mutual                     | NFU Mutual               |
| 10   | Financial Insurance Company | Co-operative Insurance Society | Fortis Insurance Company |

**Table 3 - General Insurance Business (adapted from BI 1999, IFSL 2007b; IFSL 2004c)**

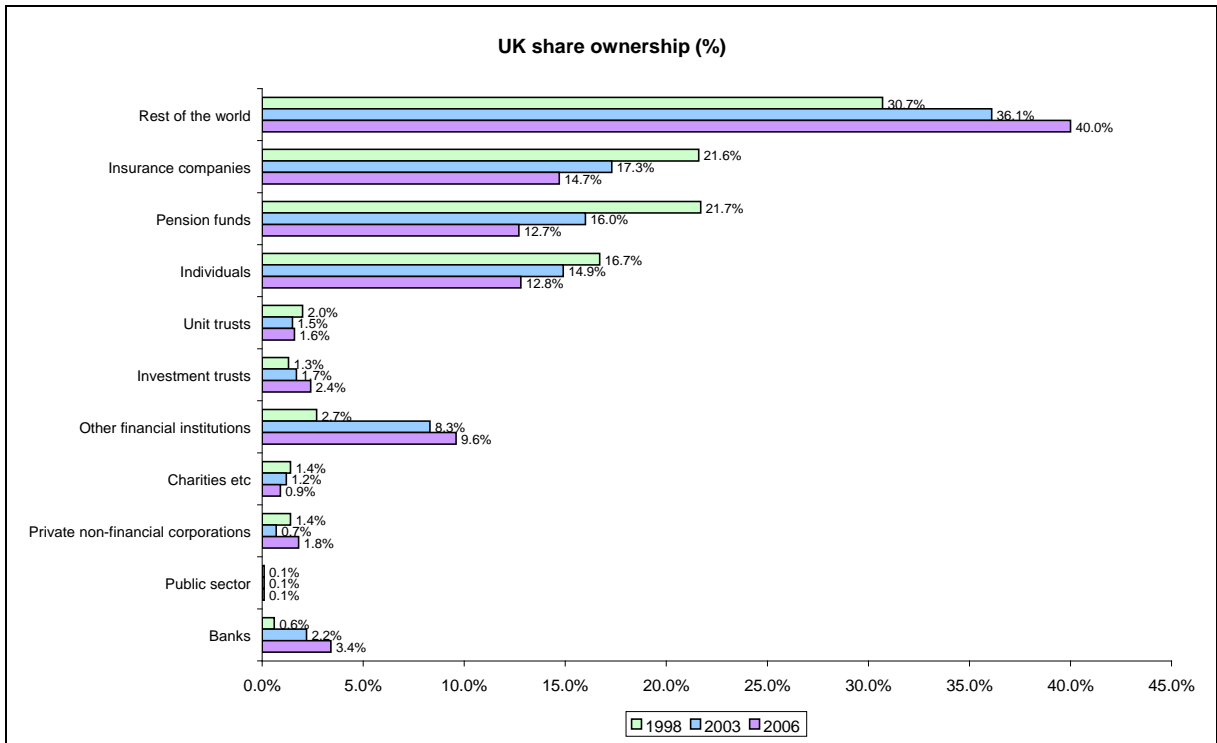
Net worldwide premium income of the UK insurance market totalled £193.9 billion in 2006: \$152.6 billion for long-term insurance and £41.4 for general insurance. Of the long-term insurance market, one-fifth corresponded to overseas premium income and the remaining was shared by occupational pensions (36%), personal pensions (27%) and life insurance (33%) (IFSL 2007b).

UK insurance companies' investments in 2006 represented £1,480bn (IFSL 2007b). According to Association of British Insurers (ABI)'s 2007 statistics, the main asset class that the UK insurance companies invested were stocks (22% in domestic shares and 14% in overseas shares). However, the sector has been reducing their investments in UK stocks in the past decade (21.6% in 1996 to 14.7% in 2006), as shown on Graph 3.

