

Big Bang

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Introduction

The Big Bang exploded in the City of London on 27th October 1986, blowing up the restrictive practices which had existed there for centuries.

In this article, I explain the main effects of Big Bang, both direct and indirect. Having explained how the pre-Big Bang Exchange operated, I give a description of the main changes that will occur on October 27th. The more far-reaching effects are then discussed, and this section draws heavily on the American experience of Big Bang on May 1st 1975. Finally, I end by briefly discussing the likely effects these changes will have on the Dublin Stock Exchange.

How the Stock Exchange Works

The Stock Exchange, like any other market, is the coming together of the forces of supply and demand to determine price. The 'Goods' on offer in this market are basically of three types: equities, gilts and options. Equities are simply shares in a company which may or may not guarantee the holder a dividend at the end of the year, while gilts or government bonds are loans to the government which do guarantee to pay the holder a fixed sum of money for a set period. Options are speculative instruments, which given an individual the right, for a given period, to buy shares in a certain company, at the present market price, at some period in the future. Obviously, if one feels that today's value of certain shares is below their true market price, it will be advantageous to purchase the option to buy those shares at that price and exercise the option if the share price rises within the specified period. While options clearly illustrate the speculative element of the Stock Exchange, it is equities and gilts which are the most important traded items.

The principle investors in the Stock Exchange are:- Life Assurance Companies, Fund Managers and Unit Trusts. Together they presently hold British equity valued at £210 billion. When one of these investors wishes to buy or sell shares, they approach their stockbroker who is a member of the Stock Exchange. The brokers' main functions are to buy and sell shares on behalf of clients and to offer advice to them, for which they are paid a commission. In order for a broker to deal in shares, he must approach a Stock Jobber, who is also a member of the Stock Exchange. The jobber is like a wholesaler, who is allowed to deal with the brokers, but not the public. The jobbers' income is derived from the appreciation in the value of shares on his book and also from 'jobbers' turn', the difference between his buying and selling price. This division of roles between jobbers and brokers is unique to the London Stock Exchange. In New York, for example, a broker wishing to sell shares on behalf of his client, searches around for a willing buyer among other brokers and market makers. If the market is depressed, he may not be able to find a buyer and so is forced to hold shares which are depreciating in value.

On the London Stock Exchange, the jobber will always agree to purchase shares from the broker. However, if the market is under pressure, the price he will be prepared to pay will be fairly low. It can be seen clearly then, that the business of jobbing is extremely risky. It involves a very careful study of the market and scrutinising of trends. On the other hand, the income the stockbroker receives is not variable, as all brokers charge the same fixed commission. An example of some commissions charged in 1986 are as follows:

Minimum Commission Rates (1984)*1

Gilt Edged:

For transactions under £200	at discretion
For transactions under £640	£4
For transactions over £640	at discretion
in short-dated stocks	
in stocks with more	
than 5 years to redemption	5/8% of the value.

Debentures and Loan Stocks:

For transactions under £200	at discretion
For transactions under £934	£7
For transactions over £934	3/4% of the value
	(with lower rates if
	above £5,000)

Ordinary and Preference Shares:

For transactions under £200	at discretion
For transactions under £467	£7
For transactions over £467	1.5% of the value
	(with lower rates if
	above £7,000)

The above then, is a brief description of how the London Stock Exchange operated for many years until October 1986. With this background, we can now judge the effects that Big Bang will have on the operation of the market.

The Transition from Cartel to Open Market

Before October 1986, the City was a cartel. Commercial banks handled the small bankloan market, merchant banks dominated corporate finances, stockbrokers acted as agents for their investors and jobbers had a monopoly on market making in securities. Everyone had their place and nobody poached another's territory. This, along with the fact that all broking commissions were fixed, resulted in brokers charging roughly twice that of their New York counterparts.

Obviously, such a situation could not be allowed to continue indefinitely, and it was only due to the ability of the City to cover its practices with a veil of decency which allowed them to operate for so long. In February 1979, the Director General of Fair Trading informed the Stock Exchange that he was going to take action under the Restrictive Practices Act, 1956. This statement took the Stock Exchange entirely by surprise. Many Committees had scrutinised the work of the City and Stock Market, but even the Wilson Committee, which was very critical of some of the practices of the financial sector, stopped short of such drastic action. Faced with the prospect of having to defend itself in front of the Restrictive Practices Court, the Stock Exchange set about preparing a detailed defence. The replacement of the Labour Government by the Conservatives in 1979 was followed by intensive lobbying of the new Trade and Industry Secretary, but he refused to reverse the decision.

