

Schenk, Catherine R.

**Working Paper**

**The big bang and the City of London**

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## The Big Bang and the City of London

### Abstract:

Brexit poses an existential challenge the City of London as a European and global financial centre. The withdrawal of 'passporting' threatens the ability of financial institutions in London to sell services to customers in the EU, and this has prompted many predictions of London's financial demise. Banks are considering relocating staff and activities to other European centres such as Frankfurt, Dublin or Paris. Reflecting on London's history offers some insights into how The City might respond to this new challenge.

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IBF – Institut für Bank- und Finanzgeschichte e.V.  
Eschersheimer Landstraße 121-123  
D-60322 Frankfurt am Main  
Germany  
Tel.: +49 (0)69 6314167  
Fax: +49 (0)69 6311134  
E-Mail: dreisch@ibf-frankfurt.de

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Professor of Economic & Social History, St Hilda's College, University of Oxford

Mailing Address: University of Oxford, Faculty of History, George Street, Oxford, OX1 2RL, United Kingdom, E-Mail: [catherine.schenk@history.ox.ac.uk](mailto:catherine.schenk@history.ox.ac.uk).

## The Big Bang and the City of London\*

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Brexit poses an existential challenge for the City of London as a European and global financial centre. The withdrawal of 'passporting' threatens the ability of financial institutions in London to sell services to customers in the EU, and this has prompted many predictions of London's financial demise. Banks are considering relocating staff and activities to other European centres such as Frankfurt, Dublin or Paris. Reflecting on London's history offers some insights into how The City might respond to this new challenge.

The City of London has reigned as the dominant international financial centre for Europe since the demise of Amsterdam in the 18<sup>th</sup> century. Based on Britain's commercial dominance through the 19<sup>th</sup> century, the agglomeration of financial and commercial services in London thrived on relatively free markets in trade and exchange until the reversal of globalization in the Great Depression of the 1930s. Even then, the persistence of controls on international banking in New York until the 1970s meant that the City remained at the pinnacle of the global financial system in the first two decades after 1945. But its position was not unassailable. London proved remarkably resilient to the decline of Britain's commercial power and the retreat of sterling as an international currency. In particular, from the early 1960s London's Eurodollar and Eurobond markets drew in banks and finance companies from around the world while regulators in Frankfurt discouraged the development of these markets.<sup>1</sup> However, during the 1970s the London Stock Exchange fell behind its much larger rival in New York. When the final British exchange controls were abandoned in 1979, there were no barriers for British investors to access the New York market and the result was that the London exchange was quickly eclipsed.

On 27 October 1986, seemingly dramatic changes in the City of London promised to transform the functioning of the securities market. The change was popularly dubbed Big Bang, which signified a dramatic and abrupt new direction for the London Stock Exchange (LSE). For the first time, brokers were able to compete on price rather than abiding by the fixed commissions set by Stock Exchange Rule Book. This seemingly minor adjustment to how the market operated had far reaching effects: the end of the separation of brokers and jobbers, a new IT trading platform, and lifting the rules that had excluded foreign companies from the exchange for centuries. The Big Bang seemed an almost instant success and has since been viewed as the savior of the City of London as the Europe's leading financial centre. Nigel Lawson, Chancellor of the Exchequer during 1986, later claimed that *"Without [Big Bang], it is doubtful if London would have retained its place as Europe's pre-eminent financial centre, and certain that it would not have become the foremost truly international financial centre of the modern globalised economy that it is today, to the great*

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<sup>1</sup> Schenk (1998).

*benefit of the British economy as a whole*<sup>2</sup> But looking more closely, the revolution in the market seems less dramatic and less impactful – less of a shocking 'Bang' and more an adaptation to longer term forces. So, what was Big Bang and how did it affect securities trading in London?

The London Stock Exchange (LSE) was a self-regulating organization with a trusted and ancient rule book enforced on its members. To avoid conflicts of interest and to protect customers, the rules separated Brokers (dealers for customers) from Jobbing (market makers for brokers). Most importantly, brokers had to abide by a framework of fixed commissions to prevent competition, and this made trading on the stock exchange particularly expensive for small investors. The New York Stock Exchange had got rid of fixed commissions in May 1974, a move which revived turnover and reduced average commissions by about 50%, particularly on large trades. For the first five years, this had a limited impact on the LSE's customers because of exchange controls, but in 1979 Margaret Thatcher's Conservative Government finally abandoned the last UK exchange controls and British investors had free access to the New York market to trade British, US and international securities. The New York stock exchange surged ahead of London, but the LSE stubbornly clung to its traditional ways, protecting incumbent members. Nevertheless, foreign firms increasingly traded outside the exchange for their institutional clients. The LSE thus faced competitive forces within London as well as beyond.