Around four-fifths of insurance companies' funds are either managed by their internal investment department or by a separate subsidiary and the remaining funds are outsourced to third-party asset management firms (IFSL 2007b). This contrasts to UK pension funds whose assets are mainly managed by external managers (Mansley 2001).



Graph 2 - UK insurance sector asset allocation (ABI 2008)



Graph 3 - UK equity ownership (adapted from National Statistics 2007)

There is greater use of passive management in the insurance industry. In 2003, the sector adopted passive strategy in 2.3% of its AUM (IMA 2003) and, in 2007, the percentage rose for in-house insurance, as seen in the figure below.

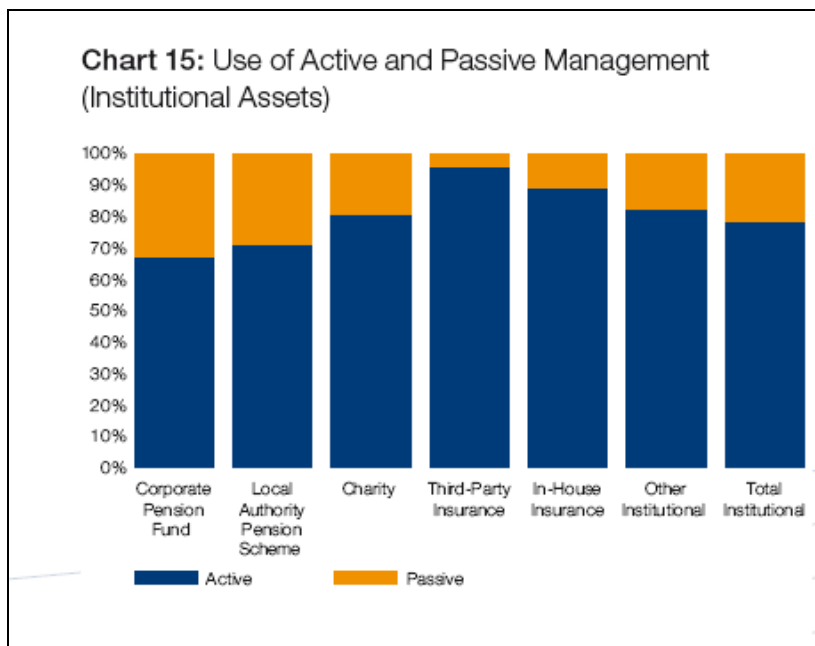
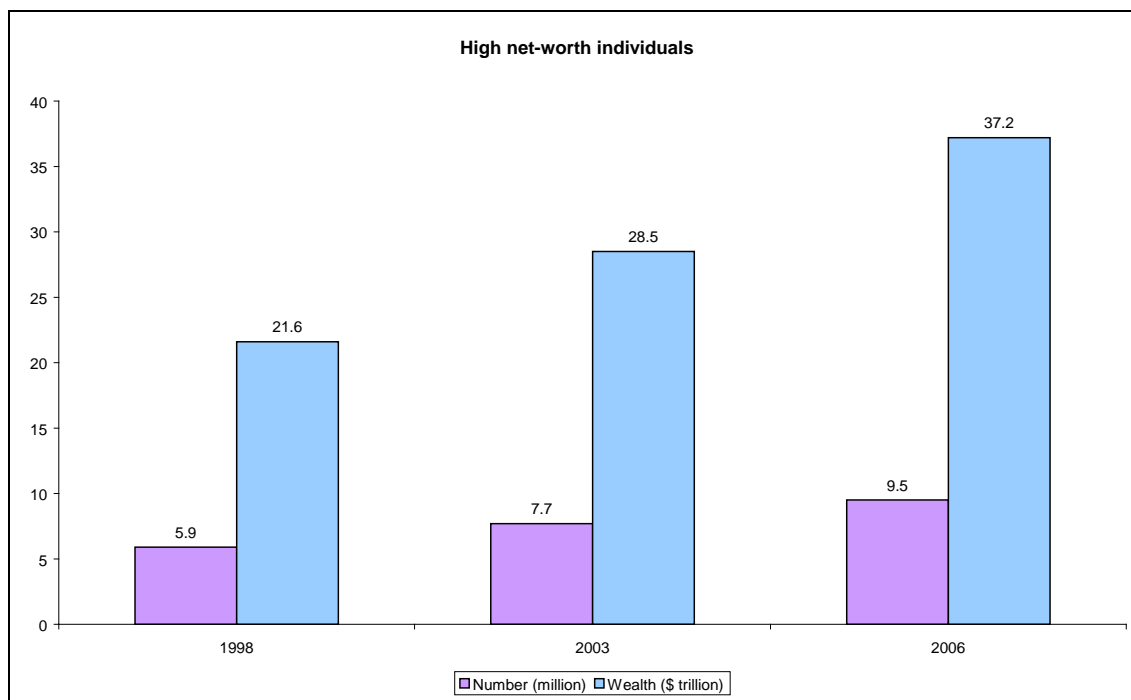