*1 How the Stock Exchange Works - Norman Whetnall.

However, in July 1983, the case was abandoned. The Secretary of State indicated to the Chairman of the Council of the Stock Exchange, that if certain changes were made to the Exchange rules, most notably those governing fixed commissions and membership, then he would be willing to drop the action. The Chairman quickly agreed and thus paved the way for Big Bang in October 1986.

The Big Bang itself - Description of exactly what changes it will bring

The Big Bang of October 27th blew away the restrictive practices of the City. It aimed to abolish what the Government viewed as being the most serious obstacles to competition, namely:-

- 1) Fixed commissions
- 2) Separation of the functions of brokers and jobbers
- 3) The absence of competition in the gilt market.

Prior to the Big Bang, all stockbrokers charged the same commissions on the sale and purchase of shares for their clients. Obviously, this fixed price system allowed inflated rates to be charged, and permitted inefficient broking firms to survive. In New York, commissions for the big institutional investors, which account for most of the trading, have fallen to between five and ten cents a share (averaging between 0.15% and 0.3%) since 1975. In London, institutions have to buy £600,000 worth of a share before reaching the lowest rate of 0.3%. However, after October 27th all this will change. Investors will be able to 'shop around' and find the broker offering the best services at the lowest price. Even further, institutions will purchase shares from three sources:-

- 1) Market makers that quote a net-net price (i.e. offer shares at a fixed price with no commission).
- 2) Market makers that quote a net price (i.e. contains an element of commission).
- 3) Broker agencies which act as middlemen with the market makers and will negotiate a commission.

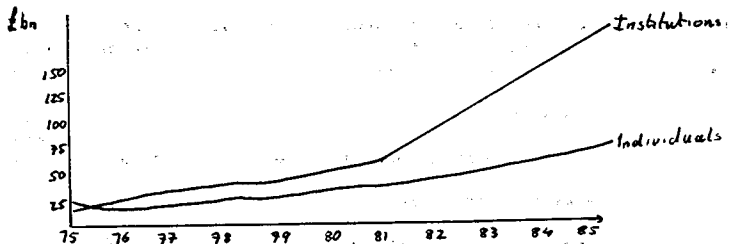
Pre Big Bang equity commission rates had many hidden extras built in. For example, most of the major stockbroking firms carry out large scale research on domestic and foreign companies, and also into market trends and movements. The major financial institutions were sent these papers whether they requested them or not, and of course were obliged to pay for them through the fixed commission. However, from now on, the institutions will pay only for the research which they expressly request. The impact of this is going to be that many broking firms, which relied heavily on research fees, may go out of business or become the object of take-over bids. The main City investors are looking forward to major declines in the price of their equity dealings which stood at over £100 million in 1985. For example, Standard Life, a life assurance company, expects its equity bill to fall by 30%, the Electricity Supply pension fund expect a drop of 25%, pension funds of British Gas by 50%, and those of the Post Office by as much as 60%.

Therefore, it can clearly be seen that the mighty financial institutions certainly had reason to cheer the Big Bang. However, what about the small private investor? What has he, if anything, to gain from Big Bang?

Many brokers, forced to reduce prices to the major investors, will be turning to the small scale investor to try and offset their losses in revenue.

As the chart shows, small investors have really returned to the Stock Market in the past five years or so:-

Value of shares held by individuals and institutions



In 1966 2.5 million people in Britain held shares directly. Now over 4.5 million do. Obviously the much publicised share sales of British Telecom, T.S.B. and British Gas have helped this trend. Also, more and more firms have started giving employees shares as part of their remuneration as a policy of promoting industrial harmony.

All pre Big Bang deals of up to £7,000 carried a commission of 1.65%, subject to a minimum rate of £12. This meant that the ill-informed investor, who took up many hours of his brokers' time having the whole Stock Market process explained to him, was charged exactly the same price as the experienced amateur, who knew what he wanted and simply informed his broker what to buy and sell on his behalf. After October 27th, brokers will cater for three types of investor:-

- 1) Knowledgeable punters, who want a 'no frills' service, commission likely to be around 1%.
- 2) Discretionary clients - those who will permit the broker to invest on their behalf.
- 3) Advisory clients - those who want to be consulted before a broker deals for them. They will have to pay more for this detailed service, either in the form of higher commission or an annual management charge.