By 1979, there was a variety of British interests promoting reform: the Bank of England wanted greater competition in the gilt market, which had reduced to only 2-3 jobbers controlling 70-80% of the market. Margaret Thatcher's government was committed to a massive privatization campaign and wanted to bring the general public into a shareholding democracy, but the public needed cheaper and easier access to the market. Fortunately, the means to overcome the LSE's closed system had been laid down by the previous Labour Government's agenda to promote consumer interests. The 1973 Fair Trading Act extended existing anti-monopoly rules to the services sector and in 1976 a Restrictive Practices Court was set up to test and enforce open competition across the economy. In February 1979, Gordon Borrie, the Director-General of Fair Trading referred the LSE Rule Book to the Court. The LSE objected and sought to be exempted, but the incoming Thatcher government remained firm: the LSE was operating restrictive practices that increased the cost of share trading especially for the small investor. For almost 4 years, the LSE continued to lobby for exemption until a deal was finally struck in October 1983. The Rule Book could continue exist so long as the fixed commission was abandoned within 3 years. The clock was ticking for reform of the market, but there was plenty of time to adapt.

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<sup>2</sup> Lawson (2006).

With fixed commission now bound to disappear, the separation of brokers and jobbers seemed unsustainable. In the run up to Big Bang, the market response was a rush of mergers and acquisitions as companies positioned themselves for a more competitive market. In 1986, London merchant banks alone acquired stakes in 11 brokers and 3 jobbers, while 22 foreign institutions acquired stakes in 26 brokers and 1 jobber. This consolidation also marked a shift from partnerships to public companies, which shifted the burden of risk from owner-managers to shareholders. But other opportunities also drove conglomeration in the 1980s: Corporate IPOs, the wave of pending privatizations across Europe, interest rate volatility and the surge in bond market trading all increased demand for investment banking services. Also, the European White Paper on completing the internal market published in 1985 signaled the looming single market in 1992 and financial institutions sought to position themselves for this new world.

Figures 1 and 2 below show the number and distribution of acquisitions in the run up to Big Bang: most targeted firms before and during the Big Bang were brokers and most acquiring firms were banks. Moreover, while 1986 marked a peak of this activity, the process of consolidation began at least two years beforehand. Moreover, the peak of merger activity was in 1990, well after Big Bang, driven mainly by insurance companies and larger financial groups.