Figure 2 - Use of Active and Passive Management (IMA 2008)

The global financial crisis has been affecting the sector. The US government has recently taken control of AIG, the leading insurance company, due to its enormous financial difficulties (Guerrera 2008a). It is still not certain what the turmoil will mean for the industry.

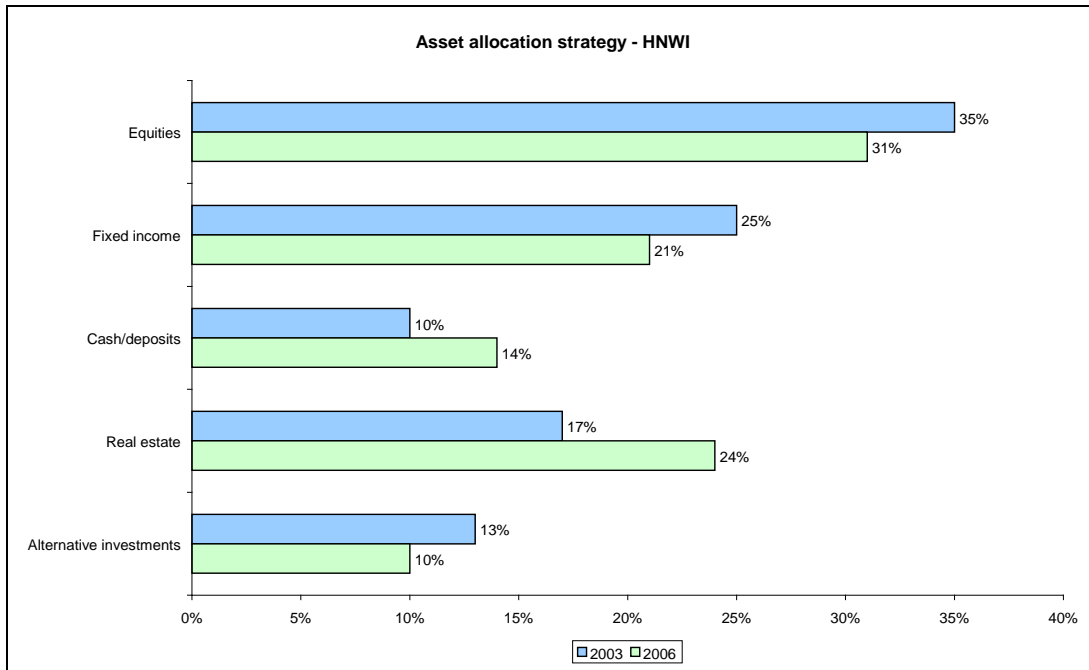
## 2 - High-net worth individuals

There is no available data on the HNWI's investment behaviour in the UK. Global statistics demonstrate that there are approximately 9.5 million HNWI worth \$37.2 trillion.