As mentioned above, the unique system of having brokers and jobbers trading with each other on the floor of the Exchange, is going to be abolished on October 27th. Single capacity will go, and from that date dual capacity will be permitted. This has led to some major broking firms taking over jobbing firms, and some investment banks have taken over both. For example, Barclays de Zoete Webb was formed by the amalgamation of Barclays merchant bank with the stockbroking firm de Zoete Bevan and the leading jobber Webb Durlacher.

The final explicit aim of Big Bang is to introduce competition into the Gilts market. Under the old system, Mullens acted as the government broker, issuing government securities. The two jobbers, Webb Durlacher Mordaunt and Ackroyd Smithers dominated market making. Now, any broking firm can apply to the Bank of England for a licence to become an official primary gilt dealer. Licences have already been granted to 29 firms

permitting them to deal from October 27th. However, it seems very unlikely that a market, which hitherto only had to support one firm, is going to prove profitable for all 29. It seems inevitable that some firms will be forced to drop out (two already have) and those that remain may merge or be taken over by their larger competitors.

New York's equivalent of Big Bang took place on May 1st 1975. As already explained, the New York Stock Exchange has always had dual capacity, so the main changes that occurred were:-

- 1) The abolition of fixed commission on share transactions.
- 2) The approval of public ownership of the New York Stock Exchange member firms.

Prior to 1975, stockbroking firms competed with each other on the quality and level of services offered. When price competition was introduced, many money managers of pension funds decided they would prefer lower commissions instead of highly expensive services. They sought out the big retail brokerage houses and investment banks which were efficient enough to provide good research facilities at low prices. Many of the smaller firms, known for their quality, but expensive, research services have disappeared (e.g. Baker Weeks and Clark Dodge).

As well as leading to a much greater range of prices and services, Big Bang in New York resulted in a massive increase in the level of business on Wall Street. The net profit of NYSE member firms totalled \$2.1 billion in 1985, compared with \$415 million in 1975. Also since May 1st 1975, the number of people employed in the securities industry in the U S has increased from 171,300 to 366,900. However, as with any policy issue, Big Bang was not Pareto efficient, there were both losers and gainers as a result of it.

Among the losers are the individual investors who, requiring detailed and frequent investment advice from their brokers, must now pay considerably more for this service than previously. This has resulted in a sizeable reduction in the number of individual investors on Wall Street. Some have left because they can no longer afford the necessary services, while others have switched to collective ownership by getting involved in mutual funds or retirement schemes, rather than holding their own portfolios. This shift has meant that the market has become even more dominated by financial institutions. For some stock market commentators, this is seen as a positive step, while others view it with regret.

Also counted among the losers are the middle to small sized brokerage houses. The larger and more efficient brokers have managed to squeeze them out by offering a much more attractive package of a wider range of financial services at a lower price.

The obvious gainers, as in the case of London, from the new regulations, have been the major financial institutions. They are now able to use their size to negotiate better rates with the broking firms. It is estimated that in the U.S. their trading costs have fallen by 70% as a result of price de-regulation. As a result of the lower rates, these major investors now trade more actively than previously. More than 60% of the stock in the portfolios managed by financial institutions is turned over every year.

The other main gainers have been the investment banks offering specialist advice in the field of mergers and acquisitions, underwriting initial public offerings etc. These banks, which can command sizeable fees for their specialist services, have enjoyed a major increase in business as a

result of the increased activity on the Stock Market. The rewards for handling the sale of a client company's shares, and the distribution of those shares, can be a commission 5 - 7%.

Therefore, if New York's experience of de-regulation over the past fifteen years is anything to go by, at the end of the century, London will have fewer, stronger brokers-cum-merchant investment banks offering cheaper services to a market dominated by institutional money handled by hyper-active money managers. Individual investors will pay more to receive less."

The Indirect Effects of the Big Bang

In this section I want to look at the more far-reaching effects of Big Bang. I have already discussed the main changes which occurred on October 27th. However, these changes are going to have a far greater effect on the way the City conducts its business than may appear at first sight.