Figure 1

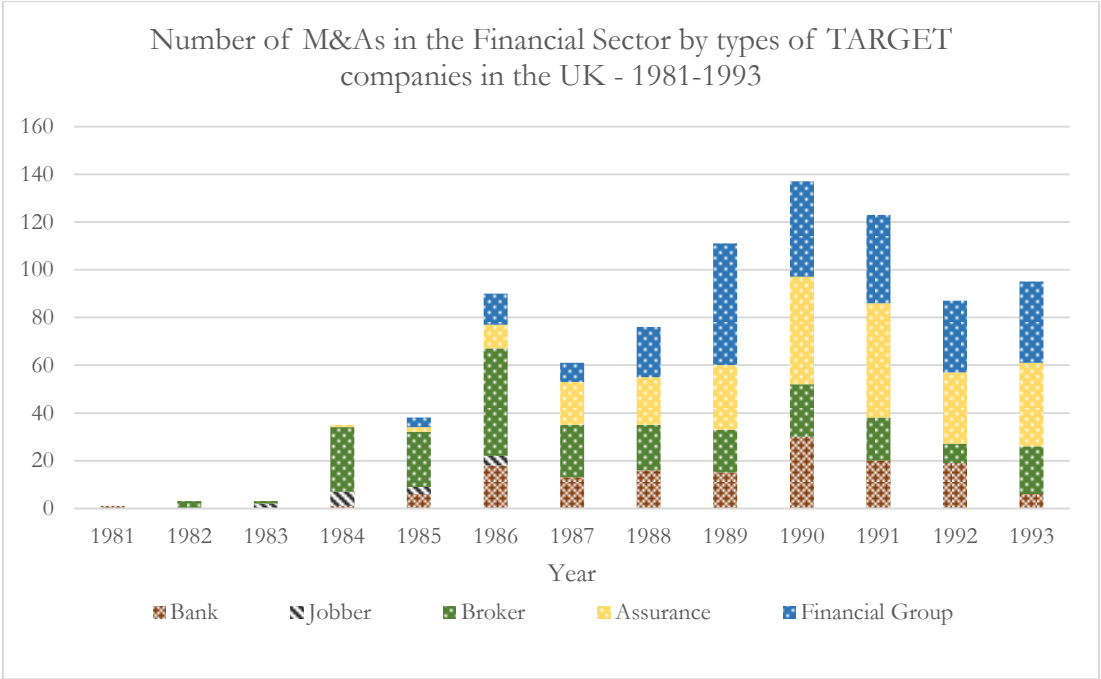


Figure 2

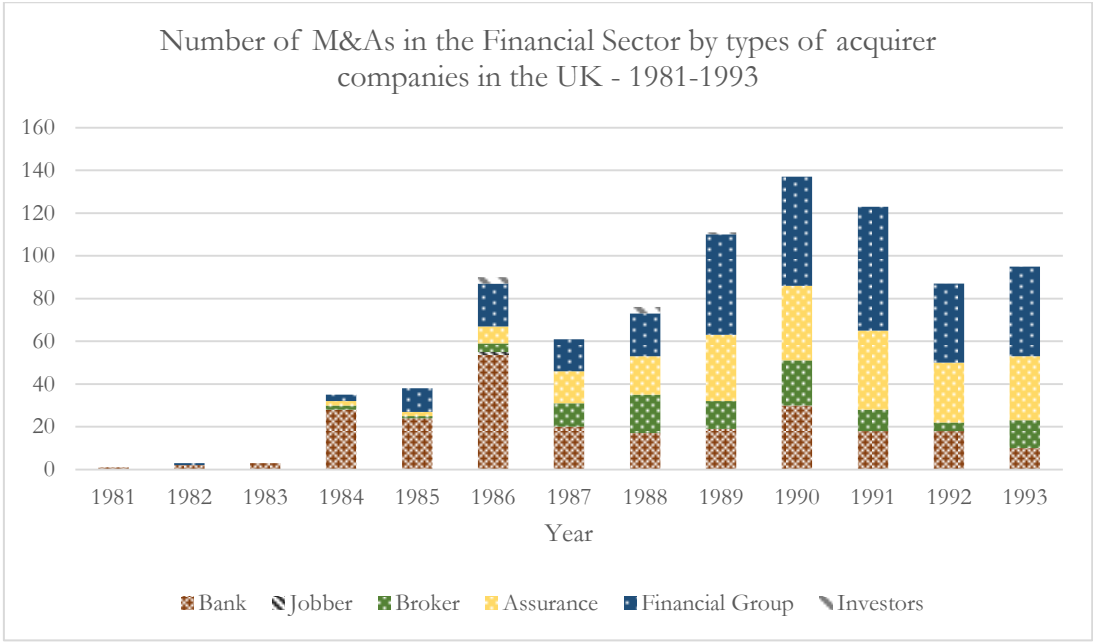
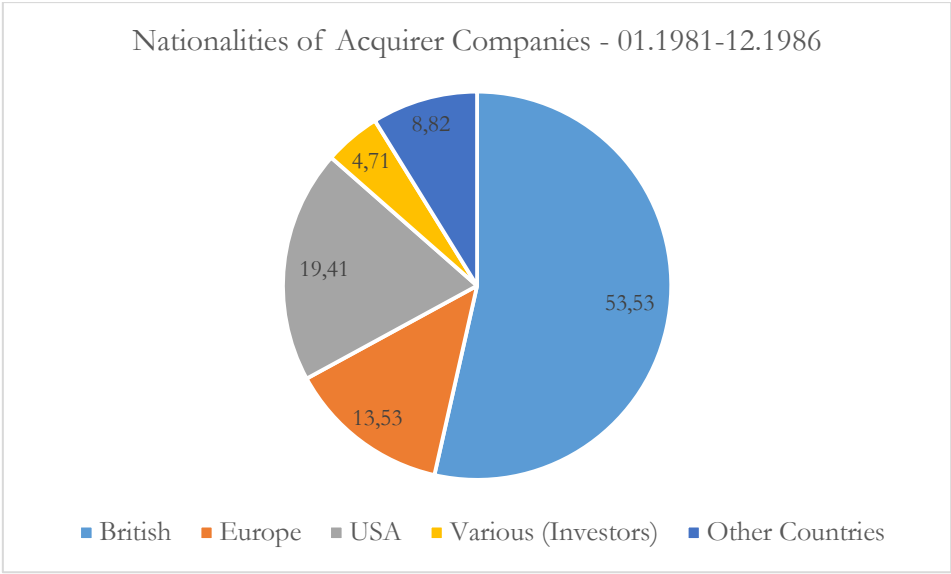


Figure 3 shows the home countries of acquiring firms from 1981 to 1986; about half were British, one in five were American and 13.5% European firms. So British institutions were as heavily involved in the consolidation as foreign banks in the run up to Big Bang.