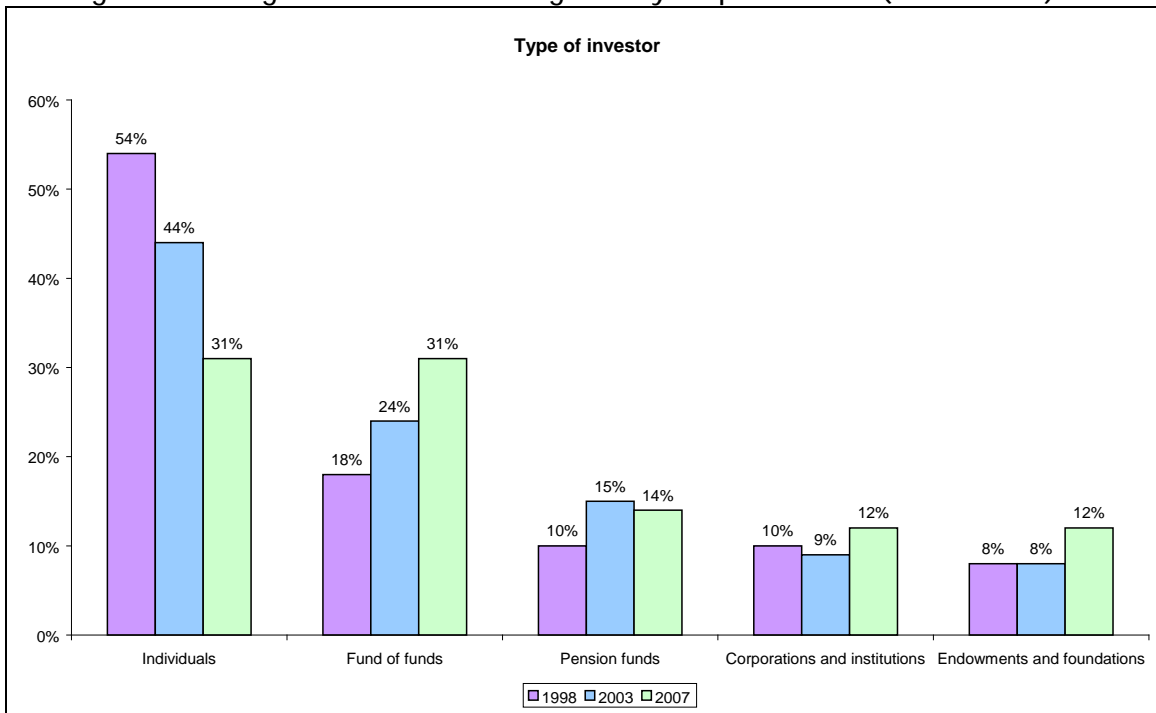
**Graph 4 - High Net Worth Individuals (IFSL 2007d)**

HNWI investors prefer to invest their assets, respectively, in equities (31%), real estate (24%) and bonds (21%). From the graph below, an investment trend is observed moving from equities and fixed income to cash and real estate. It is also noteworthy to mention that HNWIs invest a significant amount in alternative investments (10%). As Eurosif (2008, p. 19) contends, HNWI are considered "more open to new and alternative investments" than institutional investors.



**Graph 5 - Asset allocation strategy - High Net Worth Individuals (IFSL 2007d)**

World statistics for hedge funds indicate that individuals are the main type of investor (31%). High net worth individuals benefit from investing in hedge funds since offshore hedge funds are registered in tax neutral jurisdictions (such as Cayman Islands, Bahamas and Bermuda) allowing investors to reduce their tax liabilities. Moreover, there are several investment strategies for hedge funds and less regulatory requirements (IFSL 2008e).



**Graph 6 - Type of investor of Global Hedge Funds (IFSL 2008e)**

### 3 - Investment consultants

The investment consultancy industry is estimated to be worth approximately £80 million a year in fees (Myners 2001). The sector is highly concentrated. The largest organisations, according to 2002 data, are AON, Mercers, Watson Wyatt, Phillip and Drew and Hewitt Bacon and Woodrow (Insight Investment 2002 in Waygood 2006). The high concentration of the market is not caused by classic competition problems, but by a conjunction of issues, such as low profitability, high research costs and a small market. As a result, advice to institutional investors tends to be fairly “uniform, insufficiently specialised and in particular, poorly equipped currently to deal with alternative asset classes” (Myners 2001, p. 71).