I have explained the reasons for the whole-hearted welcome the financial institutions have given the Big Bang. It is expected that they will no longer spread their buying and selling orders across as wide a range of firms as they have to date. In future, it will be to their advantage to deal only with 6 or 7 of the larger brokers, using the smaller specialists only occasionally. Obviously, by doing this, the institutions can hope to negotiate much better commission reductions, they will be looking for the cheapest and most efficient dealers, particularly when choosing a broker agency. This means they will favour firms with a strong efficient back room. This will leave the small to middle size stockbroking firms in a fairly difficult position. They will be unlikely to be able to compete on cost terms. Those that have well-developed research departments may be the subject of take-over bids from the larger firms or the investment banks. It should be emphasised that these large, successful broking firms may not be British and are very likely to have a reasonable number of foreigners among them. Thus Big Bang is going to accelerate the process of removing the City from British ownership.

If the American experience is anything to go by, and there is no reason to believe things will be any different in London, Big Bang should lead to a considerable increase in the volume of trading. Merrill Lynch anticipates the increase could be as much as threefold. Increased market activity will result in much greater fluctuations in share prices. To try and counteract this, firms are going to have to be far more open with their investors than before. They will need to give them detailed information on all present projects in an attempt to prevent shareholders panicking and selling when these fluctuations occur. For many of the larger British firms, who already spend a great deal on informing their investors, the above result will not require the taking of any immediate action. However, for others, it will require spending considerable sums on the development, or in some cases, the establishment, of research departments.

One of the more concrete effects of Big Bang is the emergence of a new type of company for investors to deal with - the market maker. Market makers will be part of large broking firms which are in turn, likely to be owned by one of the leading investment banks.

"They will display their prices on a nation-wide screen linked to the Stock Exchange Automated Quotations System (SEAIQ)." They can take large positions in a share, becoming in effect, short term investors. Companies will have to build direct links with them, they could cause

huge swings in share prices."(*1)

I have already mentioned that the small stockbroking firms may have something to fear as a result of Big Bang. However, they will not be alone. Many other institutions, such as some of the British Merchant Banks and even the clearing Banks are going to find it difficult to compete with the foreign competitors, most of whom have always operated in a dual capacity market. The American and other foreign giants also have a much greater capital base than most of the British banks (except of course, the four clearing banks). This allows them to take greater risks and to weather short term losses more easily. These two characteristics, along with the fact that most foreign banks, who unlike their British counterparts have long experience in government bond trading, will give them a definite advantage in the gilt market. Five banks altogether, Citicorp, Chase Manhattan, Security Pacific, Bankers Trust and Morgan Guaranty are all setting up primary gilt dealers in London. The British banks have less to fear from the foreigners, at least for the present, in the equity markets. Few foreign banks have acquired stockbrokers, and those that have, have no previous experience of the equity market (eg Citicorp). However, the above situation is unlikely to remain indefinitely for two reasons:-

- 1) Last year British Corporations raised £5 billion in new equity. With the level of fees charged by Investment Banks, it is doubtful that the foreign banks are going to remain spectators for long.
- 2) As the full advantage of having access to SEAQ, (through membership of the Stock Exchange) the screen system where blocks of shares are advertised simultaneously on the screens of all members, are fully realised. The system will greatly facilitate exchanges by reducing information costs considerably. Those outside the system could find themselves paying premium commission rates to members in order to participate.

One long term effect of Big Bang is certain, it is going to totally change many long standing City relationships. Up to now, if a company wished to go public or make a rights issue, it would go to a Merchant bank to underwrite the new share issue and to a stockbroker to price and place the shares. However, due to Big Bang, some stockbrokers have already been taken over by Investment Banks, and as explained above, the number is likely to increase if anything. Thus, this once clear dividing line between the two trades has been blurred. So large companies, such as I.C.I., might be encouraged to dispense with long standing relationships and start experimenting with those foreigners who offer 'package deals' and are also likely to be considerably cheaper.

Finally, Big Bang has allowed the physical side of the City to expand. Since firms no longer need a broker on the floor of the Exchange in order to deal, many major banks such as BZW are moving to new headquarters outside the traditional square mile. This trend could eventually lead to the disappearance of the City as we know it today!

*1 'The Economist', September 13th, 1986.