Figure 3





Arguably, even more important than the Big Bang itself was the new IT system, which was rather an afterthought to the changes in the commission rules. The Stock Exchange Automatic Quotation System (SEAO) launched at the same time as Big Bang but its impact was not completely anticipated. On Big Bang day 28 firms had trading pitches on the floor of the exchange compared with 19 previously, but in the first week only one quarter to one third of trading was on the floor. The floor crowd fell from 1800-2000 people per day to 200-300 a week later. No longer tied to physical trading, banks built their own dealing floors. With the removal of minimum commissions, new business models focused on scale and fee generation through client advising and research. Banks need larger dealing floors so *"over 70% of banks who took space in the City in 1985 took in excess of 10,000 square feet"*.<sup>3</sup> Property developers promised a new venue at Canary Wharf on the River Thames outside the traditional City boundaries that would 'feel like Venice and work like New York'. After a shaky start, this ambitious development became the new financial centre for London.

So what did Big Bang deliver? The number of gilt market makers increased from 3 to 27 and equity turnover increased sharply. Average commissions did fall for large trades of £100,000 or more but the cost of small trades actually increased, so small traders were still subsidizing institutional investors.<sup>4</sup> The number of members of the LSE grew once foreign firms were allowed in and so the LSE captured more of the market, but it was also subject to greater regulatory oversight through the Financial Services Act. Big Bang is not an example of de-regulation; rather self-regulation was replaced by external supervision. Moreover, the enhanced competition from the end of fixed commissions did not preserve British financial institutions in the City. Instead US and European companies were able to buy up British brokers and jobbers. The Conservative government may have been a champion of the City, but it was not a supporter of the London Stock Exchange's monopoly, nor a protector of traditional British financial institutions. Many ancient names were gobbled up and disappeared in the run up to Big Bang or shortly afterward. The transformation of the City was its globalization, but at the expense of British ownership.

Despite the reforms, London did not close the gap with New York. Although turnover increased after Big Bang, this surge was halted a year later, on Monday 19 October 1987, by a short-term collapse in global share prices. Automated computer trading was blamed for a sharp fall in global stock markets that undermined investor confidence. In summary, the overall results of Big Bang were mixed: the LSE lost autonomy, small investors did not benefit and the competitive position of London vis a vis New York was not much improved, but there was definitely a change

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<sup>3</sup> Lenon (1987), p. 56.

<sup>4</sup> Clemons and Weber (1990).

in the structure of the City and its open-ness to foreign institutions. It also marked the advent of the huge investment bank conglomerate.

The verdict of contemporaries and historians on the creation of financial conglomerates in the 1980s is mixed. Thus, Clemons and Weber concluded that *"mergers led to conflict in style and business culture and to large-scale defections. There appear to be serious difficulties when bankers move into securities broking"*.<sup>5</sup> Historians Bellringer and Michie observed that *"What Big Bang had done was to expose the City of London's brokers, dealers and investment bankers to external competition and, even when combined, they lacked the scale, culture and management required to survive"*.<sup>6</sup> Perhaps more presciently, Sam Cross of the US Federal Reserve warned in 1986 that *"how the central banks would respond to the collapse of a major international investment bank that posed a threat of contagion remains to be seen"*. Financial conglomerates on an international scale posed huge challenges for supervisors who operated mainly on a national basis even after the Basel Accord tried to set minimum international standards for capital adequacy. The failure to adequately supervise these firms contributed in part to the global financial crisis of 2008.

Morgan Grenfell provides an example of the disruptive nature of the Big Bang. Morgan Grenfell was a historic and well reputed merchant bank with a century of experience in the City of London. Their response to Big Bang was similar to other institutions – to buy up jobbers and brokers in anticipation of a surge in business and economies of scale. In September 1985 Morgan Grenfell recruited John Holms from Hoare Govett and Geoffrey Collier from Vickers da Costa. Holmes took charge of the UK sales and research business and Collier headed the international and trading business. The intention was to build equity broking from scratch. The bank hired 300 people, doubling their existing base to around 500 staff.<sup>7</sup> But a year later, in November 1986, Collier was caught trading on his own personal account with inside information – from Holmes' household phone.