### 4 - Fund managers

“Fund managers include independent investment managers that are not linked to any UK-based banking, securities or insurance groups” (IFSL 2007f, p. 3). In terms of assets under management, the largest UK fund management organisations are Barclays Global Investors (£1.62 trillion), Legal & General Investment Management (£384 billion) and HSBC Asset Management (£300 billion).

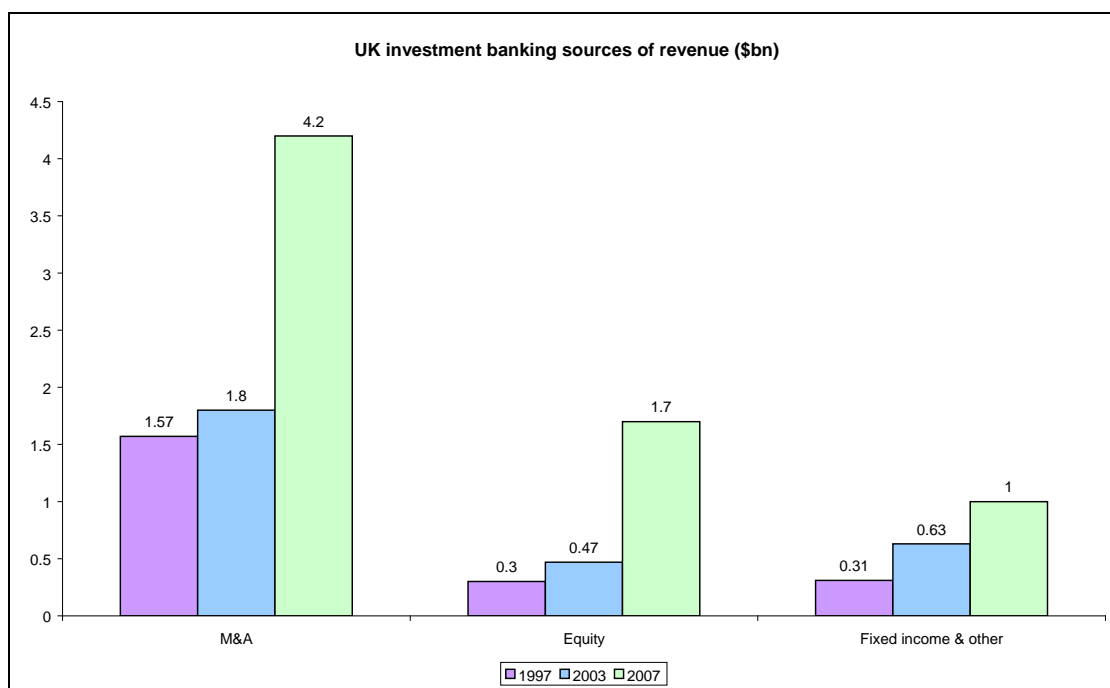
The UK market is relatively concentrated as the top ten fund managers account for half of the UK funds (IFSL 2007f).

| Rank | 2003                    | 2006                                   |
|------|-------------------------|--|
| 1    | Barclays                | Barclays Global Investors              |
| 2    | Amvescap                | Legal & General Investment Management  |
| 3    | Aviva                   | HSBC Asset Management                  |
| 4    | HSBC                    | Morley Fund Management                 |
| 5    | Prudential              | Invesco Institutional                  |
| 6    | Legal and General Group | Standard Life Investments              |
| 7    | Schroders               | Schroders Investment Management        |
| 8    | Standard Life Insurance | F&C Investment Management              |
| 9    | Lloyds TSB Group        | Scottish Widows Investment Partnership |
| 10   | HBOS Group              | Insight Investment                     |

**Table 4 (adapted from IFSL 2003 in Waygood 2006; IFSL 2007f)**

## 5 - Investment banks

As far as investment banking is concerned, UK's leading position in Europe and global importance is attributed to its trading culture, skills base and language, besides its good geographic location and regulatory environment (IMA 2008). The majority of international banks either are headquartered in London or have an office there (IFSL 2008g). Most investment banks provide work for companies, banks, government organisations and wealthy individuals. Their work can be broadly categorised as corporate finance and advisory work, treasury dealing, investment management and securities trading. In the UK, the major source of income stems from the M&A advisory work (IFSL 2008g).