Undeterred, just after Big Bang, in December 1986 Morgan Grenfell agreed to take over CJ Lawrence and Co (a mid-ranking US securities firm) to try to enter the New York market. But these efforts were undermined by the Black Monday crash in October 1987 and then the by the decline in turnover through 1988. By the Autumn, Morgan Grenfell traders were losing a million pounds per week and the Chairman, John Craven remarked that *"a small firm like Morgan Grenfell is not well positioned to stand it [dip in the market]"*.<sup>8</sup> Without a respite in sight, the equities and gilts

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<sup>5</sup> Clemons / Weber (1990).

<sup>6</sup> Bellringer / Michie (2014)

<sup>7</sup> Augar (2000).

<sup>8</sup> Augar (2000), p. 48.

division was abruptly closed. About 450 staff were fired, although most were able to find jobs elsewhere.<sup>9</sup> In 1989, after further scandals, Morgan Grenfell was weak enough to provide a take-over target for Deutsche Bank as they sought to create a presence in Anglo-American investment banking. This marked the German bank's entry into the race for the bulge bracket of global investment banks, a strategy that Deutsche Bank is still reckoning with today.

The Big Bang in the UK was a complicated affair, arguably taking on more importance in the public imagination due to its great PR name. Its most notable feature is that it did not come with a 'Bang', but rather evolved over several years; and the initial reform itself (changing commissions structure) was not that 'Big'. The term 'Big Bang' specifically applied to the question of whether to end the separation of broking and jobbing for all forms of customer at once, or to introduce it gradually. From this rather narrow concept, the reforms of the market expanded. The path began at the start of 1979 when the LSE structure of commissions was referred to Restrictive Practices Court. Once the compromise had been agreed in 1983, the market began to adapt to the new framework almost immediately. In many ways, the Big Bang reforms merely recognized the status quo or trends that were already underway such as the rise of foreign firms in London and the blurred role of brokers and jobbers. More trading had been happening over the counter outside the LSE and brokers were increasingly straying into jobbing for large clients. At the same time, specialist jobbers were finding it difficult to make profits from the bid-ask spread and this especially affected liquidity in the Gilt market. Moreover, while the LSE Rule Book barred international companies from LSE membership, they operated their own self-regulating organization with 187 members and Reuters was planning to provide IT services to support their trading. The LSE was losing its control of the securities market and the end of commissions provided an opportunity to restore the LSE's relevance. In this sense, the Big Bang was not a sudden or abrupt change in practices for the market as a whole.

Twenty years before Big Bang, the British banks had already lost their battle to dominate financial markets in the City of London. In the 1960s US and European banks surged into London to take advantage of the off-shore Eurodollar market and Eurobond market. Big Bang allowed foreign companies to extend their activities directly into the stock exchange by buying up existing members or becoming members themselves. The last bastion of national domination had been breached but it was clear by this time that the competitive position of the exclusive LSE was eroding in any case. The more dramatic change in the culture and functioning of share trading in London was caused by the IT innovation; originally a mere byproduct of Big Bang. SEAQ, with all its

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<sup>9</sup> Augar (2000), pp. 146-149.

teething pains and false starts, dispersed trading into firms and onto screens, ending the face-to-face personal contact that had characterized the market from its founding in the 17<sup>th</sup> century.

The City of London survived and prospered despite the decline of British economic dominance of the global economy, on which it was founded. Through the era of exchange controls in the 1950s and 1960s, financial innovation catapulted London into an offshore dollar centre for global banks. But by the mid-1980s, the equity market had drifted into an uncompetitive position vis-à-vis New York and faced a new single European market. These weaknesses were addressed through a cluster of reforms that allowed London to engage actively in the second era of globalization in the 1990s and 2000s. In the past 30 years, there have been dramatic changes in global financial markets, but The City has proved remarkably resilient. Brexit will require a new set of institutional structures and the creation of new networks if London is to retain its role as a European and global financial centre. As in the 1980s, there has been some lead time for financial institutions to prepare, but also considerable uncertainty about the final terms of London's relationship with the EU. But London has proved resilient to shifts in the geography of international capital markets through innovation, open-ness and flexibility. The predictions of its demise may once again prove too pessimistic.

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