**Graph 7 - UK Investment banking sources of revenue (adapted from IFSL 2008g)**

The ranking of the largest investment banks in the UK has recently changed as Lehman Brothers filed for bankruptcy protection on 15 September in the US and sold part of its business to Barclays and the Japanese bank Nomura, which acquired, respectively, the North American investment banking and capital business and the European and Middle Eastern equities and investment banking divisions (MacIntosh and Hughes 2008; Saigol 2008). On the same date, Bank of America agreed to acquire Merrill Lynch (Guerrera 2008a). Such turbulence is part of a major sub-prime mortgage crisis triggered by cheap money and easier lending which caused the acquisition of Bear Stearns by JPMorgan in March (Guerrera et al 2008), nationalisation of mortgage groups Fannie Mae and Freddie Mac on 7 September (Financial Times 2008a), the take-over of AIG by the US government on 17 September (Financial Times 2008b) and

the acquisition of Washington Mutual's banking operations by JPMorgan on 25 September ([Sender et al 2008](#)).

In the UK, the crisis triggered the nationalisation of Northern Rock on 17 February ([Croft and Gilles 2008](#)), the agreement on the purchase of HBOS by Lloyds TSB on 17 September ([Financial Times 2008c](#)) and the nationalisation of Bradford and Bingley on 29 September ([Hill 2008](#)). Several jobs are supposed to be cut, including 1,100 jobs at HSBC, 500 of which are in the UK ([Larsen 2008](#)).

Among the largest investment banks, Goldman Sachs and Morgan Stanley are the last Wall Street's independent investment banks, but the environment is still of uncertain ([Financial Times 2008d](#)). The US Federal Reserve has recently decided to allow them to become bank holding deposits. As a consequence, the Fed becomes the main regulators of these banks (instead of SEC) and gives them access to its borrowing facilities ([Guerrera 2008c](#)).

The US Treasury had recently proposed a \$700 billion bailout plan to rescue the financial sector. The House of Representatives declined the plan on 29 September 2008, while the US Congress approved it two days later (Dombey et al 2008).

According to the German finance minister P Steinbrück, the US lost its role as a global financial superpower in the the financial crisis ([Benoit 2008](#)).<sup>5</sup>

## 6 - Public listed companies

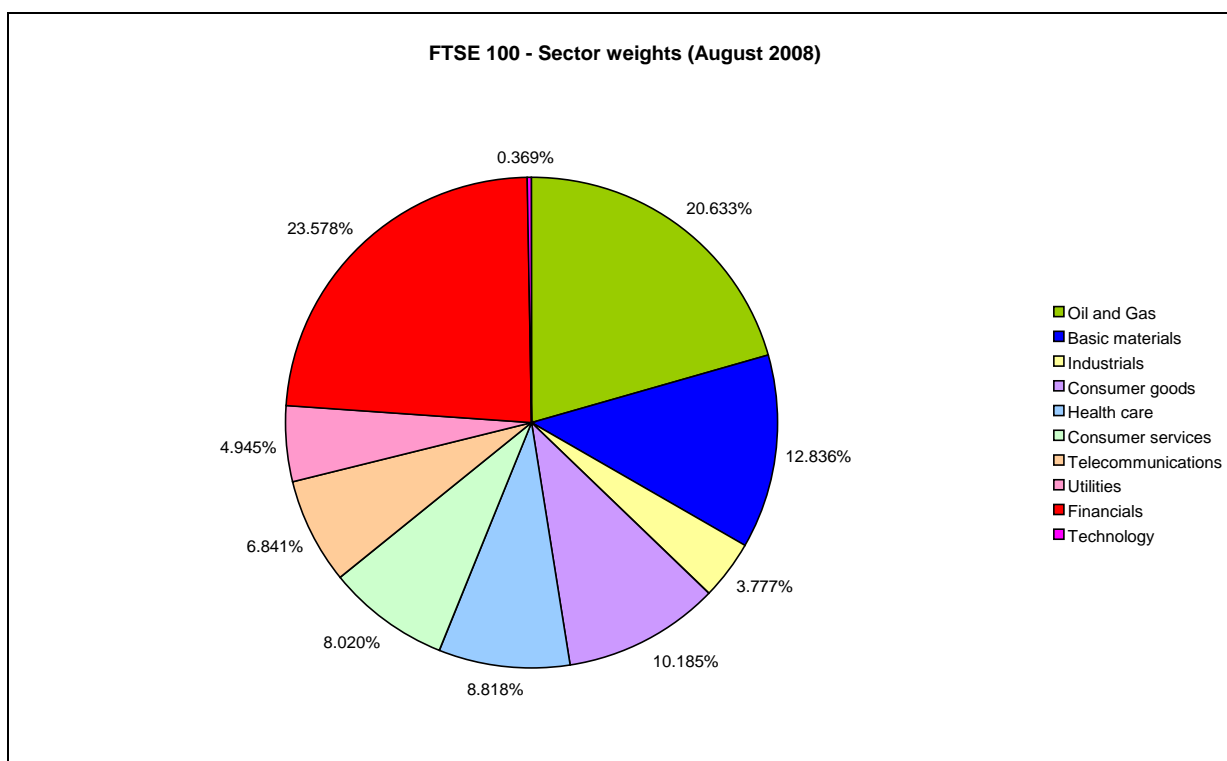
The FTSE 100 Index comprises the 100 most highly capitalised blue chip companies, representing approximately 85% of the UK market (FTSE 2008). The table below lists the 10 largest companies:

| Rank | 2008                |
|------|---------------------|
| 1    | BP                  |
| 2    | HSBC Holdings       |
| 3    | Vodafone Group      |
| 4    | Royal Dutch Shell A |
| 5    | Rio Tinto           |
| 6    | GlaxoSmithKline     |
| 7    | Royal Dutch Shell B |
| 8    | Anglo American      |
| 9    | BG Group            |
| 10   | BHP Billiton        |

**Table 5 (adapted from FTSE 2008)**

BP accounts for a net market capitalisation of almost £ 110 billion, £ 93 billion for HSBC Holdings and £ 78.5 billion for Vodafone Group. The constituent from the FTSE 100 Index are primarily from the financial and oil and gas sectors, as the graph below shows.

<sup>5</sup> Last updated 1 October 2008



**Graph 8 - FTSE 100's sector weights (adapted from FTSE 2008)**

Although UK shares were mainly owned by individual investors in the past (54% of UK shares in 1963), now the main investors are institutional (National Statistics 2007). As previously shown in [Graph 3](#), institutional investors are the main owners of UK companies. In 2006, while the insurance companies owned 14.7% of the UK shares, pension funds owned 12.7% (27.4% altogether) and individuals only hold 12.8% (National Statistics 2007).

However, the percentage of shares that institutional investors own in each company is lower than 3%. "British pension funds seldom hold more than 2-3% of any large company they invest in. Life insurance companies hold up to 3-4% and they only hold 2% or less in mega companies" (Monks & Sykes 2006, p. 231). These numbers present challenges to shareholder engagement by institutional investors if working individually (Thamotheram & Wildsmith 2007).

Another observed trend among companies is the move away from public listed companies to private companies through private equity buyout. In 2007, the US utilities company TXU was acquired by Kohlberg Kravis Roberts and Texas Pacific Group for \$45 billion, confirming the trend. Such shift leads to some concerns, one of them being transparency and accountability. Non-listed companies are subject to fewer requirements of disclosure than listed companies. On the other hand, private companies are not subject to quarterly reports (Wolf 2007), which enables them to have a longer-term investment horizon. Moreover, private companies have been more reluctant to accept that the interests of other stakeholders. This might lead to regulation in the future (Buiter 2007).

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